
Chapter 2. Islamic Law and Financial Services

Shari'a, Islamic religious law, forms the foundation of Islamic finance. *Shari'a* attempts to promote equality and fairness in society by emphasizing moral, social, ethical, and religious factors. This chapter covers the relationship between *Shari'a* and Islamic finance.

In general, Islamic finance refers to financial market transactions, operations, and services that comply with Islamic rules, principles, and codes of practice. In other words, Islamic finance is that which is guided by the ethos and value system of Islam. The goal of Islamic finance is to stress risk and reward sharing over exploitation, community well-being over materialism, and the brotherhood of humankind over the fragmentation of society.

Shari'a is not the law of the land, even in countries where Muslims make up a majority of the citizens. It is a body of religious law, aspects of which are incorporated into some countries' legal systems.

The Islamic Faith: Foundation of Islamic Law

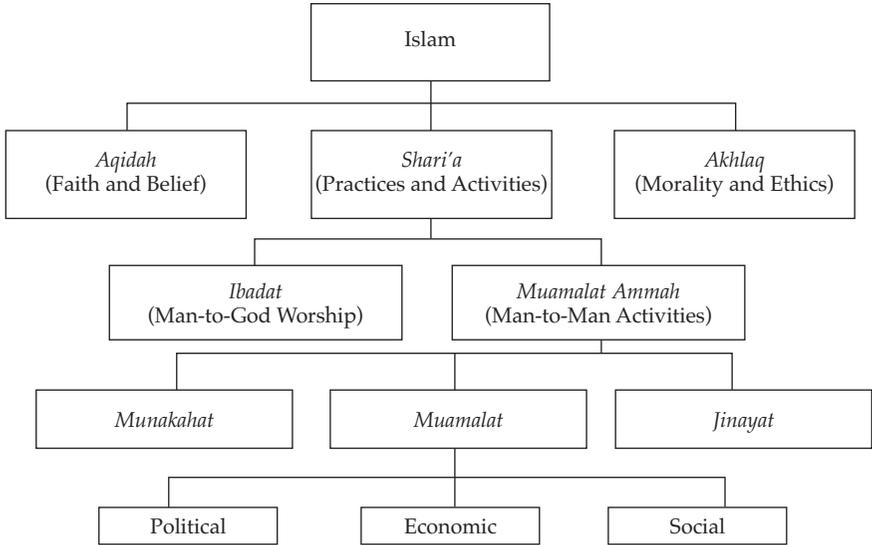
The word "Islam" is derived from the word "*salaam*," which means submission or peace. A person who believes in and consciously follows Islam is a Muslim, a word that also comes from the same root of *salaam* (Khair, Gupta, and Shanmugam 2007). *Shari'a*, or the divine law in Islam, is based on the Quran and the *Sunnah*, the reported sayings of the Prophet Muhammad.

Figure 2.1 and Figure 2.2 illustrate how *Shari'a* embraces most aspects of a Muslim's life—worship, personal attitude and conduct, social norms, politics, economic conventions, and family, criminal, and civil law. The religion of Islam encompasses three basic elements—*aqidah*, *akhlaq*, and *Shari'a*, which are the roots of Islamic banking and finance.

Aqidah is an Islamic term meaning "a creed" and, by definition, excludes any supposition, doubt, or suspicion on the part of the believer (Al-Qari, no date). It concerns all aspects of the faith and beliefs of a Muslim.

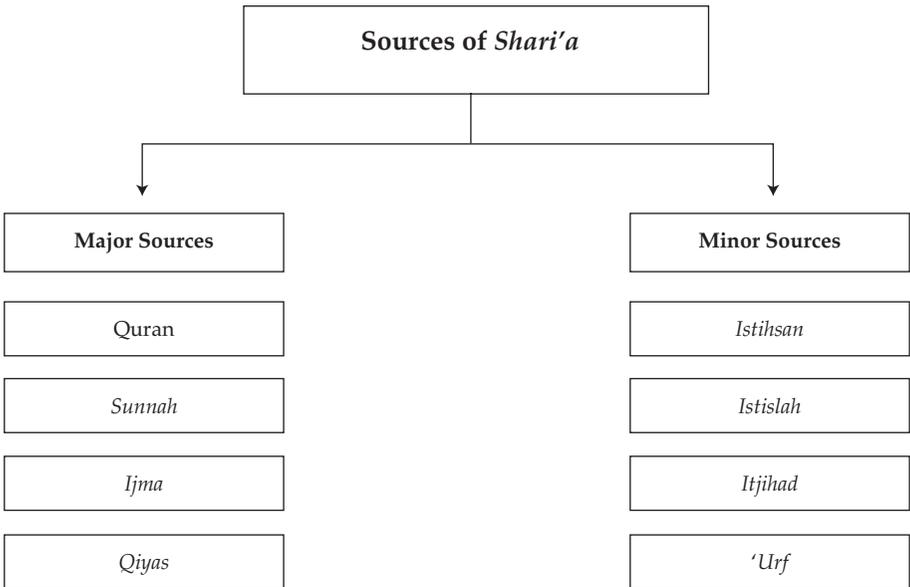
Akhlaq defines the Islamic ethical code and says how it relates to a Muslim's personal conduct. The term is derived from the Arabic *khuluq*, which aligns a person's character with his or her personal qualities and morals. *Akhlaq* includes the commands and prohibitions that govern a Muslim's personal and professional behavior, attitude, transactions, and work ethic.

Figure 2.1. Overview of Islam



Source: Bank Islam Malaysia (1994).

Figure 2.2. Major and Minor Sources of Shari'a



Shari'a, defined previously, is the law of Allah and concerns all aspects (material and spiritual) of a Muslim's life and actions. Its basic values are permanent and universal and are not confined to a specific place or time. According to the teachings of Islam, *Shari'a* protects and promotes religion, life, progeny or family, the intellect, and property or wealth (Abdullah 2005). The Islamic banking system is linked to *Shari'a* through the concept of *muamalat*, which encompasses a broad range of activities—political, economic, and social. *Muamalat* is concerned with the human-to-human relationship, in contrast to the human-to-God relationship known as *ibadat*. *Muamalat* addresses the practicalities of a Muslim's daily life, including the Muslim's relationship with not only other humans but also with animals, plants, and nonliving things.

Shari'a: Islamic Law

Shari'a rulings categorize the nature of a person's actions—namely, whether the action is obligatory, recommended, permissible, reprehensible, or prohibited—as follows:

- *Wajib* is an obligatory act. Performing an act that is *wajib* leads to reward from Allah; failing to perform the act, such as prayer, attracts a penalty in this world and in the hereafter. For the Islamic faithful to practice their religion is obligatory.
- *Sunnat/mandub* is a commendable act, one that is recommended but not binding. A Muslim will be rewarded by Allah for performing an act that is *sunnat*, such as extra prayers and charitable acts, but will not be penalized for failing to perform it.
- *Mubah/harus* is a permissible act, one about which *Shari'a* is neutral. Acting or not acting upon something *mubah*, such as eating, attracts no reward or penalty.
- *Makruh* is an act that is discouraged but not explicitly forbidden. No reward or penalty is associated with performing a *makruh* act, such as divorce.
- *Haram* is a forbidden activity and is considered a major sin. A *haram* activity is punishable by Allah, and avoidance of *haram* activities, such as gambling and drinking, is rewarded.

Sources of Shari'a

Muslims believe that Islamic law was revealed by Allah to the Prophet Muhammad. The law consists of a set of rules dealing with how Muslims should conduct their lives in this world. Figure 2.2 lists the major and minor sources of Islamic law.

First, the Quran is regarded by followers of Islam as the immutable and final revelation of Allah. It is considered to be both divine and eternal because it represents the true words of Allah (Al-Omar and Abdel-Haq 1996). Muslims believe that it is the only book of God that has not been distorted and that it awakens in humans the higher consciousness of their relationship with Allah and the universe. The Quran serves as guidance for Muslims' success in both the material and spiritual realms of their lives.

The Quran is the primary source of Islamic law. It provides not only directives relating to personal conduct but also principles relating to all aspects of the economic, social, and cultural lives of Muslims. The Quran consists of 114 chapters, of unequal lengths, called *sura* (the singular form is *surat*), which literally means “eminence” or “high degree.” The chapters are divided into verses called *ayah* (the singular form is *ayat*), which means “sign” or “communication from Allah.”

The Quran is the principal guidance for structuring Islamic banking products and services. It contains a number of divine injunctions forbidding *riba* (charged interest) and the inappropriate consumption of wealth. It also advocates that commercial engagements be conducted through written contracts.

Second, *Sunnah* is believed by Muslims to be the authentic sayings and reported actions of the Prophet Muhammad (whereas the Quran is considered to be the actual words of Allah). *Sunnah* is Arabic for “method” and explains the instructions of the Quran by making certain implicit Quranic injunctions explicit by providing essential elements and details to facilitate their practice. The three kinds of *Sunnah* are as follows (Nyazee 2002):

- *qual*, or a saying of the Prophet Muhammad that has a bearing on a religious question,
- *fi'l*, an action or practice of the Prophet, and
- *tagrir*, or silent approval of the Prophet of the action or practice of another.

Third, *ijma* is derived from the Arabic *ajma'a*, which means “to determine” and “to agree upon something.” It originally referred to the infallible consensus of qualified legal scholars in a certain time period over a particular religious matter. *Ijma* is needed to address the practical problems in the implementation of *Shari'a*, and today, it denotes the consensus of scholars and the importance of delegated legislation to the Muslim community. It is considered sufficient evidence for legal action because, as stated in the *Sunnah*, the Prophet Muhammad said, “My community will never agree in error” (Enayat 2005, p. 20). Thus, the agreement of the scholars of Islam on any religious matter is a source of law in Islam (Kamali 2005).

Fourth, *qiyas* is a method that uses analogy (comparison) to derive Islamic legal rulings for new worldly developments. Qualified legal scholars use *qiyas*, or preceding rulings (precedents), to derive a new ruling for situations that are not addressed by the Quran or the *Sunnah*. Essentially, *qiyas* is the process of taking an established ruling from Islamic law and applying it to a new case that shares the same basic elements addressed by the original ruling. Scholars have developed detailed principles of *qiyas* in the books of Islamic jurisprudence.

The four minor sources of *Shari'a* are the *istihsan*, *istislah*, *ijtihad*, and *'urf*.

Istihsan is the use of personal interpretation to avoid the rigidity and unfairness that might result from the literal application of Islamic law. *Istihsan* is an Arabic word that means “to deem something preferable.” Based on *istihsan* and a consensus among Islamic jurists, certain forms of contracts that do not conform to the accepted

principles of *Shari'a* are permitted. Some legal experts consider the concept of *istihsan* to be similar to the concept of equity in Western law. *Istihsan* plays a prominent role in adapting Islamic law to the changing needs of society.

Istislah is a method used by Muslim jurists to solve perplexing problems that have no clear answers in sacred religious texts. It is related to the Arabic *maslahat*, which can be interpreted as being “in the public interest.” The Islamic scholar Abu Hamid Muhammad ibn Muhammad al-Ghazali describes *maslahat* as that which secures a benefit, or prevents harm, and it is associated with the protection of life, religion, intellect, lineage, and property. Any measure that secures these five essential values falls within the scope of *maslahat*. *Maslahat* applies only if it is in compliance with *Shari'a* (Tamadontas 2002).

Itjihad literally means “striving” or “self-exertion.” It is the concept that allows Islamic law to adapt to situations or issues not addressed in the Quran or the *Sunnah* (or *hadith*, the oral traditions relating to the words and deeds of Muhammad). The propriety or justification of *itjihad* is measured by its harmony with the Quran and the *Sunnah* (Khir et al. 2007).

Urf, or custom, can be defined as recurring practices that are acceptable to people of sound nature. It is accepted as a basis for rulings and judgments as long as it does not contravene or contradict Islamic values and principles. Islamic jurists have described *urf* as the words and deeds acceptable to the citizens of a given region (Shakur 2001). It is based on the principle that “what is proven by custom is alike that proven by *Shari'a*” if that custom is not in conflict with the rules, essence, and spirit of *Shari'a* (Khir et al. 2007, p. 23). *Urf* is essentially local or regional practice, whereas *ijma* is based on the agreement of the community of legal scholars of Islam and *Shari'a* across regions and countries.

Islamic Contract Law

Islamic banking operates under Islamic commercial law, or *fiqh-al-muamalat*, which deals with contracts and the legal ramifications of contracts. Contracts may be categorized as valid, invalid, or void. The contract is the basis of Islamic business and is the measure of a transaction's validity. A contract also means an engagement or agreement between two persons in a legally accepted, meaningful, and binding manner.

Aqad is the Arabic term for contract and means a tie or a knot that binds two parties together. The word *aqad* is also used in the sense of confirming an oath. In legal terminology, *aqad* refers to a contract between two parties on a particular matter, which is to be concluded upon the offer and the acceptance of the parties concerned (Billah 2006).

The various forms of commercial contracts in Islam can be identified in the Quran and in the jurisprudence of ancient and modern Islamic scholars.

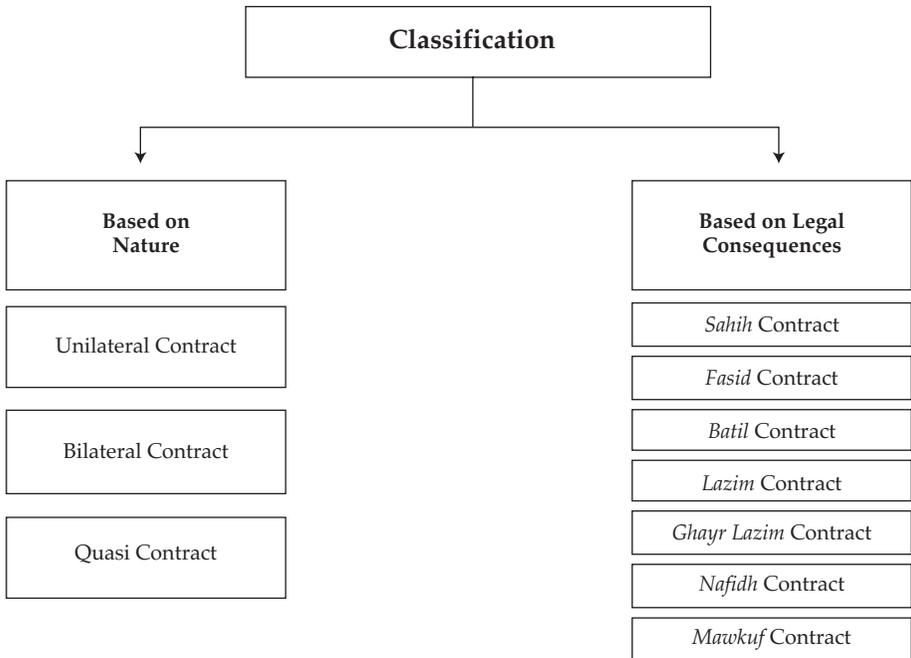
Essential Elements of a Valid Islamic Contract. Islamic banking deals with many types of contracts and other documentation related to deposit, financing, and investment products. Certain conditions must be met for an Islamic contract to be valid. The contract must include the following essential elements to ensure transparency and, if adopted in the true spirit of the elements, to reduce the potential for disputes:

- Offerer and offeree: A contract cannot be formed in the presence of a single party. Although a single person's intent may lead to a number of self-imposed obligations, such as remitting a debt or declaring a charitable donation, these commitments are not considered to be a contract according to *Shari'a*.
- Offer and acceptance: A contract must have an offer (*ijab*) and an acceptance (*qabul*), and both must be executed at the same time. Either party to the contract—buyer or seller—may make an offer. The offer and acceptance may be oral or in writing and may be made by signs or gestures or executed through an agent. A contract is binding upon acceptance regardless of whether it is written or oral.
- Subject matter and consideration: The subject matter and consideration must be lawful under *Shari'a* and must not involve materials or acts that are not *Shari'a* compliant. They should also exist at the time the contract is made and be deliverable. In addition, the quality, quantity, and specifications of the subject matter should be known to both parties. The price, or consideration, must be determined when the contract is made.

In addition, the parties to an Islamic contract must be legally knowledgeable (Bakar 2005) and should not be a minor, insolvent, prodigal, intoxicated, or of unsound mind. No party to the contract should be under any kind of duress or force. If any of the preceding situations apply, the contract will be null and void.

Classification of Islamic Contracts. Contracts in *Shari'a* can be classified in a variety of ways, as listed in **Figure 2.3**. The following three contract classifications are said to be based on “nature” (that is, on an offer, an acceptance, and some consideration, which are regarded as validating a contract in most cultures):

- A *unilateral* contract is a contract written entirely by one party (the offerer) with the second party (the offeree) having only the option to accept or reject the terms of the contract. The contract is binding upon the offerer, is conditional on performance by the offeree, and stipulates compensation for the accomplishment of a specified task. (This type of binding promise in Islamic law is called *wa'd*. An example of a unilateral contract under Islamic law is the contract offered by a real estate agent to find a house for the offerer. The real estate agent's commission for doing so is stipulated in the contract. When the agent finds a house that meets the parameters outlined in the contract, he or she is entitled to the commission. Other examples of unilateral contracts are gifts, wills, and endowments.

Figure 2.3. Classifications of *Shari'a* Contracts

Sources: Billah (2006) and Nyazee (2002).

- A *bilateral* contract is a promise made by one party in exchange for the performance of a stated act by another, and both parties are bound by their exchange of promises. It includes contracts of exchange, partnership, and usufruct (the legal right to use and derive profit or benefit from property belonging to another person or entity). The contract comes into existence the moment the promises of the offerer and offeree are exchanged. A common example of a bilateral contract under Islamic law is the agreement of two parties on the sale/purchase of a car. One party consents to sell the car to a second party who consents to buy the car with an obligation to pay the agreed-upon consideration.
- A *quasi contract* is not considered a true contract under Islamic law, but the agreement of the parties gives rise to an obligation similar to that of a contract. In a quasi contract, the terms are accepted and followed as if a legitimate contract exists. Many casual employment arrangements are quasi contracts because, although a formal contractual arrangement is absent, a contract is “apparently present” and accepted by the parties.

Seven classifications of contracts are based on legal consequences—that is, on compliance with the essential requirements and conditions of the contract.

- A *sahih* contract (valid contract) is one that contains no element prohibited under *Shari'a*. The contract is enforceable and creates an obligation and legal liability for the contracting parties. Three conditions must be met in a *sahih* contract (Nyazee 2002): (1) All the elements required by law must be complete; (2) the additional conditions must be fulfilled; (3) the purpose of the contract and its subject matter must be legal and in compliance with *Shari'a*.
- A *fasid* contract (invalid contract) fulfills all the essential conditions of a *sahih* contract, but because of an irregularity, it lacks validity. The irregularity could be a forbidden term in the contract or an external attribute attached to the contract that is prohibited by Islamic lawmakers. Examples include a contract signed under coercion and a sale contract for which the object of sale does not exist.
- A *batil* contract (void contract) is void because its elements and conditions are not in compliance with *Shari'a*. Such a contract has no legal effects and is invalid and unenforceable (Khir et al. 2007). Ownership is not transferable, nor is any other obligation of performance created in a *batil* contract. Examples are contracts to sell liquor and those signed by a minor.
- A *lazim* contract is binding and irrevocable, retrospectively and prospectively, for both parties. Neither party has the right to terminate the contract without the consent of the other unless the option to revoke the contract has been granted beforehand (Nyazee 2002). Examples are sales and lease contracts.
- A *ghayr lazim* (or *jaiz*) contract provides that either party may unilaterally terminate it at any time on the basis of the conditions specified in the contract. Examples of such nonbinding contracts are agencies and partnerships.
- A *nafidh* contract is an immediate agreement that does not involve a third party.
- A *marwkuf* contract is a valid but suspended contract. Examples include a contract that lacks proper authority and a contract in which one party suffers from a terminal illness.

Contracts in Islamic Banking

In Islamic banking, contracts play an important role in ensuring transparency and structuring transactions so that conformity with Islamic law is maintained. In Islamic law, rules are prescribed for specific contracts as illustrated in **Figure 2.4**.

Contract of Exchange. The sales contract (*bai* contract) is the primary contract of exchange in Islamic commercial law. It involves the transfer of ownership

Figure 2.4. Key Types of Islamic Contracts in Islamic Banking

Contract of Exchange	Contract of Usufruct	Gratuitous Contract	Participation Contract	Supporting Contract
<i>Murabahah</i>	<i>Ijarah</i>	<i>Hibah</i>	<i>Mudharabah</i>	<i>Kafalah</i>
<i>Bai' Bithaman Ajil</i>	<i>Al-Ijarah Thumma Al-Bai</i>	<i>Qard</i>	<i>Musaqat</i>	<i>Rahn</i>
<i>Bai' Salam</i>	<i>Ijarah Muntahia Bittamleek</i>	<i>Ibra</i>	<i>Musyarakah</i>	<i>Hiwalah</i>
<i>Bai' Istisna</i>				<i>Wakalah</i>
<i>Bai' Istijrar</i>				<i>Wadiyah</i>
<i>Bai' Inah</i>				<i>Jualah</i>

Source: Adawiah (2007).

of a lawful commodity for a fixed price or for another commodity (barter trade). Sales contracts are used extensively in Islamic banking and include the following:

- *Murabahah* contract (cost-plus-markup contract) involves the sale of lawful goods at a price that includes an agreed-upon profit margin for the bank (seller). It is mandatory for the bank to declare to the customer the cost and profit. Payment can be, depending on the agreement between the parties, spot or deferred.
- *Bai' bithaman ajil* contract (deferred-payment sale) is a sale of goods on a deferred-payment basis. The bank purchases an asset and sells it to the customer at cost plus a profit margin agreed to by both parties. The bank is not required to disclose the price and profit margin. Payments can be monthly, quarterly, or semiannually.
- *Bai' salam* contract (forward contract) refers to an agreement whereby payment is made in advance for delivery of specified goods in the future. The underlying asset does not exist at the time of the sale. This type of contract is used in agricultural financing. Funds are advanced to farmers who deliver their harvested crops to the bank to sell in the market.
- *Bai' istisna* contract (supplier contract) is an agreement in which the price of an asset is paid in advance but the asset is manufactured or otherwise produced and delivered at a later date. This type of contract is typically used in the manufacturing and construction sectors.
- *Bai' istijrar* contract (also a type of supplier contract) refers to an agreement between a purchaser and a supplier whereby the supplier agrees to deliver a specified product on a periodic schedule at an agreed-upon price rather than an agreed-upon mode of payment by the purchaser.

- *Bai' inah* contract (sale and buyback contract) involves the sale and buyback of an asset. The seller sells the asset on a cash basis, but the purchaser buys back the asset at a price higher than the cash price on a deferred basis. This type of contract is primarily used in Malaysia for cash financing; it is also used for Islamic credit cards.

Contract of Usufruct. Usufruct contracts govern the legal right to use and profit or benefit from property that belongs to another person. The key usufruct contracts in practice in Islamic banking are the following:

- *Ijarah* (leasing) refers to an arrangement in which a bank (the lessor) leases equipment, a building, or other facilities to a client (the lessee) at an agreed-upon rental fee and for a specified duration. Ownership of the equipment remains in the hands of the lessor.
- *Al-ijarah thumma al-bai* (leasing and subsequent purchase) is a type of *ijarah* contract in combination with a *bai* (purchase) contract. Under the terms of the *ijarah* (leasing) contract, the lessee leases the goods from the owner, or lessor, at an agreed-upon rental fee for a specified period of time. Upon expiry of the leasing period, the lessee enters into the *bai* contract to purchase the goods from the lessor at an agreed-upon price. This concept is similar to a hire/purchase contract or closed-end leasing as practiced by conventional banks.
- *Ijarah muntahia bittamleek* (buyback leasing) involves an *ijarah* (leasing) contract that includes a guarantee by the lessor to transfer the ownership in the leased property to the lessee, either at the end of the term of the *ijarah* period or by stages during the term of the contract.

Gratuitous Contracts. A gratuitous contract is entered into for a benevolent purpose, such as for making a charitable donation. The following are the gratuitous contracts currently used by Islamic banks:

- *Hibah* refers to a gift awarded by a bank without any commensurate exchange. For example, a bank gives *hibah* to a savings account holder as a token of appreciation for keeping money in the account.
- *Qard* involves an interest-free loan that is extended as good will or on a benevolent basis. The borrower is required to repay only the principal amount of the loan. The borrower may choose to pay an extra amount, however, as a token of appreciation for the lender. No extra payment over the principal amount can be charged by the bank; any such extra charge is considered *riba* (charged interest), which is prohibited under Islamic law. These loans are intended for individual clients in financial distress.
- *Ibra* occurs when a bank withdraws its right to collect payment from a borrower. The computation of *ibra*, a rebate, is based on the terms and conditions set forth in the governing contract.

Participation Contracts. *Shari'a*, in order to promote risk-and-reward sharing consistent with the principles of Islam, encourages wealth creation from partnership arrangements that are governed by the following types of participation contracts:

- *Mudharabah* (trust financing) is a partnership between a bank and a customer in which the bank provides the capital for a project and the customer or entrepreneur uses his or her expertise to manage the investment. Profits arising from the investment are shared between the bank and the entrepreneur on the basis of an agreed-upon profit-sharing ratio. If the project results in a loss, it is borne solely by the bank.
- *Musarakah* (partnership financing) refers to an investment partnership in which all partners share in a project's profits on the basis of a specified ratio but losses are shared in proportion to the amount of capital invested. All parties to the contract are entitled to participate in the management of the investment, but they are not required to do so. A *musarakah mutanaqisah* (diminishing partnership) is an agreement in which the customer (the partner of the bank) eventually becomes the complete and sole owner of the investment for which the bank has provided the funds. The profits generated by the investment are distributed to the bank on the basis of its share of the profits and also a predetermined portion of the customer's profits. The payment of this portion of the customer's share of profits results in reducing the bank's ownership in the investment.
- *Musaqat*, a form of *musarakah*, refers to an arrangement between a farmer, or garden owner, and a worker who agrees to water the garden and perform other chores in support of a bountiful harvest. The harvest is shared among all parties according to their respective contributions.

Supporting Contracts. The supporting contracts used in Islamic banking include the following:

- *Kafalah* contract (guaranteed contract) refers to a contract in which the contracting party or any third party guarantees the performance of the contract terms by the contracting party.
- *Rahn* (collateralized financing) is an arrangement whereby a valuable asset is placed as collateral for payment of an obligation. If the debtor fails to make the payments specified in the contract, the creditor can dispose of the asset to settle the debt. Any surplus after the settlement of the sale is returned to the owner of the asset.
- *Hawalah* (remittance) involves a transfer of funds/debt from the depositor's/debtor's account to the receiver's/creditor's account; a commission may be charged for the service. This contract is used for settling international accounts by book transfers. It obviates, to a large extent, the necessity of a physical transfer of cash. Examples are a bill of exchange and a promissory note.

- *Wakalah* (nominating another person to act) deals with a situation in which a representative is appointed to undertake transactions on another person's behalf, usually for a fee.
- *Wadi'ah* contract (safekeeping contract) refers to a deposit of goods or funds with a person who is not the owner for safekeeping purposes. This type of contract is used for savings and current accounts in Islamic banks. Because *wadi'ah* is a trust, the depository institution (bank) becomes the guarantor of the funds, thus guaranteeing repayment of the entire amount of the deposit, or any part of it outstanding in the account of depositors, when demanded. The depositors are not entitled to any share of the profits earned on the funds deposited with the bank, but the bank may provide *hibah* (a monetary gift) to the depositors as a token of appreciation for keeping the money with the bank.
- *Jualah* contract (a unilateral contract for a task) is an agreement in which a reward, such as a wage or a stipend, is promised for the accomplishment of a specified task or service. In Islamic banking, this type of contract applies to bank charges and commissions for services rendered by the bank.

Summary

Shari'a provides the foundation for modern *Shari'a*-compliant economic and financial transactions. Thus, *Shari'a* supplies the philosophy and principles underpinning Islamic banking products and services. Islamic banking, based on Islamic law, is an integral part of the attempt to develop the Islamic ideal in social and economic terms.

In this chapter, we reviewed the sources of *Shari'a*, the types of Islamic contracts, and the specific contracts used in Islamic banking. The Islamic legal system possesses a certain flexibility that provides for adaptation to new socio-economic situations in that Islamic law deals differently with permanent aspects of legal issues and changeable aspects of legal issues. Islamic law allows room for reasoning and reinterpretation in areas of law that are changeable and progressive in character. For example, *riba* (interest) is a fixed prohibition whereas the ruling of permissibility for *gharar* (uncertainty) takes into account a cost-benefit analysis. Hence, permissibility changes with changing technology, the legal framework, customary practice, and so forth (see, for example, Bakar 2005).