
The Specific Legal Nature of the Transaction in Islamic Banking Law

Tamara Milenkovic-Kerkovic¹, Mirjana Jemovic²

Abstract:

Prohibitions of interest and interest based income, proscribed by the Shariah law, have forced the Islamic banks and other financial institutions to develop special models of financing. Author examines the legal nature of various financial arrangements offered by the Islamic banks which could be classified into three basic groups of contracts. Some of those transactions are the classical legal agreements based on the profit and loss sharing where the contractual conditions relating to financing, repayments and proportions are ex ante known in which case the banks act as investors. Other models of financing are structured as commercial businesses where bank takes a role of trader or service supplier.

Key Words:

Legal nature, Islamic law, bank transactions, prohibition of interest

JEL Classification: *K22, Corporation and Securities Law, Business Law*

¹ *Associated Professor, Commercial Law / International Trade Law, Faculty of Economics, University of Nis, Serbia, e-mail: salamanca@eunet.rs*

² *ma ecc, Assistant, Banking Brzi brod, Nis, Faculty of Economics, University of Nis, Serbia 062/505915, e-mail: mirjana.jemovic@eknfak.ni.ac.rs*

1. Introduction

One of the fundamental and the best known rules of the Sharia law is that financial institutions are forbidden to collect interest-based income. What is the economic interest of the transactions by these institutions? The answer lays in the fact that Sharia law allows these institutions to collect income for the services they provide, as well as for the risk they take. In addition, these financial institutions have the right to share profit of the projects they have financed including undertaking any losses that would arise in case of so called "bad investments" or simply unsuccessfully realized projects. Hence, the subjects of Islamic banking, just like all other financial institutions, developed a series of financial arrangements i.e. models of financing that enable them to secure income not in conflict with what the Sharia law forbids. Although a certain number of models of financing, provided by these institutions, is almost identical to the models of financing offered by the classical subjects dealing with financing, there is a number of financial arrangements not offered by classical financial institutions, and they, on the other hand, represent basic financial services offered by Islamic banks. Besides, a great number of these arrangements is criticized as they contain hidden interest-based income so there are still theoretical discussions about the nature of their income.

In any case, according to their concepts, current financial and economic crisis in recent years has endangered sustainability of classical transactions of financial institutions, so Islamic financial institutions are seen as the providers of the models of financing that could potentially ease the problems immanent to happenings in crisis of the world economy and finances.

On the other hand, there is a large Muslim population in western countries, who want to use financial services in accordance to the principles of Sharia law and thus, the practice of founding Islamic financial institutions in western non-Islamic countries is becoming more and more common. Thereby, it is necessary to establish the legal nature of such transactions in accordance with the legal theory and business practice in common law and civil law countries so that these transactions could be performed in the third world countries and their obvious advantages utilized.

2. Notion of Interest and Ways of Overcoming its Prohibition

Despite the fact that interest is expressly prohibited by the Koran and other sources of Sharia law, Islamic trade practice developed, which was later adopted by banks, various mechanisms of financing that bring different kinds of income only declaratively distinct from the interest. There are numerous discussions on whether such income contains hidden elements of interest. Most sources determine that the basic element of interest is the increase of the value of money during a time period,

that is, it is considered that all the forms of profit where this element is noticed should be forbidden. In other words, all the forms of profit realized as “the compensation for renouncing current consumption” are not allowed.

Sharia law recognizes two basic kinds of interest (riba): the first kind is the classical interest based on capital value increase, without taking any risks or providing any services, while the second form of interest is, in fact, the consequence of the exchange of goods within different transactions. While the first form of riba is forbidden by Koran, the second is forbidden by Sunet. More exactly, the Koran doesn't only refer to forbidding interest based on money lending but forbidding interest has a wider meaning. Namely, it is forbidden to realize income based on even returning the lent goods in larger quantity or in the value larger than of the lent one. Furthermore, riba also means all the income realized by artificially created shortage, income based on the abuse of a dominant position, the increase of product price on the basis of different methods of payment, etc. (Hoseini, 1997).

Thereby, we have to keep in sight the character of trading activity as being the means of facilitating exchange that creates value, so profit created by merchants does not have the characteristics of riba. This understanding of the nature of trade was of crucial importance for the creation of a number of banking transactions performed by Islamic banks and which are founded on business activities where financial effects of these activities and their exchange are of secondary importance (Siddiqi, 2004).

The most important kind of riba is the one that includes interest payment. Whereby, the level of interest rate doesn't have any influence on the prohibition of interest *eo ipso*, regardless of its amount or value it represents, that is, regardless of the fact whether the interest amounts to 1% or 20% of the value of a loan on annual level.

More detailed discussion on potential elements of interest that might be contained in various financial arrangements is described in the next chapter on transactions in Islamic banking.

3. The Legal Notion and Models of Banking Transaction in Islamic Law

In order to implement Sharia law successfully, Islamic banks form within their organizational structure separate units for the control of the compliance of banking practice with these principles. These organizational units are known as “Religious Supervisory Board”/RSB. These units usually employ experts on Islamic Banking Law with years of experience. Their task is to control regularly all the transactions performed by the bank, the contracts concluded and performed by the bank, as well as to advise the bank so as to secure full compliance with the principles of Sharia law (Saeed, 1999).

The concept of Islamic banking is, in its essence, based on a whole set of various transactions performed by Islamic banks and that can be divided in three basic groups (Erico, Farahbaks, 1998):

- Transactions based on profit sharing;
- Transactions connected with commercial transactions;
- Deposit transactions.

4. Transactions Based on Profit Sharing- the Bank as an Investor

The most important group of financial arrangements used by Islamic financial institutions is based on uniting the resources of the bank i.e. investor and the lender i.e. entrepreneur.

Within these arrangements, contracting interest, as the profit of the bank set in advance regardless of the successfulness of the project realization, is, thereby, strictly forbidden. This way of uniting is reflected in the notion that the participant in the transaction borrowing the money cannot be the only one suffering a loss, since “the God is the only one who determines whether a project will succeed, therefore the risk of failure must be taken by all the participants in a certain transaction”. Practically, the investor is expected to take the entire project risk together with the entrepreneur, that is, the investor has the right to share the realized profit if the project succeeds as well as to otherwise suffer the loss. Conditionally speaking, the only exception in this case would be the loans granted to the state, that are not generally profitable, but the states, in general, pay their debts so the creditors, in this case, never suffer any losses.

In this sense, it is considered that the profit realized by a bank based on this group of arrangements doesn't have the nature of interest as it depends on the amount of the overall profit of the project and is determined ex post, while the interest rate is generally determined ex ante, after the realization of the transaction. In other words, the concept is accepted according to which the banks have the right to realize profit based on acceptance of risk or based on some other grounds. In that way, these transactions are transformed into aleatory legal transactions, where the value of mutual giving is not known in advance.

These are the arrangements based on such legal relation between the bank and the client that include both participants sharing the realized profit in a way defined in advance or that include a way of covering the loss. The basic forms of these arrangements are:

- Profit Sharing (Mudharabah – “profit and loss sharing”) – is one of the most important transactions that Islamic financial institutions deal with. This transaction has certain similarities with the previous arrangement with some significant differences though. The major difference is in the fact that in the

previous case both participants invest capital, while in this case only the bank does so while the entrepreneur provides other resources. This arrangement implies giving a loan, that is, the investor i.e. bank investing capital, on one side, and the entrepreneur investing labour and other physical and intellectual resources.

- It is held that the reason why this transaction is allowed is the fact that the principle of equality is met (the principle that, according to Muslim notion, does not exist in interest) which means that although the investor, having invested the money, practically doesn't have any other obligation, on the other hand, he is the one who would have to absorb the loss if the project was unsuccessful. (Saeed, 1999) Namely, in this transaction, the bank is in fact the investor who takes the risk so there is no element of interest in the profit that the bank could collect.
- Joint investment (Musharakah) – This arrangement is a specific form of “mudharabah” arrangement applied to business entities and implies joint investment of capital of the bank and of the entrepreneur in a certain project in a certain proportion. Thereby, the proportion where both sides would share the profit doesn't have to match the proportion of the capital invested but the proportion of loss sharing has to be identical to the proportion of the invested means. In addition, it is not allowed to contract the profit in a fixed amount in these transactions, for the same reason that exists with “mudharabah”. Within such an arrangement, the bank has the right to its representatives in the managing organs of the legal entity that they entered the arrangement with.
- Musharaka al-Mutanaqisa – In this kind of legal transactions, the bank and its client form a joint legal entity that they contribute means in a certain percentage. This entity buys the asset that the client needs and for the usage of which the client pays a rent to the entity. After a certain number of installments has been paid, the asset used so far becomes the ownership of the client. This arrangement has a large number of elements of leasing; however, there is a difference in the fact that the client in this case enters a particular kind of financial arrangement with his initial participation and the repayment of a rented item, that is, the client repays the participation of the bank in the value of jointly bought subject of the contract. Practically, by means of these installment payments the client changes his status of a co-owner into the status of the only owner of the subject of the contract. This kind of transaction is mainly used for new industrial, agricultural projects or service businesses, while it is less common for commercial transactions (Saeed, 1999).
- Musaqat – represents a specific form of the previous arrangement. It is applied in fruit production. The bank and the client share the profit in the same proportion they invested their capital.
- Muzara'h – also represents a specific form of “mudharabah” arrangements used in farm production. The profit is shared between the bank and the farmer in the

proportion defined in advance, where the bank invests either the capital or the land.

- Direct investments – the concept of these transactions doesn't differ from classical banking. It is based on the participation in share capital of various companies, where investing in the economic activities forbidden by Islam, such as gambling or prostitution is not allowed.
- In this part are analyzed the different types of taxes. The tax rates are analyzed per category and structure and volume of each tax are correlated with their contribution to public revenues as percentage of GDP and total taxation in order to find the trends, similarities and differences between tax regimes among countries.

5. Transactions Connected with Commercial Businesses- the Banks as a Trader

What is stated as the basic reason for conceiving different financing methods is the fact that previous businesses involve high risks and a series of uncertainties. Other reasons for creating different arrangements for these businesses are contained in the facts that these are mainly consumer loans and other loans of smaller value. Some of the most important forms of this arrangement are:

- Cost-plus (Murabahah) – Within the framework of this arrangement the client who wants to buy certain goods, and doesn't have sufficient means at the moment, enters a contract with the bank, according to which the bank takes the obligation to buy the product and the client takes the obligation to buy it up from the bank. Thereby, the banks charge certain percentage of profit for financing businesses such as: import-export transactions, real estate, and equipment purchasing. The client should be familiar in advance with the price of the subject of transaction, other transactional cost as well as the profit rate which is charged to the sum of the price and transactional costs. At the same time, it is necessary that the subject of the transaction should be in the ownership of the bank at the moment it is being sold, which is certified by corresponding documentation. On the other hand, the client has the right to refuse to buy up the product from the bank if it is damaged or if it doesn't match the attached documentation or specification defined in the contract, by some characteristics. Some authors identify this transaction with commission sale. What the bank negotiates with the client is not the price of the product but the profit rate that the bank will charge as a compensation for the service. This is the most significant transaction performed by Islamic banks, i.e. about 75% of the assets of Islamic banks are the investments based on such arrangements. (Saeed, 1999):

Perhaps the most heated discussions are lead in connection with this transaction. As a matter of fact, the main argument in favour of the claims that profit based on this transaction has the elements of interest is the notion that a higher price

on grounds of postponed payment might be identical to selling on credit, whereby the augmented value of the product based on this transaction is equivalent to the interest charged on the basis of the passage of time. In other words, certain economists hold that the economic effect of this arrangement is identical to the one where the bank grants a classical loan, that is, they hold that this financial arrangement only disguises the interest character of the income based on these grounds.

- Leasing (Ijarah) – means the purchase of a commodity by the bank in their own name and on their own behalf and ceding the commodity to the client to use, and the client has the obligation to regularly pay the installments of the leasing arrangement, i.e. the costs of the usage of the commodity, until the complete value of the used commodity has been paid, after which the client acquires the right of ownership over the commodity. In its essence, this arrangement doesn't differ from leasing transactions performed by classical financial institutions. It is necessary to differentiate operative leasing (Ijarah) from financial leasing (Ijarah wal-*Īqtina*).
- Qard al-Hasanah – these are credits with zero interest rate that Koran stimulates the Muslims to grant to those that really need them. The bank has the right to charge administrative costs for granting the credit but this charge shouldn't depend upon the amount of granted loan.
- Istisna – this is the arrangement of purchase with deferred delivery, applied to specified made-to-order items. Thereby, the nature and quality of the item to be delivered must be specified, the manufacturer must make a commitment to produce the item as described, the item is deliverable upon completion by the manufacturer, where the price is fixed in advance while the delivery date is not fixed, that is, a maximum period can be determined after the lapse of which the financier is not obliged to take the item (Islamic-finance.com, 2012). The moment the contract is concluded, it cannot be cancelled one-sidedly (finance.alislam.pk, 2012). As a mode of financing, it is suitable for building constructions as well as for airplanes, ships, complex machinery etc.
- Bonds (Sukuk) – Although interest is forbidden in Islamic financing systems that are not the reason for the bonds not to exist as one of most important financing instruments. This form of financing in Islamic financing is the subject matter of greatest debates as to the answer to the question whether it contains an element of interest. However, bonds in Islamic finances have a somewhat different purpose than in classical financial institutions. Namely, their purpose is not to be the evidence of any debt but they are commercial papers which give the investor a share of ownership in the underlying asset of the issuer, and the income depends upon the successfulness of the issuer's business (al-sukuk.com 2012). They are transferable up to the moment when the debt arises, on the basis of which they were issued, and after that they cannot be traded with but can only be made payable upon maturity.

6. Deposit Transactions Offered by Islamic Banks

Deposit transactions of Islamic banks are a very specific category as it is necessary, on one hand, to motivate the deponents to deposit the means in the bank, and, on the other hand, to follow the prohibition of giving interest to deposits, as it is forbidden by Sharia law.

Some of the transactions by means of which Islamic banks attempt to attract deposits from Islamic population are the following:

- “Two windows”- within this arrangement the deponents have the possibility to choose which kind of deposit they desire to have. Practically, they have a choice between transactional and investment deposits.
- In case of transactional deposits, the bank would have the obligation to set apart 100% of obligatory reserve to these deposits (although this is not the case in practice), and it also has the obligation to guarantee the complete value of deposited means of its clients. These deposits are available a vista.
- In case of investment deposits, they are intended for various investment projects that involve a certain level of risk. The bank wouldn't have the obligation to set apart obligatory reserve for these deposits, but the deponents would bear complete risk of investing the means they deposited, i.e. they would share loss covering just as they would share the profit in the ratio defined in the contract. These deposits can only be withdrawn upon their maturity. If the characteristics of this arrangement are taken into consideration, what can be noticed is that there are numerous similarities with investment funds, where the value of investment unit bought by interested parties depends upon the value of financial instruments, which are in the portfolio of the investment fund. Anyway, investment deposits are connected with an arrangement known as “two tier” that is “mudarabah”. In this case, the assets and liabilities of the bank are completely integrated. More exactly, in the assets of the balance, the bank acts as the financier of various projects within the framework of a classical “mudarabah” arrangement, and here there is no difference in relation to the previous case. On the other hand, in the liabilities of the balance, the deposits of the clients are viewed as investments of a kind, so the value of the deposited clients' means would depend on the successfulness with which the bank places its means, which means that the deponents who enter the “mudabah” contract on deposit with the bank, practically agree to finance the bank as an entrepreneur and bear the risk of the success of the project that the bank invested in. Among other things, this arrangement stimulates saving among Islamic population since saving is not common in Islamic countries because of a relatively low gross national income and the forbidden interest. In this sense, the deponents are allowed to realise compensation based on the deposited money only if they accept the risk, and this is what this arrangement actually enables them to do (Siddiqi, 2004).

- Safekeeping (Wadiah) - The bank guarantees the deponents the complete value of the deposited means. If a deponent pays the bank for this service, the bank is obliged to compensate the value of the safe kept commodity in case of its being lost (wiki.islamicfinance.de, 2012). Otherwise, the bank may freely dispose of these means, whereby the deponents do not have the right to share profit on the basis of the placement of these means, but they wouldn't suffer any losses either. One should also keep in mind that the banks have the right of discretion to give their deponents a gift ("Hibah") and the banks mainly do that in order to keep or attract clients. There are theoretical debates even in relation to such gifts as to whether this gift represents a form of a concealed interest. However, the arguments indicate that this not interest since the banks gives the gift voluntarily and the value of the gift does not depend on the time of keeping the deposit in the bank; there are, in addition, other arguments that justify the existence of such practice.

7. The Adaptation of Transactions of Islamic Banking to Western Legal Regulations

Basel capital adequacy standards are rather arguable in relation to their application in Islamic banks. It can be said that their adaptation to the business principles of Islamic banks represents the greatest problem for the entrance of Islamic banks onto the markets of non-Islamic countries. The problem refers to the question how to keep accounts of certain categories in balances of Islamic banks that do not have an adequate counterpart in the structure of balances of classical banks. A great role in the standardization of accounting standards in Islamic banks may be played by the body known as "Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)". A cautious solution of this issue will be of crucial importance for the regulatory bodies in non-Islamic in relation to assessment of the risk these banks are exposed to.

In order for the Islamic banks to be more competitive and in order for them to open their subsidiaries in other countries and thus spread the area they run business on, it is necessary to reformulate some of the basic principles that Islamic banking is founded on. Some of the advised reforms are (Gafoor, 1996):

- Financing and investment have a different treatment: Loans are granted without calculating interest (riba), but the service costs are charged. Commercial banks deal with loan granting. In this sense, they are not perceived as money lending institutions but as the institutions which provide services and, thus, the banks have the right to be compensated for the provided services.
- Investment is based on profit and loss sharing (mudarabah). Another name for this arrangement may be "participation in financing". Thereby, there are different modes of this arrangement. Investment banks and companies deal with these transactions. The essence of this arrangement is reflected in the association

of two parties: the financier, who has the capital, and the entrepreneur who has the knowledge and technology, with the goal of the realization of a common project.

- The bank does not have the obligation to calculate interest on deposits. Interest rates are forbidden in Islam. Namely, deposit is seen as the credit granted to the bank. The suggested reformulated system does not change this regulation based on the Koran. Traditionally, Islamic banks do not guarantee the safety of deposited amount for all kinds of deposits. Concretely, the deposits of physical persons are completely guaranteed. However, investment deposits are not guaranteed since the banks themselves enter various investment arrangements where losses could arise, so there is no reason why they can guarantee the means invested on the basis of investment deposits. This element is not consistent with the general principles of classical banking and represents an obstacle to the entrance of Islamic banks on foreign markets. Guaranteeing the entire deposited amount for all kinds of deposits would enable these banks to open their daughter companies in any country of the world and to function as a deposit bank. This would be a significant convenience for the Muslims living in non-Islamic countries.
- On the other hand, although Islamic banks should not charge interest to granted loans, according to contemporary opinions, they have the right to be compensated for the costs they have during granting a loan: service costs, overheads, corresponding risk premiums, profit and compensation for the loss of money value on account of inflation. Interest that is forbidden according to Islamic notion is seen as only one component of the costs that Islamic banks are not entitled to, while all the other kinds of income are allowed. In that sense, the compensation based on the placement of Islamic banks would be lower than the cost of interest charged by traditional financial institutions. However, it is also stated that the deponents should have the right to certain income based on some of these ground, as they do not have the right to interest.

8. Conclusions

Islamic banking law is a rare legal system that takes the principles defined by the holy book of the Muslims Quran and other sources of the law that cumulatively make the so called Sharia law as the principal sources of the law. What Islamic banks are expressly prohibited to do is to place monetary means with the interest (riba) set in advance, since it is considered that the poor population is exploited by means of the interest and that their difficult material conditions are used so that the rich would get even richer. Thereby, riba has a much wider meaning than classical interest. There are numerous theoretical discussions as of what riba is at all, what its connection with interest is, if it, among other things, represents the income based on interest regardless of the interest rate or it only refers to so called usury interest.

Nevertheless, the notion of the prohibition of collecting income based on interest represents an important obstruction to the development of economy in Islamic countries. For this reason, commercial practice developed, and later the banks adopted and further developed, some new financial arrangements that enable placement of means and creation of profit on various bases such as taking the risk, profit based on commercial-like transactions, compensation for the loss of money value caused by inflation and others. Within each of these transactions the banks has the possibility of creating profit, but its basis cannot be the mere passage of time, so that in *mudaraba*, for example, there is profit sharing with the risk of sharing a loss as well, while *murabaha* is connected with commercial transactions. At the same time, there is an ongoing discussion about whether these transactions incorporate and skillfully conceal the right to interest or those transactions are really different from the ones that classical financial institutions deal with.

In spite of the fact that interest is forbidden in Sharia law, what is never questioned is the right of the bank to the compensation for the services provided, to income based on transactions in which the bank acts as an investor and consciously accepts the risk, as well as to compensation for the loss of money value caused by inflation.

Among other things, it is necessary to adapt the transactions of Islamic banks with official regulations of the countries where they are founded, which poses a great challenge especially in recent years when founding of these banks in traditionally non-Islamic countries is becoming more and more common, whereby there is also the challenge associated with the fight for survival in the competitive environment of classical financial institutions, which requires a precise adjustment of transactions of Islamic banks with Sharia law, official regulations and happening in the environment.

In this sense, the prohibition of interest imposed to Islamic banks may be best understood as the principle of justice toward the clients and poor population that Islamic banks are supposed to follow. According to this principle, the banks would only have the right to income based on real factors such as risk sharing, service charges and the like. If they are effective and really follow these principles, they will be more competitive in relation to traditional financial institutions so the global effect of such competition could not be assessed as negative.

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