Centre for Banking & Finance Law
Faculty of Law

# Muslim Law Practice Committee Seminar: "Introduction to Islamic Finance"

*Seminar by Asst Prof Arif A Jamal[1], Ms Ferzana Haq[2] and Mr Zhulkarnain Abdul Rahim[3] at the Finexis Building, 108 Robinson Road, Singapore, 11 November 2014*

## Seminar Report

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This report is based on the seminar organized by the Muslim Law Practice committee of the Law Society of Singapore entitled "Introduction to Islamic Finance", held on 11 November 2014. The seminar was conducted by three panelists: Assistant Professor Arif A Jamal from NUS Law, Ms. Ferzana Haq from HS Legal and Mr. Zhulkarnain Abdul Rahim from Rodyk & Davidson LLP. The seminar consisted of two presentations, the first by Arif Jamal and the second by Ferzana Haq, and then a discussion session moderated by Zhulkarnain Abdul Rahim. Research assistance for this report was provided by Ahmad Faizin bin Muhammad Ariffin (NUS Law, Class of 2016).

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**Report on the Muslim Law Practice Committee Seminar "Introduction to Islamic Finance"**

As the Islamic banking industry continues on its trajectory growth worldwide, there will inevitably be an increase in the number of cross-border transactions and disputes involving Islamic finance. In such cases, the Shariah-compliance of such transactions will be closely examined. The increasing globalized nature of the industry means that any decisions made by the forum in a particular jurisdiction may have repercussions, not only on the industry practices within that jurisdiction, but also on how Courts in other jurisdictions decide similar issues in their own jurisdiction.

What are the key features and principles behind Islamic finance? What is the approach that has been taken by courts in certain jurisdictions in respect of matters involving Islamic finance? What are some of the practical and legal issues that have to be considered in dealing with Islamic finance transactions?

## I. Islamic law and Islamic finance

The particular norms and rules relating to Islamic finance emerge out of the context of Islamic law more generally. Thus, underlying Islamic finance are the concerns, issues, sources and methodologies of Islamic law. The relevant sources include the text of the Holy Qu'ran, which is the most important source of the law, and the Sunna (or traditions) of the Prophet Muhammad. To these may be added other classical 'roots' of the law such as the use of analogical reasoning (*qiyas*) and the impact of scholarly consensus (*ijma*). These sources and juristic devices have resulted in a vast interpretive literature that has sought to explicate the rules and principles of Islamic law. This literature has engendered considerable interpretational diversity – sometimes expressing profoundly different points of view – and this in turn means that discussions and debates on the dictates of Islamic law are continuing. Indeed, the presence of different schools of law (*madhhab*; pl *madhahib*) testifies to the long-standing interpretational plurality which has been present in

Muslim legal thought, and which continues to be present today. Indeed, the ongoing effort or struggle to define and determine the law (which can be captured in the term *ijtihad*) applies to Islamic finance as much as to other areas of law.

For Islamic finance in particular, critical discussions and debates center on the prohibitions against *riba* and *gharrar*, respectively understood as a prohibition on interest or unlawful gain and on uncertainty or speculation. The fact that *riba* and *gharrar* are prohibited is undisputed, but the scope of what constitutes *riba* and *gharrar* is often debated. Does *riba* include only simple interest or does it extend to prohibit unjustified enrichment (and, if so, how is this to be defined)? Does *gharrar* encompass any 'uncertainty' in commercial matters or, if it prohibits 'speculation', what counts as speculative and what limitations does this impose on risk-taking? In addition, to these matters, there exists a general concern for the underlying asset of Islamic finance arrangements to be 'halal'. This in turn raises questions of what happens if an enterprise has halal and non-halal assets. Is it acceptable that non-halal assets can be severed from halal assets so that the latter may properly be dealt with by Islamic finance? Or do non-halal assets 'contaminate' the entire enterprise?

At a more meta-level, questions have also arisen about whether contemporary Islamic finance structures are properly Islamic or are only paying lip-service to the norms of Islam and Islamic law? On the other hand, Islamic finance vehicles are sometimes vaunted for being more 'ethical' forms of financing, which might commend themselves to Muslims and non-Muslims alike.

## II. Why Islamic finance?

In Singapore, Islamic finance appears to be a niche market, but globally, it has grown considerably. Two important centres of Islamic finance are the Middle East and Malaysia – the latter being a regional hub for Islamic finance in Southeast Asia. However, Islamic finance is not limited to

countries of Muslim-majority countries. In fact, many transactions originate from non-Muslim-majority countries like Hong Kong, South Africa and Luxembourg and the UK.

Why would one opt for Islamic finance versus conventional finance? For Muslims, opting for Islamic finance may be viewed as a matter of faith and piety and, in addition, some may see it as providing a more ethical alternative as the general tenor of Islamic finance emphasizes the need to 'do good'. While Islam permits profit-making and if fact encourages it, the earning of profit should be linked to economically beneficial activity such as the creation of jobs, the building of infrastructure and be for the betterment of society.

The oil wealth in the Middle East has also generated a substantial pool of liquid capital that, in line with the religious sentiments of many in the region, is available only to financing structured in Islamic terms. The owners of such capital would prefer to invest in Shariah-compliant assets and products. Thus, whether within or outside the Middle East and whether Muslim or not, offering Islamic financial products becomes a way to tap into significant amounts of capital that are not available to conventional financing. As a result, there has been increasing demand for banks to issue Shariah-compliant products.

Islamic finance is also attractive to those who view it as providing greater protection against risk since, as noted above, it incorporates prohibitions against (overly) risky financial products and (excessive) speculation. As a rule of thumb, Islamic finance requires greater due diligence and control over contracts than its conventional finance, thus mitigating obvious risks.

## III. Determining what counts as 'Islamic' for Islamic finance

One of the most basic and yet difficult questions in the development and offering of Islamic finance products is whether the product is, properly, 'Islamic', i.e., that the product is held to conform with the normative requirements of Islamic law, particularly in light of the above-noted interpretational diversity that has been part of the tradition. As a basic premise, each individual or entity investing in Shariah-compliant products has the right to determine whether the product is, in their view, Shariah-compliant. Of course, it is usually out of the scope of knowledge and expertise for most people to make that determination. Moreover, if an investor wishes to sell or trade an Islamic financial product, the investor would usually be required to provide some evidence that the product was certified as Shariah-compliant by an authoritative body. Current practice is for Islamic Financial Institutions (IFIs), which can act as issuers, arrangers or investors, to appoint highly skilled Shariah-trained scholars to sit on their in-house Shariah Supervisory Boards to vet the proposed financial products. The Boards derive their authority from the expertise of such scholars in Shariah law and interpretation. The process of determining Shariah compliance is ultimately attested by the issuance of a *fatwa* (or pronouncement), but begins with a 'preliminary structure memo' prepared by financiers, lawyers and accountants. An 'interim *fatwa'* is then provided by the Shariah Supervisory Board based on Islamic principles. Finally, when satisfied that the financial product conforms to Islamic principles, the scholars will issue a final *fatwa* to assert that the product is, in their view, is Shariah-compliant. Shariah Supervisory Boards also conduct annual audits and compliance checks within the IFIs and the scholars sitting on the board are appointed and reappointed in a manner similar to members of a board of directors.

Two main issues arise with this structure. First, there is a widely-noted shortage of qualified Shariah scholars such that a relatively small number of individuals are called upon repeatedly. Second, depending on the composition of Shariah boards, there could be a divergence in the standards and interpretations applied by them. Such divergence is sometimes found in different regional contexts where practitioners note that Shariah Supervisory Boards in the Middle East have a reputation for being more conservative or restrictive in their interpretation of Sharia principles than Shariah Supervisory Boards in Southeast Asia, for example. From a practitioner's point of view, and especially in light of the international nature of contemporary financing, there is felt a need for greater conformity and consistency in determinations of Shariah-compliance. At present,

and since fatwas are opinions and thus non-binding, divergence in standards and determinations could encourage some fatwa 'shopping', which can adversely affect the reputation of the Islamic finance industry as it compromises the certainty that any one particular fatwa will be sufficient to assure Shariah-compliance.

## IV. Standard setting in Islamic finance

Although the discursive nature of Islamic law does not admit of curtailment to suit the consistency or predictability needs of the Islamic finance industry, efforts have been made to set standards and guidelines. To ensure uniformity, IFIs are voluntarily regulated through codes of corporate governance. Furthermore, standard-setting bodies include the Accounting & Auditing Organisation for Islamic Financial Institutions (AAOIFI), and the International Islamic Financial Market (IIFM). These bodies seek to operate internationally, rather than being tied to just one jurisdiction or region and thus to promote international standards. The guidelines developed by these organisations do obviously not have the force of law, but they are influential as the guidelines are developed by well-known and highly regarded Shariah scholars who sit on the boards of such standard-setting bodies.

Other countries have adopted a more centralized approach. For example, in Malaysia, Islamic finance is regulated at a national level by the Shariah Advisory Council (SAC) of the central bank, the Bank Negara Malaysia (BNM). The SAC issues fatwas and monitors the appointment of Shariah scholars sitting on Supervisory Boards and as expert witnesses in litigation cases before the commercial courts. The opinions of the SAC on Shariah matters in a dispute are binding on commercial courts.

There is no equivalent to this set-up in Singapore. While Islamic finance transactions are subject to regular banking regulations, fatwas are handled privately by commercial parties without the central bank (Monetary Authority of Singapore - MAS) becoming involved.

## V. Varieties of Islamic finance contracts and governing law

Examples of Islamic contracts include *murabaha* (cost-plus financing), *ijara* (lease, or lease with purchase option), *wakala* (investment agency), *mudaraba* (funded participation), *musharaka* (joint-venture or partnership) and *sukuk* (trust certificate). These products exist along a spectrum with "equity" (risk-sharing) and "loan" at opposite ends.

*Murabaha* (cost-plus financing) involves the sale and purchase of commodities or goods. A bank will buy the good or commodity from a supplier and then sell it to the customer for spot delivery, but with a deferred payment at cost plus mark-up. *Murabaha* are predominantly used for cash-funding. Elements which define a *murabaha* agreement include certainty of scheduled payment fixed at the outset, absence of discount for early repayment, and prohibition against compound interest for late repayment. Although it is not permissible to impose a penalty for late payment, Shariah scholars have recognised that there should be a disincentive for late payment and therefore allowed late payment charges to be imposed provided that the proceeds are donated to charity and are not for the benefit of the financier or investor.

*Ijara* (lease with or without purchase option) requires certainty in the following four elements: asset, parties, term and termination of contract. The subject matter must be a tangible asset with an intrinsic value, and be capable of being leased without being consumed. A lessor must have ownership interest in the asset (either legal or beneficial), and bear the responsibilities of ownership of the an asset, as well as maintenance and insurance (a requirement which is seen as problematic for commercial banks). While the preference is for Shariah-compliant insurance (*takaful*) to be obtained, it is not always available and therefore conventional insurance is permitted, because of the lack of Sharia compliant alternatives. The term of lease must be fixed and the rental fee must be agreed at the outset. The rental fee can be floating, but the formula must be agreed at the outset. The lease can only be terminated at the end of the term, although there can be an option for a lessee to purchase the ownership interest from the lessor.

Comparing the two structures above, a *murabaha* contract is better suited for short-term financing while an *ijara* agreement is more suitable for long-term financing.

*Mudaraba* (funded participation) involves risk-sharing of profits and losses. It is a partnership between a capital provider (*rabbul-mal*) and a fund manager (*mudarib*), in which the latter is given a share of profits. It can either be unrestricted or restricted for a specific purpose or business. Any

investment undertaken by the fund manager must be Shariah-compliant. Other commonly used structures are *musharaka* and *wakala*.

*Sukuk* is *a* trust certificate and can be in the form of a negotiable instrument issued by the issuer representing undivided asset ownership. It is often used in conjunction with other structures like *mudaraba* and *ijara*.

On the issue of governing law, the English Court of Appeal in *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd*[4] held that the validity of agreements are to be decided according to English, not Shariah, law. The court dismissed the appeal by the appellants, who were attempting to rely on a governing law clause which read "*Subject to the principles of the Glorious Sharia'a, this agreement shall be governed by and construed in accordance with the laws of England*". Instead, the court held that the Rome Convention (on the Law Applicable to Contractual Obligations) contemplates that the chosen governing law of a contract shall be the law of a country as opposed to a non-national system of law such as Shariah law.

By contrast, in Malaysia, the commercial courts are obliged to consult the SAC of the central bank, which gives binding opinions on Shariah matters in disputes heard in commercial courts.

In Singapore, there are various laws and regulations governing Islamic finance. Other than tax law and stamp duties, MAS has released "*Guidelines on the Application of Banking Regulations to Islamic Banking*". Furthermore, there are regulations which allow Shariah-compliant transactions to use certain structures pre-approved by MAS. For instance, MAS would regard an Islamic *ijara* as a regular lease financing. The purpose of these regulations is to ensure that there is no hindrance for Islamic finance in Singapore by creating a level-playing field for Islamic and conventional fianance products. While such arrangements are welcome, there is more that can be done to facilitate Islamic finance in Singapore, which might otherwise be transacted in other countries. Unlike other jurisdictions, MAS does not currently provided incentives for investors and banks to engage in Islamic finance. It went even further by removing a 5% concessionary tax rate that had previously been allowed for certain types of Islamic finance transactions. More needs to be done to encourage Islamic finance and there should be specific incentives to make Islamic finance more

[4] [2004] EWCA Civ 19.

attractive. In addition, there is a need to challenge the conventional wisdom amongst practitioners that Islamic finance is prohibitively expensive since the cost differences between Islamic and conventional are not very large. Especially since many banks can make use of standard documents and templates for Islamic finance transactions, the transaction costs are not prohibitive.

## VI. Conclusion: Prospects and challenges for Islamic finance in Singapore

Overall, the future prospects are good for Islamic finance in Singapore. Given the available capital, Islamic finance provides a viable alternative to conventional finance, and should no longer be considered as just a niche market. In fact, it is a potentially large market, which can provide greater stability and fairness.

Islamic finance is also a particular opportunity for Singapore. Singapore can tap on its existing reputation as a stable, established financial center and to attract transactions and products that otherwise might be undertaken in other countries. Singapore could consider providing additional incentives to develop its Islamic finance market in order to create a truly level playing field. It is suggested that there are certain key steps Singapore, and the government of Singapore in particular, can take to enhance the local Islamic finance industry. The government should implement favourable tax treatment and other incentives for Islamic finance transactions. As with any nascent industry, incentives should be given, and tax incentives especially would be a powerful tool to encourage an industry to develop until it has enough of a local market and demand to flourish by itself. In addition, to address the local lack of familiarity and expertise, more education and awareness raising initiatives about Islamic finance amongst local Singaporeans should be undertaken so as to build greater confidence in the market. This could be done by a combination of academic as well as practitioner-orientated course, seminars etc. Although all these initiatives will take time to bear fruit, globally, institutional investors have already demonstrated that they have an appetite for Islamic finance products and are keen to see a wider range of products in different asset classes.

In taking these steps, Singapore should not be too concerned about diversity within Islamic law because this factor is a long-standing and well-recognized feature of the tradition. Competition between countries is not necessarily a problem. If Singapore invests in education in areas of Islamic law and finance, the interpretational differences will not seem unusual or threatening. Such education would build on Singapore's existing excellent legal infrastructure in terms of financial expertise in finance law amongst practitioners and within the courts. Singapore is also well placed due to geographical and cultural familiarity to tap into what could be a significant regional Muslim market as well as a Chinese market for Islamic finance products. In addition, Islamic finance disputes have already been heard in Singapore through particularly through arbitration. Indeed, new developments such as the Singapore International Commercial Court (SICC) may add to this reputation as the SICC could become a forum to hear disputes, under the laws of other jurisdictions, relating to Islamic finance.