

## **A Brief Introduction to the *Fiqh* of Contemporary *Sharī`a*- Compliant Finance \***

by

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*Fiqh* (lit. “deep understanding”) is a traditional Islamic discipline (*`ilm*) that is concerned with the ethical-legal values (*aḥkām*, sing. *ḥukm*) that are assigned to actions by Allah (God) in the sacred law (*sharī`a*). The values of these *aḥkām* include validity (*ṣiḥḥa*) and invalidity (*fasād*) and degrees of permissibility ranging from obligation (*wujūb*) to disapproval (*karāhīya*) and prohibition (*tahrīm*). A *faqīh*, a *fiqh* practitioner, discerns the *ḥukm* assigned to an action through knowledge of the indicants (*adilla*, sing. *dalīl*) that point to the *ḥukm*. The term “*fiqh*,” when used by itself, usually refers to *furū` al-fiqh* (lit. “the branches of *fiqh*”), the discipline that is concerned with the results of applying the rules that govern the use of indicants, i.e. the *aḥkām* themselves. The discipline that is concerned with the study of the indicants—what they are, how they indicate what they indicate and so forth—is called *uṣūl al-fiqh* (lit. “the bases of *fiqh*”).

*Fiqh* has evolved, as a traditional discipline, throughout the history of the Muslim community. The Companions (*saḥāba*) of the Prophet Muḥammad (*salla llāhu `alayhi wa-sallam*) were encouraged by him to record his statements and to deduce the *aḥkām* of actions that had not been addressed explicitly in the Qur`ān and the Prophet’s exemplum (*sunna*). The *fiqh* positions of the *fuqahā`* of the first few generations of the Muslim community—the *fiqh* positions of the *saḥāba*, their students, their students’ students—were critically transmitted. Eventually, schools (*madhāhib*, sing. *madhab*) of *fiqh* came into being. Increasingly sophisticated *fiqh* texts were produced in which terms of art and concepts were developed and refined.

One of the standards that came into being was the set of topics (*abwāb*, sing. *bāb*) with which the *fiqh* texts dealt and the order in which these topics were presented. According to this standard, the presentation of topics began with acts of worship (*ibādāt*), such as ritual purity and prayer, then dealt with transactions (*mu`āmalāt*), such as sales, leases and marriages. One of the concepts that is indispensable to the *fiqh* of these transactions, *fiqh al-mu`āmalāt*, is the concept of the contract (*‘aqd*).<sup>1</sup> The integrals (*arkān*) of the contract include: 1) the two contractual parties; 2) a spoken form (*sīgha*) that consists of a spoken, written or otherwise communicated offer and a spoken, written or otherwise communicated acceptance and 3) the object of the contract.<sup>2</sup> The spoken form (*sīgha*) indicates the willingness (*riḍā*) of the contractual parties to enter into the contract, which is condition (*sharṭ*) for the validity of the contract according to most *fuqahā`*.

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<sup>1</sup> *al-Fiqh al-Islāmī* 4:78-284.

<sup>2</sup> *al-Fiqh `alā al-Madhāhib al-Arba`a*, 2:131-141.

In the *fiqh* texts, the *fuqahā'* transmitted various types of prohibited transactions. For example, transactions that are characterized by chance (*maysir*), inappropriate consumption of wealth (*akl al-māl bi l-bāṭil*), deception (*ghabn*), indeterminateness (*gharar*) and gross ambiguity (*jahāla*) are prohibited.

Exchange transactions (*mu'āwadhāt*) that are characterized by *ribā* are also prohibited. The *fiqh* texts define *ribā* and give examples of it. Although there is a diversity of opinion among the *fuqahā'* about some of the details of its definition, the essential nature of *ribā* is well understood in *fiqh*: *ribā* is a *sharī'a*-specified surplus in an exchange transaction.<sup>3</sup> Some *fuqahā'* divide *ribā* into *ribā al-faḍl* and *ribā al-nasī'a*. *Ribā al-faḍl* is a type of *ribā* in which the exchange items 1) are of certain categories (*ribawī* items) and 2) are exchanged in unequal quantities. The *ribawī* items are gold, silver, dates, salt, wheat and barley or things that resemble them in certain ways that differ across *madhāhib*. For example, in some *madhāhib* the quality that the jurists extrapolated from the six named items is the quality of being money. According to this approach anything other than gold or silver that has the quality of being money must also be exchanged in equal amounts. *Ribā al-nasī'a* is a type of *ribā* in which the prohibited increase is in consideration of a delay. *Fuqahā'* opined that an increase on a debt (*dayn*) in consideration of a delay is *ribā* and therefore prohibited.<sup>4</sup>

The *fiqh* texts typically present a standard set of *mu'āmalāt*. These nominate transactions figure prominently in *sharī'a*-compliant finance.

The *bay'* transaction is typically presented first in the standard set of *mu'āmalāt* in the *fiqh* texts. The *fuqahā'* define *bay'* slightly differently across the *madhāhib*, but it is defined by some as the exchange of wealth, the price, for wealth, the sales item. A valid *bay'* contract results in the transfer of ownership (*milk*) of the sales item (*mabī'*) from the seller (*bā'i*) to the buyer (*mushtarī*). The buyer or seller may introduce stipulations (*shurūṭ*, sing. *sharṭ*) and exercise various types of options (*khiyārāt*, sing. *khiyār*). There are other contracts—such as *salam*, *istiṣnā'* and *ṣarf*—that are treated as types of *bay'* by some *fuqahā'* and as distinct contracts by others.

The *qarḍ* transaction is a loan. Any stipulation that the borrower repay more than the loan amount is void (*bāṭil*) since this surplus would be *ribā* as mentioned above.

The *ijāra* transaction is defined as the sale of the use (*manfa'a*, lit. “benefit”) of an object. It applies to both the hiring of human beings, as when an employer employs a laborer, and the leasing of objects, as when a lessee rents a vehicle. Various details, including the conditions for the validity of the transaction, that are presented in detail in the *fiqh* texts.

The *shirka* transaction is a partnership. The *fuqahā'* present several types of this transaction in the *fiqh* manuals. According to one form of this transaction, partners (*shurakā*, sing. *sharīk*) agree to contribute money to a common pool and divide the profits that results from their transacting with the pool's funds among themselves according to agreed upon ratios. *Muḍāraba*, called *qirāḍ* by some *fuqahā'*, is treated in some of the *fiqh* texts as a type of *shirka*. In a *muḍāraba*, the two contracting parties are the investor (*rabb al-māl*, lit. “owner of the wealth”) and the entrepreneur (*muḍārib*). The investor provides the funds and the entrepreneur buys and sells with the funds. Any profits are distributed between the two as agreed upon.

<sup>3</sup> *al-Fiqh al-Islāmī*, 4:668; *al-Fiqh 'alá al-Madhāhib al-Arba'a*, 2:202.

<sup>4</sup> *al-Fiqh al-Islāmī*, 4:668-702; *al-Fiqh 'alá al-Madhāhib al-Arba'a*, 2:202-221.

When attempting to ascertain the *ahkām* of conventional financial transactions, contemporary *fuqahā'* use the standard nominate transactions and others concept from *fiqh al-mu`āmalāt* as analytical tools. They typically conceive of contemporary financial transactions as complex combinations of the traditional nominate transactions and evaluate them for validity or permissibility accordingly. For example, when ascertaining the *hukm* of transacting in stock markets, contemporary *fuqahā'* conceive of modern corporations as a type of *shirka* and treat the shares of these companies as certificates of partnership in the corporation. In keeping with the condition of validity for a *bay'* transaction that states that anything whose use is impermissible may not be sold, they observed that it is *harām* to transact in the shares of companies that sell items that are impermissible themselves. This *hukm* applies to transacting in the shares of companies that manufacture intoxicants, for example.<sup>5</sup>

Contemporary *fuqahā'* have identified several widely used classes of conventional financial transactions that feature *ribā*, *gharar*, gross *jahāla* and other characteristics that indicate the impermissibility of the transactions in question. The majority of contemporary *fuqahā'*, for example, hold that interest-bearing loans—such as personal loans, home financing loans, educational loans, international loans, conventional bonds—are characterized by *ribā* and are therefore impermissible.<sup>6</sup> Similarly, the majority of contemporary *fuqahā'* hold that conventional insurance transactions feature *gharar*, *jahāla* and *ribā* and are therefore impermissible.

In response to the positions of contemporary *fuqahā'* on several conventional financial transactions, the *sharī`a*-compliant finance sector has developed a set of transactions that are named after and based on the traditional nominate transactions but serve the purpose of the conventional transaction that they are meant to replace. Contemporary *fuqahā'* aided in the innovation of these contracts—either by collaborating with financial engineers during the design process or by responding to the inquiries of financial engineer who came to them for approval of the contracts after they had been designed. *Sharī`a*-compliant financial institutions—in the areas of project finance, trade finance, consumer banking, home finance and insurance—have developed substitutes for interest-based debt financing and conventional insurance contacts. In the case of interest-based debt financing, the sector has developed three major classes of *sharī`a*-compliant financing: *bay'*-based financing (e.g. *al-murābaḥa li l-āmir bi l-sharā'*), *shirka*-based financing (e.g. *al-mushāraka al-mutanāqisha*) and *ijāra*-based financing (e.g. *al-ijāra wa-al-iqtinā'* or *al-ijāra al-muntihī bi l-tamlīk*).

In a typical example of the first method, *al-murābaḥa li l-āmir bi l-sharā'* (lit. “the cost-plus sale to one who orders the purchase [of the sales item]”), an individual who wants to finance her purchase of an item (such as a factory, an airplane, a house or a car) identifies the item that she wants to purchase, brings it to the attention of the financing entity (e.g. a *sharī`a*-compliant finance company), promises that she will buy the item from the financing entity if the financing entity purchases the item. The financing entity buys the item and sells it to the buyer at an agreed upon, cost-plus price in installments.

<sup>5</sup> Nizam Yaquby [Nizām al-Ya`qūbī], “Participation and Trading in Equities of Companies Which Main Business is Primarily Lawful but Fraught with Some Prohibited Transactions,” Fourth Harvard Islamic Finance Forum, Cambridge, Massachusetts (October 1, 2000) 21.

<sup>6</sup> *al-Fiqh al-Islāmī*, 4:682.

In a typical example of the second method, *al-mushāraka al-mutanāqisha* (lit. “the reducing partnership”), an individual who wants to finance her purchase of an item (such as a factory, an airplane, a house or a car) identifies the item that she wants to purchase and brings it to the attention of the financing entity (e.g. a *sharī`a*-compliant finance company). The financing entity agrees to purchase the item along with the buyer as a her partner. The financing entity and the buyer are now joint owners of the item. Then the buyer purchases the larger share of the item from the financing entity over time and thereby eventually own the entire item.

In a typical example of the third method, *al-ijāra wa-al-iqtinā`* (lit. “*ijāra* and acquisition [of the leased item by the lessee]”) or *al-ijāra al-muntihī bi l-tamlīk* (lit. “*ijāra* terminating in transfer of ownership [to the lessee]”), an individual who wants to finance her purchase of an item (such as a factory, an airplane, a house or a car) identifies the item that she wants to purchase and brings it to the attention of the financing entity (e.g. a *sharī`a*-compliant finance company). The financing entity agrees to purchase the item, and after doing so leases the item to the lessee. At the end of the lease the financing entity sells the item to the lessee.

Generally, *sharī`a*-compliant financial institutions tend to be structured in a manner similar to the structure of their conventional counterparts. In keeping the prevailing custom (*`urf, āda*) of locales in which they operate, these institutions often have shareholders, directors, senior management (e.g. chief executives, presidents and vice president) and other corporate officers. *Sharī`a*-compliant financial institutions, however, tend to have organizational features that conventional institutions do not: namely organizational features responsible for *sharī`a* compliance. One such feature is the *sharī`a* supervisory board (*hay`at al-riqāba al-shar`īya*). Each of these should consist of members who can ascertain the *aḥkām* of the various activities of the financial institution with which it is associated. Ideally, this board is composed of *fuqahā`* who are capable of ascertaining these *aḥkām* themselves. A minority of the board members may also be economists and other trained researchers in *fiqh* who are not technically *fuqahā`*. Periodically often annually, each *sharī`a* supervisory board is expected to review the operations of the financial institution with which it is associated and issue a statement about the institution’s state of *sharī`a* compliance. The *sharī`a* supervisory board is expected to respond to questions that the management of the financial institution brings to its attention, to proactively issue statements of guidance to the management of when it decides that this is appropriate and to be accessible to the general public so that issues of concern related to the behavior of the institution can be brought to its attention. The role of the *sharī`a* supervisory board is so important that it is an emerging matter of agreement in the *sharī`a*-compliant finance sector that an institution should not be called ‘*sharī`a*-compliant financial institution’ without one.