

# “Islamic Finance”

## Arbitraging the Ancient Law

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# The Islamic Canon on Financial Transactions

## Echoes Familiar Earlier Religious Injunctions

### The Qur'ān – Scripture on financial affairs

- Mandates mutual consent, fair dealing, documentation of debts
- Encourages charity and moderation in saving/spending
- Discourages asceticism, greed/materialism & hypocrisy/deception
- Forbids injustice, theft, and *riba* (main focus of juristic discourse)

### The Sunna – Oral Prophetic Tradition

- Echoes, elaborates on, and explains all Qur'anic injunctions
- Provides examples and extends the scope of forbidden *riba*
- Forbids various forms of deception & avoidable uncertainty: *gharar*
- **No formal definitions are given for prohibited *riba* and *gharar***

# Ancient Prohibition of Usury/*Ribīt*

## Exorbitant or Any Interest?

### Early prohibitions – Built-in arbitrage opportunities

- Code of Hammurabi (ca 1760 BC) imposed interest rate ceilings at 33% and 20% (for in-kind loans)
- Aristotle: capital is not a valid factor of production, money is sterile

### Judeo-Christian prohibitions – Prohibition of interest-based lending

- Exodus [22:25], Leviticus [25:35-7], Deuteronomy [23:19-20], *Bava Metzia*, Chapter 5, *Mishna* 2
- Luke [6:27-36], Benedict XIV (*De Synodo Diocesana* X.iv, m.6), First Council of Carthage (345) through Fourth Council of the Lateran (1215) and beyond



# Arbitrating Judeo-Christian Prohibition of Interest/*Ribīt*

## The *heter iska* – (investment contract)

- Silent-partnership contract with “profit” as a fixed percentage
  - Add provisions to assure that only relevant risk is credit risk
- In *Barclay Commerce Corp. v. Finkelstein* (1960), the Appellate Division of the New York Supreme Court found the *heter iska* to be “... merely a compliance in form with Hebraic Law...”

## The Medici bill-of-exchange – solution to Church ban on interest

- de Roover, R. *The Rise and Decline of the Medici Bank 1397-1494*:  
“Around July 15, 1441, the Medici of Venice bought a bill on Bruges at the rate of 54 1/2 groats per Venetian ducat ... With the proceeds of this bill ... bought a bill on Venice, payable at the end of two months, at the rate of 51 1/2 groats per ducat. The Medici of Venice thus made a profit of 3 groats on each ducat over a period of four months ...”



# Good Financial Jurisprudence: Form Serving Substance

## Coherent Classical Jurisprudence – ibn Qayyim and ibn Taymiyya

- ibn Qayyim Al-Jawziyya (ca. 1340): “The demarcation in contracts is based on [economic] substance and not on forms and structures.”
- ibn Taymiyya (quoted by ibn Qayyim): Shari‘a would not forbid one transaction and permit another that is more harmful
- ibn Taymiyya (ca. 1300): *Gharar* is unavoidable in exchange, prohibition (excessive *gharar*) decided by cost-benefit analysis

## Coherent Contemporary Jurisprudence – Khallaf (1972)

- “Benefit analysis and other legal proofs may lead to similar or different rulings . . . In this regard, maximizing net benefit is the objective of the Law for which rulings were established. Other legal proofs are means to attaining that legal end [of maximizing net benefits], and objectives should always have priority over means.”

# Rent-Seeking Contemporary Jurisprudence

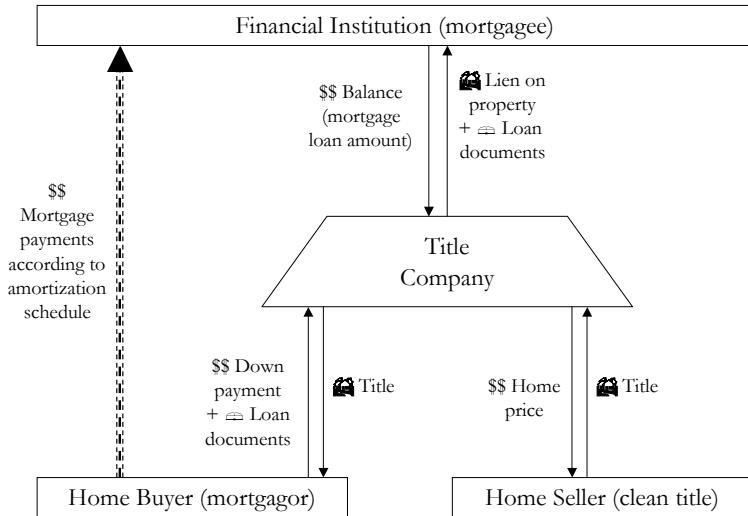
## HSBC Amanah – Shari‘a FAQ (2007)

- “Consider the example of a Muslim butcher . . . there is no reason for him not to benchmark his prices to that of conventional Chinese butchers selling **the same meat that is not halal**. After all, he is **providing the same function** as a conventional butcher, and **seeks similar revenues and profits**. Now you may wish that he priced his goods independently of haram (prohibited) meat, but **you cannot conclude that the meat he sells is no longer halal.**”
- “The HSBC Amanah Shariah Supervisory Committee has approved the utilisation of conventional capital for the purposes of Shariah compliant financing while restricting the usage of funds in generating Islamic assets only.”



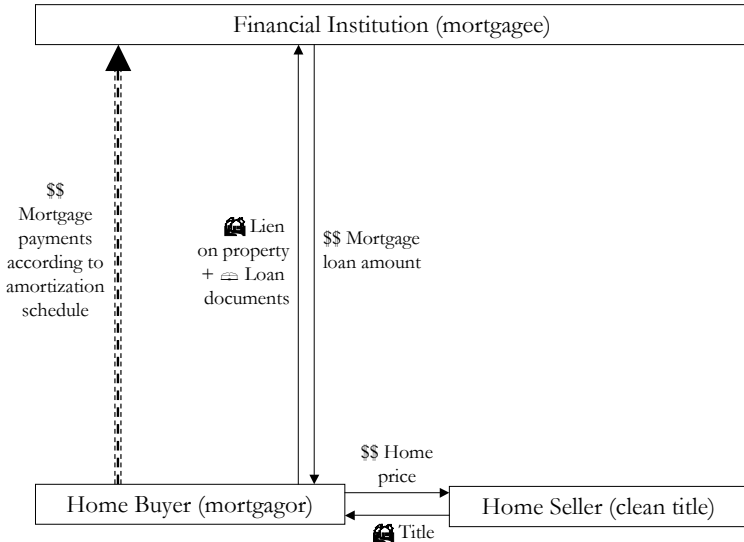
# Example 1: Actual Mortgage Transaction

'Legal Title to House' for Money, NOT Money for Money



# Example 1: False Interpretation of Mortgage Transaction

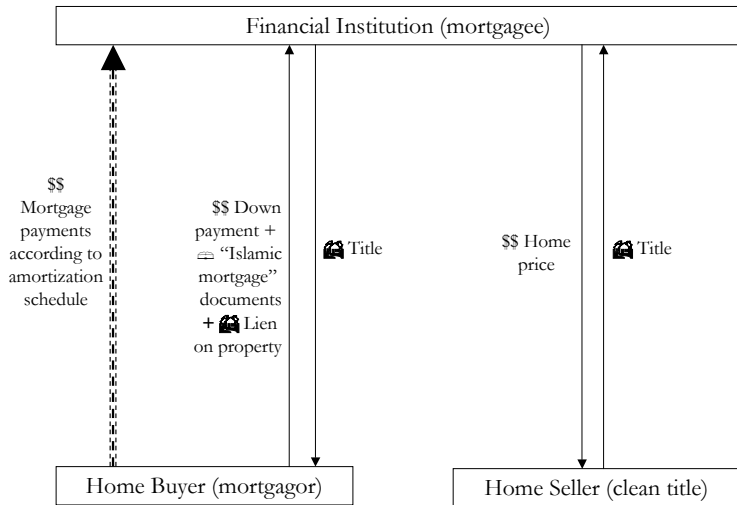
Under Islamic Law, Borrower Would Own Lent Money – not the case in mortgage ‘loan’





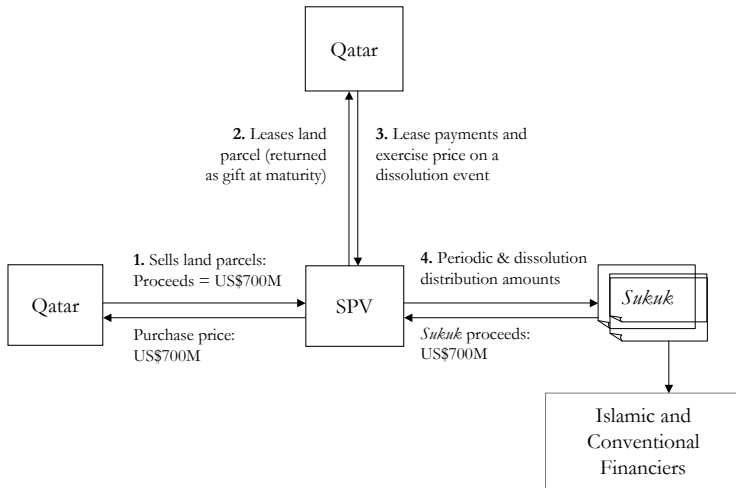
# Example 1: Inefficient Alternative for Mortgage Transaction

Note – Forbidden in Rabbinic Analysis: Interest in Credit Sale is still *Ribī*



## Example 2: Islamic Bonds (*Ṣukūk*)

Note – Inefficient Design Introduces Numerous Unnecessary Legal and Economic Risks



SPV: Qatar Global *Sukuk* QSC

Land Parcel: Land in Doha designated for the development of Hamad Medical City

# Three Steps of Contract-Based Shari'a Arbitrage

## Step 1: Prohibition – Creating market demand

- False analogy (food) to forbid conventional practice (mortgage fin.)
- Example: claim that *riba*  $\equiv$  interest, and all “loans” are *qurūd*

## Step 2: Bundling & Unbundling – Providing supply

- False analogies to synthesize practice with premodern contracts
- Simple financial engineering tricks unbundle desired components
  - Reduced efficiency marketed as piety: “cost of being Muslim”

## Step 3: Separation – Establishing the “Islamic” brandname

- Abuse nominate contracts + authentic-sounding Arabic names
- Appeal to sacred authority of “scholars,” classical & contemporary