

ISLAMIC LAW, ADAPTABILITY AND FINANCIAL DEVELOPMENT

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A large literature contends that legal systems that adapt efficiently to meet the contracting needs of the economy foster financial sector development. The paper discusses the adaptability features of Islamic law related to commercial transactions (Islamic commercial law) in light of contemporary financial system. After discussing the nature and way the common and civil law traditions can evolve, the paper discusses the history and the adaptability features of Islamic law. Given the principle of permissibility, Islamic commercial law can evolve within the limits imposed by Shari'ah. Recent history of the growth of the Islamic financial sector based on new rulings of Shari'ah scholars is an indicator of the adaptability of Islamic law to changed situations. While Islamic law can evolve, other elements of the legal infrastructure like laws and statutes and dispute settlement institutions also need to be strengthened. The adaptability features of Islamic law along with the strengthening the legal infrastructure are vital components of the development of the Islamic financial sector.

1. INTRODUCTION

A large literature has discussed the role of law and legal institutions on financial development. One of the important determinants of financial development is adaptability of law to changing conditions. Adaptability underscores the formalism of laws and the ability of legal traditions to evolve. Specifically, legal systems that adapt efficiently to the contracting needs of the economy foster development of the financial system. Empirical studies have compared the adaptability features of the civil and common law countries and found that more flexible legal systems can explain the status and development of the financial system.¹ While most studies on the effect of legal system on financial development are related to variants of the civil and common law regimes, there is no attempt to discuss the status of Islamic law on finance. This research will fill this void. The paper first aims to examine the main features of Islamic law and identify its adaptability characteristics, and then

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¹ For example see Beck and Levine (2003) and Beck et al. (2004).

discusses the scope of developing a sound legal infrastructure related to financial sector development.

A legal system comprises the legal order and legal regime (Kornhauser 2001). While the order consists of the legal norms of the system as expressed in the constitution, statutes, administrative regulations, juridical decisions, etc., the legal regime represents the existing legal institutions like legislatures, administrative agencies, courts, etc. Elements that support the proper functioning of the legal system can be termed as infrastructure institutions. These include appropriate laws enacted by legislature, courts for implementing the laws, etc. The financial structure of a modern economy is composed of the financial markets and intermediaries (Santomero and Babbel 2001). Financial development, therefore, signifies efficient functioning of the markets and intermediaries in providing the financial needs of the economy.

The question of adaptability of the law to changing circumstances is vital to the development of Islamic financial system. Issues like legal formalism, dynamism, and the efficiency with which laws can adapt to changing circumstances will determine to a large extent how this sector will grow in the future. The scope of this paper is, however, narrow. This study does not deal with the whole body of law or the legal system. While the main focus of the paper is the adaptability of law, some aspects of the legal infrastructure related to the financial sector development are also discussed. While Islamic law encompasses various subject matters like rituals, family, inheritance, criminal, constitutional, fiscal, etc. the focus of this paper is on injunctions on commercial transaction (Islamic commercial law) only, as it is this law that is relevant to financial growth.

The paper is organized as follows. Section 2 discusses the nature and adaptability features of the civil and common law traditions. While Section 3 outlines the sources and evolution of Islamic law, Section 4 analyzes its adaptability features. In Section 5, some recommendations related to the legal infrastructure institutions that may facilitate growth of the Islamic financial sector are provided. The last section concludes the paper.

2. COMMON AND CIVIL LAWS: FEATURES AND ADAPTABILITY

Law entails a body of rules which can be formed in various ways like statutes, decrees and edicts, decisions of judges or jurists, etc. While various legal traditions exist, civil and common law systems dominate the scene.² These Western legal systems spread around the world through conquest, colonization, and imitation (Beck and Levine 2003). With the exception of few, most Muslim countries have also adopted these Western legal models, particularly when it comes to commercial

² For example, excluding the legal systems based on religion, World Bank (2004) identifies common law, civil law, German civil law, Socialist law and Nordic law as prevalent laws in the world.

law. Specifically, countries that were ex-British colonies have adopted the English common law framework and the ex-French colonies adopted the civil law tradition.³

Being from the Western law family, these legal systems share similar social objectives of individualism, liberalism, and personal rights (Tetley 2000). One of the features of the Western legal systems is the secular overtures resulting from the European enlightenment (Mallat 1993, p. 3). To have a comparative perspective of the civil and common law systems with that of the Islamic system, we highlight the concepts, sources, and styles of these Western legal systems and their adaptability features in this section and give details of the Islamic legal system in sections that follow.⁴

2.1. Civil Law

The civil legal system has its roots in Justinian's Roman law in which he assumed all law-making and legal interpretations power. It developed later in continental Europe in the 19th century. Before the French revolution, the judicial system in the country was fragmented and corrupt, serving the interests of the elite. After the revolution, this was corrected by bringing in a strong central legal system that placed the state above the courts. This limited the role for judges to interpret the civil law. The civil law tradition also evolved in Germany, Italy, Poland, and Scandinavia in form of codified laws and asserting the power of the state. Similar legal system was later adopted in Near East, Northern and Sub-Saharan Africa mainly through conquests and colonization.

In civil law tradition, general principles are embodied in codes and statutes. The civil laws are codified and written in complete and coherent codes leaving little gaps. Civil law codes and statutes do not provide any definitions and state principles in broad and general but concise phrases. The civil codes form the core of the laws exposing the general principles systematically and exhaustively. While statutes are important in both civil and common legal systems, they differ in their functions. The role of statutes is to complement and complete these codes in the former system.

Judges apply law based on a doctrine that provides guidance to interpret the general codes and statutes. The doctrine style focuses on the history, identifies the functions, and determines the domain of applications of the legal principles. While the effects of the legal principles in terms of rights and obligations are explained, the general and exceptional effects are also inferred. Judges enjoy authority of reason to interpret these general codes and rules for specific cases. Civil law judgements first identify the relevant legal principles and then evaluates if these

³ See World Bank (2004) for legal regimes adopted by different countries, including the Muslim countries.

⁴ Information on civil and common law systems are taken from Tetley (2000) and Owsia (1994).

can be used to the facts to the case. The rules and principles also serve as guide for solutions of particular cases to both practise and courts. Determining the area of applying the legal principles require some statutory analysis and induction from existing case law. Judgements of one court do not have any bearing on other courts.

2.2. Common Law

The common law developed in England in the 11th century with emphasis on property rights and assertion of the law over the state (king). English common law is not as rigid and formalistic as the civil law as it gives the judges more room to manoeuvre in terms of evidence, witnesses, etc. In common law system, the principal source of law is jurisprudence. Jurisprudence in terms of case law forms the core of the law expressed through specific rules applicable to specific facts. As judgements become law, these extensively expose facts and distinguish between facts of previous cases, and then decide (or create) the specific legal rule applicable to the case in question. The style of doing this is to focus on fact patterns. Cases with similar (but not identical) facts are analyzed to extract specific rules and then determine the narrow scope of each rule for specific cases through deduction. Sometimes new rules can be proposed to cover facts that have not yet occurred. Thus, the judges can interpret and create laws as the circumstances change and demand and hence jurisprudence evolves with the experience and decisions of the judges.

In common law system, reason of authority exists whereby lower courts are bound to follow decisions of higher courts (termed as the doctrine of *stare decisis*). Common law statutes are precise in providing detailed definitions and descriptions of specific applications or exceptions. The statutes indicate the specific part of the law that needs reform so that courts can use these rules to particular facts that the law covers. In this legal tradition, the statutes complete the case law.

2.3. Adaptability of Laws and Financial Development

Recent literature has discussed the link between the legal origin and financial development. One of the important factors that determines the financial sector development is the legal system and the adaptability of laws.⁵ Adaptability focuses on the 'process of law making' and refers to the ability of the laws to evolve in response to the changing socioeconomic conditions (Beck et al. 2004, p.3). Laws that are slow and costly to change leave gaps between financial needs of an economy and hinders efficient financing and financial development. While there are various ways in which adaptability is measured, we focus on a couple of these. First, sources of law in terms of juridical decisions and statutory law. Second, legal justification as to whether juridical decisions are based on equity or on statutory law (Beck et al. 2004).

⁵ See Beck and Levine (2003), Beck et al. (2003), Pistor et al. (2002), Bailey and Rubin (1994).

The ability of laws to evolve depends on the degree to which judicial decisions or case law are sources of law. Case law enables inefficient laws to be replaced by efficient laws through litigation and jurisprudence. The common law rules can change from time to time subject to the doctrine of *stare decisis*. Legal systems based on case law and judicial discretion are more flexible and can respond to changing financial conditions. This change cannot happen easily in cases where law is based on statutes and codes framed by the legislature. Thus, the civil law system in which laws and statutes can change by the legislature and are imposed on courts, introduces procedural formalism. With the absence of jurisprudence and the fact that statutory law is slow and costly to change in civil law systems, the efficiency of adaptability of laws is affected adversely. According to the adaptability channel, firms face higher financing obstacles in countries where juridical decisions are based on statutory law rather than principles of equity.

In empirical studies, case law and legal justification are used as proxies for adaptability. Empirical studies confirm that the case law as a source of law is positively linked with stock market development and bank development (Beck and Levine 2003 and La Porta et. al 2002). Beck et al. (2004) finds that adaptability has a significant effect on the obstacles that firms face to get external finance. Specifically, firms in civil law system countries where statutory law are source of law and Judgements are based on statutory law rather than equity, face higher financing obstacles than common law countries where case law is the source of law and Judgements are based on equity rather than statutory law.

3. ISLAMIC LAW: SOURCES AND EVOLUTION

Islamic law started with the advent of Islam. The overall goal of the Islamic law is to promote welfare (*masalih*) of mankind. This goal in broad general terms implies, among others, to ensure growth (*tazkiyah*) and justice (*qist*) and in specific terms relates to *maqasid* al-Shari[ah] implying the protection of religion, life, reason, progeny and property. Thus, the objective of Islamic commercial law would be to ensure one or several of these goals. For example, the goals of prohibition of *riba* is to ensure justice and equity.⁶

The sources of knowledge in Islam can be broadly classified into two: revealed and derived. The revealed knowledge, the Shari[ah], constitutes the primary source of Islamic principles and rulings.⁷ Shari[ah] can be further divided as the recited revelation (the Qur'an) and the non-recited revelation (the *Sunnah*) (Al Alwani 1990). The second source of knowledge is that derived from human intellect through *ijtihad* (exertion). *Ijtihad* is a process of independent reasoning by qualified scholars to obtain legal rules from Shari[ah] using the analogical reasoning

⁶ See Siddiqi (2004a and 2004b) for a discussion on the objectives of Shari[ah].

⁷ Sometimes the word Shari[ah] is used to mean the whole body of Islamic law. In this paper, it is defined more narrowly, as is usually done in Arabic usage.

and induction.⁸ Note that *ijtihad* is used only in cases when revealed knowledge has no explicit views. This derived knowledge resulting from *ijtihad* is referred to as *fiqh* (Hassan 1992). The scholars/jurists come up with resolutions based on the Shari[ah principles and the *fatawa* of the preceding jurists to expand the body of Islamic law.

Given that Islamic law is derived by *ijtihad*, it is developed by scholars/jurists. Other than jurists, an important institution that affected the law in the past was the office of *qadi* (*judgeship*). The role of the *qadi* (judge) was to interpret and apply the law. In some cases, decisions of *qadis* did contribute to the Islamic law. Example of this was during the Ummaya period when such a body of law was assimilated (Masud 1995).

Owsia (1994) outlines the historical timeline of the evolution of Islamic law. The introduction of *fiqh* led to diversity of the legal opinions that crystallized into four major schools of thought in the Sunni tradition.⁹ One of the factors that distinguishes these schools is emphasis on the traditionalist and rationalist trends with regards to the sources of law. While the pure traditionalists consider the Qur'an and *Sunnah* as the basis of law, the rationalists complement these primary sources with rational principles to develop rules and laws.¹⁰ Shafi organized a set of rational principles (*usul al aqliyyah*), which laid down the rules of application of reason in developing laws. These principles latter evolved into the Islamic methodological discipline of Islamic legal theory or *usul al fiqh* (Owsia 1994, p. 20).

After the establishment of the legal schools by the end of the 9th century AD, the role of the *qadis* was reduced to the strict application of the rulings of the respective school. Starting from the 13th century AD, a long period of almost a millennium of *taqlid* (imitation) in which the teachings of the respective schools were strictly followed ensued. During this extended period, the doors of *ijtihad* were closed and this led to the stagnation of the evolution of Islamic jurisprudence.

⁸ Other than depending on the essence of laws and rules in the primary sources, *ijtihad* also derives knowledge using other sources and methods that include the following: *ijma'* (consensus), *al-qiyas* (analogy), *istihsan* (juristic preference), *al masalih mursala* (unrestricted interest), *saddudh dharae* (blocking the means), *al-furf* (custom), *sharman qablana* (previous legal system), *qawlus sahabi* (sayings of the Prophet's companions) and *al istishab* (presumption of continuity). For a discussion of the other sources of knowledge see Kharoufa (2000a). Rayner (1991) classifies these sources of knowledge into secondary and tertiary. According to her, *ijma'* and *qiyas* form the secondary and the rest the tertiary sources of knowledge.

⁹ The other major division being the *Shia* tradition. For a discussion on the evolution of *Fiqhi* schools see Owsia (1994) and Phillips (2002).

¹⁰ Of the four Sunni schools, the Hanafi school adopted a rationalist (*ra'y*) approach and the *Hanbali* and *Maliki* schools a more traditionalist one. The Shafi[school combined elements of both, with more inclination towards the rationalist (Owsia 1994).

Legal reasoning became mechanical and Islamic law became a rigid body of rules and principles.

Since the early history there has been resistance to legislate Islamic law by government bodies. The absence of legislation, however, led to the lack of uniformity of the Islamic law. For example, during the Abbasid period, the administration of justice under Islamic law was in a disarray due to the lack of unified judicial doctrines. Attempts to legislate the law by the state were resisted by scholars/jurists as they insisted that the law was superior to the state. This trend continued and Islamic law, for the most part, was independent of state control. Thus, in the Islamic legal environment, the law precedes the state and the state's role is to enforce and maintain the law (Masud 1995, pp. 11-12). In later times, under the influence of the civil codes of the Western legal system, the Ottoman Caliphate adopted a code called *Majallah* used during 1877-1926.¹¹ The *Majallah* was a collection of legal rules based on the Hanafi School related mainly to commercial transactions. The judges used the *Majallah* as a guide for their judgements and were not obliged to strictly follow it in their rulings (Bakar 2001).

From the middle of the 19th century, almost all Muslim countries adopted the Western laws and legal systems particularly in commercial sphere due to colonization. After the independence of Muslim countries around the middle of the 20th century, these countries assumed the laws and legal systems of their ex-colonial powers. Muslims scholars and thinkers, however, had an urge to free themselves from the colonial legacy and sought solutions for various aspects of life from Islam. This resulted in the re-emergence of Islamic thought in general and Islamic economics in particular. One manifestation of this process was the establishment of Islamic banks during the 1970s. With the spread of Islamic banking and finance, some countries enacted laws/statutes related to Islamic banking. At the same time, Shari[ah advisory committees/boards at various levels constituting groups of scholars/jurists were formed and they started pronouncing various *fatawas* (rules or resolutions) related to economics and finance. These rulings form the essence of Islamic commercial law during contemporary times. In this paper, we examine these rules and resolutions to ascertain the adaptability of Islamic commercial law related to financial transactions.

4. ADAPTABILITY OF ISLAMIC COMMERCIAL LAW

The adaptability aspect of Islamic law is approached in couple of ways. First, the underlying principles of adaptability of Islamic law are discussed in general terms and then specific examples are presented to show how Islamic commercial law has evolved during the recent past to meet the financing needs of contemporary

¹¹ The full name of the document was *Majallah al-Ahkam al-Adliyyah* (Book of Rules of Justice).

economies. The section then critically evaluates the adaptability features of Islamic law.

4.1. Adaptability of Islamic Law: Basic Principles

Over the centuries, Islamic law has evolved to a body of ‘a highly sophisticated system of rules, covering the whole field of what the contemporary world perceives as law’ (Mallat 1993, p. 3). Islamic laws and rulings regarding human activities can be divided broadly into two: devotional matters (*ibadat*) and dealings or transactions (*muamalat*) (Kamali 2000 Chapter 7).¹² There are couple of interrelated differences regarding the rulings of these two categories of activities. First, the Shari’ah principle regarding rulings of *ibadat* is that anything not validated by Shari’ah is prohibited. That is, all that is permitted of *ibadat* are clearly specified in Shari’ah and additions or variations to it are not allowed. The principle is opposite in case of *muamalat* in which every thing is permitted other than those explicitly forbidden by divine guidance. This is called the principle of permissibility (*ibahah*).¹³ Note that the prohibitions are clearly specified in Shari’ah and one has to be careful not to expand the list of prohibitions. In particular, *riba* and *gharar* are prohibited in commercial transactions. Thus, Islamic commercial law permits all contracts that are devoid of *riba* and *gharar*.¹⁴

The other difference implied in the two types of activities is that while there is no room for changing the rites and rituals of *ibadat*, the rulings of *muamalat* can be adapted through the process of *ijtihad* (Kamali 2000). While the basic principles or doctrines of the *muamalat* are given in Shari’ah, the interpretation of these principles to suit circumstances in different times and places constitutes the *fiqh-muamalat*. New rulings can be reached by understanding the effective cause (*illah*) and rationale (*hikmah*) of the original ruling and the importance of *maslahah* (benefit) under the changed circumstances (Kamali 2000, p. 78). The attaining *maslahah* and *maqasid*-as-Shari’ah (goals of Shari’ah) form essential elements and underlying ends in the framing of new Islamic rulings and law.¹⁵

Ijtihad is used to derive laws from the basic principles of Shari’ah to address the needs of people in different places and times. The important aspect of these new rules is that they may at times change depending on the context of application. For example, while the Prophet (PBUH) refused price control (*tasir*) during his

¹² Hassan (1992) also includes other *fiqh* like *fiqh al Jinayat* (dealing with criminal law) and *fiqh al-hukm* (dealing with administrative and constitutional matters).

¹³ Fatwa No. 1 of the First Albaraka Seminar 1981 (Dallah Albaraka 1994, pp.75-76).

¹⁴ For a discussion on *riba* see Siddiqi (2004a) and Chapra (1985) and for *gharar* see Al-Dhareer (1997) and Kamali (2000).

¹⁵ Alwani points out the Umar Ibn Al Khattab's *ijtihad* considered public interest and Imam Malik emphasis on *masalah al mursalah* (interest of greater good) (Alwani 1990 pp.16, 35). Similarly, *maqasid al-Shari’ah* and *maslahah* were main elements of Shatibi's work during the 13th century (Masud 1995, p. 120). See Siddiqi (2004b) for a discussion on the role of *maslahah* in developing Islamic law.

lifetime, some jurists belonging to Maliki and Hanafi schools and Ibn Taimiyah allowed it under special circumstances.¹⁶ Similarly, the leading imams of *fiqh*, Abu Hanifah, Malik and Shafi changed their rulings (*fatwas*) depending on the customs prevailing in different social settings. For example, Imam al Shafi changed some of his earlier rulings after he moved from Baghdad to Egypt after observing the different customs in the latter place.

As commercial activities fall under *mu'amalat*, the underlying principle related to commercial laws is that of permissibility (*ibahah*).¹⁷ The transactions validated in the Qur'an and Sunnah are not exhaustive and new transactions can be introduced as long as they are not contradictory to the principles of Shari[ah (Kamali 2000, pp. 69-70). While rules and principles can be derived from the legal doctrine expounded in Shari[ah principles and *fiqh* doctrines of earlier jurists, there is a limitation to this. As mentioned above, while Shari[ah is considered divine and forms the immutable and permanent source of the Islamic law, *fiqh* has human element and can change over time and place (Hassan 1992, Vogel and Hayes 1998, Mallat 1993). Thus, the new rules derived cannot contradict the Shari[ah principles.

While Islamic commercial law is adaptable and can change, it is not as free as the Western legal systems, which have no such boundaries. Muslims believe, however, that these boundaries enhance social welfare as God instituted Shari[ah principles for the *masalih* (benefits) of the people (Masud 1995, p.119). Since the principles of Shari[ah aim to bring about fairness and good measure, these are given more consideration than freedom of contracts (Saleh 1992, p. 146).

4.2. Adaptability of Contemporary Islamic Commercial Law

To examine the adaptability of the Islamic commercial law, we compare some of the traditional *fiqhi* rulings pertaining to contracts used in economic transactions to the contemporary ones. Traditional Islamic nominate contracts related to economic transactions fall under three main categories - exchange, accessory, and gratuitous. Exchange contracts include simple spot sale (*bay'*), and sales creating debt like *bay' mu'ajjal*, *salam istisna'*, hire contract (*ijarah*), and work done for a fee/reward (*ju'alah*). Accessory contracts are ones in which one party assigns work/capital/obligation to other party(ies). These contracts include agency (*wakalah*), partnerships (*sharikah*) contracts in the forms of *mudharabah* and *musharakah*, assignment (*hawalah*), and pledge or mortgage (*rahn*). In gratuitous contracts ownership or possession (rights of use) are transferred without consideration (payment) or compensation. Gratuitous contracts are loans (*ariya* and *qard*), deposits (*wadi'ah*), gifts (*hibah*), and guarantee/security (*daman* or

¹⁶ For a discussion see Islahi (1988, Chap.3).

¹⁷ While Kamali (2000, p. 76) points out his to be the view of Hanbilites, this is widely accepted among contemporary scholars (see Fatwa No. 1 of the First Albaraka Seminar 1981, Dallah Albaraka 1994, pp.75-76)

kafalah).¹⁸ Though some of these traditional contracts (like *salam*, *istisna'*, *mudharabah* and *musharakah*) can be used for financing, they take place directly between the parties involved.

Financing in contemporary financial system takes place either through the markets or intermediaries. The traditional nominate contracts in their pure forms do not have the features that can cater to the needs of the contemporary financial markets and institutions. Thus, the challenge for Islamic law was to adapt to this new financial structure to enable financing through markets and intermediaries. In other words, Islamic law had to create a new set of financial contracts that could cope with transactions and dealings of the contemporary financial structure. These new contracts would have to fulfil the needs of various sections of the society without violating any principles of Shari[ah]. The adaptation and expansion of the existing body of Islamic law in economic matters has taken place in several ways. One can observe the following trends in this process.

4.2.1. Adapting traditional contracts to contemporary concepts/transactions

The rules and principles of nominate contracts are applied to new concepts and problems and by the process of analogy, applicable solutions are arrived at. For example, the concept of copyright and patent is novel and important as it may drive inventions and innovations. Islamic Fiqh Academy has recognized this new concept and given it a status of something that can be bought/sold in the market. Accordingly, the Academy has given protection to these contemporary concepts of copyrights and patents.¹⁹

Another example of using a traditional concept for contemporary settings is the use of sale of *arbu*n (advance payment) as a call option.²⁰ In case of traditional sale of *arbu*n, a buyer pays a fraction of the price of a good on the understanding that he will buy the good at some future date to which the seller will fulfil his obligation to sell. If the buyer does not buy the good, the advance paid is forfeited to the seller. Elgari (1993) shows how *arbu*n can be used in stock markets as a 'call option'. The buyer of the call option, by paying the option price, buys the right to purchase a specific number of shares of a certain company at fixed price during a particular period. The seller of the call option is equally obliged to sell these shares when the buyer decides to do so.

4.2.2. Using multiple traditional contracts to create new financial contracts

The most common method of creating financial contracts has been by far the

¹⁸ Discussion on the types of Islamic nominate contracts can be found in Vogel and Hayes (1998, Chap. 5) and Rayner (1991).

¹⁹ See Resolution No. 43 (5/5) (IRTI and IFA 2000, p. 89).

²⁰ For a discussion on the permissibility of *arbu*n, see discussion in Section 4.3 below.

combination of traditional nominate contracts to create new contracts.²¹ Examples of these include the contemporary financial *murabahah* (or *murabahah* to the purchase orderer) a widely used instrument by Islamic financial institutions. The original sale contract (*murabahah*) is used with several other concepts (promise, guarantee) to produce a financing tool. Similarly, traditional *ijarah* contract is used with a sale or gift contract to form a financing instrument called *ijarah wa iqtina'* or *ijarah muntahia bittamleek*. Diminishing *musharakah* associates *musharakah* contract with that of a sale for financing purposes. Similarly, contemporary *sukuk* is a composite of multiple transactions/contracts.

4.2.3. Adapting conventional financial products

Another method of creating new contracts in the Islamic financial sector is to adopt and adapt conventional products/contracts that meet the Shari[ah criteria.²² The conventional contracts or products can be modified by removing the undesirable components to make them comply with the Shari[ah principles. For example, equity based mutual funds have been adopted by Islamic financial institutions by adapting the stocks that can be included in these funds. Investments in stocks are allowed if they Fulfil certain business and financial criteria derived from Shari[ah and *fiqh*. Accordingly, investment in companies that deal with forbidden goods/services like alcohol and tobacco, gambling, pornography, interest based financing institutions, etc. are not allowed. The financial filter is used to weed out firms that have unwarranted dealings with interest-based transactions.²³

4.3. Adaptability of Islamic Law: Evaluation and Synthesis

As discussed above, adaptability of legal system relates to the process of law making and is measured by observing the source of law and legal justification. Source of law seeks to identify if case law or statutory law are the basis of new law and legal justification relates to whether the principle of equity is used in judgements rather than statutory law. While the above discussion shows that Islamic law is adaptable, we critically analyze this feature in the light of the two criteria. Islamic law, being based on religion, has different foundations and process of adaptability compared to those of the Western legal traditions. To understand this process in the light of the criteria of adaptability given above, we first clarify

²¹ For a discussion on combining contracts to form new contracts see Arbouna (2003). For a discussion of the contemporary financial contracts see AAOIFI (2003), Ahmad (1993), Kahf and Khan (1992), and Khan (1991), Tariq (2004), and Usmani (1999).

²² Zarqa (2002, p. 261) maintains that contracts and social institutions from non-Muslim societies can be accepted with little or no modifications if they meet the Shari[ah criteria.

²³ According to the Shari[ah Board of Dow Jones Islamic Index, a company must meet three specific financial constraints. First, its debt ratio must not exceed 33 percent, second, cash and interest based securities as a percentage of capital should represent less than 33 percent, and finally accounts receivables to total assets must remain below 45 percent (Dow Jones Indexes 2004).

the use of terms used under the Western legal systems and the Islamic legal framework.

While civil law, based on statutes and codes, can be called the law of the legislators and common law based on jurisprudence termed as the law of the judges and lawyers, Islamic law can be characterized as the law of scholars or jurists. In deriving rules for specific cases, scholars consider both the immutable divine sources (Shari[ah] of law along with the human interpretation of these (*fiqh*). The evolution of new Islamic law is on a case-to-case basis resembles the common law tradition. The difference, however, is that in the latter system the principle of *stare decisis* is used and in the former *taqlīd* in terms of earlier juristic rulings are used to arrive at decisions (Fadel 2002). As mentioned, historically there is no tradition of legislation of Islamic law. However, Shari[ah] provides the immutable principles that jurists cannot violate. These Shari[ah] principles can be considered similar to the statutory laws and codes in the civil law tradition that judges have to abide by in giving Judgements. The difference between the two, however, is that while statutory laws can be changed by legislation, the Shari[ah] principles are considered divine and immutable.

The second criterion of adaptability is the legal justification in framing new rulings. In this respect, the concept of equity in Western legal system is replaced by *maqāsid* al-Shari[ah] and *maslahah* in the Islamic framework. Note the concept of *maslahah* in Islamic law is much broader than the notion of equity under Western laws. To understand the adaptability features of Islamic law, we discuss the process of law making and the role of *taqlīd* in the source of law and the importance of *maslahah* in legal justification below.

4.3.1. Source of law and *taqlīd*

Given the principle of permissibility, Islamic commercial law can evolve within the boundaries set by Shari[ah]. The development of Islamic law in response to changing environment can take place in couple of ways (Masud 1995, pp. 17-18). The first way is to expand the already existing body of law by analogy and *ijtihad*. The second alternative is to open the law itself to transform according to changed conditions. While arriving at solutions under the first alternative using *ijtihad* based on previous *fiqh* (*taqlīd*) is not a problem and is being practised widely, it is the second alternative that is more challenging. Under this latter option, some of the *fiqhī* rules may be modified, given the changed environment and new knowledge about the implications of these rules in the contemporary times. As a result, new rulings may be formed that were not sanctioned in *fiqh* literature of the past. This calls for not adhering strongly to *taqlīd*. This can happen in two ways.

The first way is the weaker form in which new rulings are formed by overcoming the tradition of *taqlīd* related to specific school of thought. This would involve breaking away from the rulings of the past by analyzing the new conditions on their own merit. Contemporary practise of *ijtihad* through various bodies like

Islamic *Fiqh* Academy, where scholars from various schools of thought come together and discuss issues to arrive at resolutions appear to have resolved the practise of *taqlid*. For example, with the exception of Ibn Hanbal, the sale of *arbutun* was not permitted by the other major schools (Elgari 1993, p. 14). Islamic *Fiqh* Academy has taken the minority view and ruled *arbutun* to be a permissible transaction.²⁴ Another example is that of binding conditions in a promise. According to the traditional scholars like Imam Abu Hanifah, Al-Shafi, Imam Ahmad and some Maliki scholars, a promise was considered neither mandatory nor enforceable through courts (Usmani 1999, pp.121-22). OIC *Fiqh* Academy has ruled that promise is binding a financial *murabahah* contract as it is made conditional upon a fulfilment of an obligation and if the promisee has already incurred expenses on the basis of such a promise.²⁵ Note that in moving away from *taqlid*, the resolutions still have some anchor in past jurisprudence.

The second challenging alternative is to come up with new resolutions by resolving contemporary issues that do not have any anchors in *fiqh*. While *fiqh* can be consulted to do so, the contemporary reality in terms of human knowledge and technology cannot be ignored (Siddiqi 2004b). Many contemporary issues cannot be found in the *fiqh* literature of the past as the present reality and environment are very different from those of the past. Couple of examples of unresolved present-day issues illustrate the urge to seek solutions for contemporary problems by severing strict adherence to *taqlid*. First, contemporary futures contract in which both payment and receipt of good/asset are postponed are prohibited under Islamic law due to the presence of *gharar*. Kamali (2003) argues that if new technology can eliminate *gharar* in the contract, then it may be reconsidered. He asserts that the implementation of contemporary futures contract removes *gharar* that is the basis of forbidding these contracts and, as such, may be allowed.

A similar argument is forwarded with regards to the sale of debt created by Islamic financial institutions. The majority of the Islamic jurists forbid the sale of debt other than its face value based on classical injunctions.²⁶ Chapra and Khan (2000, pp. 77-78) distinguishes between debt arising from borrowing money and debt created from transactions of contemporary Islamic financial institutions. In the latter case, debt is created by selling goods and services using sale-based modes of financing like *murabahah*. Arguing that the price in these transactions is profit and not interest, and also the availability of credit ratings that reveal information of the issuing institution thereby eliminating *gharar*, may form different bases compared to the case where the original rules on sale of debt applied. Given the changed realities, they argue for the reconsideration of the verdict on the sale of debt originating from sale-based modes of financing in contemporary Islamic financial markets.

²⁴ Islamic *Fiqh* Academy Resolution No. 72/3/8 (IRTI and IFA 2000, p. 156).

²⁵ See Resolution No. 40-41(2/5 & 3/5) (IRTI and IFA 2000, p. 86).

²⁶ The exception being Malaysia, where sale of debt at negotiable prices is permitted.

4.3.2. Legal justification and *maṣlahah*

The other indicator of adaptability is legal justification whereby the principle of equity is used to make juridical decisions instead of statutory laws. As pointed out above, in case of Islamic legal framework, principles of Shari[ah replace statutory law and the concept of *maqasid* al-Shari[ah (goals of Shari[ah) and *maṣlahah* (benefit) take the place of equity in arriving at juridical rulings. Muslims believe that God instituted the Shari[ah (laws) for the *masalih* (benefits, good) of the people, both immediate and future.²⁷ The primacy of *maṣlahah* has couple of important implications for legal justification. First, Muslims believe that the immutable principles of Shari[ah are meant to enhance *maṣlahah* of people. The inherent *maṣlahah* in the immutable principles of Shari[ah, therefore, does not restrict the equity aspect of legal justification as is the case of statutory law in the civil law system. The Shari[ah principles rather reinforce *maṣlahah* and enhance the overall benefit by balancing the needs of all humans. Second, the doctrine of *maqasid* al-Shari[ah establishes *maṣlahah* as an essential element of the ends of law, so that it becomes an important goal in framing new rules through *ijtihad* (Masud 1995, p. 120). Thus, both the principles set by Shari[ah and use of *ijtihad* to frame new rules have *maṣlahah* or benefit of people as the underlying basis and goal.

Alluding to the fact that the *maqasid* al-Shari[ah is not being given its due importance in framing new rules during contemporary times, Siddiqi (2004b) asserts that there is a need to integrate the *maqasid* approach with the *fiqhi* approach “in order to deliver meaningful agenda for economic development” (p. 3). This may also need revisiting the *usul-al-Fiqh* that has remained stagnant since the 13th century CE (Alwani 1990). In this light, the scope of *maqasid* may need to be expanded for contemporary times. According to Siddiqi (2004b), the *maqasid*-al-Shari[ah in the realm of contemporary economics and finance would include “sustenance for all, dignity, security, justice and equity, freedom of choice, moderation and balance, peace and progress, reduction in inequality in the distribution of income and wealth...”.

5. ISSUES RELATED TO THE ISLAMIC LEGAL INFRASTRUCTURE

As pointed out, most Muslim countries have adopted one of the Western legal systems. The absence of a comprehensive legal system for a long time resulted in the lack of legal infrastructure institutions that can support the use of Islamic commercial law during contemporary times. With the advent of Islamic finance, Islamic financial contracts are being used, but this is being done in an alien legal environment. Even if individuals agree to use Islamic contracts, the laws and courts may not be there to interpret and enforce the form of these contracts. Successful application of Islamic law in contemporary financial transactions requires various

²⁷ For example, this view is held by Shatibi as quoted in Masud (1995, p. 119).

supporting legal infrastructure institutions. Some issues related to the development of Islamic law and legal infrastructure institutions with respect to the financial sector are discussed below.

5.1. Harmonizing Islamic Law and Standardization of Shari'ah Rules

Good documentation of contracts is important determinant of growth and liquidity of markets in financial products. Carse (2002) points out different benefits of standardized documentation of financial contracts. Standardized documentation creates more predictability and certainty about the characteristics of the financial contracts. Agents involved are better able to understand their rights and obligations under the contract and enhances the confidence to enter the market and transact. Standardized contracts are advantageous at the individual level also. The whole process of negotiating different aspects of a transaction becomes more simplified and streamlined. Negotiations are more specific on the issues that are unique and specific to the particular transaction rather than on all the aspects of the contract. Furthermore, financial institutions are better protected against risks that they can not anticipate or may not be enforceable. Standardized contracts also imply that transactions are easier to administer and monitor after the contract is signed.

The long history of the development of *fiqh* under the various schools of thought has led to the diversity of legal opinions.²⁸ While the diversity of traditional legal opinions constitutes a vast body of knowledge from which new laws can be extracted and derived, the variety of rules related to economic transactions introduces legal risks and can affect growth of the Islamic financial industry. Khan and Feddad (2004) assert that standardization of Shari'ah principles will help the interface of Islamic finance with conventional financial institutions and will not act as a constraint in the global growth of the Islamic financial.

The standardization of Shari'ah rules needs to take place at two levels. First, at the national level, the rules governing economic transactions can be standardized by a national Shari'ah body. This body will be responsible not only for issuing rulings but also codifying them for application. Examples of national level Shari'ah boards/authorities are those existing in Sudan and Malaysia. The harmonization of Shari'ah rules within national borders, however, will not solve the problems of global Islamic financial transactions. There is a need for a international body that can issue standardized rulings on economic transactions. Efforts by AAOIFI to issue a codified version of Shari'ah standards in this respect is noteworthy.²⁹ But as AAOIFI is an institution dealing with mainly accounting and auditing standards, there is need for a global Shari'ah body that can harmonize diverse bodies of knowledge to one standardized version that the Islamic financial industries around the world can use. Khan and Faddad (2004) suggest establishment of an

²⁸ Various reasons are given for this legal diversification. See Hammad (1992) for a discussion.

²⁹ See AAOIFI (2003).

international body (which they call International Organization of Standards for Shari[ah Application in Finance Industry) to play this role.

One has to be careful, however, that standardized contracts do not get entrenched and rigid. Contracts should be flexible enough to adjust to changing businesses and environment. The flexibility is desirable at both the transaction and market levels. The contracts should be flexible enough so as to adapt to individual transactions. Each transaction has unique features, which need to be taken care of in the documentation. The implication is that the documents will have a core portion and one that is left blank for filling in for individual transactions. The contracts and documentation should be flexible enough so as to evolve to match the changes in the market conditions and environment. This is particularly true in a world witnessing financial innovations and change.

5.2. Need for Islamic Financial Law/Statutes

As most Muslim countries have adopted either the common law or civil law framework, their legal systems do not have specific laws/statutes that support the unique features of Islamic financial products. For example, whereas Islamic banks main activity in trading (*murabahah*) and investing in equities (*musharakah* and *mudharabah*), current banking law and regulations in most jurisdictions forbid commercial banks to undertake such activities. This calls for specific laws and statutes that can support and promote Islamic financial services industry. While in some countries separate Islamic Banking laws have been passed (e.g., Kuwait and Malaysia), in others Islamic banking is covered under a section of the existing banking law (e.g., Bangladesh and Indonesia). The implications of these Islamic banking/financial laws on the operations and growth of Islamic financial sector will depend on the type of legal system in place.

Djojosugito (2003) discusses the scope of operations of Islamic banks under the two main legal systems. As the laws and their implementation are codified under the civil law regime, it would be difficult to have Islamic financing if new laws are not enacted as the existing rules and regulations are geared towards conventional banking practises. The Islamic banking law enacted by the legislature will form the legal foundation for Islamic banking and financial dealings. The Islamic banking laws passed in civil law country like Indonesia, however, are worded in general terms and lack details of the different Islamic modes of financing.³⁰ Examples of such omissions include the prohibition of trading and taking equity positions and the absence of resolution of the double taxation in Islamic financial transactions (e.g. in case of *ijarah*). While Bank Indonesia is trying to fill some of the gaps through some regulations, these may not hold in the courts of law.³¹ Such uncertainty in the laws related to Islamic banking will have Islamic banks at a

³⁰ The information on Indonesia has been taken from Idat (2003) and Djojosugito (2003).

³¹ Over the years Bank Indonesia has passed regulations that encompass operational, institutional, accounting, monetary, and financial market issues (Idat 2003).

disadvantageous position compared to the conventional banks. Thus, there is a need for detailed codification of the law that would include the Islamic principles for financial transactions and the administrative procedures for carrying out these activities.

Islamic contracts and transactions under the common law regime may have problems of interpretation as no precedents on these activities may exist. Promulgation of law in this system may not be as effective as in case of civil law regime as the judges may deviate from the statute if the statute is incompatible with the precedents. Common law regimes, however, provide more predictable results under legal documentation relative to the civil law system. While in the civil law system, the courts will interpret the contracts on the basis of reasonableness and fairness, the Common law system will consider the provisions in a legal document more weight irrespective of other considerations like materiality or fairness. As the sanctity of the contract is greater in the common law system, there may be lower legal risk involved for Islamic banking instruments under this regime.

5.3. Dispute Settlement/Conflict Resolution Institutions

Lack of Islamic courts in most Muslim countries that can enforce Islamic contracts increases the legal risks of using these contracts. As such, partners in transactions avoid using Islamic law as they want to avoid the “impracticalities or the uncertainty of applying classical Islamic law” (Vogel and Hayes 1998, p. 51). In an environment with no Islamic courts, Islamic financial contracts include choice-of-law and dispute settlement clauses (Vogel and Hayes 1998, p.51). In such cases, two approaches can be taken. The first is to use Shari[ah as the governing law as the Islamic financial contracts’ legitimacy should be judged by the principles of Shari[ah. To ensure such settlements the contracts would include a clause indicating Islamic law to be used for settlement of disputes. The second approach is to use the law of the country to settle disputes. In the former approach, the contracts should be shielded from the legal environment and disputes settled through commercial arbitration.

The implications of using the alternative of existing legal system for dispute resolution for Islamic financial contracts depend on the type of the legal system in place. As discussed above, in a civil law country, laws related to Islamic banking give the general features of Islamic banking and leaves the interpretation of these in the courts. While Islamic banks have the freedom to define the financial instruments they use, lack of specifics in the law adds to uncertainty and increases the legal risks. For example, Islamic banking in Indonesia has faced various problems related to the legal aspects of banking. Specifically, the laws of 1998 and 1999 are not comprehensive and cover only the basic elements of Islamic banking. As mentioned above, the laws exclude important aspects of Islamic financial transactions. As such, it will be difficult to protect the *mudharabah* contract as the elements of this transactions are not in the domain of the legal foundation of commercial banking. While the profit sharing principles of the *mudharabah* contract

can be covered by the freedom of contract principle, some other features of the contract like dual or multiple ownership and the implications in case of insolvency may not be governed by the Civil law doctrine (Djojosedjito 2003, p.18).

Hamid (1998) and Vogel and Hayes (1998) discuss the use of English common law as the governing law so that the rules of the English law will prevail over the principles of Shari[ah. In this case, the documentation conforms to Shari[ah but prepared so as to enforce it under the English law. This approach has the problem of interpretation and enforcement of the Islamic contracts as they fail to understand the form of contract. A contract that elaborates all the main elements of the transactions that make it Islamic will be most likely to be honoured in common law court.

To ensure the growth of the Islamic financial industry, there is a need to have dispute settlement institutions or Islamic courts that understand the form of the contracts so that these can be interpreted and enforced accordingly. While the whole court system can not be expected to change, a solution is to have special Islamic bench that deals with, among others, financial transactions. In this regard, Malaysia has adopted several steps to build some legal infrastructure institutions for Islamic financial industry. At the highest level, the High Court in Malaysia has dedicated high court judges to oversee litigations related to Islamic banking and finance. Furthermore, to complement the court system, the Kuala Lumpur regional Centre for Arbitration has been enhanced to deal with disputes on Islamic banking and finance for both domestic and international cases. To ensure the efficient functioning of the Islamic financial sector, the Central Bank of Malaysia has also set up a Law Review Committee to assess the common law based legislations and to assimilate the Shari[ah principles (Aziz 2004).

6. CONCLUSION

While Islamic legal tradition has a long history, commercial law related to the contemporary financial system is at the developing stage compared to the civil and common legal traditions. The paper discusses the adaptability features of Islamic commercial law for contemporary financial settings and puts forward some suggestions to develop the Islamic legal system that can facilitate the growth of Islamic finance. While civil law can be called the law of the legislators and common law the law of the judges and lawyers, Islamic law can be characterized as the law of scholars. As the scholars consider both the immutable divine sources of law (Shari[ah) along with the human interpretation of these (*fiqh*), the development of Islamic jurisprudence can be considered a combination of the procedures found in the civil law and common law systems.

The challenge for Islamic law was to create financial contracts from traditional nominate contracts to meet the modern day needs of financial markets and intermediaries. Recent history of the growth of the Islamic financial sector is an

indicator of the adaptability of Islamic law to changed situations. Given the principle of permissibility, Islamic commercial law can evolve as long as the limits imposed by Shari[ah are not traversed. The adaptability features of source of law and legal justification for Islamic law were closely examined. While contemporary Shari[ah scholars and jurists have done an admirable job of modifying the classical nominate contracts into financial contracts, there still remains a lot of work to be done to make Islamic commercial law relevant to modern day needs. To enable this, there is a need to develop Islamic law, keeping in mind the *maqasid* al-Shari[ah and the existing technology and environment.

While Islamic law can evolve based on a rich source of body of legal theory and rulings, other elements of the legal infrastructure like laws and statutes, harmonizing the Islamic rules related to financial dealings, and dispute settlement institutions are still weak in many countries. The adaptability features of Islamic law has to be complemented with the strengthening of the legal infrastructure to ensure the development of a comprehensive Islamic financial sector. Given the noble objectives of Islamic law, its evolution can help produce an alternative financial system that can benefit not only Muslims, but humanity at large.

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