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Author(s): Nicholas H. D. Foster
Source: *Arab Law Quarterly*, Vol. 21, No. 2 (2007), pp. 170-188
Published by: BRILL
Stable URL: http://www.jstor.org/stable/27650582

BRILL

*Arab Law Quarterly 21 (2007) 170-188*

Arab Law Quarterly
www.brill.nl/alq

# Islamic Finance Law as an Emergent Legal System

**Nicholas H. D. Foster***

**Abstract**
The recent growth in Islamic finance has drawn attention to the alleged "uncertainty" of the sharia, highlighted in 2004 by the *Beximco* case. On the institutional level, various organisations are addressing the issue; there are also "organic" tendencies towards standardisation. These phenomena are combining with others to form a new legal system, albeit one with particular characteristics. This system has matured sufficiently to merit categorisation as a separate field of study and practice: Islamic Finance Law.

**Keywords**
Islamic Finance; Islamic Finance Law; legal system; standardisation.

* School of Law, School of Oriental and African Studies, University of London. This article is partly based on ideas formulated during the Sixth Harvard Forum on Islamic Finance, 8-9 May 2004 ("the Sixth Forum"). The author gratefully acknowledges the financial support provided by the Institute of Advanced Legal Studies which made possible his attendance at the Sixth Forum. An account of the Forum can be found on the website of the Islamic Finance Project of Harvard Law School's Islamic Legal Studies Program at: http://ifptest.law.harvard.edu/ifphtml/index.php?module=ForumReport01 (last visited 19 December 2006). Selected papers have been published in Ali, S.N. (ed.) (2005) *Islamic Finance: Current Legal and Regulatory Issues* Islamic Finance Project, Islamic Legal Studies Program, Harvard Law School. The author thanks Antony Dutton and Neil Miller of Norton Rose for sharing some of their experience with him in a conversation on 2 May 2006 (all the contributions attributed to them took place in this conversation), Dr. A.H. Buang for drawing his attention to the *Affin Bank* case and for allowing the author to see his paper on the subject, Bill Ballantyne and Ian Edge for stimulating discussions, and Michael Foster Vander Elst for comments on a previous draft. The usual caveat applies. See also the companion piece to this article, Foster, N.H.D., "Encounters between Legal Systems: Recent Cases concerning Islamic Commercial Law in Secular Courts", (2006) *Amicus Curiae*, 2. Some parts of the two articles mirror each other; for the sake of brevity individual instances have not been pointed out.



DOI: 10.1163/026805507X214433

Islamic finance has grown considerably in importance and visibility in recent years. It has made the front page of the London Financial Times,[1] and an Islamic financial institution has been licensed to conduct business in the United Kingdom.[2] One might say that Islamic finance is coming of age. However, according to some, its legal basis suffers from a lack of certainty and uniformity.

## The Uncertain Sharia?

### *Islamic Finance Fundamentals*[3]

First, a few words concerning the fundamentals of Islamic finance. Islamic finance has its base in the need felt by devout Muslims to conduct their affairs in accordance with the sharia, using transaction types which, inter alia, do not contravene the prohibition of *riba* (not the same as interest, although the consensus is that *riba* includes it; one might start a discussion of this complex subject by treating it as "unacceptable profit"),[4] *gharar* (roughly speaking, an unacceptable level of risk),[5] *maysir* (gambling),[6] and forbidden things, such as wine, blood and idols.

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[1] Anon., "Islamic Financing Top Scholar Hails Boom", *Financial Times*, 2 June 2006, London, 1, linked to Tett, G., "Islamic Banking Confounds Sceptics", *Financial Times*, 2 June 2006, London, 19.

[2] The Islamic Bank of Britain plc. See http://www.islamic-bank.com (last visited 5 July 2006).

[3] See, e.g., Archer, S., and Abdel Karim, R. A., "Introduction to Islamic Finance" and Wilson, R., "The Development of Islamic Financial Institutions and Future Challenges", both in Archer, S., and Abdel Karim, R. A., (eds) *Islamic Finance: Innovation and Growth*, (Euromoney Books and AAOIFI, 2002).

[4] On *riba* see, e.g., Koran IV:161; Vogel, F. E., and Hayes, S. L., *Islamic Law and Finance: Religion, Risk and Return*, (Kluwer Law International, 1998), at chapter 4, "Islamic Laws of Usury, Risk, and Property", especially the section headed "Plumbing the Rules of *Riba*", 77-87.

[5] On *gharar* see Koran II:219 and V:91; Rayner, S. E., *The Theory of Contracts in Islamic Law*, (Graham & Trotman, 1991), chapter 6.7, "*Riba, Gharar* and *Maysir*", especially §2.1, "The definition of *gharar*"; a full account with reference to Malaysia is contained in Buang, A. H., *Studies in Islamic Law of Contracts: The Prohibition of Gharar*, (International Law Book Services, 2000).

[6] Koran II:219 and V:93-94; Rayner, *The Theory of Contracts in Islamic Law*, at chapter 6.7.

The basic principle behind such approved transactions is the construction of a transactional structure based on ownership and sale. This approach is rooted in the Koran itself, which contains the famous passage: "They said that sale is like *riba* whereas Allah has allowed sale and has banned *riba*".[7] Participation in trade, and gaining an honest profit therefrom, is acceptable, even encouraged, so methods based on it are also acceptable.

The most common transaction type is the *murabaha*, an agreement pursuant to which A and B agree that A will buy items at price X from C and sell them to B at price X+Y. In other words, it is a trade finance device, the pre-determined difference in price playing, in economic terms, the same role as interest in a conventional trade finance transaction.[8]

### *Issues Recently Raised in the English Courts*

Some of the legal techniques used so far, and the issue of further development, arose in two cases in which the English courts were asked to consider Islamic finance contracts: *Symphony Gems* and *Beximco*.[9] In both,

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[7] Koran II:275 (author's translation); see also IV: 29.

[8] On *murabaha* and its uses see Bälz, K., "Islamic Law as Governing Law under the Rome Convention. Universalist Lex Mercatoria v Regional Unification of Law", (NS 6) *Uniform Law Review* (2001), 37, 41-42.

[9] *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV & Ors*, unreported 2002 WL 346969, [2002] All ER (D) 171 (Feb) (QBD: Comm Ct), transcript available on LexisNexis, comment in Bälz, K. "A Murabaha Transaction in an English Court: The London High Court of 13th February 2002 in *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV & Ors*", (11) *Islamic Law and Society* (2004), 117; Moghul, U. F., and Ahmed, A., "Contractual Forms in Islamic Finance Law and *Islamic Inv Co of the Gulf (Bahamas) Ltd v Symphony Gems NV & Ors*: A First Impression of Islamic Finance", (27) *Fordham International Law Journal* (2003), 150; and Foster, "Encounters between Legal Systems"; *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2003] EWHC 2118 (Comm); 2003 WL 22187542, available on Westlaw (QBD); [2004] EWCA Civ 19; [2004] 1 WLR 1784; [2004] 2 All ER (Comm) 312; [2004] 2 Lloyd's Rep 1 (CA), comment in Bälz, K., "Islamic Financing Transactions in European Courts", in Ali, *Islamic Finance: Current Legal and Regulatory Issues* (2005), particularly at 65-67; Anon., "Shari'a Law as Governing Law for Financial Transactions", (6) *Finance and Credit Law* (2004); and McKnight, A., "A Review of Developments in English Case Law during 2004—Part 2", (20) *Journal of International Banking Law and Regulation* (2005), 151. Compare these judgments with that of the Kuala Lumpur High Court in *Affin Bank Berhad v Zulkifli Abdullah* [2006] 1 *Current Law Journal* 438, Bernama, 29 December, 2005, summary at: http://www.malaysianbar.org.my/content/view/2174/2/ (last visited 4 April 2006), comment in Foster, "Encounters between Legal Systems". The case is to be the subject of a study by Dr. Buang.

English law was used as the "enforcement/host" (state) law of the contract. It is well suited for this task, partly because it is one of the major financial law systems, partly because it has a very broad interpretation of the principle of freedom of contract, enabling transactions to be structured in accordance with the sharia.

*Beximco* is the more important of the two decisions,[10] and is the only one which will be considered here. The Court of Appeal had to consider the following form of governing law clause in *murabaha* financing agreements: "Subject to the principles of the Glorious Shari'a this Agreement shall be governed by and construed in accordance with the laws of England." The bank's customer argued that the agreement was only enforceable if it complied with the sharia and that, since the contract was in fact tantamount to a loan at interest, it was in contravention of the prohibition on *riba*, therefore void. Under English law, questions concerning the governing law of a contract are determined by the Rome Convention, as enacted into English law by s 2(1) Contracts (Applicable Law) Act, 1990.[11] It was held that the sharia could not be a governing law for two reasons:

1. The accepted interpretation of the Convention is that the law chosen must be the law of a jurisdiction (in the English text Art 1.1 refers to "a choice between the laws of different countries", and Article 3.3. refers to "foreign law" and "country"). The sharia is not the law of a country, therefore cannot be the governing law.[12]

[10] In *Symphony Gems* the reference to Islamic law was contained only in a recital: "The Purchaser wishes to deal with the Seller for the purpose of purchasing Supplies (as hereinafter defined) under this Agreement in accordance with the Islamic Shariah". The judgment of Tomlinson J is difficult to understand in this area, as he does not deal in any detail with the effect of the recital on the contract. The essence of what he says on the subject is that: "it is a contract governed by English law. I must simply construe it according to its terms as an English law contract."

[11] Convention on the Law Applicable to Contractual Obligations, Rome 1980.

[12] Para 27 of Morison J's judgment; paras 43 and 48 of Potter LJ's judgment. Article 1.1 provides: "the rules of this Convention shall apply to contractual obligations in any situation involving a choice between the laws of different countries". This may change with the coming into force of the EU Regulation which is to replace the Rome Convention; see Commission of the European Communities (2005), "Proposal for a Regulation of the European Parliament and the Council on the Law Applicable to Contractual Obligations (Rome I)" COM(2005) 650 final (available at: http://ec.europa.eu/justice_home/doc_centre/civil/doc/com_2006_83_en.pdf: last visited 15 July 2006) at 5 and draft Article 3.2, the text is at 14). However, the certainty and sole governing law requirements will remain,

2. A contract cannot be governed by two different laws.[13]

Counsel for the customer claimed, though, that the sharia could be, and had been, incorporated by reference. The Court of Appeal held that it could not, and had not been; it therefore found for the bank.[14]

It is in the discussions concerning the incorporation claim that the main point of interest arose as far as this article is concerned: the certainty/uniformity of the sharia. The issue was referred to at first instance by Morison J when he said: "There is clearly great controversy as to the strictness with which principles of Sharia'a law will be interpreted or applied", and when he stated that those principles were "highly controversial".[15] Counsel for the customer submitted on appeal that the judge had been wrong to come to this conclusion,[16] and that "the principles of Shari'a [...] amount to legal rules ascertainable and applicable by an English Court".[17] The Court of Appeal rejected the submission. Potter LJ said that there are:

> areas of considerable controversy and difficulty arising not only from the need to translate into propositions of modern law texts which centuries ago were set out as religious and moral codes, but because of the existence of a variety of schools of

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so the result of a *Beximco* situation would probably be the same. Thanks to Ian Edge for help on the Regulation.

It is also worth noting that one might argue the sharia is the law of one country, viz., Saudi Arabia, and that is either *a* or *the* principal source of law in others (e.g., Art. 2 Egyptian Constitution adopted 11th September 1971 as amended in 1980, *the* main source; Art. 2 Kuwaiti Constitution 11th November 1962, *a* main source). However, if the parties had wished the law of Saudi Arabia to be the governing law, they would presumably have said so; and in the other states the sharia is not the law, just a/the principal source of it. Also, the problem of the dual governing law remains. Thanks to Bill Ballantyne for drawing attention to the possibility.

[13] Paras 28-30 of Morison J's judgment, referring to *American Motor Insurance Co v Cellstar Corpn* [2003] EWCA Civ 206, [2003] All ER (D) 26 (Mar) at 32. This point was common ground by concession between the parties.

[14] For incorporation to work, the parties must have "by the terms of their contract sufficiently identified specific 'black letter' provisions of a foreign law" (para 51 of Potter LJ's judgment). No such identification had occurred, so there could be no incorporation. This was enough to dispose of the appellants' case which, as both the first instance judge and the Court of Appeal observed, had little merit.

[15] Para 36.

[16] Para 45, summarising the argument of Mr. Hacker QC.

[17] Per Potter LJ, at para 42, summarising the argument of Mr. Hacker QC.

thought with which the Court may have to concern itself in any given case before reaching a conclusion upon the principle or rule in dispute.[18]

The following sections consider this issue of certainty.

*Islamic Commercial Law in the Classical Period*

The Koran contains a substantial number of provisions which can be qualified as "legal", but it by no means constitutes a code. The practice, or *sunna*, of the Prophet, as related in "Traditions" (*hadith*) handed down orally by chains of narrators starting with a witness of an event in the Prophet's life, furnishes considerable further guidance, but even the combination of the legal verses of the Koran and the *sunna* do not constitute a comprehensive body of norms. It therefore had to be supplemented by the scholarly work of the jurists. The overall result seems to have been a regime of considerable sophistication and detail, surpassing anything Europe could offer at the time, or for some centuries thereafter.

However, the existence of several "schools" (*madhahib*), which could vary quite substantially, and divergent interpretations within them, caused difficulties which were recognised even in the classical period.

Another difficulty is that it is not easy to know what the law was. The available sources are sparse, most are still un-researched, and their interpretation is a matter of debate. There was no relevant legislation in the classical period, for Islamic law existed, albeit with some degree of necessary interaction between the jurists and the ruling polity, outside the government, which only enacted regulations in narrow fields. Nor was there any case-law in the modern Western sense.[19] As for what went on in the courts,

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[18] Para 55, referring to the evidence given by the sharia experts, Mr. Justice (retd.) Khalil-Ur-Rehmam Khan, former chairman of the Sharia Appellate Bench of the Supreme Court of Pakistan, and Dr. Martin Lau, School of Oriental and African Studies. The divergence of views on the content of the Sharia seems also to have been a relevant factor in the decision not to accept the incorporation argument: "It is plainly insufficient for the defendants to contend that the basic rules of the Sharia applicable in this case are not controversial" (Potter LJ at para 55). See also El-Gamal, M. A., "'Interest' and the Paradox of Contemporary Islamic Law and Finance", (27) *Fordham International Law Journal* (2003), 108 at 111: "The lack of a widely accepted contemporary legal codification based on Islamic jurisprudence makes to difficult to speak with any authority regarding the Islamic permissibility or prohibition of any given transaction."

[19] In North Africa and Spain, the Maliki school developed the doctrine of *'amal* (court practice): see Serrano, D., "Legal Practice in an Andalusi-Maghrib Source from the Twelfth

although there is a growing body of scholarly work on the considerable amount of court documentation available (particularly from the Ottoman period), there is not enough yet to give a clear picture, nor is much known about the role of custom (*'urf*).[20] The main evidence we possess is to be found in the writings of the jurists, and scholars disagree as the extent to which the law in the books was, or was not, actually law in action.[21] The difficulties are exacerbated by the immense changes which occurred after Napoleon's conquest of Egypt in 1798, and the ensuing Western domination of the Muslim Middle East and other Muslim territories. The old legal system disappeared, use of the sharia in commercial transactions was discontinued, Western law was introduced (a long process in which notable events included the Napoleonic invasion of Egypt, and the Balta Liman trade treaty of 1838 between the United Kingdom and the Ottoman Empire), and the tradition was broken.[22]

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Century CE. The Madhahib Al-Hukkam Fi Nawazil Al-Ahkam", (7) *Islamic Law and Society* (2000), 187, the nearest concept to common law precedent which Islamic law knew, and one not generally adopted in other regions for, in principle, the idea of precedent is anathema. See Al-Hejailan, F., "Precedent in the Shari'a—with Special Reference to Saudi Arabia", (3) *Middle East and North Africa Legal Yearbook* (2000), 36. However, if it is true, as claimed by some scholars, that the decisions contained in *fatwa*s found their way into the books of *fiqh*, then those books do reflect the reality of law as developed through litigation: see Hallaq, W. B., "'From Fatwas to Furu': Growth and Change in Islamic Substantive Law", (1) *Islamic Law and Society* (1994), 29.

[20] On custom, see Mallat, C., "Commercial Law in the Middle East: Between Classical Transactions and Modern Business", (48) *American Journal of Comparative Law* (2000), 81 95-97.

[21] Cf. Crone, P., *Roman, Provincial and Islamic Law: The Origins of the Islamic Patronate*, (Cambridge University Press, 1987), at 18 ("work of pure scholarship") with Hallaq, W. B., "Usul Al-fiqh: Beyond Tradition", (3) *Journal of Islamic Studies* (1992), 172 182 ("inextricable relationship between positive law and legal theory").

[22] In Hourani's words, the Sharia was "abandoned with astonishing speed and completeness": Hourani, A., *Arabic Thought in the Liberal Age 1798-1939* (Cambridge University Press, 1983), at 350. On the capitulations, see Feroz, A., "Ottoman Perceptions of the Capitulations 1800-1914", (11) *Journal of Islamic Studies* (2000), 1, especially at 4-5; on secularisation, see Asad, T., *Formations of the Secular: Christianity, Islam, Modernity* (Stanford University Press, 2003), chapter 7, "Reconfigurations of Law and Ethics in Colonial Egypt"; on legal reform generally, see Anderson, N., *Law Reform in the Muslim World* (The Athena Press, 1976), (the Ottoman experience is dealt with at 15), and Castro, F., "La codificazione del diritto privato negli stati arabi contemporanei", (31) *Rivista di diritto civile* (1985), 387; Egypt generally, Brown, N. J., "Law and Imperialism: Egypt in Comparative Perspective", (29) *Law & Society Review* (1995), 103; on the first separation of commercial law in Egypt, see Goldberg, J., "On the Origins of Majalis al-Tujjar in

Consequently, it is now difficult to determine the content of the commercial sharia. It is one thing to cry: "back to the commercial sharia", quite another to achieve it when "the commercial sharia" was in significant respects far from unified, and current knowledge of what it actually was, and how it worked, is hazy in many areas. A further problem is that some aspects of classical law and practice, such as the Hanafi *hiyal*, or fictions, which dressed up illicit transaction types as licit types, may not be perceived as proper today by those who wish to return to a "pure" law.

This issue arises both in the enactment of sharia-based provisions into the positive law of a Muslim-majority jurisdiction, and the use of the sharia as a non-state system, adopted by the agreement of the parties as a consensual regime operating within the confines set by a secular jurisdiction. However, there are also differences between the two situations. In a consensual regime, how is it possible to establish the rules in the absence of any legislative or case-law process? The method presently used employs the study of Islamic legal literature (much of which is still unexplored, or at least needs fresh interpretation or a new perspective), the extraction from it of principles by deduction, and the application of those principles using analogy to current issues.[23] The result is a modification of transactions devised and approved in the classical era of the sharia. The adaptation techniques include, notably: *takhayyur* (choice of solutions among the schools); *talfiq* (the "fusing of different legal opinions");[24] and re-interpretation (in a strict sense correctly, but also somewhat confusingly, referred to as "*ijtihad*"), described by Anderson as "legal interpretation and development unbound by law school considerations",[25] in order to meet the needs of *maslaha* (very roughly, public interest). The aim of the users of

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Mid-Nineteenth Century Egypt", (6) *Islamic Law and Society* (1999), 193. Anderson draws attention to the importance of commercial and penal law reform: "a fundamental change of attitude was inherent even in [the early commercial/penal law] stage of the reform movement" (id. at 38).

[23] The phrasing of the latter part of this sentence derives from an e-mail from Dr. Buang to the author dated 20 April 2006, on file with the author. On the controversy surrounding the techniques of Islamic finance, see footnote 56 and accompanying text. See also DeLorenzo, Y. T., "The Religious Foundations of Islamic Finance", in Archer and Abdel Karim, *Islamic Finance: Innovation and Growth* (2002), at 26-27.

[24] See Krawietz, B., "Cut and Paste in Legal Rules: Designing Islamic Norms with Talfiq", (42) *Welt des Islams* (2002), 3, at 3.

[25] Id. at 4; the author also cites Anderson, *Law Reform in the Muslim World* 34-82. See generally chapter II of the latter work, "The Philosophy and Methods of Reform".

such techniques is to create a "modern Shari'a",[26] a process described by one scholar as being of "unprecedented dimensions, the only historical parallel being that of the major formulation of the major schools of Islamic law in the fourth century Hijri".[27]

## Creating More Certainty and Uniformity in Islamic Finance Law

The end result of these methods was considered by the Court of Appeal to be too uncertain and varied to be incorporated as a body of rules into the *murabaha* agreements. The judges in the Court of Appeal are not alone in this opinion. According to one report, "many practitioners complain that the market is highly fragmented, with little uniformity amid a wide range of product structures and differing standards of Sharia compliance".[28] Such fragmentation increases transaction costs.[29]

Phenomena relevant to these issues can be roughly divided into *institutional* (deriving from a planned approach, dealing with the problems consciously and rationally within an organisational framework, aiming at comprehensive coverage of the issues), and *organic* (arising as a result of the "natural" pressures in the market and the professions, particularly the legal profession, which service it).[30]

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[26] The use of the ambiguous word "law" (meaning both state legislation and legal regime) is intentional, as is the use of the plural. See generally the series of articles in issue 1, volume 4 (2004-2005) *UCLA Journal of Islamic and Near Eastern Law*.

[27] Arabi, O., *Studies in Modern Islamic Law and Jurisprudence*, (Kluwer Law International, 2001), at 200.

[28] Lane, K., "IIFM to Start Work on Islamic Standardization", *Dowjones Newswires* (10 May 2006), available at: http://www.iifm.net/news063.php (last visited 2 May 2007); see also Smith, K., (2005), "Islamic Banking and the Politics of International Financial Harmonization", in Ali *Islamic Finance: Current Legal and Regulatory Issues*, at 185 (describing the market as "extremely fragmented").

[29] The Islamic Financial Services Board, *Guiding Principles on Corporate Governance for Institutions Offering only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds) (Exposure Draft No 3)* (2006), takes the view that diversity is inevitable but should, at the same time, be reduced as much as possible (see paras 45 and 46). See contra Anon., "Unified Islamic Finance Law 'Not a Must'", *Trade Arabia* (2006), available at: http://www.tradearabia.com/tanews/newsdetails_snBANK_article106654.html (last visited 7 July 2006): "The head of the Islamic Development Bank Group sees no problem in the lack of a unified interpretation of sharia law although some critics say this may be holding back the fast-growing Islamic finance industry."

[30] The distinction is not completely clear-cut; an institution created by market players

*Institutional*

Some of the relevant institutions are briefly described below.[31]

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was established and registered in Bahrain in 1991. Set up by Islamic financial institutions, including the Islamic Development Bank (IDB), it has two divisions: the Accounting and Auditing Standards Board, and the Shari'a Board. They have issued, and regularly update, *Accounting, Auditing & Governance Standards for Islamic Financial Institutions* and *Shari'a Standards*. One of the aims of the Shari'a Board is:

> Achieving harmonization and convergence in the concepts and application among the Shari'a supervisory boards of Islamic financial institutions to avoid contradiction or inconsistency between the *fatwa*s and applications by these institutions, thereby providing a pro-active role for the Shari'a supervisory boards of Islamic financial institutions and central banks.[32]

The Islamic Financial Services Board (IFSB)[33] is an "international standard setting body of regulatory and supervisory agencies".[34] It was established under municipal law by the Islamic Financial Services Board Act 2002 (Malaysia). Its members include central banks, international financial organisations such as the IMF, the World Bank, and the Bank for International Settlements, and financial institutions. Based in Kuala Lumpur, it was set up in 2002, and started operations in 2003. Its principal objective is: "To promote the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with Shariah principles, and recommend these for adoption".[35] To date, it has issued two standards, one on risk management, and one on capital adequacy,[36] plus a draft on corporate

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falls in a grey area between the two categories, for example. Thanks to Michael Foster Vander Elst for pointing this out.

[31] See Henry, C. M., "Introduction", in Ali *Islamic Finance: Current Legal and Regulatory Issues* (2005), 4-5, and Smith, "Islamic Banking and the Politics of International Financial Harmonization", 172-177 (AAOFI), 184-185 (IIFM). The list is not exhaustive.

[32] http://www.aaoifi.com/index.html (last visited 7 July 2006).

[33] http://www.ifsb.org (last visited 7 July 2006).

[34] http://www.ifsb.org/index.php?ch=2&pg=1&ac=1 (last visited 7 July 2006).

[35] Art. 4(a) IFSB Articles of Agreement.

[36] *Guiding Principles of Risk Management* and *Capital Adequacy Standard for Institutions (Other than Insurance Institutions) Offering only Islamic Financial Services*, both issued in 2005.

governance.[37] Further drafts in preparation cover supervisory review process, transparency and market discipline, and special issues in capital adequacy and governance of investment funds.

The International Islamic Financial Market (IIFM),[38] also an international organisation, was created by Malaysia, Indonesia, Bahrain, the Sudan, and the IDB. It was established under municipal law by Amiri Decree No, 23-2002 dated 11th August 2002 (Bahrain) as a non-profit institution. It aims "to establish, develop, promote and self-regulate an international financial market based on Shari'a rules and principles". Among its secondary objectives are: "To streamline and enhance the market by issuing guidelines to players issuing and marketing Islamic financial products and instruments"; "to create an environment that will encourage both Islamic and non-Islamic financial institutions to actively participate in the Islamic Capital and Short Term Financial Market"; and to: "Work to enhance the cooperative framework among Muslim countries and their financial institutions".[39] In accordance with these objectives, the IIFM aims "to help develop specifically uniformity and standardization initiatives".[40]

The International Islamic Rating Agency (IIRA), sponsored by the IDB (its major shareholder), was formed in 2002 in Bahrain as a Joint Stock Company.[41] Apart from the IDB and the Islamic Corporation for the Development of the Private Sector, its shareholders include two rating agencies and several financial institutions. It aims to provide not just conventional credit and corporate governance rating, but also "shari'a rating", described as "providing information and independent assessment of Shari'a compliance" by institutions providing Islamic financial services, and "Islamic financial products such as Sukuks". Notably: "Major elements of this evaluation will cover an institution's internal mechanism for Shari'a compliance, the authority, strength and resources of the entity's Shari'a

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[37] *Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds*). All the documents mentioned are available from the IFSB website.

[38] http://www.iifm.net (last visited 7 July 2006).

[39] Art. 2 IIFM Agreement of Establishment.

[40] http://www.iifm.net/ser-endorse.php (last visited 19 December 2006). On 30 January 2007, the IIFM signed a memorandum of understanding with the International Capital Markets Association regarding the standardisation of *sukuk*.

[41] http://www.iirating.com (last visited 7 July 2006).

committee, the opinion expressed by Shari'a committee members and the differences in opinion if any".[42]

Longer-standing institutions include the Institute of Islamic Research (Majma' Al-Buhuth Al-Islamiyyah) of Al-Azhar University in Cairo (set up in 1961), the Islamic Jurisprudence Institute (Al-Majma' Al-Fiqhi Al-Islami) of the Islamic League (Rabita Al-'Alam Al-Islami) (set up in 1979), the Fiqh Institute or Academy (Majma' Al-Fiqh Al-Islami) of the Organisation of Islamic Conference (OIC, Munazamma Al-Mu'tamar Al-Islami), operating in Jedda, Saudi Arabia (set up in 1984). According to Professor El-Gamal, the last mentioned "is currently the most widely cited jurisprudential council, which is comprised of representatives from Islamic members of the OIC".[43]

Clearly, a great deal of work remains to be done, but these are, nonetheless, significant steps towards the development of industry standards.

### *Organic*

Despite the desire of financial institutions to keep their products to themselves (they rightly regard them as valuable property), it is inevitable that a degree of standardisation will spontaneously emerge in the market even if, as stated above, the level of standardisation is at present far from ideal.[44] Market forces are perhaps most evident in traded products such as *sukuk* (commonly called "Islamic bonds", although they more closely resemble trust certificates), since the market regulator and the market player both need to know what is being bought and sold.[45] However, there are also standardising tendencies in other types of products. Customers using different institutions justifiably expect a certain uniformity of method and result, because unnecessary variety creates greater transaction costs. People

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[42] http://www.iirating.com/rating_methodology.htm (last visited 7 July 2006).

[43] El-Gamal, M. A., "'Interest' and the Paradox of Contemporary Islamic Law and Finance", (27) *Fordham International Law Journal* (2003), 108, at 114; the list comes from 113-114. Also note the role of the Islamic Development Bank Group.

[44] See contra Smith, "Islamic Banking and the Politics of International Financial Harmonization", at 185.

[45] "Currently, most Islamic investors buy and hold Islamic instruments such as sukuk because of the small number of products available and because they fear being unable to find the same credit in the market if they liquidate their positions." Lane, "IIFM to Start Work on Islamic Standardization". See also Tett, G., "Secondary Trading in Islamic Bonds Promises Earthly Riches", *Financial Times*, 14 July 2006, London, 36: "GFI, the large US broker, is creating the first interdealer market for secondary trading in *sukuk*".

communicate with each other, both formally (at conferences and seminars, for example) and informally, and move between institutions in the course of their careers, taking their expertise with them.

On the legal side, various phenomena reflect the market need for standardisation, as well as forces tending in that direction in the legal profession itself. In other areas, one such force is case-law, but there is as yet very little case-law in Islamic finance. The reasons for this absence are both practical and theoretical. The practical reason is that there is no system of courts to produce such case-law; the theoretical reason is that there is no precedent in the sharia.[46] However, means do exist which produce similar effects, in the sense that they produce standard rules derived from following authoritative solutions adopted by a legal authority when resolving a controversial legal point. One such means is the large body of *fatwa*s relating to Islamic finance. The activities of the Islamic Fiqh Academy, part of the OIC, should be noted here. Another is the consensus of scholars. Their small number, which results in their participation on various boards, ensures a high degree of consensus and consistency.

Another matter raised at the Sixth Forum can also be seen in the light of the certainty issue. One contributor drew attention to "the conflicts of interest inherent in the relationship between Islamic financial institutions (IFIs) and IFI *muftis* (*muftis* serving as IFI *sharia* board members or providing IFIs with ad hoc consulting services)".[47] In other words, if such scholars issue opinions, but are paid by the bank requesting their opinion, justice is not seen to be done,[48] not as regards an individual dispute, because

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[46] See footnote 19 and accompanying text. Formally speaking, an English court cannot produce precedents for another legal system, but a considered pronouncement from a superior court could nonetheless have considerable influence in practice.

[47] Hegazy, W., "Fatwas and the Fate of Islamic Finance: A Critique of the Practice of Fatwa in Contemporary Islamic Financial Markets", in Ali, *Islamic Finance: Current Legal and Regulatory Issues* (2005), 133 at 133. See also Bakar, M., "The Shari'a Supervisory Board and Issues of Shari'a Rulings and Their Harmonisation in Islamic Banking and Finance", in Archer and Abdel Karim, *Islamic Finance: Innovation and Growth* (2002), particularly at 76-78. See also *Accounting, Auditing & Governance Standards for Islamic Financial Institutions 2004—5 Edition, Shari'a Supervisory Board: Appointment, Composition and Report*, AAOIFI, cited by Bakar at 76.

[48] Perhaps the most well-known statement to this effect in English law is: "justice should not only be done, but should manifestly and undoubtedly be seen to be done": *R v Sussex Justices; Ex parte McCarthy* [1924] 1 KB 256 at 259; [1923] All ER 233 at 234, per Lord Hewart CJ. It must be stressed that this does not in any way imply any criticism

that is not the function of the IFI muftis, but as regards an unbiased determination of the law, a law-making exercise which is very similar to that performed by a common law appellate judge.[49] In other words, as one leading practitioner put it, the scholars' advisory and audit roles conflict.[50] The possibility of uncertainty, and lack of uniformity, is therefore increased.

It is also of some interest in this connection that, despite the sharia principle disapproving precedent, there was a call at the Sixth Forum for a Permanent Court of Arbitration, and that the word "precedent" was actually used in the subsequent discussion.[51] Such an institution would avoid the problematic issues which arise from the submission to the jurisdiction of a secular legal system. It must also be said though, that, quite apart from the precedent issue, arbitration is not a particularly attractive option in finance as compared to litigation in a reasonably efficient system such as that of England. It can be more expensive and much slower, and it does not provide some of the remedies available through the courts.[52]

Standard documentation and standard practice (the "settled understanding" of specialist legal practitioners),[53] both essential to make transactions time and cost efficient, and keep risk at acceptable levels, are further significant standardising factors, which are strengthened by the present

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of individual scholars, and that no allegation is or, to the knowledge of the author, ever has been made that any scholar has actually produced a partial opinion.

[49] Mr Hegazy compares the muftis' function to that of public accountants and, to a lesser extent, to that of lawyers. The analogy to judges is my own.

[50] Neil Miller.

[51] The paper was delivered by Husam Al-Khatib of the Royal Bank of Scotland. Unfortunately, the author does not have a record of the person who used the word "precedent".

[52] *Beximco*, for example, took only 13 months to go from the initiation of proceedings to the Court of Appeal. Thanks to Antony Dutton for pointing this out.

[53] A concept recognised by the English courts: see *Kleinwort Benson Ltd v Lincoln City Council* [1999] 2 AC 349, HL at 363, per Lord Browne-Wilkinson: "Much commercial and property activity occurs on the basis of law which is not laid down by judicial decision. Such 'law' consists of the practice and understanding of lawyers skilled in the field. [...] There are areas of the law which are sparsely covered by judicial decision, for example, real property, banking and regulatory law. In such areas the commercial world acts, and has to act, on the generally held view of lawyers skilled in the field. [...] I doubt whether today anyone would claim that a uniform practice of the profession makes the law. But in the present context it does have a significant impact." See also *Hollis' Hospital Trustees and Hague's Contract, In Re* [1899] 2 Ch 540 (QBD) at 551, and *Downshire Settled Estates, In Re; Marquess of Downshire v Royal Bank of Scotland* [1953] Ch 218 (CA) at 279 (per Lord Denning). More generally, see Baker, J. H., (2001), *The Law's Two Bodies*, Oxford University Press.

restriction of expertise to a few law firms. Such firms cannot be prevented, either practically or legally,[54] from using expertise acquired when acting for one client when acting in subsequent transactions for other clients. The formulation of standards by means of this phenomenon is slow, and cannot be comprehensive. However, it may well be more efficient in the long term than bureaucratic processes, unless they involve the extensive and intensive involvement of a wide range of participants.[55]

Another technique which can be considered in the context of the certainty issue is the search for guiding principle. As mentioned above, the present method relies on modification on the basis of principles deduced by modern scholars of transaction types formulated in the classical era. Some criticise this technique as favouring form over substance, claiming that "the industry thus configured is destined to move away, rather than toward, strict adherence to Islamic jurisprudence",[56] and suggest that it would be more appropriate to base modern transactions on the "true spirit of Islamic law" rather than "medieval juristic forms".[57] Others, however, disagree: "An appeal to *maqasid al-shari'a* (objectives of *shari'a*) is not as easy as it may initially seem to the uninitiated. It involves an understanding of Islam as a way of life, a process of social reconstruction, and a mission with humanity—an understanding far deeper than what one would normally expect from a contemporary legal expert."[58]

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[54] The copyright in the document belongs to the law firm.

[55] Such as the Master Agreements produced by the International Swap and Derivatives Association, Inc. (ISDA) (http://www.isda.org). The point is made regarding Islamic finance by Lane: "Many in the Islamic markets say standards need to be established by the market players, who understand better the needs of investors, or to be allowed to develop naturally as Islamic practices and products gain critical mass." Lane, "IIFM to Start Work on Islamic Standardization". See generally Oakeshott, M. J., *Rationalism in Politics: and Other Essays* (Methuen, 1962), at 26.

[56] El-Gamal, M., "Limits and Dangers of Shari'a Arbitrage" in Ali, *Islamic Finance: Current Legal and Regulatory Issues* (2005), at 127.

[57] El-Gamal, "Limits and Dangers of Shari'a Arbitrage", 130, 128. A general call for the building of an Islamic financial system based on the establishment of agreed principles can be found in Moghul and Ahmed, "Contractual Forms in Islamic Finance Law", 193-194. See also El Diwany, T., *The Problem With Interest*, 2nd ed., (Kreatoc Ltd., 2003). Other articles by this author, along the same lines, can be accessed at: http://www.theproblemwithinterest.com/pwi_articles.htm (last visited 2 May 2007).

[58] Siddiqi, M. N., "Social Dynamics of the Debate on Default in Payment and Sale of Debt", in Ali, *Islamic Finance: Current Legal and Regulatory Issues* (2005), at 116. See also the description and defence of "traditional" techniques in DeLorenzo, Y. T., "The Religious

*The Uncertain Sharia: A Counterbalance*

One must also add that the concerns expressed above, concerning the alleged uncertainty of the sharia, are arguably exaggerated. Some would claim that, although there might be a greater degree of uncertainty in Islamic finance than in, say, many areas of English law, the sharia was a relatively uniform and practical system. On the latter point, for example, Professor Hanna has demonstrated, by her research into 17th-century court records, that the merchants of that time made extensive use of the legal system in their business.[59] As regards the multiplicity of schools, solutions do exist, such as that adopted in the classical period of allowing the users of the system to choose their law. In 1265, Sultan Baybars appointed one chief *qadi* for each of the four main Sunni schools and, by the second half of the 14th century, many towns had the same system.[60] Professor Hanna's research shows that Cairo merchants would select the school most suited to the transaction in question. There is nothing to prevent participants in Islamic finance from doing something similar. They could choose the law of a particular school, the law of a Muslim-majority jurisdiction such as Saudi Arabia, a set of standards such as those drafted by AAOIFI,[61] or arbitration combined with a choice of the sharia as the governing law.[62] And diversity can actually be an advantage, providing a choice of solutions and thinking.

One can also argue that the need to make the surrounding "enforcement/host" legal systems function in such a way as to facilitate Islamic

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Foundations of Islamic Finance", in Archer and Abdel Karim, *Islamic Finance: Innovation and Growth* (2002) at 26-27.

[59] Hanna, N., *Making Big Money in 1600: The Life and Times of Isma'il Abu Taqiyya, Egyptian Merchant* (Syracuse University Press, 1998).

[60] See Rapoport, Y., "Legal Diversity in the Age of Taqlid: the Four Chief Qadis under the Mamluks", (10) *Islamic Law and Society* (2003), 210.

[61] Bälz, "Islamic Financing Transactions in European Courts", pp 73-74; Anon., "Shari'a Law as Governing Law for Financial Transactions". The adoption of the law of a Muslim-majority jurisdiction has some potential advantages, such as being the law of a "country" for the purposes of the Rome Convention, but it might be problematic for some participants. For example, Saudi law is based on the Hanbali school alone, Omani law is Ibadi.

[62] See Art. 28(1) UNCITRAL Model Law, discussed by Bälz. "Islamic Law as Governing Law under the Rome Convention", at 44. See also s 46(1)(b) Arbitration Act 1996 which seems to allow the recognition of Islamic law: "The arbitral tribunal shall decide the dispute [...] if the parties so agree, in accordance with such other considerations as are agreed by them". Recall, however, the disadvantages already mentioned of arbitration in financial disputes.

finance is more pressing than the need to expend considerable efforts on the international setting of standards. Such disincentives as double stamp duty on Islamic mortgages (recently abolished in the UK),[63] and poorly developed real estate, insolvency, and other regimes, can be more significant barriers in practice than the uncertainty of the sharia, and can lead to a greater lack of uniformity across jurisdictions than that created by divergent interpretations of the sharia itself.[64]

In addition, it is worth noting that the sharia is not alone in experiencing uncertainty. English finance lawyers will recall the many years of controversy surrounding the key issues of charges over bank balances, and the status of charges over book debts before the House of Lords decisions in *BCCI (No 8)* and *Spectrum Plus*.[65] What would English commercial lawyers have thought of a non-English court pre-*Spectrum Plus* deciding that the English law on the matter was so uncertain that a choice of English law could not be supported?

## Conclusion: An Emergent Legal System

The search for certainty and uniformity in the adaptation of the sharia for modern financial purposes has played a major part in the formation of a new, rapidly developing transnational legal system. This is something which few, if any, commentators have noticed—at the Sixth Forum, no paper, panel discussion, comment or question from the floor mentioned it. The reason, no doubt, is that it is difficult for those market participants deep within the wood to see anything other than the trees.

Looked at from a Western, positivist perspective, that legal system appears rather strange, for there are no signs of the usual Western sources of law, i.e. legislation and case-law. However, it does have norm-creating mechanisms. The institutional creation of "standards", the collecting of *fatwa*s, the organic forces mentioned above, including such processes as the consensus of scholars, standard documentation, and the search for guiding principle: all are creating certainty and uniformity in legal rules.

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[63] Finance Acts 2003 and 2005.

[64] Thanks to Antony Dutton for pointing this out.

[65] *Bank of Credit and Commerce International SA (in Liquidation) (No 8), In Re* [1998] AC 214 (HL); *National Westminster Bank PLC v Spectrum Plus Limited and Others* [2005] UKHL 41, [2005] 3 WLR 58 (HL).

Indeed, similar mechanisms are familiar to the Western lawyer used to dealing with market practice, terms drafted under the auspices of such bodies as the International Swaps and Derivatives Association, Inc. (ISDA), or the International Chamber of Commerce (ICC), law firm standard documentation, "settled understanding", and QC's opinions. The norm-creating mechanisms of the new system can be enforced either through host systems, such as English or Malaysian law, or via arbitration. Such a combination of norm-creating and enforcement mechanisms can, it is submitted, justifiably be called a legal system, "an operating set of legal institutions, procedures, and rules".[66]

Further evidence can be found in the similarity of the issues encountered in this system and those encountered in other, notably Western, legal systems. The Islamic finance principle/tradition debate resonates strongly with the constant tension between traditionalists and reformers in the common law. Organic evolution and institutionalised development are familiar processes to the Western lawyer and student of comparison between the common and civilian law traditions, as are the disagreements as to their relative merits. Questions relating to the independence of arbiters (sharia board members in Islamic finance, judges in Western systems) are also common to the civilian law, common law, and Islamic finance systems.[67]

It should go without saying that the system is still in the early stages of development, hence the adjective "emergent" in the title of this article. The emergence is, however, a significant step in the maturing of the law, and, in order to further the maturation process in a more sophisticated manner, lawyers involved in the field need to recognise the phenomenon for what it is, and adapt their methodology accordingly.

That methodology has so far been in line with the state of development of Islamic finance until very recently. Since it was a minor, specialist field in the early stages of evolution, the natural tendency was for financiers to view the relevant law as just another technical, albeit important, step in the

[66] Merryman, J. H., *The Civil Law Tradition: An Introduction to the Legal Systems of Western Europe and Latin America*, 2nd ed., (Stanford University Press, 1985) 1. See also the definition of "system" in *The Shorter Oxford English Dictionary* (3rd rev. ed.): a "set or assemblage of things connected, associated or interdependent, so as to form a complex unity".

[67] The fact that the activities which make up this trend are relatively unconnected, and the absence of a grand plan, or an authoritative body, do not detract from the force of the argument. Systems do not have to be planned.

process, and for lawyers to regard it as a variation on the theme of banking law, undertaken as an addition to more significant parts of one's practice.

In this regard, it is telling that the usual word employed in discussions of the phenomena described above, which in fact constitute the initial stages of the creation of a legal system, is "standardisation", very much a financier's term rather than a lawyer's. Also revealing is the way in which legal discussions are dealt with, as one item in a list of papers on a phenomenon, something clearly seen by looking at any conference programme or book, as is the fact that many non-lawyers write on legal matters.[68] The attitude can also be seen in the terminology. Until very recently, we have always spoken of "Islamic finance" or "Islamic banking"[69] when referring to legal matters, rather than "Islamic finance law", a term which is still very rarely used.[70]

In other words, the legal aspects of Islamic finance have not yet been considered to constitute an independent subject. However, with the growth in the importance, maturity, and complexity of the field, and as more and more lawyers specialise in the area, that approach is starting to look outdated. The time has come for a conscious recognition that the phenomena described above are more than a set of disparate events, that they are the beginnings of a system. The time has also come for an acknowledgement that a new area of legal studies has emerged: Islamic Finance Law.

[68] Which some do with great skill, of course.

[69] Strictly speaking, this term is best avoided, since the word "bank" has, for purists, connotations of *ribawi* transactions.

[70] There are exceptions, such as the titles of two items cited above, "Unified Islamic Finance Law", and "Contractual Forms in Islamic Finance Law".