

# Legal aspect of islamic finance

Finance



## 1. Introduction

It has to be conceded that Islamic financing is one of the most accelerated growing industries in the field of global banking and financial systems during the last three decades. 1 Beginning with Dubai Islamic Bank which was founded in 1975, nowadays there are more than 300 global institutions specializing in Islamic financing across the world. The assets of these institutions are approximately \$250 billion with estimated growth at 10-15 percent per annum. 2 This unparalleled growth was no coincidence.

There are many factors contributing to this soaring growth, such as the continued prosperity in the middle east states in respect of oil wealth, an increased desire among Muslims to elicit financial services that meet the Sharia (Islamic law) requirements, and the attractiveness of the Islamic financing products which are appealing to both Muslim and non-Muslim investors. 3 It is worth mentioning that Islamic financing is not merely confined to the Middle East or to Islamic countries only, but also, it is sought after, wherever there is a reasonable Muslim community worldwide. 4

The aim of this essay is to advise The Islamic Bank of Transylvania (IBT), which has recently founded an Islamic bank in the UK, regarding its intent to take a part in Ijarah (one of the Islamic financing techniques) transaction with East Airlines (EA) for the purpose of purchasing four aircrafts which currently are owned by Universal Airways (UA). This advice will draw attention to the pertaining issues of Ijarah transaction including the intrinsic elements which Ijarah contract contain for the sake of eliciting the approval of Sharia (Islamic law) Supervisory Board. Also, it will shed light on the

number of legal risks that IBT may encounter during the Ijarah transaction, and to what extent such risks could be diluted.

## 2. Nature of the Islamic financing

For the sake of providing a comprehensive advise for IBT, it would be recommended to present at the beginning a brief overview of the nature of Islamic financing.

### 2. 1. Definition

The term 'Islamic Financial system' could be defined as 'a financial service principally implemented to comply with the main tenets of Sharia'.<sup>5</sup> Sharia in turn is derived primarily from four sources. First, Quran (the sacred book of Islam) which is consisted of God revelations to Prophet Muhammad. The bulk of Quran legal verses are none detailed. Second, Sunna which is comprised of the sayings, practices and approvals of Prophet Muhammad (May peace be upon him) during his lifetime. The third source is Ijma (consensus) which refers to the consensus of the whole religion scholars on a particular subject in the era of the ages. The last main source of sharia is Qiyas (analogical reasoning). Qiyas is the process of analogical reasoning that aim to provide a legal opinion upon a new case, which is not referred to in previous sources, by comparing it to other refereed cases which have the same effective reason.<sup>6</sup> These authentic sources draw the big picture of the Islamic law.

### 2. 2. The Features of Islamic Financing

The Islamic financing framework, at present, has several numbers of characteristics which may be unique in its field. These qualities could be summed up in three prime attributes. First, Money is exclusively a medium of exchange. The concept of money, within Islamic financing system is merely a mean of exchange. Therefore, it is forbidden, in general, under Islamic law to use money as a subject matter of trade.

In other words, making profit through trading in money is not allowed in sharia, because money in essence is lacking of genuine value. 7 Second, asset-backed financing. One of the intrinsic qualities which characterizes the Islamic financing system is that, it is an asset backed financing. On the contrary of the conventional system which is dealing merely in money and monetary papers, Islamic financing framework is often grounded on non-liquid assets. The core of any Islamic financing transactions must be something that has a genuine utility. 8 Third, Islamic financing is concerned with ethical investment. The Islamic financing lays a particular stress on the fairness of trade.

Thus, any transactions containing unethical criteria such as deception, circumventing and monopoly are invalid and not compliant with Islamic law because of the contradiction of such criteria with the overall tendency of Islamic law to achieve social justice and fair economic prosperity. In addition, in spite of the inducement of Islam to achieve the economic wellbeing, sharia differentiates clearly between the acceptable commercial activities and those that are, unacceptable from the Islamic point of view. For example, commercial activities involving alcohol, pork and its products, armaments,

gambling... etc are certain to be void within Islamic financing system because it is basically forbidden under sharia. 9

## 2. 3. The Major prohibitions of Islamic financial system

It is advisable for international companies that are looking forward to take a part in transactions under Islamic financing system, as is the case with the Islamic Bank of Transylvania, to be keenly aware of the major financial prohibitions lying within the Islamic law. Fundamentally, there are three overarching prohibitions in Islamic law which directly affect Islamic financing industry.

### 2. 3. 1. First, Prohibition of Riba (an excess)

The term 'Riba', in the strict sense of the word, is "an excess" which could be construed in the context of Islamic financing system as ' any unjustifiable increase of capital whether in the form of loans or sales'. The prohibition of Riba, which is derived mainly from Quran, Sunna and Ijma, constitutes a milestone in Islamic financing system. In fact, Sharia has incontrovertibly forbidden the charging of interest on moral grounds. From the Islamic point of view the loan contract is a 'charitable' contract (good deed).

The shortfall that would arise on the value of money lent, during the period of the loan is considered Islamically as a charity or a gift from the debtor. Therefore, any loan contracts that would bring any form of benefits for the interest of the lender are unacceptable under sharia. 10 Yet, it is certainly incorrect that Islamic law is ignoring the time value of money. In an

interesting manner, this value could be observed in many Islamic financing techniques such as Bay'Mu'ajjal (sale with deferred payment) technique.

### 2. 3. 2. Second, Prohibition of Gharar (extreme uncertainty)

The prohibition of Gharar (extreme uncertainty) sales could be seen clearly through considerable number of Sunna. The concept of Gharar refers to " the sale of probable items whose existence or characteristics are not certain, due to their risky nature, which makes the trade similar to gambling". 11 This uncertainty could be arisen as a result of lacking of vital information in a contract<sup>12</sup> for example, it was mentioned in the following Sunna by Ahmad and Ibn Maajah narrated on the authority of Abo Sa'eed Al'kudry mAbpwh :

The Prophet Pbuh has forbidden the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to their distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver. 13

The main reason for prohibiting these sales, mentioned above, is the high level of ambiguity or uncertainty which is inherent in such sales.

Furthermore, in some of these sales the purchaser does not have the slightest idea what he would obtain. However, in contrast to Riba, a considerable number of Islamic scholars have permitted some of the contracts which include Gharar, provided that this Gharar is minor. 14 They maintain that there is no contract that is totally detached of any level of Gharar. Thus, they have differentiated between major Gharar and minor Gharar in the validity of the contract or not. Based on this distinction, the

Fatwa (a legal opinion by an Islamic scholar) in this field may vary from one scholar to another, in a certain issue<sup>15</sup>.

### 2. 3. 3. Third, Prohibition of Maysir (Gambling)

" Maysir" has been explicitly forbidden in the Holy Quran and the Sunna.

Given the risky nature of gambling which may result adverse consequences for one of the parties at the expense of the other, Islamic law perceives Maysir as an unacceptable vanity attitude and way to make money. Hence, Islamic financing system considers any contemporary transactions that highly depending on chance, not effort or crafts as unequivocally contrary to Sharia<sup>16</sup>. But, likewise Gharar, the fatwa about a specific transaction is likely to be different from one scholar to another.

### 3. The General Conditions of The Sale Contract in the Islamic Financing System.

It is a matter of importance to the Islamic Bank of Transylvania to be familiar with the principles of the Islamic sale contract as it will take a part in sale agreement with UA. Unlike conventional sale contract, Islamic law lays great emphasis on several numbers of conditions which must be fulfilled in any sale contract to comply with sharia. These conditions could be summarised in six prime conditions. First, the merchandise must be owned by the seller at the time of the contract (with some exceptions). Second, the contract of sale must be immediate and final. Third, the merchandises must be precisely identified.

Otherwise, the contract will be considered as major Gharar, which is forbidden under Islamic law. Fourth, the sale price must be certain. Furthermore, the price of the sale become immutable once it is fixed. Fifth, the commodity of sale must have a value from an Islamic perspective. Merchandises such as alcohol, pork related products... etc are Haram (forbidden by Islamic law) and have no value under sharia. The sixth condition, the commodity should not be used for forbidden purposes such as armaments. 17

If any contract of sale fails to meet one of these conditions, it is then almost certain to be void under Islamic law. It is, therefore, should be recommended that IBT should make sure, in advance, that its contract with UA has abided the conditions of the sale contract according to Islamic financing system.