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Ijtihad in Islamic Finance

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ABSTRACT

Islamic finance is a case-study of the modern development of *fiqh*. Examining Islamic finance yields valuable insights into how Islamic legal thought progresses in practice as it approaches novel situations. Even though notable for their conservatism, scholars have made tremendous doctrinal advances to adapt to new circumstances. Finally, novel approaches to innovation, in particular the design of new institutions, have emerged that are underutilized by Islamic scholars.

I. INTRODUCTION

I view Islamic finance here not in its own right but as an example or case-study of the modern development of Islamic law or *fiqh*. When Professor Samuel Hayes and I set out to do a study of Islamic finance back in 1994 or so, it may be that what motivated Sam, the business professor, was the strong impression, gained from his trips to the Gulf and Malaysia, of the surging importance of the new industry of Islamic finance. But what motivated me, as a student of Islamic law, was the importance of Islamic finance as an area where the classical Islamic law is being brought into application in modern times. Islamic finance insists, on the one hand, on the application of the classical law, but also, on the other hand, seeks to become a thoroughly modern industry meeting all the modern needs of its participants. Therefore, it seemed an obvious place to look for case-studies on how the old law is applied to meet modern needs.

I also remember thinking that Islamic finance has two other advantages as an area for research on modern Islamic law. First, in some other areas of modern life, such as politics, human rights, criminal law, or women's status, social and political sensitivities greatly complicate the *fiqh* scholars' tasks. But in finance, in contrast, the issues are relatively politically and socially insensitive ones—how one chooses to obtain or place funds. Second, in most areas of Islamic law controversy today, one is debating laws that in theory will be compulsorily applied by, or otherwise involve, a state, but Islamic finance is an area where deciding to adhere to Islamic law is largely a matter of free choice and voluntary association.

Therefore, it seemed to me, Islamic finance would be a wonderful field in which to observe *fiqh*'s advancement in modern times—its degree of progress, the methods it has used, the institutions it has evolved, and the degree to which it has earned the approval or satisfaction of ordinary Muslims.

From the study Sam and I did, I did come away with many new ideas about Islamic *fiqh* development. First, I gained an opportunity, invaluable for an outsider to Islam and Islamic law, to observe closely how change happens in Islamic *fiqh* when it faces novel issues. Second, by closely studying the subject I identified a number of legal issues on which scholars of Islamic finance had achieved intellectually bold and satisfying solutions. Third, I detected some possible methods of advancing the law that, it seems to me as an outsider, are not as yet fully exploited. My impressions can be put under three headings: one, the methods of the scholars; two, some points where the scholars have achieved striking doctrinal advances; and three, some approaches to change that it seems to me have not yet been fully employed. By such remarks I hope to encourage others to spend time discussing Islamic finance not only for its own sake but also as an important instance of contemporary Islamic legal innovation and development.

II. METHODS FOR THE SCHOLARS

Examining legal debates in Islamic finance fields leads to many valuable impressions about how Islamic legal thought progresses in practice. Notable among these is the discovery—seemingly new to modern Western scholars of Islamic law—of the centrality in contemporary Islamic legal reasoning of the famous basic legal principles called *qawa^{c}id*. It is rather striking—in view of Islamic law's reputation as "casuistic" or consisting of

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solutions for a collection of discrete and unrelated cases—to find out how internally consistent Islamic *fiqh* is, at least in contract and commercial law. The legal corpus in this field seems linked together by a number of generalizations or general principles, some of these articulated as actual verbal maxims and others largely unarticulated. These general principles are discovered by scholars by induction from the entire collection of *fiqh* outcomes; they are in a way generalizations or commonalities across a great many *fiqh* rulings. In fact, the most important *qawa^{c}id* in contract law are the prohibitions in the Qur'an and Sunna of *riba* and *gharar*. Indeed, it seems that a great part of the Islamic contract law, and most of its principles, derive in complex ways from these very two principles. The bans on *riba* and *gharar*, together with other principles that derive from them, create a vigorous internal structure for Islamic contract law, and give it internal coherence and regularity.

Most Islamic finance scholars in particular have great admiration for the classical law and for its success in unfolding the meaning of the Qur'an and Sunna. Therefore, they also have great admiration for the old *qawa^{c}id* or principles, and these will greatly guide and shape their views when they set out to consider any development in the classical law. Thus, a scholar—even one who practices a relatively free *ijtihad*—will want to test any new idea against the *qawa^{c}id*. If it comes into conflict with them, he may legitimately worry whether his idea will tear a gap in the texture of the old law, and thus allow many unintended consequences to enter in. For such a scholar, the *qawa^{c}id* are in a way guidelines to help him avoid breaching fundamental norms of the Qur'an and Sunna, among them, most importantly, the prohibitions of *riba* and *gharar*. When a proposed change offends no *qawa^{c}id*, then change may be relatively easy; but when it confronts one or more of them (and many proposed changes will, given how pervasive these *qawa^{c}id* are), then approving a change becomes far more risky. This explains some of the commonly noted conservatism of modern Islamic legal scholars in the field of Islamic finance and elsewhere.

III. DOCTRINAL ADVANCES

Scholars of Islamic finance have achieved some striking, intellectually satisfying advances in legal thought. Here there are a great many candidates for mention, since Islamic finance has made many ingenious adaptations of classical law to modern situations. But, still, certain innovations are from a legal perspective weightier or bolder than others. (I confine myself here to innovations that seem to have been widely accepted, as opposed to individual opinions.) One single major set of legal innovations that can be marked for admiration consists of those that opened the way for the valuation and transfer of ongoing partnership interests. These innovations are striking since, as Sami Homoud once told me, the classical law nowhere even mentions the possibility of sale of an interest in a partnership as an on-going concern. The old law required that, if a partnership interest is to be sold, the entire partnership must be first terminated and liquidated—to permit the exact valuation of the interest. From the viewpoint of the classical law, all this is the natural result of concerns about *riba* and *gharar*.

Yet modern Islamic finance has made the transfer of interests in ongoing partnerships an everyday occurrence. One example is when an investor in a *mudaraba*, such as a depositor in an Islamic bank or an investor in an Islamic fund, liquidates or transfers his interest during the lifetime of the investment and receives a pro-rata share of profits. Another much more complex example is the modern scholars' acceptance of the concept of common stock, and particularly of the concept of buying and selling such stock. Accepting such modern practices—much needed in modern financial life—required a series of sophisticated legal innovations. If the scholars had been too narrow-minded or too wed to the obvious analogies to the old law, they would have balked somewhere along the way. But they instead wisely rose to higher levels of reasoning from which it could be seen that, while these were innovations and did involve apparent breach of long-standing *fiqh* rules, still, considered in the context of modern life with institutions such as artificial personality, reliable accounting practices, securities and financial institution regulation, and duties of disclosure, they actually did not offend the most fundamental *qawa^{c}id* and could be accepted as novel and valid legal institutions.

IV. FURTHER APPROACHES TO CHANGE

Seemingly, there are approaches to innovation that the scholars of Islamic finance have not yet fully availed of. Here the basic problem is the one just mentioned, that, in an industry that is almost by definition based on respect and devotion for the old classical *fiqh*, the pervasiveness of *qawa^{c}id* mentioned above will typically act to greatly constrain innovation at the doctrinal level. Radical change therefore may require invoking legal arguments that supervene mere doctrine, or in other words, invoke more important objectives of the law than just doctrinal consistency. In particular, modes of argument are needed that can take systematically into account the setting in which laws are applied—the conditions of society, technology, legal institutions, communications, etc. (all wildly

changed from the conditions when the *fiqh* was first devised)—and use these to argue for particular doctrinal changes.

A somewhat narrow example of this general approach, still somewhat neglected in Islamic finance circles, is the approach of innovating not only by devising new rules but also by simultaneously creating new institutions that will help the rules achieve their *shari*^{c}*a* objectives. Many proposed changes or deviations from the old rules arouse fears in scholars of abuses; but those fears may often be allayed if the doctrinal change is conditioned on a specific institutional setting that tends to obviate those abuses. Or a specific institutional setting may allow a wholly different contractual approach to a problem, one that surmounts the doctrinal objections that otherwise apply. To give an actual example, this is how the problem of Islamic insurance was solved. When the individual contract of insurance was found to offend laws on *riba* and *gharar*, some innovative scholars set out not only to modify the contract but also to create a new institution in which it operated—the *takaful* company. Viewed from the perspective of a new institution, with its different moral objectives and motivations, the insurance contract was seen in an altogether different light and was legalized, overcoming various doctrinal objections. It seems to me that this approach could be followed much more commonly, exploiting the greatly increased capabilities in the modern world to create made-to-order institutions for all purposes, public and private. For example, many industries face the need for certain risk hedges, but Islamic law raises strong objections to the derivative contracts typically used to achieve hedges. But what if we shift our attention from individual contracts to the creation of institutions that would provide the needed hedges only under certain conditions and protections or only to persons with proven need and records of appropriate behavior?

The full implementation of Islamic financial exchanges in the future will probably rely more heavily on the creation of institutions to achieve Islamic objectives than on mere doctrinal innovation. This approach will likely grow as the Islamic finance industry reaches its maturity. Indications in this direction include the creation of institutions for accounting standards (AAOIFI), ratings, and *fatwa* uniformity.

V. CONCLUSION

These few observations demonstrate the importance of Islamic finance both as a vital and successful arena for contemporary Islamic legal development and as a useful case-study for learning more about the prospects and methods for advance in other areas of contemporary Islamic legal thought. Our findings under each of the three headings have significance for other areas of Islamic legal development. One might attempt to restate these abstractly: under the first heading, the importance of appreciating not just the specific rules of the old law but also its internal terminology, logic and structure; under the second heading, the importance, when weighing innovations, of considering not just consistency with old rules but also how those rules will operate in the changed institutional and legal setting of modern times; and lastly, under the third heading, the importance once again that *fiqh* evolution occur with full awareness of the current social and legal institutional setting, but adding also the awareness that that setting is in fact malleable, and that new institutions should evolve along with *fiqh* in order better to meet Muslim religious aspirations.