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**Jurisprudential Schizophrenia:  
On Form and Function in Islamic Finance**

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SYMPOSIUM: ISLAMIC BUSINESS AND COMMERCIAL LAW  
ARTICLE

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# Jurisprudential Schizophrenia: On Form and Function in Islamic Finance

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## I. INTRODUCTION

My father is a medical doctor living in Ohio, nearly seventy years of age with sufficient savings accumulated during decades of professional practice to enable him to live comfortably. He is also a devout Muslim. He prays five times every day, fasts one month of the year, and has made the mandated pilgrimage to Mecca not once, but twice. In many ways, therefore, my father is almost the paradigmatic example of a person who might be interested in investing his money in institutions and instruments that are deemed to be compliant with Islamic rules. In asking why Islamic banks have such difficulty attracting him and others like him as potential clients,<sup>1</sup> I intend to shed light on the central existential problem facing Islamic finance. Specifically, Islamic finance has failed to achieve its articulated, functional goal of an alternative system of commerce based on notions of fairness and social justice.

The reasons for this functional failure are the means by which the constituent rules of Islamic finance are derived; that is, the use of an interpretive system that, at least in its contemporary manifestation, is a type of rather extreme quasi-scientific, logic-driven formalism. Proponents of Islamic finance tend to divorce the problem of means from that of ends, pretending that with sufficient creativity and ingenuity, the formalist hermeneutic will permit the

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\* Associate in Law, Columbia Law School. I would like to thank Abdullahi An-Naim, Mahmoud El-Gamal, Mohammad Fadel, Clark Lombardi, Hoi Kong, and the members of the Associates Workshop at Columbia Law School for their substantial comments and support. Any errors are my own.

<sup>1</sup> See generally Mahmoud A. El-Gamal, *Limits and Dangers of Shari`a Arbitrage* 5 (2005), available online at <<http://www.ruf.rice.edu/~elgamal/files/Arbitrage.pdf>> (visited Jan 15, 2007) (describing apprehension of large parts of the Muslim community towards Islamic banking).

realization of the functional ends they endlessly promote.<sup>2</sup> Lon Fuller has criticized similar approaches in the development of social order, indicating that unless means and ends are considered in relation to one another, the architecture of social order cannot be sensibly conceived.<sup>3</sup> Fuller's analogy is to physical architecture, where an architect cannot divorce her ultimate ends of utility and beauty from the means she employs to achieve them. A building suspended in mid-air, for example, might serve the conceptual ends of an architect, but there are no real means by which it might be built.<sup>4</sup>

This lesson appears lost on Islam's contemporary formalists in the context of finance, who appear uninterested in either defining their practice as mere formal compliance with doctrine or developing functional hermeneutical means to attain the functional goals they articulate. Rather, there is something akin to schizophrenia in the Islamic financial community, where formalist means have led to formalist ends, which proponents describe as functional, alternatively engaging in obfuscation, self-serving cant or incoherence in their defense.

There are only two ways to unravel this Gordian knot. Either Islam's interpretive modalities require adjustment to achieve the articulated functional ends, or the proponents of the system will ultimately have to acknowledge that, from a functional perspective, Islamic banks operate on the same basic financial and economic bases as their conventional counterparts and that the differences between the two are entirely formal in nature. I find the latter neither desirable nor sustainable for a variety of reasons that will be explored in this Article. As a result, I advocate the development of realizable and principled functional interpretive approaches to achieve the primary functional goals of an Islamic financial institution.

This Article is divided into three parts, excluding this Introduction. In part II, I briefly discuss the contemporary practice of Islamic finance and the interpretive principles that gave rise to it. Part III explains precisely why, from the standpoint of potential investors such as my father, this practice is deeply, ontologically flawed. Part IV sets forth another model of an Islamic financial institution, based on functional approaches to the jurisprudence, and explains the benefits provided by such an institution.

At the outset, however, given the extent to which I use them in this Article, definitional clarifications of the terms "formalism" and "functionalism" are

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<sup>2</sup> See Mahmoud A. El-Gamal, *Islamic Bank Corporate Governance and Regulation: A Call for Mutualization* 4–5 (Sept 2005), available online at <<http://www.ruf.rice.edu/~elgamal/files/IBCGR.pdf>> (visited Jan 15, 2007).

<sup>3</sup> Lon L. Fuller, *Means and Ends*, in Kenneth I. Winston, ed, *The Principles of Social Order: Selected Essays of Lon L. Fuller* 47 (Duke 1981).

<sup>4</sup> Id at 50–52.

necessary. In using the term “formalism,” I am referring to an interpretive methodology relying almost entirely on logic (and excluding more contextual and experientially based techniques) to derive clear and specific rules whose application in particular factual contexts is non-controversial, without regard to whether those rules serve any particular end. There are other types of formalism, including the neo-formalism that characterizes the jurisprudence of Justice Scalia.<sup>5</sup> Justice Scalia’s conception of formalism, however, presumes the continuing presence of an elected legislature that enacts and amends the rules that govern the legal system. This framework is completely absent in the Islamic context, where rules are based on past Revelation. A more apt comparison for Islamic orthodoxy would be to nineteenth-century Langdellianism.<sup>6</sup>

“Functionalism” refers to the methodology whereby rules are purposefully derived to achieve particular ends that relate to preferred modalities and institutions of human association. These rules necessarily involve an interpretive approach that is contextual, discretionary, and experiential rather than logic-driven, uniform, and certain. The terms “functional ends” and “functional goals” merely refer to the ends that functionalism seeks to achieve.

Under these definitions, a rule that serves no end other than to obey the will of God in some ethereal sense does not concern modalities or institutions of human association and is therefore not “functional.” Moreover, the design of the rule to serve the end must be purposeful and intentional to be functional. Mary Douglas, for example, suggests that dietary rules that appear to have no function often result in a strengthening of communal bonds.<sup>7</sup> While this may be an incidental effect of the rule, and while the effect may result in its perpetuation, it would be fair to say that the dietary rules are not purposefully sustained to achieve this end and therefore are not by this definition exercises in “functionalism.”

## II. FORMALISM IN THE CONTEXT OF FINANCE

### A. ORTHODOX INTERPRETIVE PRINCIPLES

In order to discuss formalism within Islamic finance competently, a brief introduction to the mechanics of the contemporary Islamic interpretive system is necessary. The primary materials from which law is derived pursuant to contemporary Islamic orthodoxy are, in addition to the relatively few verses of

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<sup>5</sup> Antonin Scalia, *A Matter of Interpretation: Federal Courts and the Law* (Princeton 1997).

<sup>6</sup> See Haider Ala Hamoudi, *Muhammad’s Social Justice or Muslim Cant: Langdellianism and the Failures of Islamic Finance*, 40 *Cornell Intl LJ* (forthcoming 2007).

<sup>7</sup> See Mary Douglas, *Purity and Danger: An Analysis of the Concepts of Pollution and Taboo* 41–57 (Routledge 1984).

the Qur'an containing legal content,<sup>8</sup> the utterances or examples of Muhammad known as *hadith*.<sup>9</sup> These utterances or examples are expanded and clarified through a form of primarily analogical reasoning known as *qiyas* to develop sets of broad rules.<sup>10</sup> Any consensus among jurists as to the proper application of *qiyas* in any particular context sanctifies that application as per se valid and binding through use of a source of law known as *ijma*, or consensus.<sup>11</sup> The Qur'an, the *hadith*, *qiyas*, and *ijma* constitute the four primary sources of law in the Sunni Islamic tradition.<sup>12</sup> Other doctrines such as *istislah*, a form of equity, and *istislah*, or public interest, exist, but they are disputed and in any event are of minor importance in developing the jurisprudence.<sup>13</sup>

What is most striking about this list, and particularly the primary items, is the extent to which it purports to develop rules with almost no concern for their functional value. Revelation, either in the form of the Qur'an or the *hadith*, or the extension of that Revelation through *qiyas* and *ijma*, is not only the wellspring of the rules, but also the chief determinant of their precise contours and parameters. Thus, Islamic interpretive theory, like Langdell's scientific approach to the development of jurisprudence, seems to find considerations of public policy or interest irrelevant.<sup>14</sup>

This is not to say that it is impossible to develop functional rules in spite of the seeming formalism of the interpretive system. One prominent authority has indicated that in some areas of law, such as criminal law, rules were developed functionally in the classical era even if they are often rigid in contemporary

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<sup>8</sup> See Muhammad Baqir al-Sadr, *Lessons in Islamic Jurisprudence* 1 (Oxford 2003).

<sup>9</sup> Cherif Bassiouni and Gamal Badr, *The Shari'ah: Sources, Interpretation, and Rule-Making*, 1 UCLA J Islamic & Near E L 135, 138–39 (2002).

<sup>10</sup> Badran Abu al-Aynayn Badran, *Usul al-Fiqh (The Principles of Jurisprudence)* 229 (Dar al-Ma'arif 2d ed 1965).

<sup>11</sup> Id at 200.

<sup>12</sup> Id at 286. See also Hossein Modarressi Tabataba'i, *An Introduction to Shi'i Law: A Bibliographical Study* 3 nn 1, 4 (Ithaca 1984). Shi'i Islam has the same four sources, but substitutes in the place of *qiyas* the doctrine of *'aql*, which denotes similar logic-driven reasoning not necessarily analogical in nature. A paradigmatic example of *'aql* is the "rule of correlation" (*qaidat al mulazama*), pursuant to which, among other things, the prerequisites of an obligatory act are deemed obligatory and the direct opposite of an obligatory act is deemed prohibited.

<sup>13</sup> Muhammad Abu Zahrah, *Usul Al-Fiqh* 251, 281–83 (Dar al-Fikr al-Arabi 1969). See also Bassiouni and Badr, 1 UCLA J Islamic & Near E L at 138–59 (cited in note 9) (describing other potential sources of law within Islamic jurisprudence).

<sup>14</sup> For Langdell's famous expression of disdain for public concern in the context of the "mailbox rule," see C.C. Langdell, *A Summary of the Law of Contracts* 20–21 (Boston, Little, Brown 2d ed 1880).

application.<sup>15</sup> Another commentator has shown certain jurists were willing to ignore the interpretive system in “deriving” rules from it in the classical era.<sup>16</sup> At least one classical jurist apparently liberated his jurisprudential ideas from vast numbers of *hadith* by suggesting that they could be ignored to serve social interests that were more in harmony with predefined, broad legal objectives.<sup>17</sup> Ibn Taymiyah, a prominent fourteenth-century jurist whose writings have influenced some of the most conservative Islamic movements currently in existence, seems to have disregarded a restriction on stipulations in contracts in order to advocate a more liberal commercial regime.<sup>18</sup> One recent commentator has written thoughtfully and extensively about *siyasa shar’iyya*—a Sunni doctrine developed by Ibn Taymiyah and his disciple Ibn Qayyim Al-Jawziyya that identifies purposes of Islamic jurisprudence and therefore presupposes a high level of functionalism.<sup>19</sup>

It suffices to say, however, that in the context of contemporary jurisprudence, none of these or any other potential liberalizing approaches would be acknowledged as permissible means of deriving rules within the hermeneutic. Today, no traditionalist Islamic scholar could credibly write rules without explaining their precise basis under orthodox Islamic jurisprudential principles. Certainly no traditionalist scholar interested in preserving his reputation would openly and obviously disregard contrary *hadith* or previously reached *ijma* in fashioning rules, nor would he suggest some *hadith* were not binding. One modern prominent Shi’i scholar who made precisely such an argument was sharply criticized for promulgating heresy.<sup>20</sup>

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<sup>15</sup> See M. Cherif Bassiouni, *Introduction*, in M. Cherif Bassiouni, ed, *The Islamic Criminal Justice System* xvii (Oceana 1982); M. Cherif Bassiouni, *Sources of Islamic Law and the Protection of Human Rights in the Islamic Criminal Justice System*, in Bassiouni, ed, *Islamic Criminal Justice* 3, 5 (cited in note 15).

<sup>16</sup> See Mohammad Fadel, “*Istihsan is Nine-Tenths of the Law*”: *The Puzzling Relationship of Usul to Furu’ in the Maliki Madhhab*, in Bernard Weiss, ed, *Studies in Islamic Legal Theory* 161–76 (Brill 2002).

<sup>17</sup> Sherman A. Jackson, *Islamic Law and the State: The Constitutional Jurisprudence of Shihab Al-Din Al-Qarafī* 59, 62 (Brill 1996).

<sup>18</sup> Specifically, Ibn Taymiyah adopts a highly permissive theory of stipulations in contracts, indicating that the only stipulations to be prohibited are those that violate the contract itself or Islamic law generally. See Ibn Taymiyah, 6 *al-Fatawa l-Kubra* 408 et seq (Dar al-Qalam 1987); Ibn Taymiyah, *Nazariyat al-Aqd (Opinions on the Law of Contract)* 14–16 (Beirut: Dar Al Ma’rifa 1978). This clearly is contrary to the terms of a *hadith* accepted by the Hanbali school of thought to which Ibn Taymiyah adheres, and reported by Ibn Hanbal himself, prohibiting two stipulations in any given contract. Ibn Qudamah, 6 *al-Mughni* 321–22 (Cairo: Imbābah 1986).

<sup>19</sup> Clark B. Lombardi, *State Law as Islamic Law in Modern Egypt: The Incorporation of the Shari’a into Egyptian Constitutional Law* 49–53 (Brill 2006).

<sup>20</sup> See Chibli Mallat, *The Renewal of Islamic Law* 143 (Cambridge 1993) (describing reaction to Muhammad Baqir al-Sadr’s *Iqtisaduna*).

As a result, and without prejudice to the jurisprudence that may have existed in the classical era, Islam's interpretive orthodox system is in contemporary application rigid, quasi-scientific, and dependent on excessively formal exercises of logic. It is also highly suspicious of contextual, discretionary, and experiential interpretive approaches that do not result in the type of jurisprudential uniformity and certainty that formalism is meant to ensure. It is precisely this perspective that has led jurists in the modern era to determine that the Qur'anic prohibition on an activity known as *riba* necessarily encompasses the taking of interest on a money loan.<sup>21</sup> The Qur'an itself is entirely unclear on the definition of *riba*. The Qur'an forbids *riba* and denounces it as exploitative and unfair, akin to theft, the opposite of charity, and responsible for generating unnaturally high levels of return, but otherwise provides little guidance respecting the elements of the forbidden practice.<sup>22</sup> One of the principal *hadith* on the subject refers exclusively to a particular exploitative practice in Muhammad's time, wherein a creditor agrees to a deferral in the repayment of a loan on its due date in exchange for a significant increase in the value of the loan, hence the Qur'anic reference to "doubling and redoubling."<sup>23</sup> The *hadith* indicates that this practice is the only form of *riba*.<sup>24</sup>

However, a second *hadith* prohibits uneven or delayed trades of particular items—basically precious metals and simple foodstuffs.<sup>25</sup> This *hadith* was expanded through *qiyas* to encompass items of various sorts in the classical era and extended ultimately in the modern era to forms of currency that have little to do with precious metals or foodstuffs. According to proponents of Islamic finance, this conclusion was consecrated through *ijma*, thereby rendering any other interpretation fundamentally illegitimate.<sup>26</sup>

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<sup>21</sup> El-Gamal, *Islamic Bank* at 2 (cited in note 2).

<sup>22</sup> See Qur'an 2:275; 4:161 (promising a "painful punishment" for those who take *riba* and those who devour the property of others falsely); Qur'an 3:130 ("O you who believe, devour not *riba*, making it double and redouble"); Qur'an 30:39 ("And whatever you lay out as *riba*, so that it may increase in the property of men, it shall not increase with Allah; and whatever you give in charity, desiring Allah's pleasure, you shall get manifold.").

<sup>23</sup> Frank E. Vogel and Samuel L. Hayes, III, *Islamic Law and Finance: Religion, Risk and Return* 72–73 (Kluwer 1998); S.E. Rayner, *The Theory of Contracts in Islamic Law* 269 (Graham & Trotman 1991); `Abd al-Razzaq Ahmad Sanhuri, 3 *Masadir Al-Haqq fi al-Fiqh Al-Islami, Dirasa Muqarina ma' al-Fiqh al-Gharbi* (*The Sources of Truth in Islamic Jurisprudence: A Comparative Study with Western Jurisprudence*) 241 (al-Qahira 1967).

<sup>24</sup> Sanhuri, 3 *Masadir Al-Haqq fi al-Fiqh Al-Islami* at 241 (cited in note 23).

<sup>25</sup> Vogel and Hayes, *Islamic Law and Finance* at 74 (cited in note 23).

<sup>26</sup> See Muhammad Uzair, *The Impact of Interest Free Banking*, 3 J Islamic Banking & Fin 39, 40 (1984) (describing the exemption of interest from the *riba* prohibition to be "apologetic"); Muhammad Taqi Usmani, *An Introduction to Islamic Finance* iii (Idaratul Ma'arif 2d ed 1998) (describing similar position as "defeatist"). See also Council of Islamic Ideology, *Consolidated Recommendations on the*



An alternative functional approach that accepts the earlier, narrower *hadith* and uses it either to limit or abrogate the latter *hadith* is possible. The great Arab jurist Abdul Razzaq Al-Sanhuri advocated something along these lines, thereby rendering the interest prohibition a nullity in the contemporary era.<sup>27</sup> Using antiformalist tools such as *istislah* and *istihsan*, functionalists might take an additional step and expand this earlier *hadith* to propose a doctrine on *riba* that would meet the functional objectives articulated in the Qur'an—namely, avoidance of exploitation or oppression resulting in unnatural gains to the stronger party. Specific rules could be developed to define such practices and ensure that they are based on core Qur'an and *hadith* prohibitions.

However, rather than developing rules to serve the doctrine functionally, the contemporary hermeneutic prefers a logic-driven formal ban that, while uniform and clear, serves no end. The empty formalism of the *riba* rule cannot be understated; a trade, for example, of one automobile for a more valuable one to be delivered at a later date does not fall within the prohibition. The prohibition relates only to particular items, most importantly for our purposes, money.

Similarly, the Islamic prohibition of *gharar*, or certain forms of commercial risk, has developed from a vague Qur'anic principle banning games of chance and from a series of Prophetic *hadith* forbidding speculative activities such as the sale of fish in the sea.<sup>28</sup> *Qiyas* and subsequent *ijma* rendered this into a prohibition of astonishing breadth that basically invalidated any contract with a fundamentally high level of uncertainty, including uncertainties over price and duration.<sup>29</sup> *A fortiori*, an insurance contract, where not only the duration, but indeed the very existence of a payout was in question, was declared invalid. Ironically, the formal requirement against this sort of “risk” not only failed to serve the original function of avoiding games of chance, but also undermined that very purpose because it required the believer to “gamble” his entire business by failing to take insurance to protect himself against foreseeable harms. Again, a functional alternative would be to take the specific practices banned by the Qur'an and the *hadith* and expand them using a combination of *qiyas*, *istihsan*, and *istislah* to develop rules to meet the objectives set forth in the Qur'an.

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*Islamic Economic System* 7 (Govt of Pakistan 1983) (indicating the presence of “complete unanimity among all schools of thought in Islam that the term *riba* stands for interest in all its types and forms”).

<sup>27</sup> Sanhuri, 3 *Masadir Al-Haqq fi al-Fiqh Al-Islami* at 219–49 (cited in note 23).

<sup>28</sup> Id at 231.

<sup>29</sup> Id at 249.

B. ARTIFICE AND ISLAMIC FINANCE—ON THE MATTERS OF  
THE SYNTHETIC *MURABAHA* AND *TAKAFUL*

Needless to say, the formal restrictions against *riba* and *gharar* as developed under the orthodox principles make the practice of Islamic finance extraordinarily challenging. The theoretical solution has been to structure the financial institutions under a form of partnership known as a *mudharaba*, which operates much like a mutual fund or a private equity fund. Passive investors place their money in a broader institution that purchases and sells assets and distributes profits between itself and the investors based on an agreed percentage.<sup>30</sup> Manifold problems with this approach have rendered it entirely infeasible, however.<sup>31</sup>

The industry therefore fell back on artifice and stratagem to circumvent the *riba* and *gharar* prohibitions on the barest technical grounds. I provide two central examples. The first, *murabaha*, is by an overwhelming margin the primary investment vehicle of Islamic financial institutions,<sup>32</sup> and the second, *takaful*, is a rapidly growing segment of the Islamic financial market.

The *murabaha* is a form of short-term financing permitted by proponents of Islamic finance wherein the financial institution agrees to purchase an item on behalf of a client and then sell it to the client on the basis of an agreed markup, with payment usually coming at a later time.<sup>33</sup> While the *murabaha* seems harmless, it can easily be manipulated to function for all intents and purposes as an interest-based transaction which would otherwise be banned under the doctrine of *riba*. For example, an Islamic financial institution could not simply lend \$1000 to a borrower. Under the *murabaha* exception, however, it could purchase \$1000 of copper at its market value, immediately sell the copper to a buyer, with the buyer promising to pay for it at a higher price on a later date. In this example, I will assume that the buyer promises to pay \$1100 in one year's time. As part of the same *murabaha* transaction, in a procedure known as *tawarruq*,<sup>34</sup> the bank may also arrange for the buyer to immediately sell the copper back into the commodities market for the same \$1000. No party will have ever taken possession of the copper they "owned" for a fraction of a

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<sup>30</sup> Vogel and Hayes, *Islamic Law and Finance* at 109–10 (cited in note 23); Hamoudi, 40 Cornell Intl L J at n 7 (cited at note 6).

<sup>31</sup> See Hamoudi, 40 Cornell Intl L J (cited at note 6).

<sup>32</sup> Ibrahim Warde, *Islamic Finance in the Global Economy* 133 (Edinburgh 2001).

<sup>33</sup> El-Gamal, *Limits and Dangers* at 4 (cited in note 1).

<sup>34</sup> Mahmud A. El-Gamal, *Mutuality as an Antidote to Rent-Seeking Shari`a-Arbitrage in Islamic Finance* 10–11, available online at <<http://www.ruf.rice.edu/~elgamal/files/Mutuality.pdf>> (visited Jan 15, 2007) (hereinafter "Arbitrage").

second.<sup>35</sup> The result will be that the copper will have been bought and sold back into the market, and what remains after the near simultaneous set of transactions is \$1000 in the possession of the buyer, and a promise on the buyer's part to pay the bank \$1100 in one year's time. The \$100 "mark-up" is effectively an interest rate, and the bank can structure its transactions so that the "mark-up" in any given transaction reflects precisely the prevailing market fixed interest rate.<sup>36</sup> By one commentator's recent estimate, between 80 and 90 percent of the investments of Islamic financial institutions take the form of the *murabaha*.<sup>37</sup>

However, it also seems reasonably clear that no formal rule is broken in the synthetic *murabaha*. The Islamic financial institution charges no interest in the sense of lending money in exchange for more money to be received at a later date. Instead, goods were bought from a third party and then resold to the "borrower," a perfectly acceptable Islamic practice under the formalist hermeneutic.

By contrast, the stratagem used to circumvent the rules of *gharar* in the case of insurance is problematic even from a formal perspective. *Takaful* derives from the determination by some scholars that gratuitous contracts are exempt from the rules of *gharar*.<sup>38</sup> Pursuant to *takaful*, a group of Muslims agrees to protect one another in the case of casualty or loss by pooling their resources through making regular payments in the form of premiums to be invested in commercial products deemed permissible under the rules of Islamic finance.<sup>39</sup> The scheme functions in theory as an Islamic financial institution would, with "profits" shared among the beneficiaries and the providers.<sup>40</sup> When a casualty or loss occurs, the participants each "gift" a portion of the premiums already collected (as well as any undistributed profits) to the bearer of the loss.<sup>41</sup> Aside from its creative labels, there is little that distinguishes *takaful* from more conventional forms of insurance.

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<sup>35</sup> Id at 9.

<sup>36</sup> The above example, a mimicking of a fixed interest rate, is by far the most simple. Other, more complex examples abound with respect to more sophisticated transactions, among them a loan with a varying interest rate. See Hamoudi, 40 Cornell Intl L J (cited at note 6).

<sup>37</sup> Vogel and Hayes, *Islamic Law and Finance* at 198 (cited in note 23).

<sup>38</sup> Id at 151. For a classical reference, see Ibn Rushd, *Bidayat Al-Mujtabid* 2:361 (al-Quahirah 1970) (stating that "all which cannot be sold legitimately from the standpoint of *gharar* [may be gifted]").

<sup>39</sup> Vogel and Hayes, *Islamic Law and Finance* at 151–52 (cited in note 23).

<sup>40</sup> Ma'sum Billah Mohd, *Principles & Practices of Takaful and Insurance Compared* 25 (Intl Islamic U 2001).

<sup>41</sup> Id.

### III. THE PITFALLS OF FORMALISM

#### A. CONTRARY APPROACHES

The fact that Islamic financial institutions are formalist does not, however, end the inquiry per se. Vogel and Hayes, the authors of the authoritative work on Islamic finance in the English language, argue that Islamic commerce as currently practiced satisfies broad segments of Muslim society that are “socially and politically conservative, seeking individual piety and social mores built around traditionalist compliance with *fiqh* [Islamic law], and look[ing] to social and political improvements mainly as a result of that.”<sup>42</sup> Timur Kuran, a well-known critic of Islamic economics, points out that the central reason that these financial institutions exist has much less to do with economic or commercial sense than with a desire for a form of cultural distinctiveness.<sup>43</sup> This objective can certainly be achieved in a purely formal system.

Adding to this might be the fact that formalism presents no central difficulty in most matters concerning ritual practice of the faith, and may even be salutary. Returning to my earlier analogy, my father does not eat pork, yet, as a medical doctor, he knows that there is no functional reason relating to health or welfare that justifies his abstention. He is not seeking to avoid a disease or a chemical addiction; he pretends no functionality in the rule. God, through Revelation (as determined by the jurists), has prohibited the consumption of pork. The benefit to be gained, in my father’s opinion, is derived solely from faithfully obeying the will of God.

My father is not alone. I have been to hundreds of Islamic butchers, and nearly all sell “Islamic bacon” made from turkey, or “Islamic hot dogs” made from chicken, advertised and designed to resemble, as closely as possible in every way, their Islamically prohibited pork analogues in the broader market. In their observance of dietary ritual, Muslims may at times point out the risk of tapeworm in pork or its high cholesterol content, but the statements can hardly be taken seriously. If asked about salmonella in chicken, the cholesterol in certain cuts of beef, or the wisdom of prohibiting items containing pig enzymes which carry neither tapeworm nor cholesterol, Muslims inevitably, and sensibly, return to the Qur’anic verse on the consumption of pork and abandon any functional position.

Moreover, particular social benefits may arise from the strict formalism. As I mentioned earlier, Mary Douglas points out the strengthening of the bonds of a community through the mutual observance of a precisely and formally defined

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<sup>42</sup> Vogel and Hayes, *Islamic Law and Finance* at 27 n 2 (cited in note 23).

<sup>43</sup> Timur Kuran, *Islam and Mammon: The Economic Predicaments of Islamism* 101–02 (Princeton 2004).

ritual.<sup>44</sup> These benefits could not arise if the formal rituals and rules were subject to continual change by parts of the community on the basis of some sort of external functional analysis.

## B. INAPPLICABILITY OF FORMALISM IN FINANCE

As valid as some of these considerations might be, they are entirely misplaced when applied in the financial sector, for the reasons set forth herein.

### 1. Hypocrisy

The most obvious problem with approaching Islamic finance in such formalist terms is that its proponents never discuss it in this manner. Indeed, they endlessly promote functional benefits to the formally derived rules, which are by and large nonexistent. To cite only a few examples, Mohammed Taqi Usmani, a former judge on the Shari'ah Appellate Bench of the Pakistani Supreme Court and a major proponent of Islamic finance, indicates that the charging of interest is partially responsible for the massive disparities in wealth in capitalist societies.<sup>45</sup> Umer Chapra, an economist at the Islamic Development Bank in Jeddah, Saudi Arabia, and one of the most well-known and most prolific advocates of Islamic finance in the Muslim world, makes notions of social justice central to his robust defense of Islamic finance.<sup>46</sup> Muhammad Nejatullah Siddiqi, a professor of economics in Saudi Arabia, opens one of his most well-known books on Islamic economics with the sentence "[I]n prohibiting interest Islam has endeavored to do away with a hideous form of tyranny and injustice prevalent in human society."<sup>47</sup> Timur Kuran describes the prohibition of interest as being "the most celebrated" injunction in Islamic economics among the proponents of the discipline.<sup>48</sup> According to Kuran, these proponents ground the injunction on the principle of fairness.<sup>49</sup>

Muslims generally are captivated by this perception and are shocked when, in seeking to obtain Islamic financing, they discover the ruse. I have more than once fielded calls from angry Muslim congregation leaders in the United States asking me to direct them to "real" Islamic financial institutions, as the particular banks to which they went indirectly charged interest in their view, albeit in the form of an elaborate and obfuscatory transaction. In addition, while serving as a

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<sup>44</sup> Douglas, *Purity and Danger* at 41–57 (cited in note 7).

<sup>45</sup> Muhammad Taqi Usmani, *An Introduction to Islamic Finance* at 17 (cited in note 26).

<sup>46</sup> See generally Umer Chapra, *Towards a Just Monetary System* (Islamic Found 1985).

<sup>47</sup> Muhammad Nejatullah Siddiqi, *Banking without Interest* 11 (Islamic Found 1983).

<sup>48</sup> Timur Kuran, *On the Notion of Economic Justice in Contemporary Islamic Thought*, 21 *Intl J Mid E Stud* 171, 174 (1989).

<sup>49</sup> *Id.*

legal adviser to the Finance Committee of the Governing Council of Iraq, I noticed several fellow members of the Committee expressing grave concern over any financial law or regulation that might affect entities such as currency exchange houses in addition to banks. It was not unusual for one or more of them to remark that currency exchange houses were run by honest, God-fearing Muslims less in need of regulation than conventional banks, which were hardly to be trusted given the exploitative nature of their interest-taking business.

In light of this, suggestions regarding the propriety of formalism seem secondary; few within the industry seem to be addressing the community in such terms. Admittedly, however, this problem could simply be fixed with better and more honest communication, and a frank admission that Islamic finance aspires to be little more than mere formal compliance with doctrine. At present this has not occurred, nor is there any indication that it will. This may be because proponents of the current practice are aware that this information may well doom the practice given the broader societal interests in an alternative form of financial intermediation steeped in Islamic conceptions of fairness and social justice.

In all likelihood, however, most proponents are not quite this manipulative and instead engage in a delusion that some magical way will be found in the near future for Islamic banks to adhere simultaneously to form and function. That more than three decades have passed since the first modern Islamic bank was founded,<sup>50</sup> and that the *murabaha* continues to dominate the practice, should be evidence enough that this mythical convergence cannot possibly be achieved.

## 2. Nature of the Discipline

Finance is by its nature a functional affair. There is no requirement under Islamic law that my father place his money in any sort of financial vehicle. He could simply rent a safety deposit box, drop into it the entirety of his savings in cash, and withdraw from it as he pleased. By choosing to deposit in a bank, Islamic or otherwise, he is seeking some sort of functional gain, and clearly the bank is doing the same by using those deposits to make investments of its own. Financial institutions exist for functional reasons and it seems strange to approach them in the highly formalist manner that modern proponents of Islamic finance currently do.

Implicitly, the formalist approach suggests that the functional purposes of the institutions are to be decided not by the broader Muslim community, nor the jurists, nor the institutions themselves, but by the global commercial marketplace, with the sole areas of Islamic distinction being purely formal. Given the extent to which Islamic conservatives everywhere preach the

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<sup>50</sup> Warde, *Islamic Finance* at 75 (cited in note 32).

importance of adhering to Islam as an all-encompassing way of life, the notion that Islamic commerce should in terms of ultimate objectives mimic more conventional forms of commerce is difficult to sustain.

Modern proponents of Islamic finance respond to these challenges in a manner that seems to flirt with functionalism in proposed commercial practices without adopting it. Usmani, for example, describes the *murabaha* as a “borderline transaction,” and insists that the underlying asset be a genuine one intended to be used by the purchaser, not a fungible or synthetic product readily resold.<sup>51</sup> Others require the asset to be in the hands of the bank for some period of time, though in practice, this can be, and often is, limited to one tenth of one second or less with the contractual obligation of the purchaser having been secured long before the bank purchases the product.<sup>52</sup> Even Vogel and Hayes seem to find it difficult to support the use of the synthetic *murabaha* where the asset purchased is not used by the borrower at all.<sup>53</sup> *Tawarruq* remains even more controversial in the Islamic finance community.<sup>54</sup>

These concerns are necessarily functional, but not sufficiently functional to make any real sense out of the discipline. What purpose does it serve, for example, to require a bank to own the fungible asset for one minute before transferring it? Would it make a difference if fifteen minutes were to elapse instead? How does the fact that the asset is to be used by the buyer-borrower rather than immediately sold for its cash value prevent the type of misdistribution of wealth that Usmani indicates is a result of the taking of interest? If interest is a form of tyranny, why is the delayed sale of an asset at a higher value reflecting a return equal to interest not equally tyrannical?

Answers to these questions seem impossible because the concerns themselves are misplaced in the context of a formal discipline. It seems that proponents of formalism are aware of the inherently functional nature of finance and their mostly suppressed functional assumptions and presuppositions therefore rise to the surface from time to time, but only in the oddest and most misplaced ways. Having decided on a formalist course, it will not do to attempt to inject functional principles at the end of the inquiry, when particular formalist solutions seem especially transparent. Even the attempt lays bare a certain incoherence at the heart of any endeavor to make an enterprise as functional as commerce into a formal exercise.

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<sup>51</sup> Usmani, *An Introduction* at 151–53 (cited in note 45).

<sup>52</sup> See Mahmoud A. El-Gamal, “Interest” and the Paradox of Contemporary Islamic Law and Finance, 27 *Fordham Intl L J* 108, 130 (2003).

<sup>53</sup> *Islamic Law and Finance* at 135–36 (cited in note 23).

<sup>54</sup> El-Gamal, *Arbitrage* at 10–11 (cited in note 34).

The functionalist assumptions of Islamic finance are shared by the broader community as well. Islamic banks, for example, routinely hide the prevailing market interest rates, such as LIBOR, that they use in their internal calculations in the context of *murabaha* and other Islamically-acceptable transactions. Vogel and Hayes explain that this is due to the fact that such figures might be “mistaken” as an intention to take interest, but this hardly seems convincing.<sup>55</sup> Islamic butchers do not shy away from the sale of turkey bacon on the grounds that it might be “misunderstood” as pork; to the contrary, the meat is colored artificially to resemble pork more closely. If Muslims at Islamic financial institutions operated under the same expectations, the bank could simply indicate that the reference to LIBOR reflects the bank’s expected “asset sale-based rate of return” or some similar cleverly developed term meant to indicate that the return was based on LIBOR, but that formal interest was not charged. The bank’s embarrassment at such an explanation, or its expectation of consumer anger, only demonstrates further the hopelessness of the formalist endeavor.

### 3. Futility of the Enterprise

It is not even clear that Islamic financial institutions or any form of Islamic finance or commerce would be commercially viable if it attempted to adhere to formalist principles. The case of *takaful* makes this perfectly clear. One may legitimately question whether “formalism” is even an accurate word to describe the *takaful*; it appears to be more an exercise in incoherent semantic reclassification than any genuine attempt to avoid through formal means a central commercial prohibition. There is nothing that distinguishes *takaful* from insurance other than its name; it would seem as sensible to permit a believer to eat pork simply by calling it white beef.

*Takaful* is by no means the only example of an area in which Islamic financial institutions fall short of the formal requirements of Islamic law. Under formalist Islamic transactions operating today, lessees bear risks that they may not bear under the formally developed rules of Islamic finance. Contracts that must be cancelable at will often are not and variable return rates corresponding to a shift in the interest rate are frequently included through a “renewable” lease that parties are required by the contract to renew. All of this is handled readily through agreements that reference New York or English law to ensure enforcement, demonstrating better than anything how this system simply cannot operate on its own.<sup>56</sup>

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<sup>55</sup> *Islamic Law and Finance* at 139 (cited in note 23).

<sup>56</sup> *Id.* at 144–50, 263; Umar F. Moghul and Arshad A. Ahmed, *Contractual Forms In Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Ors.: A First*



If there were some way to develop the practice in keeping with formal requirements, one would have expected Islamic banks to have discovered it by now, or at least to have begun a convergence in this direction, rather than to be moving beyond formalism to semantic fantasy through “innovations” such as the *takaful*.

### C. THE POTENTIAL DEPOSIT

What then might a potential, pious investor such as my father achieve through investing in an Islamic financial institution as currently developed? He might believe, based on what he has read or heard, that he was depositing funds with a bank that was functionally fairer and more socially just than one that took interest. He might continue to believe this until he investigated the matter rather exhaustively, given that the bank would characterize its transactions as profit-sharing on the sale and purchase of assets. Moreover, the bank would not, to the extent permitted by law, disclose any material or information that would give the impression that it operated as “tyrannically” and “oppressively” as conventional banks do.

Were this investigation undertaken, the methods of the bank might strike him as improper, not only because he had been deluded by claims of social justice, but also because Islamic banks should, in his view, be functionally different in their operations. The bank might struggle to keep his business, raising such substantive but functionally irrelevant differences as the fact that, unlike a conventional bank, this bank had to purchase assets and sell them seconds, minutes, or perhaps hours later. The bank would have a harder time explaining why the choice of law clause selected New York law, particularly if the transaction took place in a Muslim country.

All the while, the interest rates of the bank might be higher, and my father’s return lower, to compensate for transaction costs incurred in avoiding interest. It is not difficult to see precisely why so many pious Muslims shy away from the practice of Islamic finance given these formalist realities.

### IV. BRIDGING THE GAP

The other option is an overhaul of the formalist structure set forth in the orthodox approach to jurisprudence and a recognition that outside of particular, ritualized aspects of faith, formalism cannot continue to have the same hold over the Muslim imagination. Instead, elements of equity, discretion, and public

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*Impression of Islamic Finance*, 27 *Fordham Intl L J* 150, 189–90 (2003) (“Parties to Islamic finance transactions often assert English or New York law as the governing law relying on the probability that the contracts are more likely to be enforced as written.”).

interest require greater consideration through doctrines such as *istihsan* and *istislah*. Clearly there is significant demand for the Islamic financial institution, as evidenced by its explosive growth into an industry with assets in excess of \$200 billion operating in over 70 nations and growing at an annual rate of over 20 percent per year.<sup>57</sup> Yet without the increasingly difficult to maintain understanding that Islamic finance is a functionally fairer and more socially just alternative to conventional finance, so central to the conception of Islamic finance among Muslims, it is unclear that the industry can continue to expand, or indeed even keep those who have already invested their funds in it. There is already evidence that many Muslim investors eschew Islamic banks precisely for their excessive formalism and failure to articulate a meaningful alternative to conventional finance.<sup>58</sup>

What would such a functional Islamic financial institution look like? I identify three key components, as described below.

First, Islamic finance must recognize commercial necessity. By this I mean that functional Islamic banks redevelop the prohibitions on *riba* and *gharar* so that they no longer cover vital commercial activities in which any bank must engage in order to be commercially viable. A failure to do this merely forces the bank to observe formal prohibitions and utilize valuable resources to circumvent them that could better be used elsewhere.

Second, Islamic finance must remain centered around fairness and social justice. If Islamic jurisprudence simply rendered irrelevant the historic *riba* and *gharar* prohibitions, this would hardly serve the Islamic public interest. It would disregard the populist demands for an alternative form of finance that gave rise to the practice of Islamic finance in the first place. Moreover, it would then be difficult to understand what the purpose of an “Islamic” financial institution would be given its stunning resemblance in that event to a conventional bank. Finally, a functional approach by its terms should not involve the creation of ways to subvert Islamic doctrine but rather should redevelop doctrine into more practical use. *Riba* and *gharar* are real prohibitions meant to serve a functional purpose, and they should do so.

Fortunately, there are ample examples of exploitative or highly speculative gain that an Islamic bank can eschew in keeping with a functional jurisprudence. The savings and loan industry collapse at the end of the 1980s was exacerbated significantly as a result of federally insured savings institutions investing excessively in highly speculative ventures.<sup>59</sup> Stories abound of financial

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<sup>57</sup> Warde, *Islamic Finance* at 1 (cited in note 32).

<sup>58</sup> See note 2.

<sup>59</sup> Martin Lowy, *High Rollers: Inside the Savings and Loan Debacle* 33–34 (Praeger 1991).

institutions offering credit cards and other forms of high-interest consumer debt to individuals clearly without the capacity to pay them. There are various ways banks can recast themselves to address such broader concerns. For example, Professor El-Gamal has suggested that the banks adhere to the “spirit” of the *riba* and *gharar* prohibitions by taking a mutual form.<sup>60</sup> This would minimize the necessity of high-risk, high-return, and potentially exploitative investments to please shareholders seeking maximum profit.

Third, Islamic finance must avoid highly speculative financial products. If the prohibitions in the Qur’an and the *hadith* banning games of chance and the sale of uncaught fish in the sea are to have meaning, even in a limited fashion, then there must be some sort of limitation on the level of speculation in which an Islamic financial institution may engage. In particular, those types of activities that are so speculative in nature as to resemble a “game of chance” prohibited by the Qur’an might be suspect, particularly if they appear to lack a commercial purpose. The precise contours of the doctrine would require refinement, but quite clearly there is an Islamic preference for safer and more predictable investments, and one would expect Islamic banks to adhere to such preferences.

## V. CONCLUSION

If my father were to choose to invest in a functional Islamic institution that adhered to the principles mentioned above, the institution’s representatives would inform him that it operated as conventional banks do: by charging interest and engaging in some form of commercial risk including insurance. However, they could quickly add that they did act in certain ways that conventional banks would not and that an Islamic board approved each and every one of the bank’s investments to ensure that it met certain fairness standards. Also, they could indicate that they shunned investments in financial products that were so highly speculative as to approach a game of chance. The institution in question might take a mutual form, so that my father and his fellow Muslim investors were themselves the shareholders, eliminating the need to attract and retain external shareholders through high profit levels. The institution might also devote a specific portion of its portfolio to interest-free loans to support local Islamic nonprofit ventures. Inasmuch as it failed to offer rates of return that were entirely competitive with conventional banks, this would be because of its dedication to principles which emphasize that communitarian notions of fairness and social justice play as important a role as profit in the commercial affairs of the pious.

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<sup>60</sup> El-Gamal, *Arbitrage* at 9 (cited in note 34).

This would be, it seems, a desired outcome not only for potential investors such as my father, but for the industry as well, if the rhetoric is to be believed.