



City Research Online

City, University of London Institutional Repository

Citation: Mersadi Tabari, N. (2010). Islamic Finance and the Modern World; the Legal Principles Governing Islamic Finance in International Trade. *The Company Lawyer*, 31(8), pp. 249-254.

This is the accepted version of the paper.

This version of the publication may differ from the final published version.

Permanent repository link: <https://openaccess.city.ac.uk/id/eprint/18114/>

Link to published version:

Copyright: City Research Online aims to make research outputs of City, University of London available to a wider audience. Copyright and Moral Rights remain with the author(s) and/or copyright holders. URLs from City Research Online may be freely distributed and linked to.

Reuse: Copies of full items can be used for personal research or study, educational, or not-for-profit purposes without prior permission or charge. Provided that the authors, title and full bibliographic details are credited, a hyperlink and/or URL is given for the original metadata page and the content is not changed in any way.



**The University of East Anglia
Norwich Law School Working Papers Series**

<http://lawwp.webapp2.uea.ac.uk/wp/index.php/workingpapers>

NLSWP 10/01 (published January 15, 2010)

**Islamic Finance and the Modern World
The legal principles governing Islamic Finance in International
Trade
by
Nima Mersadi Tabari**

Abstract: Islamic law or *Shari'a* purports to govern all aspects of the private and public life of the believers. Its all-embracing character is the constant narrative of Islam as a religion and a civilization. While *Shari'a* does not address finance in its modern meaning, it does incorporate general principles governing the economic behaviour of the Islamic society and specific instruments regulating classic commercial transactions. Thus, Islamic banks are unable to use conventional methods of financing and seek to provide *Shari'a* compliant alternatives to the services rendered by western banks. They use a different paradigm of financing, namely asset based financing and employ the well defined structure of nominated contracts in Islamic law. This paper would look in some detail to the structure of Islamic Finance instruments and the practical and theoretical implication of the growth of this method of financing for the western lawyers. More specifically the paper seeks to present a concise analysis of the place of Islamic Finance in English Law.

Keywords: Islamic Law, Finance, Banking, Economic Behaviour

Contact details: Nima Mersadi Tabari IALS, University of London,
nimamtabari@yahoo.com

ISSN: 1754-5218

1. Introduction

The last century saw the rise of revivalist Islamic movements, from the Muslim Brotherhood in Egypt to the Islamic Revolution in Iran, seeking to embrace the modern developments without sacrificing strict adherence to the principles of Islam. It was also the age of petro-dollars and huge oil windfalls in the Middle East and the dawn of globalization and free trade. The accumulation of huge amounts of capital in the hands of adherent Muslims, who due to their religious beliefs could not use the conventional banking system, along with the efforts of the revivalists resulted in the creation of Islamic Banking as an alternative to the western system. The industry grew parallel to the conventional banking in many Islamic countries and in some replaced the conventional system.¹ Over the last 15 years Islamic Banking industry has grown significantly and has leaped from its regional markets in search of a global presence. Today, there are more than 300 Islamic banks and financial institutions worldwide, with estimated assets of more than £150 billion.²

While, *Shari'ah* does not address finance in its modern form, it does incorporate general principles governing the economic behaviour of the Islamic society and specific instruments regulating classic commercial transactions. Relying on these, Islamic banks seek to provide *Shari'ah* compliant alternatives to the services rendered by western banks.

2. Islamic Law

Islamic law or *Shari'ah* purports to govern all aspects of the private and public life of the believers, dividing all human actions to objectively good and inherently bad. Its all-embracing character is the constant narrative of Islam as a religion and a civilization. After *Hijrah*³, prophet Muhammad acted not only as the messenger from *Allah* but he also claimed the leadership of the Islamic society, went to war, signed peace treaties, introduced taxes and solved disputes.⁴ Islam purported to address not only the *Ubudiyyat* (Godly issues) but also it claimed the ultimate authority in *Muamalat* (worldly issues).

Historically however, *Shari'ah*, as the structured jurisprudence and formal theology of Islam, was shaped by *Fuqaha* (Islamic scholars) long after the prophet's time. It was the backlash by the traditionalists against the *Mihna* (inquisition), forcefully imposing the ideas of *Mu'tazelah*⁵, during the realm of the Caliph Alma'mun (AD 813-833), which resulted in the establishment of the Asha'ri *Madhab* (school).⁶ Today there are four Sunni

¹ In Iran, Pakistan and Sudan no conventional financial market exists and the entire banking system operates under Islamic principles. Look at: Barbara L. Seniawski, 'Riba Today: The Economy, Social Equity and Doing Business Under Islamic Law' (2000) Columbia Journal of Transnational Law 39

² J. Pollard and A. Samers, 'Islamic Banking and Finance: Postcolonial Political Economy and the Decentering of Economic Geography' (2007) Transactions of the Institute of British Geographers 32(3)

³ The migration of Muhammad from Mecca to Medina (AD 622)

⁴ For a detail account look at: Prof. S. J. Shahidi, *The Analytical history of Islam, to the end of Omavian*, (Tehran University Publications Center, 1983)

⁵ A rationalist school of *Kelam* (theological philosophy) who promoted the prominence of *Aql* (reason) as the main source of law.

⁶ Look at: A. Gurgy, *History of Jurisprudence and Jurisprudents*, (Samt Publications, Tehran, 1997) and Daftar Hamkari Huzah wa Daneshgah, *An Introduction to Islamic Law*, (Intesharat Samt, Tehran, 1986)

schools of *Fiqh* (Islamic Jurisprudence) and one Shi'ah school, all of which are based on the orthodoxy of *Usul al-Fiqh* (sources of jurisprudence).

The *Usul al-Fiqh* or the sources of Islamic law are defined as *Qur'an*, *Hadith* or *Sunnah* (prophet's traditions), *Qiyas* (analogy) and *Ijma* (consensus of the jurists). While the first two are material sources, the third is the rational hermeneutic method, which enables the *Fuqaha* to interpret the two revealed sources. The last one, *Ijma*, was designed to serve as a dialectical sanctioning mechanism for the results of *Ijtihad* (juristic efforts) in the material sources by way of analogy.⁷

During centuries of *Ijtihad*, the body of *Fiqh* was enriched relying on the four sources to become what is now the *Shari'ah*. However, the competing schools are not always of the same opinion, and since their ideas are the result of human efforts, as only *Qur'an* is divine and *Hadith* is quasi-divine⁸, a mechanism of *Ikhtelaf* (disagreement) which provides for "agreeing to disagree" amongst the schools is worked out. Thus, variant opinions of different schools are all considered equally valid. Another innovation by the *Fuqaha* is the utilization of the doctrine of *Masalaha al-Mursalah* (unrestricted public interests) for issues not previously defined in the body of *Shari'ah* rules. According to this doctrine, the jurist may consider the cost and benefit analysis of an opinion in a macro level within the boundaries of the defined framework of the *Maqasid*⁹ (objectives) of *Shari'ah*. For this purpose the *Maqasid* are agreed by the majority of scholars to include the protection of religion, life, intellect, lineage and property. Here, protection of life includes safeguarding the means of facilitating an honourable life and protection of property not only encompasses the right of ownership but also a right to free trade¹⁰ within the limits of *Shari'ah*.¹¹

On the basis of the above-mentioned mechanism and by relying on the sources of Islamic law, the Islamic socioeconomic model was devised. In line with the general principle that, in Islam everything is *Halal* (allowed) unless it has been declared *Haram* (forbidden),¹² the Islamic scholars found the general rules governing economic activities in *Qur'an* and *Sunnah* and on that basis a doctrine of fairness in commercial dealings was

⁷ Look at: M. Mutahhari, *Ashenaei ba U'loum-e-Islami Part 3: Usul -e-Fiqh and Fiqh* (Intesharat Sadra, Qum, 1982)

⁸ "Whatsoever the messenger ordains, you should accept, and whatsoever he forbids you should abstain from" *Qur'an* 4:80

⁹ For an introduction on *Maqasid al-Shari'ah* look at: S.A. Jackson 'Literalism, Empiricism and Induction: Apprehending and Concretizing Islamic law's *Maqasid al-Sharia'h* in the Modern World' (2006) Michigan State Law Review, 1469

¹⁰ "Allah has made trade lawful" *Qur'an* 2:275 ; "Let there be among you traffic and trade by mutual goodwill" *Qur'an* 4:29

¹¹ Look at: 4 and 6

¹² According to the classical view the Islamic economic model is based on the freedom of trade and freedom of contract so far as the limits of *Shari'ah* allow. Thus, trade is limited to *Amwal* (commodities) which are *Halal*. For example selling or buying pork is absolutely forbidden. Moreover, trading in options would be forbidden as options would be categorized under *Huqooq* (rights) not *Amwal*.

established.¹³ This doctrine is based on prohibition of *Riba* (usury), *Gharar* (uncertainty) and *Qimar*¹⁴ (gambling) and encouragement of *Taa'won*¹⁵ (mutual cooperation).¹⁶

Prohibition of *Riba* requires that any reward or return should be accompanied by undertaking a level of risk and liability. Thus, there can be no reward for time preference alone. Prohibition of *Gharar* forbids contracting under conditions of excessive uncertainty and unacceptable levels of risk. Prohibition of *Qimar* forbids gambling and any game of chance which may result in accumulating *Maysir* (unearned income). Thus, uninformed speculation not based on a proper analysis of available information is not allowed. This means that speculative practices such as short selling even if accompanied with a proper mechanism of hedging the risks would not be allowed under *Shari'ah* as each individual trade in such a system of hedging may amount to betting on a stock and has the characteristics of *Qimar*. Of the above principles the prohibition of *Riba* and *Gharar* which are of greater importance will be explained in more detail.

Prohibition of *Gharar* means that existence of any avoidable uncertainty in a commercial dealing would invalidate it as it may lead to deceit or unjust enrichment. In practice however, as no commercial dealing can ever be completely free of risk and uncertainty, it has always been assumed to mean an unacceptable level of uncertainty, where the level of acceptability is largely defined by the facts of each individual case. Classically the question was mostly raised with regards to two sales in one contract, sale of an object which did not yet exist¹⁷, sale of an object which was not yet in the control of the seller¹⁸ or when the consideration furnished by one party in a contractual agreement was undeterminable¹⁹. It is agreed by a majority of scholars that *Jahl* (ignorance) of price or subject matter, characteristics of price or subject matter,²⁰ quantum of the price or quantity of the subject matter and finally date of performance or delivery would render a contract void for existence of *Gharar*. Thus in the context of modern commercial

¹³ What followed from this general doctrine of fairness created an ethical economic model were the forces of the market are protected from unfair manipulation. Thus, inflating the price of commodities by creating artificial shortages (*Ihtekar*), overbidding for the sole purpose of driving the prices up (*Najash*) and concealment of vital information in a transaction from the other party (*Ghish*) are forbidden.

¹⁴ "They ask thee concerning wine and gambling. Say: "In them is great sin, and some profit, for men; but the sin is greater than the profit." They ask thee how much they are to spend; Say: What is beyond your needs. Thus doth Allah Make clear to you His Signs: In order that ye may consider" *Qur'an* 2:219 "O ye who believe! Intoxicants and gambling, (dedication of) stones, and (divination by) arrows, are an abomination,- of Satan's handwork: eschew such (abomination), that ye may prosper." *Qur'an* 5:90 "Satan's plan is (but) to excite enmity and hatred between you, with intoxicants and gambling, and hinder you from the remembrance of Allah, and from prayer: will ye not then abstain?" *Qur'an* 5:91

¹⁵ The prophet approved of the pre-Islamic practices of cooperation amongst the tribes of the Arabian peninsula and such practices became part of the Islamic tradition and found their way to *Shari'ah* mostly by reliance on the prophets *Sunnah*.

¹⁶ For a detailed account on Islamist Economics: M. Mutahhari, *Mabani-e-Eqtesad-e-Islami*, (Intesharat-e-Hekmat, Tehran, 1970); also: Imam Musa Sadr, *Eqtesad dar Maktab-e Islam* (Ashraf, Lahore, 1971)

¹⁷ An unborn calf: "The people used to sell camels on the basis of Habal-al-Habala. The Prophet forbade such sale. Nafi' explained Habalal-Habala by saying. The camel is to be delivered to the buyer after the she-camel gives birth." *Sahih Bukhari, Volume 3, Book 35, Number 457*

¹⁸ The bird in the sky or the fish in the sea

¹⁹ The promise of delivering the catch of a certain day by a diver against a fixed price

²⁰ "The Prophet forbade two kinds of sales i.e. Al-Limais and An-Nibadh (the former is a kind of sale in which the deal is completed if the buyer touches a thing, without seeing or checking it properly and the latter is a kind of a sale in which the deal is completed when the seller throws a thing towards the buyer giving him no opportunity to see, touch or check it) and (the Prophet forbade) also Ishtimal-As-Samma' and Al-Ihtiba' in a single garment." *Sahih Bukhari, Volume 1, Book 8, Number 364* Thus the purchaser should have opportunity of examining the goods to ascertain the information.

dealings *Gharar* may rise from unacceptable levels of settlement risk, inadequate and/or inaccurate information²¹ and complex contracts where multiple transactions are not identifiable with multiple independent contracts.

Any excess to the principle amount of loan, which a creditor is settled to receive from the debtor in return for the time the debt is owed, is *Riba* and absolutely *Haram*.²² The issue was first raised with regards to *Riba al-Jahiliyya*, which referred to a common pre-Islamic practice in the Arabian Peninsula, according to which the debtor would have the option of settling the debt on maturity or swapping it for a larger debt with a longer maturity period.²³ The principle was extended to avoid any kind of unjust disparity between the exchange objects. Specifically, this includes *Riba Alfadhl* (*Riba* of excess) and *Riba Alnisiyah* (*Riba* of delay). The former refers to the principle that, exchanging units of the same merchandize is only allowed when they are equal in quantity and quality.²⁴ The latter in essence refers to the deferral of the payment of the price/value of a merchandize in money or of the delivery of another kind of merchandize in return. Moreover, the majority view is that discounting a debt in a commercial relationship unless for benevolent reasons and wholly unrelated to the time of maturity is also *Riba*.

It follows from the above that *Bai al-Dyn* (sale of debt) for a negotiable price is forbidden. Thus in principle, based on the orthodoxy, Islamic banks may not indulge in bill discounting and asset securitization as conventional banks do, nor are they allowed to trade in swaps, forwards and futures as they all involve sale of one debt to another. Moreover, although the Islamic bank may charge a fee for the services rendered it may not calculate the fee based on the size of the subject debt but rather on the basis of the actual costs of the service. Any *Ujr* (fee) not solely based on the costs occurred and in any way related to the amount of the debt transferred, is *Riba* and forbidden.

3. Instruments of Islamic Finance

Prohibition of *Riba* in Islamic finance effectively means that under *Shari'ah*, loans are charitable agreements and any loan made in order to make profit is considered to involve *Riba* and thus is prohibited. However, some scholars have argued that the prohibition of *Riba* does not necessarily cover all forms of interest. For example, Iranian banking laws provide for two exceptions to the rule; first, charging a reasonable rate of interest as penalty for late payment and second, charging interest in dealings with foreign entities.²⁵

²¹ "Both the buyer and the seller give the option of either confirming or cancelling the bargain three times, and if they speak the truth and mention the defects, then their bargain will be blessed, and if they tell lies and conceal the defects, they might gain some financial gain but they will deprive their sale of (Allah's) blessings." *Sahih Bukhari, Volume 3, Book 34, Number 327*

²² "O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers" *Qur'an 2:278*

²³ "That which ye give in usury in order that it may increase on (other) people's property hath no increase with Allah; but that which ye give in charity, seeking Allah's Countenance, hath increase manifold." *Qur'an 3:39*

²⁴ "The bartering of gold for silver is *Riba*, except if it is from hand to hand and equal in amount, and wheat grain for wheat grain is usury except if it is from hand to hand and equal in amount, and dates for dates is usury except if it is from hand to hand and equal in amount, and barley for barley is usury except if it is from hand to hand and equal in amount" *Sahih Bukhari, Volume 3, Book 34, Number 344*

²⁵ B. Sabahi, 'Islamic Financial Structures as Alternative to International Loan Agreements: Challenges for US Financial Institutions' (2005) Annual Review of Banking and Financial Law 24

Nevertheless the majority view is in line with the orthodoxy that loans can only be charitable contracts and never means of making money.

Prohibition of *Gharar* in Islamic finance means that a transaction involving an unacceptable level of uncertainty would not be valid. Thus derivatives, including options, forward contracts and futures would be invalid.²⁶ Another result of this prohibition is that conventional insurance would be invalid, since the total amount of the premium paid by the policyholder is undeterminable and this imposes an unacceptable level of uncertainty on the price of the agreement.

As a result of these two general prohibitions Islamic banks are unable to engage in many conventional banking practices through standard methods. Islamic banks use a different paradigm of financing, namely asset based financing and profit-loss sharing agreements, and employ the well-defined structure of nominate contracts in Islamic law. A simple nominate contract which is used as a starting point on many other instruments is *Bai* (sale).

It follows from the general prohibitions on *Gharar* and *Riba* that a *Bai* contract to be valid under *Shari'ah* must be instant and absolute. Thus, a sale attributed to a future date or a sale conditional on a future event is void. The *Mabi'y* (subject of sale) must be a property of value.²⁷ It should be in existence, in the ownership of the seller and in his/her constructive or actual possession at the time of sale. The *Mabi'y* should not be forbidden in Islamic law, for example: selling or buying pork is not permissible. The *Mabi'y* must be specifically known and identified to the buyer. The delivery time must be certain and should not depend on a condition or chance. And finally the *Thaman* (price) must be certain and determinable.

In principle the premise of "time value for money" where conventional banks operate is a no go area for Islamic banks as in the context of debts it would always amount to *Riba*.²⁸ However, according to *Shari'ah* a seller may charge a purchaser the cost of a merchandise plus an added value. The profit accrued from such a *Bai* contract entered to by the free will of the parties is *Halal* in absent of *Ghish* or *Gharar*.²⁹ On the basis of this general economic model, Islamic scholars created different models for commercial dealings based on *Bai* (sale) to define and regulate *Halal* methods of financing commerce. *Murabaha*, is one of the models of *Bai* which is used in international trade as the main part of a hybrid instrument along with a *Bai bi Thaman Ajil* (sale with deferred payment), or simply *Bai Mua'jjal*, more than any other method of Islamic finance.

²⁶ Mahmoud E. El-Gamal, 'A Basic Guide to Contemporary Islamic Banking' Available at: <http://www.ruf.rice.edu/~elgamal/files/primer.pdf> access 24/04/08

²⁷ For the purpose of *Bai* this is defined as a tangible asset, which is an onerous definition for the utilization of *Bai* in Islamic finance. Thus under the doctrine of *Masalaha al-Mursalah* the majority of contemporary jurists have ruled that where tangible assets and monetary obligations are combined, for example in sale of a company, if the tangible assets constitute a significant part then the price is negotiable if how ever monetary obligations constitute the significant part then any discounting or pricing of those obligations would result in *Riba*.

²⁸ It can be argued that an interest may be charged on debts in compliance with *Shari'ah* if its value is pegged to the purchase power of the debt at the time of maturity as defined by a commodity index thus in effect applying a "time value for money" principle to Islamic finance.

²⁹ "Those who devour usury will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (The offence) are companions of the Fire: They will abide therein (for ever)." *Qur'an* 2:275

Arguably more than 80% of the Islamic banking business is in trade financing on the basis of *Murabaha*.³⁰

4. *Murabaha* in Islamic Finance

Murabaha is a variation of *Bai*, where the buyer purchases a commodity for the price for which it was acquired plus a defined profit. Thus, the distinctive feature of *Murabaha* is that the seller discloses the actual cost incurred and asks for a set amount of profit which can be demanded as a lump sum or as a percentage of the cost. For trade finance purposes a customer approaches an Islamic bank, instructing it to purchase a certain item at a defined price and offers the bank to buy that item from it with a set profit. The bank buys the item and then sells it to the customer at a marked-up price. Very rarely do the Islamic banks use a simple *Murabaha* transaction, as cost plus profit sale, with the price paid by the customer immediately and in full. In this case no financing is involved and the bank would only act as a *Simsar* (broker or middle-man).

In Islamic finance *Murabaha* is usually used for providing trade financing in conjunction with *Bai Mua'jjal* which is a form of credit sale permitted in Islamic law. Thus, the customer would pay the price later and often in fixed installments and the bank would receive a set margin of profit in return for the initial spot purchase that it had made on the instruction of the customer. The bank is entitled to the profit as it takes the title, even for a very short time, and assumes a risk. The profit is usually defined in reference to an interest rate index such as the LIBOR (London Inter-Bank Offered Rate).³¹ This method of determining the profit in a *Murabaha* sale is a natural outcome of a dual financial system. The profit obtained is not *Riba*, as the market value of assets and the interest rate index are indicative of one another. Hence, the similarity of the outcome to the conventional financing method is a predictable result of the two systems operating in the same global market.

The *Murabaha* component insures the validity of the hybrid method by imposing a set margin of profit and the *Bai Mua'jjal* component satisfies the requirement of definite amount of payment in a certain time. The bank is entitled to the profit as it takes the title, even for a very short time, and thus assumes a risk. It is in essence, first a buyer in a simple *Bai* and then a seller under a variation of *Bai* and in none of the two stages it assumes the role of a conventional creditor. In practice banks ask for an assurance from the customer that it would buy the item, this form of promise is enforceable as *Iqa'* (unilateral contract) according to the unanimous opinion of the Shi'ah scholars of Ja'fari school, as the bank has relied on a promise and acted on it by making a purchase in accordance with the instructions of the customer. However, according to the majority of scholars in Sunni schools a promise on its own is not enforceable in law and is at best only morally binding. This exposes the banks to an unjust high degree of risk. Hence, some scholars are of the view that such a promise in a *Murabaha* agreement should be enforceable in law as an exception to the general rule.

³⁰ Ibrahim Warde, *Islamic Finance in the Global Economy*, (Edinburgh University Press, Edinburgh, 2000), 133

³¹ Tarek S. Zaher and M. Kabir Hasan, 'A Comparative Literature Survey of Islamic Finance and Banking' (2001) *Financial Markets, Institutions and Instruments* 10 (4)

Acting as a buyer based on the instructions of the customer obviously puts a duty on banks which they are not particularly well placed to undertake, specially when the subject of the deal requires special expertise which the bank may not possess. To remedy this shortcoming a common practice used by the banks is appointing the customer as their agent to get involved in the actual sales process on behalf of the bank. Thus, the customer would be responsible for negotiating all of the commercial terms with the seller of the assets. This is a practical way of avoiding complexities such as the delivery of nonconforming goods, but is irrelevant as to the validity of the whole method of financing by way of *Murabaha* in conjunction with *Bai Mu'jjal*. Moreover, it is common to put the risk of any fine or penalty rising from strict liability, taxation and customs on the customer by express terms in a covenant package containing indemnity provisions.

5. *Murabaha* and English Law

The prominence of London, as the hub of international trade and home to many of the influential financial institutions in the world and the presumed high degree of certainty which English law provides for commercial disputes have resulted in a large amount of Islamic banks using English law as the governing law of their *Murabaha* agreements. A common practice is to incorporate a choice of law clause in the underlying *Murabaha* contract expressly designating English law as the governing law of the contract. However, as the validity of any commercial activity under *Shari'ah* requires the applicability of the rules of *Shari'ah* to that activity, the Islamic banks invariably add a phrase to the choice of law clause to the effect that the applicability of English law is subject to the rules of *Shari'ah*.

The United Kingdom is a signatory to the Rome Convention³² and with regards to any questions arising from a choice of law clause or applicability of an alien law would enforce the Convention as applied in English law by way of the Contracts (Applicable) Act 1990.³³ Article 3 of the Rome Convention by implication provides for the applicability of one law, this is similar to the common law prohibition of applicability of competing laws, thus putting the words "*Shari'ah*" and "English law" in the choice of law clause of the underlying contract will not solve the problem, as English courts, if they have to choose on discretion, would most definitely choose English law. Furthermore, the wording of Article 5 of the Convention impliedly excludes the choice of a law other than the law of a State. Thus, *Shari'ah* which is not the law of a specific state but rather a set of general rules as illusive to the English courts as *lex Mercatoria* is excluded by the Rome Convention from being the governing law.

In *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Limited*³⁴, where the parties had stated in a choice of law clause, the English law would apply to their contract subject to the principles of *Shari'ah*, the trial judge gave judgment to the applicability of English law in line with the above reasoning and also added that, the parties had not intended to choose *Shari'ah* as a governing law as it is a mere set of religious principles and the English court should not and will not get involved in religious controversy. This

³² Convention on the Law Applicable to Contractual Obligations, 1980 O. J. (L 226), 19 I. L. M 1492 (1980)

³³ Jason C. T. Chuah, 'Islamic Principles Governing International Trade Financial Instruments: A Study of the *Murabaha* in English Law' (2006) *Northwestern Journal of International Law and Business* 27

³⁴ [2003] EWHC (Comm) 2118 (Eng.)

judgment was later upheld on appeal³⁵ where the court accepted the banks submission that the reference to the “principles of the glorious *Shari’ah*” was no more than a reference to the fact that the bank purported to conduct all its affairs according to the principles of *Shari’ah* as monitored by its own *Shari’ah* Board.

Article 10(2) of the Rome Convention, encourages the courts in finding the governing law of a contract, to consider the law of the jurisdiction that the performance takes place. Thus, *Shari’ah* could govern the contract by way of imposing *Shari’ah* based laws of an Islamic state if the performance takes place under the jurisdiction of that state. In *Islamic Investment Company of the Gulf (Bahama) Ltd v Symphony Gems NV and Others*³⁶ the defendant unsuccessfully relying on the doctrine of *loi d’application immediate*³⁷ argued for the application of *Shari’ah* on the basis that it was the law of the land in Saudi Arabia and the contract, at least in part, was to be performed there. The court rejected the argument on the facts, asserting that as the payment obligation was not to be discharged in Saudi Arabia the agreement was at best peripherally related to Saudi Arabia. Thus, unless it can be proven on the facts of the case that the performance of a *Murabaha* agreement is substantially in a *Shari’ah* jurisdiction, neither the illegality argument nor the Article 10 argument would succeed. In any case, most of the supposedly Islamic jurisdictions either have a dual secular and *Shari’ah* based legal system (such as Malaysia) or have consolidated *Shari’ah* principles in form of written legal codes sanctioned by one or another school of *Fiqh* and thus indirectly apply *Shari’ah* (such as Iran).

6. Conclusion

A general referral to the applicability of *Shari’ah* would not suffice for the English court to regard it as the governing law of the underlying transaction. A solution to this problem is to refer to the laws of a State implementing the *Shari’a* rules in its laws. This, however, may fail since if the transaction would be substantially performed in, and/or related to the United Kingdom, exclusion of the mandatory rules of English law would be prohibited. A more practical solution is to incorporate the Islamic principles by way of express terms in contractual form, or by creation of an instrument similar to the International Chamber of Commerce’s Uniform Customs and Practice for Documentary Credits³⁸ to be referred to

³⁵ Look at: [http://www.ipsofactoj.com/international/2004/Part12/int2004\(12\)-009.htm](http://www.ipsofactoj.com/international/2004/Part12/int2004(12)-009.htm) accessed 27/04/08

³⁶ Unreported, see Balz, K. “A Murabaha Transaction in an English Court- The London High Court of 13th February 2002 in *Islamic Investment Company of the Gulf (Bahamas) Ltd. V. Symphony Gems N.V. & Ors.*” (2004) *Islamic Law and Society* 117-134

³⁷ English law would regard an otherwise legal act illegal if it is unlawful at the jurisdiction where it should be performed.

³⁸ One of the legal instruments used in international trade to shape a reliable commercial relationship is the documentary credit (DC). DC is in essence a conditional guarantee of payment made by usually a bank (issuing bank) to a named beneficiary (seller) on behalf of the applicant (buyer) undertaking to pay the beneficiary, provided that the terms of the credit (tender of the required documents to the nominated bank) are met. A DC may also be a financing tool, reducing the liquidity constraints associated with open-account transactions. As the value of a DC backed receivable is linked to a bank, the seller is more likely to be able to sell the receivable at a discount or use it as security to borrow capital and raise liquidity. However, DCs can only be attractive risk mitigation and financing tools if the underlying process would be a consistent and predictable one. Sellers and buyers in international transactions should be confident that the banks would handle documentary credits in a uniform manner. In 1933 the first Uniform Costumes and Practice for Documentary Credits (UCP) was devised by the Commission on Banking Technique and Practice

and incorporated in the contracts. This would solve the problem of definability of *Shari'ah* for the English courts and as a set of definite rules it would be applicable under the principle of party autonomy as *lex contractus*.

However, while this could be an efficient solution it may be repugnant to the strict adherence of many of the clients of the Islamic banks to Islamic principles, as it seeks to reduce the large and diverse body of Islamic jurisprudence to a mere set of forms or standards of practice and in effect negate centuries of the application of the doctrine of *Ikhtilaf*. Moreover, this means that the contract would be solely governed by English law, which may be incompatible with some of the provisions of *Shari'ah* and thus contradict the application of Islamic rules. Nevertheless, it is the only pragmatic solution for now.

Islamic Banking is a relatively young industry and while it is growing in a phenomenal rate, for it to reach the degree of sophistication of the conventional Banking Industry would take time. However, the future of Islamic finance looks bright despite the slowdown in the international financial markets and current recession in global economy. As an asset based method of financing it is more inclined to gradual market corrections and less prone to over lending or over borrowing. This, however, is far from economic dogma and the Islamic banks should be aware of the inevitable risks that any financial institution is exposed to.

(CBTP) of the International Chamber of Commerce (ICC) to serve this purpose. Since then approximately every decade CBTP has revised and updated the UCP to insure its consistency with the developments in international trade and banking practice. UCP 600, the latest result of these revisions, came into effect in July 2007.