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Reforming the Methodology of Product Development in Islamic Finance

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Abstract

It is commonly observed that the current methodology of product development in Islamic finance has failed to reflect the productive nature of Islamic economics. This is evidenced by a number of current products being substantially undistinguishable from their conventional counterparts according to the commonly-held views. Reform in this regard, if to be undertaken, must not overlook the positive and sound aspects of the current methodology used for product development, since this methodology has undoubtedly yielded some good products and helped fulfill basic Sharia requirements in transactions. As such, the following methodology needs to be adopted. First is to identify the necessary Sharia elements in any product structuring in terms of both form and substance, with a special emphasis on the ones that reflect the special constructive nature of Islamic finance. Second is to group these elements according to their observance in the current structured products. Having identified the neglected Sharia elements, the article will then examine the reasons behind their negligence, whether it is for necessary and unavoidable factors or just for ease pursuance. In light of the findings, the article will either consolidate the current methodology adopted for product development, or propose and lay down the basics of a new one that upholds the unjustifiably neglected Sharia requirements.

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Introduction

The necessary Sharia elements in product structuring

Sharia dictates that in any structure, the underlying contract must fulfill the Sharia requirements in contracts. Some of these requirements relate to the contractors, like being eligible to initiate agreements and being possessors of the necessary legal capacity. Others relate to the contract itself being independent and unconditional on the occurrence of something else. The subject matter of the contract needs also to be in line with the Sharia, most importantly being permissible itself and meant for permissible use. Having fulfilled all the structural requirements, the contract must also harmonize itself to meet, or at least not to be in conflict with, the objectives of Sharia, since an apparently valid contract may be misused to reach an evil end, or its implementation may result in causing serious harms and negative impacts. Therefore, it is indispensable to distinguish in Sharia validation of contracts between two elements, the form of the contract and the substance of the contract. The first relates to the structure of the contract, and the second relates to the essence, spirit and implications of the contract. Both are equally important and essential in product development; however, this equation has not been fully observed in many of the developed products. The balance has been obviously tilted in favor of the form of contracts at the expense of their substance.

The following discussion will posit the importance of not compromising the contract substance when structuring products, and will identify the forms through which contract substance has been compromised and neglected in some of the already developed products.

The relationship between form and substance in contracts

- The maintenance of the form and the negligence of the substance has been the major problem in structuring and developing Islamic financing products. A careful study of the literature of Islamic law leads to discovering the fact that in contracts, the form is meant to protect the

substance. In many *Fiqh* applications, it is noticeable that schools of Islamic law have somehow compromised some aspects of the contract's form but never compromised the contract's essence or spirit.This [1] implies that jurists viewed the form as something not meant for itself but rather to help protect the essence of contracts and agreements. Some modern practices of Islamic financing product development have implied the opposite; taking care of the form and neglecting the substance of contracts. This negligence of contract substance is manifested in different forms as explained in the following discussion.

- Negligence of the contract substance by the deactivation of some contract rules

No doubt that any contracts' rules and conditions are meant to enable the contract to serve its purpose in fulfilling the contractors' needs in a just, positive and productive manner. This explains why contractors in Sharia are not allowed to make personal stipulation that may harm others' rights (Ibn Qudamah, 1982, p. 4/167). Naturally, a contractor, when given an absolute right in making stipulations, will try to turn the scale to his favor even if at the expense of the other. However, in some cases we find, especially in *uqud al-ez'an* (contracts of subjection) where only one party of the contract formulates the contract, that some contracts rules relating to the rights of the other contractor are indirectly neutralized by adjusting some existing clauses or incorporating new ones, as in the following example.

Example: Ijarah Muntahia Bittamlik[2]

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[1] For more details on this matter see Abozaid, A. A. (2004). *Fiqh Al-Riba*, (p. 367).

[2] This type of *Ijarah* is not found in classical books of *Fiqh;* it is a creation of the modern day jurists. It comprises two different contracts: contract of leasing (*ijarah*), and contract of sale (*bay'*). Bank promises the client that upon the successful completion of the Ijarah, bank will sell the asset to the client at a nominal price, or will gift it.

Being basically a contract of lease, *Ijarah Muntahia Bittamlik* in the Islamic banking application is supposed to fulfill the following basic Sharia structural conditions:

- The leased asset requested for financing is valuable from Sharia perspective and not declared by the client to be used for Haram purposes. This would exclude for example financing clients in acquiring machineries that process tobacco products.
- The leased asset is clearly identified by the parties, and the rent is specified in the contract. If there is *gharar* (uncertainty) in the contract, then it must be minor, since the excessive *gharar* invalidates the contract.
- The leased property remains in the ownership of the lessor for the duration of the *Ijarah* period, and then it is transferred to the lessee by virtue of a completely independent contract, like a sale or gift.
- The bank, as lessor, bears all the liabilities that are normally associated with ownership, like property taxes and major maintenance required for keeping the asset valid for usage by the client.
- The lease period commences from the date on which the leased asset has been effectively delivered to the lessee (Al-Shafi'i, 1973, p. 3/14). [3]

These are the basic rules of *Ijarah Muntahia Bittamlik*, and a theoretical investigation of any of its contracts in Islamic banks will prove consistency and full abidance. However, some apparently-valid clauses are added to this contract, leading to the deactivation of some of these basic rules and thus to the negligence and distortion of the *Ijarah* essence. One clause relates to the division of lease rental into three elements: fixed, variable and complementary.

[3] This ruling has been agreed upon by the remaining schools of Islamic law. References include: Ibn Abedeen, I.A. (1987). *Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar*), (p. 4/88); Al-Kasani, K.H. (1982). *Badai' Al-Sanai'* (p.5/67); Al-Bahuti, M.M.(1995). *Kashaf Al-Qina'*, (p. 3/53); Al-Dasuqi, A.H. (1985). *Hashiyah* (p. 3/143).

The problem, however, lies with the complementary rent and to a certain extent with the variable rent. The complementary rent represents any cost the bank as owner has incurred in the past *Ijarah* period. The cost includes taxes, insurance and major maintenance expenses. Although these are supposedly the responsibility of the bank as owner, the bank after paying them claims back, under this clause, from the client the same amount by adding it up to the next *Ijarah* rental.

Obviously this paralyzes and renders ineffective the in-contract Sharia rules pertaining to the liability of the owner in *Ijarah* for the property risks. In fact, this practice of effectively shifting property risks to the lessee is especially critical in the application of *Ijarah Muntahia Bittamlik* since it brings this financing instrument closer to conventional financing after removing the justification for profiting, which is based on the notion of "*al-Kharaj bid Daman*"[4] (liability justifies the gain). The core difference between Riba and trade remains the risk taking which is normally associated with trade. This risk taking is totally eliminated when the bank indirectly shifts the leased property liabilities to the client, and even in case of property partial or total damage, it is the client who bears it as he is the one who effectively pays the insurance premiums without a real recourse to the owner.

On the other hand, the problem with the variable element of *Ijarah* rental relates to the uncertainty this practice involves. Banks tie this element to an interest rate benchmark like LIBOR. The problem starts when banks do set and cap only one end of this excessively volatile benchmark, i.e. its floor. However, a ceiling needs also to be set and capped at a certain figure in order to minimize the *gharar* then involved and thus maintain the validity of the contract. Nevertheless, banks tend to only protect themselves from the undesirable movements of the benchmark by capping the minimum amounts payable by

[4] "*Al-Kharaj bid Daman"* is originally a Hadith narrated from the Prophet Muhammad (peace be upon him); however, it was recorded as a *Fiqh* maxim by Al-Soyoti, J. D. (1980) in his "*Al-Ashbah Wal Naza'ir*", (p. 154).

their clients and have no desire to cap the maximum amounts payable by their clients. This practice creates excessive *gharar* and opposes the Sharia requirement to determine the lease rental in any Ijarah contract, not to mention the injustice involved therein.

Moreover, the above deviation from *Ijarah Muntahia Bittamlik* rules manifests itself more blatantly when the asset leased in *Ijarah Muntahia Bittamlik* has been originated from the same client. A client who needs cash or refinancing will be instructed by the bank to sell to it an asset or a common share thereof, then to lease it back from the bank through *Ijarah Muntahia Bittamlik*. The bank frees itself from all asset liability in the manner described above and the client repays with a markup the financed amount in form of rentals. This transaction has been widely used recently to enable banks to restructure non-performing debts in the wake of the recent financial crisis.

Thus, we see how the same clause in one contract can be neutralized by another, leading eventually to the distortion of the contract substance and thus to stripping the contract of its Sharia spirit and objective. Although Islamic finance has developed *Ijarah* contract into a new model and helped maintain most *Ijarah* rules in this creative instrument, it has however left a room for individual Islamic banks to twist the substance of contract and deprive it of its nature as a lease contract.

Negligence of the contract substance by attaching another contract

Contracts of financial transactions in the Sharia are meant to fulfill the various needs of contractors, like acquiring an asset, acquiring an asset's usufruct, investment of capital and delegation of authority. However, it can be observed that some of these contracts are driven totally out of their objectives when they are predetermined to be followed by other reversing contracts.

Murabaha[5], which is a sale contract originally designed in its banking application to finance clients in their acquisition of assets, is used for a different objective altogether. It is used to provide clients with cash money through colluding to sell them assets on *Murabaha* basis then to sell the same assets on their behalf in the market for cash price. Clients get the desired cash and remain indebted to the bank for the *Murabaha* deferred price. Here we have two independent sale contracts each of them is independently lawful but the end result of executing them consecutively is a cash financing technique whose substance is effectively no different from conventional cash financing. Obviously, the result of this transaction is against the essence of the *Murabaha* sale contract. *Murabaha* in this transaction does not lead to real holding of asset ownership by the client. This is a deviation from the objective and substance of *Murabaha*, which is a commodity financing instrument that helps clients own their desired assets.

Negligence of the contract substance by misapplication

Contemporary collective fatwas have helped structure many products that are essential for the operation of Islamic financial institutions. However, the misapplication of some of these products may have caused them to deviate from what they were originally designed for. A good example would be using for speculation what was designed for hedging.

Islamic finance has developed certain tools to hedge against some inevitable excessive market risks. These tools include unilateral binding promises and tools whose underlying contracts are *Salam*[6] contract and *Urbun*[7] sale. Now, a part from the Sharia debate over the validity of these tools to be used as hedging

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[5] *Murabaha* in the banking application is a sale contract preceded by an agreement with client to buy the desired commodity from its supplier then to sell it to the client at the cost plus a markup (*murabaha*).

[6] *Salam* is the sale of future delivered goods against upfront paid price.

[7] *Urbun* is a sale with the condition that buyer has the right to revoke the agreement in return of forfeiting the advanced down payment, which is called *urbun*. If, however, the sale is concluded, then the *urbun* advanced is deemed as part of the price.

instruments in contemporary Islamic finance or Islamic capital market, some of these tools have been misapplied and used for speculation as well, although speculation was considered an invalid domain in what is known as "Islamic derivatives".

Recently one Islamic financial institution has offered a product whose structure is basically as follows: The client opens a designated investment account with the bank. The bank operates the designated account in its capacity as investment manager. The Investment Manager then uses the amount deposited in the said account to purchase Sharia compliant assets at some prevailing market prices. In most cases the assets will be shares selected from an Islamic stock index.

The client gives a unilateral promise to the bank to sell the shares at a predefined price called the "Settlement Price". The bank in return gives a unilateral promise to the client to buy the shares at the Settlement Price.

The settlement price relates to the performance of some specified underlying reference asset (the "Reference Asset", which could be an index) rather than to the performance of the Shares in the Islamic Account. Thus, two scenarios are perceived:

Scenario I: The value of the relevant shares goes higher than the value reflected in the performance of the Reference Asset. In this case, the bank can purchase the relevant Shares from the client at a price lower than the market value for such shares at that time. Thus, the bank would hold the client to his promise, while the client would not be interested in holding the bank to its promise as selling the shares at a value which is lower than the market value at that time would incur a loss.

Scenario II: The value of the relevant shares goes lower than the value reflected in the performance of the Reference Asset. In this case, the bank can purchase the relevant shares from the client at a price higher than the market value for such shares at that time. Naturally, the bank in this case would not be interested in holding the client to his promise while the later would hold the bank to its

promise, since he can then sell the relevant shares at a value higher than the market value for such shares at that time.

Therefore, in both scenarios noted above the client will sell the relevant shares to the bank for the settlement price, as agreed, on the basis of the performance of the reference asset. This sale is certain since it will serve the interest of either the bank or the client. The certainty of this sale makes the mutual promise to execute the sale biding on both parties and thus the promise would be tantamount to a forward sale contract, which is unlawful.[8]

Obviously the substance of this transaction is hardly distinguishable from that of any conventional derivative with the speculation element embedded therein; both contractors are speculating on the movement of the value of the reference asset, which is mostly an index. It is very likely that such a structure may even develop to involve financing the client to purchase the shares, then settling the deal with the loser of the two parties by merely paying the price difference.

In conclusion, this transaction involves a misapplication of promise which can originally function as a hedging tool for risk mitigation, and cannot be used for speculation.

Reasons for neglecting the contract's substance in some Islamic financing products

A direct examination of the Islamic banking market conditions, challenges and products identifies the following reasons for any deviation from the true rules of Sharia.

1. **The desire to offer the same financing facilities of conventional banks**

Conventional Islamic banks treat money as commodity, therefore they have no problem in providing cash financing with profit to clients. This cash financing

[8] It is unlawful in the Sharia to initiate a sale contract whereby both counter values are deferred to the future.

can take the form of personal loans, over draft facility or refinancing, all through interest-bearing loans. However, since lending money on interest is haram, the Islamic banks willing to offer these profitable financing facilities had to design certain products that would serve such purposes. Logically, the designed products would necessarily lose Sharia spirit and breach contracts essence because they are basically meant to fulfill unlawful objectives, i.e. profiting from providing cash to clients. The structured products relied on bogus operations of selling and buying commodities, using mostly the highly controversial *eina* and *tawarruq* sales as their underlying contracts[9]. In fact, sale contract is basically designed to help people acquire commodities for their own use or to resell them and make profit, but it is not designed to justify unlawful dealing in cash by buying expensive and selling cheap simultaneously. This is a deviation from the purpose of the sale contract and a defeat of the purpose behind Riba prohibition. If engaging in cash financing with a mark-up through the technicalities of sale contracts like eina or tawarruq is halal, then the whole purpose behind Riba prohibition will be defeated. Any two willing to deal in loans with a return would simply do so through eina or tawarruq-like sale contract, the end result being exactly the same.

2. The unwillingness to bear genuine property/contracts risks

Being financial institutions, Islamic banks tend to avoid as far as possible the risk that is normally embedded in the Sharia contracts used in products structuring. This avoidance of risk may lead to depriving contracts of their

[9]*Eina* is a sale of commodity then immediately buying it back from the same party at a higher or lower price in order to justify exchange of cash with increment. *Tawarruq* serves the same purpose as the financier of cash sells a commodity to the client on credit then sells on his behalf to a third party for cash price. For more details on these sales see Abozaid, A.A. (2004). *Contemporary Eina is it a sale or usury"* (p. 5); Abozaid, A.A. (2010). Contemporary Islamic Financing Modes between Contracts Technicalities and Shari'ah Objectives. *Journal of Islamic Economics Studies, Islamic Research and Training Institute, Islamic Development Bank*, 17-2.

Sharia identity and rendering them spiritless. The application of *Ijarah Muntahia Bittamlik* in the manner described earlier is an example. The liability risk related to the ownership of the leased asset is effectively transferred from the bank to the client and thus the essence of the lease contract is distorted. *Murabaha*, which is a financing instrument which helps the clients acquire commodities, is another example when the bank frees itself from the *Murabaha* commodity liabilities. Neglecting the sale essence in *Murabaha* product is at its peak when the *Murabaha* client is appointed as the bank's agent to buy the commodity from its supplier, take delivery then deliver to himself, without the bank being responsible for even the commodity defects or claim. In this scenario the bank's role is limited to only extension of money to the property supplier, thus mimicking the limited role of conventional banks.

3. **Legal constraints facing the right application of Sharia rules in products**

In some countries the legal system stands as a stumbling block to the proper application of Sharia rules required for product structuring in Islamic finance. Some Islamic banks for example find it inescapable to make the purchase appear in the client's name, because according to some laws, banks are not allowed to trade in assets. Others are prohibited from leasing assets to clients and therefore they are left with no choice but to dodge and execute *Ijarah* in the form of sale. Imposing high taxes on registration of assets purchased is also a legal constraint as it eventually leads to increasing costs on clients when banks are commanded by law to register in their names what they buy before they sell to clients. Some banks tend to avoid payment of high taxes by reducing some necessary contractual steps or faking some contracts.

Are these reasons justifiable?

No doubt that legal constraints can justify some leniency and indulgence when necessary; however, Islamic banks have no excuse to follow the example of conventional banking offering the same products regardless of whether a

particular product is *Islamizable* in spirit or not. Islamic banks have to acknowledge the fact that not all conventional products can be Islamized, and that any attempt to this effect will yield nothing but a product borrowing its legitimacy from adherence to mere technicalities and meaningless structures. The avoidance of inherent risks to the degree of twisting contracts and deforming their nature is not justifiable either. In fact, it is necessary for Islamic banks to note that they become distinguished from conventional banks only when they genuinely submit to Sharia rules and maintain the nature and essence of Sharia contracts. The mere maintenance of contracts technicalities and terminologies does not render contracts in compliance with the Sharia rules. This issue is particularly important since Islamic banking derives its credibility from the declared full adherence to Sharia rules; therefore, compromising this notion, unless it is extremely necessary, is never justifiable.

Conclusion

The proper methodology for product development

It has become obvious from the past discussions that for a proper structuring of a product under Islamic finance, three aspects of the product must be well taken care of.

First is form, and form relates to fulfilling the Sharia basic structural requirements and conditions in contract and contractors. A contact whose form is invalid produces no legal consequences and is considered as null and void.

Second is substance, and it is concerned with the essence and the spirit of the structured product, especially when more than one contract or element is involved in the product, since this may yield a controversial product as is the case with *eina* or *tawarruq*. Two sale contracts are involved herein, each is independently valid in essence, but the total outcome of having them consecutively executed is a highly controversial cash financing product.

Third is the implication of the structured product that has passed the form and substance test. The structured product must not lead to evil or have unfavorable or negative implications. Just like selling weapons to a criminal, or grapes to a wine maker, does not comply with Sharia although the contract itself may have fulfilled all of its structural conditions, an Islamic banking product cannot be truly labeled Sharia compliant unless it is free from evil implications. For example, in the absence of sufficient controlling measures on shares trading in the stock market, this market may become an arena for gambling and zero-sum games; therefore, developing a financing product that helps finance clients willing to participate in such market becomes haram, although the product itself may be sound in its structure and essence.

In other words, for a product to be rightly labeled as Sharia compliant the underlying contract and tools used in its structuring and developing must be valid in form and essence, and the usage and implementation of the developed product must also be in line with the Sharia rules and principles. Reexamination of the current Islamic banking and finance products in light of this elaborated criterion is deemed extremely necessary, since there exist among the current Islamic banking products ones which have successfully fulfilled the Sharia requirements in terms of form, but unfortunately failed to fulfill that of substance or implications.

On a final note, the recent trend of distinction in product development between a Sharia compliant product and a Sharia based product is inaccurate and lacking Sharia bearing. What complies with the Sharia is only what is halal, and a contract that is structurally valid but eventually leading to an unlawful end can never be regarded as halal. In other words, when we say that something is Sharia compliant, it means that it fits within the Sharia rules and principles. But how would a product that carries the same economic evils of Riba or gambling fit within Sharia set of rules and principles even if it has a valid structure!?

If a distinction is ever made in Sharia contracts acceptability, then it is the juristic distinction between the two legal terms within the framework of Islamic law: valid and permissible. A valid contract is the one that has a valid form regardless of the validity of its purpose or the contractors' intention. Conversely, a permissible contract is the one that has a valid form, purpose and objective. Obviously, a valid contract is not necessarily permissible since a contract can be structurally valid but it is conducive to evil or meant by contractors to reach an unlawful end, like selling weapons to a criminal or executing a series of sales to legalize Riba like in eina. This distinction between *valid* and *permissible* corresponds in fact to the issue of form, essence and implication of contracts. "Valid" relates to form, while "permissible" according to all schools of Islamic law[10] relates to contract essence, implication and intentions of the contractors.

Therefore, a contract is acceptable to Sharia, or is compliant with the Sharia, only if it is valid and permissible, since both concepts are necessary elements of Sharia clearance, and Sharia does not admit a contact or a structure that is invalid in essence or implications.

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[10] This principle based on the well-known Fiqh maxim "Contract are judged by their essence and meaning, not by their form and structure", which is originally derived from the famous *Hadith* "matters are determined by intention". (This *Hadith* was narrated by Omar bin Al-khattab as in Al-Bukhari, I.A. (1984), (p. 1/3, *Hadith* No1); Muslim, M.S. (1990), (p 3/1515, *Hadith* No 1907); Ibn Nujaim, Z.N. (1989) *Al-Ashbah Wal Naza'ir,*(P. 1/34); Al-Seyoti, J.S. (1980), *Al-Ashbah Wal Naza'ir,* (p.21); Al-Kurdi, A.K. (1988) *Al-Madkhil Al-Fiqhi*, (p.33).
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