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Islamic finance law as an autopoietic system. The relevance of formalism over principles

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1. *Introduction*

One of the main misunderstandings in approaching Islamic finance as a cultural, economic and legal field of study is the superficial idea that it all comes down to the rediscovery of a set of theories and legal practices dating back to the earlier history of Muslim societies. Indeed, there is no clue enabling us to affirm that financial transactions (to be interpreted in their broadest meaning) in the Islamic medieval period or during Ottoman ages were structured in line, or were entirely compliant, with the principles underlying modern Islamic finance tools. In addition, there are few substantial relations between the medieval Muslim scholars, and their contribution on economic thought in Islamic tradition, and contemporary Islamic economics[1].

Rather, Islamic finance seems to be more a "modern, all too modern" phenomenon. In the 1930s the young *maulana* born in Aurangabad, Sayyid Abu'l-A'la Maududi (1903–1979) began developing the theoretical framework of a purely Islamic economic system based on Qur'ānic and Sunnaic principles. Such a concern for comprehensive elaboration on Islamic economics was also advocated, at the same time and in the same geographical context, by thinkers like Anwar Iqbal Qureshi (who later became Economic Advisor to the Pakistani Government) and Naeem Siddiqui. Interestingly they shared a common

[1] A worth reading on the matter could be M. EL GAMAL, *Islamic Finance: Law, Economics, and Practice*, Cambridge, 2008.

background that might have exerted, to a certain extent, an influence on the main features of their economic theories[2].

Between the 1930s and 1940s, Muslim Indians were striving to promote greater cohesion for Muslims of the Indian sub-continent, before the partition of Pakistan from India in 1947. This search for a stronger identity resulted in the revival of Islam as a pillar of cultural identification, where, however, religious discourse mixed with contemporary anti-colonialist – and to a certain extent – Marxist ideology[3].

Maududi was a preeminent figure of such cultural spirit and in his extensive writings he recurrently stressed the idea that forced contacts with Westerners were jeopardising the survival of Muslim cultures. Maududi maintained that secularism was one of the greatest threats for Muslims, because of its ability to permeate their habits, and that it could have been faced only by challenging the *reductio ad unum* of the principles of human morality encouraged by westernisation. He was determined to demonstrate to Muslims that Islamic values were radically alternative to Western values[4]. Maududi's opinion can be vividly summarized by his well-known statement: «*The plan of action I had in mind was that I should first break the hold which Western culture and ideas had come to acquire over the Muslim intelligentsia, and to instil in them the fact that Islam has a code of life of its own, its own culture, its own political and economic systems and a philosophy and an educational system which are all superior to anything that Western civilization could offer. I wanted to rid them of the wrong*

[2] T. KURAN, *The Economic System in Contemporary Islamic Thought: Interpretation and Assessment*, in *International Journal of Middle East Studies*, 1986, 135 ff.

[3] See J. CARVALHO, *A theory of the Islamic Revival*, Oxford, 2009, *passim*. Maududi wrote in 1939 the essay *The Philosophy of History in Hegel and Marx*. Indeed, his conceptualization of the Islamic revolution remained greatly indebted towards Hegel and especially Marx. A good overview on the issue is provided by A. IRFAN, *Islamism and Democracy in India: The Transformation of Jamaat-e-Islami*, Princeton, 2009. The influence of Marxist language may also be found in other Islamic radical thinkers like Sayyid Qutb.

[4] T. KURAN, *The Discontents of Islamic Economic Morality*, in *The American Economic Review*, 1996, 438 ff.

notion that they needed to borrow from others in the matter of culture and civilization»[5].

Economics stood as a primary issue in the intellectual production of Muslims revivalists[6] since it was perceived as the most influential field in the debate against Westernisation. The necessity of an opposite model to capitalism urged such scholars to develop an economic theory in opposition to Western Economics. It was created by adopting legal and moral rules from different sources of the Islamic legal and philosophical tradition and by gathering them in a newly combined *pastiche*[7].

This attempt to develop a specific Islamic economic model, due to its intrinsic dialectic construction, obviously owed to capitalistic economic theory more than it could consciously admit. As a matter of fact, being devised as an "alternative", Islamic economics (and Islamic finance as one of its practical outcomes) tended to put the conventional one as its negative benchmark. The glaring opposition highlighted divergences in the approach that made Islamic economics compliant with mandatory religious prescription and more economically efficient as well[8].

A significant example of such tendencies was the attitude towards admissibility of the payment of interest in commercial transactions, which (along with *gharar* and the theory of *Homo Islamicus*) was one of the major differences between Islamic finance and conventional

[5] Quoted in H. VISSER, *Islamic Finance Principles and Practice*, Cheltenham, 2008, 2.

[6] On 20 October 1941 Maududi gave a speech at the Aligarh Muslim University on *The economic problem of man and its Islamic solution*, now in S.A.A. MAUDUDI, *Economic System of Islam*, Lahore, 1999, 8-36.

[7] Paradigmatic of this approach is Chapter 3 *Differences between Islam and Capitalism* in S.A.A. MAUDUDI, *First Principles of Islamic Economics*, London, 2011.

[8] A defence of the greater efficiency an Islamic interest free economic model could promote is in M.A. ZARQA, *Capital Allocation, Efficiency and Growth in an Interest-Free Islamic Economy*, in *The Journal of Economics and Administration*, 1982, 43-58. On the other side, recent studies tend to dismiss or reduce the alleged efficiencies of Islamic banks: see T. BECK, A DEMIRGÜÇ-KUNT, O. MERROUCHE, *Islamic vs. Conventional Banking: Business Model, Efficiency and Stability*, in *Journal of Banking and Finance*, 2013, 433-47.

finance[9]. As a matter of fact, the assertion that *ribā* (which is generally interpreted as interest on money) is prohibited under Islamic finance is one of the first notions taught when introduced to Islamic finance.

This could be understandable given that payment of interest is a key element of debt-based financing as conventional finance is. It is therefore particularly suitable for it to be addressed as a heinous source of injustice from a moral point of view. Nevertheless, despite the strict adherence to the prohibition of interest, there is no evidence that in old Muslim communities (either at time of the Umayyads, or during the Ottoman rule, or in Moghul India) commercial transactions were interest-free, while, at the same time, religious prescriptions on the ban of *ribā* could be interpreted in a variety of ways.

Indeed, the Qu'rān directly forbids only *ribā al-Jahiliyyah*, *i.e.* the practice of doubling the amount of debt outstanding if payment was not made on time. However, such a practice cannot be credited *tout court* as mere "payment of interest" in the common understanding[10]. Conversely, Ḥadīths on *ribā* are not clear and can be variously declined so that the straightforward idea that they prohibit any payment of interest could be questioned[11].

This "bad conscience" underlying the theoretical superstructure of Islamic finance and the need to be perceived as a tangible alternative promoted a greater degree of legal formalism and a rather extreme and logic-driven formalism, as hinted with reference to *ribā.* The focus on formal restrictions like *ribā* and *gharar* (whose strict interpretation under the terms normally proposed is at least doubtful) gives rise to rigid legal structures whose aim is to replicate conventional financial transactions by formally complying with the said restrictions[12].

H.A. Hamoudi acutely observes that the proponents of Islamic finance tend to separate the problem of means from that of purposes «*pretending that with sufficient creativity and ingenuity, the formalist*

[9] Interestingly, one of the first books on Islamic Economics was *Islam and the theory of interest* published by Anwar Iqbal Qureshi in 1946.
[10] See L. NONNE, *Il Prestito ad interesse nel diritto islamico tra solidarietà e profitto*, in *Il Libro e la Bilancia. Scritti in Memoria di Francesco Castro*, M. PAPA, G.M. PICCINELLI, D. SCHOLART (a cura di), Napoli, 2011, 831 ff.
[11] M. EL GAMAL, *An Economic Explication of the Prohibition of Riba in Classical Islamic Jurisprudence*, in *Islamic Economic Studies*, 2011, 1 ff.
[12] *Murābaha* is an outstanding example of such tendency, as discussed *infra.*

hermeneutic will permit the realization of the functional ends they endlessly promote»[13].

However, this approach could also facilitate a wrong conceptual overlapping between Islamic finance formalism and Islamic law formalism. Indeed, Islamic finance makes use of intellectual and legal tools derived from Islamic law, thus exposing Islamic law to the risk of being deemed the real source of the formalistic approach to legal issues and to the implementation of fully rigid schemes.

The aim of this paper is to challenge any misconception about the rigidity of the Islamic legal system, whilst demonstrating the formalistic underpinnings of Islamic finance, also due to the logical premises discussed above. To this end, the first section will discuss Joseph Schacht's definition of "freedom of contract" in Islamic law - one the most sound opinions on the lack of flexibility in Islamic law - and will critically analyse the concept of "freedom of contract" and Schact's denial of the existence of such freedom in the Islamic legal system. The second section, instead, will highlight how Islamic finance tends to let the form prevail over the ends, resulting in a sophisticated, but sometimes clumsy, set of rules where the Islamic law spirit and the Islamic economics ideological aspirations are constantly facing the risk of vanishing.

2. *Schacht's conventional perspective*

Schacht's opinion on freedom of contract in Islamic law is unequivocal: freedom of contract has no place, because the sole contractual agreements that parties can enter into are those fitting the unchangeable nominative schemes that classical *fiqh* elaborated.

Contractual freedom in Islamic law faces further ontological obstacles due to the religious and moral background of the Islamic legal system. As a matter of fact, the parties and their agreements must comply with *Sharīʿah* "moral" provisions. The latter cover a wide range of duties and prohibitions that include acting fairly, balancing gains and losses between parties, reducing any possible uncertainty in the

[13] H.A. HAMOUDI, *Jurisprudential Schizophrenia: On Form and Function in Islamic Finance*, in *Chicago Journal of International Law*, 2007, 605.

transaction outcomes and excluding any practice likely to become usurious[14].

According to Schacht, this interaction between fixed contractual schemes and set of duties and prohibitions significantly affects the principle of contractual autonomy, thus leading to the conclusion that the Islamic legal system does not fit well within the idea of contractual freedom, which is *par excellence* identified with Western law.

Schacht's view postulates an axiomatic conceptual definition of "freedom of contract". However, legal history and case-law evolution of civil law systems demonstrate that freedom of contract is an evolving concept, linked to socially conceptualised changes, always needing to be interpreted in relation to a specific historical and cultural context[15]. At the same time, the evolving nature of the concept of freedom of contract in civil law legal systems recalls the inner dynamism of the legal rules interpretation under Islamic law that Schacht seems to fail to understand.

Indeed, as other legal systems, Islamic law recognizes freedom of contract within limits which derive from moral – ethical prescriptions that underlie any legal system. These limits need to be interpreted and every interpretation varies, depending on the social and historical context. Some interpretations are more likely to reduce the room of freedom of contract, while others strongly open its horizons.

2.1. *The myth of freedom of contract*

The utmost freedom of entering into transactions without any external interference began to be considered one of the fundamental rights of the individual in the jus-naturalistic theory that, as known, put the contract theory at the foundation of its modern concept of sovereignty[16].

However, despite the shared common ground, natural-law legal theorists debated between those who supported the idea of *iustum*

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[14] J. SCHACHT, *An introduction to Islamic Law*, Oxford, 1964, 144

[15] P.J. NERHOT, *Law, Interpretation and Reality: Essays in Epistemology, Hermeneutics and Jurisprudence*, New York, 2013; 20 ff.; J. CROWE, *The Role of Contextual Meaning in Judicial Interpretation*, in *Federal Law Review*, 2013, 417-442.

[16] T. HOBBES, *Leviathan*, book II ch. 17-21, London, 1985.

pactum[17], such as Grotius, Pufendorf and De Luca[18], and those who put a greater emphasis upon the contracting parties' autonomy, such as Thomasius and Pothier[19].

While the former had a propensity for assuring a certain balance to transactions based on *aequalitas*[20], the latter justified a judicial intervention on a contract only in case of *laesio enormis*[21]. This dichotomic dynamism of *aequitas* and complete freedom cannot be ignored.

The French revolution and the industrial revolution (the bourgeoisie revolutions), the rise of liberalism and the *Homo Oeconomicus* theory favoured the idea that the contract is the main mean for a proper distribution of wealth within society, for the achievement of personal interests and the major expression of personal freedom[22].

The idea of the sovereign freedom of the individual was perfectly embodied by the French civil code[23], where the principle of the contracting parties' formal equality was fully adopted.

The free meeting of the minds was considered an adequate means of guaranteeing justice in transactions and, subsequently, obligations arising from a free agreement were deemed necessarily just. Consequently, no power to scrutinise the outcome of private bargaining was to be entrusted to the judge, nor was it admissible that any legal

[17] See J. GORDLEY, *The Philosophical Origins of Modern Contract Doctrine*, Oxford, 1991, *passim* and I. BIROCCHI, *Alla ricerca dell'ordine*, Torino, 2002, 280 ff.

[18] A remarkable contemporary view on the just price doctrine can be read in A. PERRONE, *The just price doctrine and contemporary contract law: some introductory remarks*, in *Orizzonti*, 2013, 1-16 available on http://odc.seminabit.com/edizioni/2013/3/saggi/perrone-the-just-price-doctrine-and-contemporary-contract-law-some-introductory-remarks/. About American contract law refer to W. BOYD, *Just Price, Public Utility, and the Long History of Economic Regulation in America*, in *Yale Journal on Regulation*, 2018, 721-777.

[19] In this sense, the statement «*Qui dit contractuel, dit juste*» – attributed to A. Fouillée – is still well used.

[20] *Natura aequalitatem imperat*.

[21] See J. GORDLEY, *Foundations of Private Law: Property, Tort, Contract, Unjust Enrichment*, Oxford, 2007, 330 ff.

[22] For a general overview see A.M. ANTO HESPANHA, *Introduzione alla storia del diritto europeo*, Bologna, 2003, 20 ff.

[23] S. MAZZAMUTO, *Libertà contrattuale e utilità sociale*, in *Persona e mercato*, 2011, 13.

authority could impose a heteronomous rule affecting the contractual agreement's content[24].

In the aftermath of World War II, one hundred and fifty years later, civil law systems experienced a vigorous theoretical shift from the classical liberal contract idea of the parties' parity logically implying contractual balance and just agreements, to a new perspective on contractual justice. Legal reflection focused mainly on the idea of "just" contract[25].

In particular, from the second half of the 20th century, legal studies promoted a new approach to contract law highlighting that justice could not be automatically implied by the mere agreement of the parties, but that freedom of contract needed to be balanced with principles of social justice, the dignity of the human being and the protection of weaker contractual parties and that it had also to deal with the limited rationality of contracting parties[26].

All these principles, which also found a formal recognition in the post-war Constitutions,[27] started being perceived as limits to freedom of contract. At the same time, an almost constant constitutional case-law denied that freedom of contract could be perceived as an intangible principle, therefore admitting the constitutional legitimacy of its limitations.[28]

Generally, these limitations worked as constraints applied for reasons of distributive justice and the remedies aimed at satisfying the need for distributive justice were those that have affected the space attributed to contractual freedom the most. By way of example, the principles of social justice, and *a fortiori* of distributive justice, were interpreted as promoting the protection of weaker social groups or

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[24] C. GHISALBERTI, *La codificazione*, Bari, 2013, 105.
[25] R. SACCO, G. DE NOVA, *Il contratto*, Torino, 2016, 15-38.
[26] This is clearly a conscious oversimplification of a more complex trend. Anyway, it is sufficient to note that limited rationality has a remarkable impact on legal and economic studies and even in the theory of financial markets, where freedom of contract was thought to realize the most perfect competition according to certain economic theories. See S.L. SCHWARCZ, *Controlling financial chaos: the power and limits of law*, in *Wisconsin law review*, 2012, 821 ff.
[27] See *Costituzione della Repubblica Italiana*, art. 41 and *Grundegesetz für die Bundesrepublik* Deutschland*, art. 14.*
[28] *Ex multis* see C. Cost., 14 febbraio 1962, n. 5; C. Cost., 28 giugno 1963, n. 125; *Conseil Consitutionnel* d. 3 août 1994, d. 10 june 1998.

classes (workers, money savers, consumers), in a manner that influenced the content of contractual arrangements in order to pursue a better protection of such groups or classes. This was achieved also by implementing legislation fixing a minimum wage, a maximum number of working hours and restrictions on the possibility of employers' dismissal[29].

On the other side, consumers' weaker position in the market was addressed by significant European legislation on consumers' rights providing remedies to information asymmetry and other unbalances of rights between consumers and professionals; establishing duties of information towards consumers; and listing, *inter alia*, a set of clauses that created a presumption of the unbalance of rights and obligations between the parties (and therefore are deemed null and void)[30].

Public policies in Italy and France have also directly intervened in the housing market in order to determine rent prices. The above can easily demonstrate how "narrow" – using the words of an Italian jurist[31] - the concept of freedom of contract has become in civil law systems.

Lastly, even the economic analysis of law (which spread the idea of freedom of contract as ground for efficient norms the most[32]) seems to revise the belief in the *homo oeconomicus* model, recognizing that rules cannot be set by assuming the existence of a world without rationality failures[33] and that freedom of contract seems nothing more than a way to pursue market policies.

Since freedom of contract does not exist in nature but it always needs to be recognised under the relevant legal system, its content and limits cannot be conceptually separated. Talking about freedom of contract without calling into question its limits is not possible. Freedom of

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[29] See, *inter alia*, art. 18, l. 20 maggio 1970, n. 300 (*Statuto dei lavoratori*).

[30] N. REICH, H.W. MICKLITZ, P. ROTT, K. TONNER, *European Consumer Law*, Cambridge, 2014, *passim*;

[31] V. ROPPO, *Il contratto*, Milano, 2011, p. 41 ff.

[32] For a general overview, R.A. POSNER, *Economic analisys of law*, Philadelphia, 2014, 1 ff.

[33] Reference is made to behavioral law and economics and particularly to T.S. ULEN, *The growing pains of behavioural law and economics*, in *Vanderbilt law review*, 1998, 1747 ff. and to the seminal works of R.C. SUNSTEIN, *Behavioural analysis of law*, in *The University of Chicago Law Review*, 1997, 1175–1195 and R.H. THALER, C.R. SUNSTEIN, *Nudge: Improving Decisions About Health, Wealth, and Happiness*, London, 2009, *passim*.

contract implies limitations that, nonetheless, reflect a regulatory policy choice.

To a certain extent, it could be argued that the very idea of contract law as a neutral system should be abandoned. Contract law – and the related operating normative regulation – involves a balancing of conflicting social values, conflicting with the classic thought that legal reasoning is a deduction from consistent scientific principles. Such conclusion should be carefully considered while approaching Islamic law.

3. *Freedom of contract in Islamic law*

Joseph Schacht was unable to take into consideration that freedom of contract is not an absolute principle and that, instead, it has an evolving meaning related to the historical context. Such a freedom is in a dynamic balance with the principles of equity, social justice and fairness, which are, in their turn, concepts whose interpretation is never static. In this sense, comparing freedom of contract in Islamic law to a pure theoretical model of contractual liberty happens to be methodologically incorrect. Conversely, comparing different legal systems can help understand how freedom of contract is limited in a variety of ways and the underpinning rationale for such limitations. At the same time, it could emphasise the policy choices behind limitations and the relevant economic implications[34].

It could be said that Schacht showed a limited analytical approach supporting his judgment on the lack of Islamic law capability in guaranteeing any freedom of contract on the assumption that Islamic law can only offer to potential contracting parties a fixed set of nominate contract schemes.

This opinion, indeed, greatly relies upon documentary evidence from classic Islamic jurists' writing. Such an approach, despite its remarkable scientific depth, represent a clear example of what can be called a scripturalist-orientalist[35] approach towards non-Western sources. This, however, led him not to duly take into consideration the

[34] J. HUSA, *A new introduction to comparative law*, Oxford, 2015, esp. Chapter 5.
[35] A. SHALAKANY, *Islamic legal history*, in *Berkeley Journal of Middle East and Islamic Law*, 1, 2008, 1-81.

distinction between classical *uṣūl al-fiqh* and Islamic law, thus missing the key role *ijtihād* and *siyāsa shar'iyya* played in shaping Islamic law.

3.1. *Classical uṣūl al-fiqh and modern Islamic law*

The term scripturalism has been coined by the anthropologist Clifford Geertz to identify a theory on the capacity of the sacred texts to shape behavioural patterns among members of a community.[36] Applied to Islamic legal studies, scripturalism is intended as the reduction of the Islamic law content to the legal prescriptions of the sacred texts (Qur'an and Sunna) and, partially, to the classical theory of *uṣūl al-fiqh* as embodied in the treaties of the four *madhahib*, definitively formed at the end of the 14th century.[37]

To a certain extent, this angle of analysis tends to prefer Islamic law as represented in books over Islamic law in action[38]. This has direct effect on the representation of Islamic law as a pure juristic speculation[39], far from having a real application, and has encouraged an essentially static comprehension of the Islamic legal system.

Scripturalists such as Schacht assume that the Islamic system of contracts is a fixed one. The underlying rationale is that since Islamic law is influenced by a set of moral tenets derived from the sacred texts –which are immutable and fixed over time – there is no room for freedom of contract because it would be incompatible with the alleged need for ethical control on legal transactions. From this perspective, the only admissible agreements under Islamic law are those falling under the schemes of the nominated contracts listed in the medieval treaties of classic *fuqahā',* which are the translation of sacred prescription into a legal structure.

Nonetheless, this theoretical reconstruction faces some challenges. In particular, we know that no specific provision regarding contracts is

[36] C. GEERTZ, *Islam Observed: Religious Development in Morocco and Indonesia*, Chicago, 1971, Chapter 3.
[37] A. SHALAKANY, *op. cit.*, 77.
[38] J.L. HALPERIN, *Law in books and law in action: the problem of legal change*, in *Maine Law Review*, 2011, 46-76.
[39] N. COULSON, *A history of Islamic Law*, Edinburgh, 1984, 30 ff.

found in either the Qur'an or the Sunna[40], which only provide for very broad principles applicable to the law of contracts, like those related to the duty to fulfil the agreements entered into[41].

The same whole *apparatus* of the nominate contracts elaborated by classic jurists has been the result of the efforts of a jurisprudential activity to derive typical schemes – which are deemed to be compliant with Islamic precepts – from the sacred sources, by applying the process of *qiyas* (analogy) and legal reasoning, and from the existing customary practices. The results reached were validated by *hadiths* or other legal sources, in what appears to be an inversion of the deductive reasoning[42].

The Islamic jurists' activity of extracting normative rules from the texts (or *ijtihād*) [43] is comparable to the hermeneutical attitude in reading legal texts that belongs to any jurist[44].

As with every interpretative activity, *ijtihād* produces a modification of the text of the sources, which consequently become legal rules[45].

This methodology is intimately linked to the elaboration of Islamic law, since every *mujtahid* exerts his ability in discerning the sense of the sacred source and its legal implication. At the same time, no jurist has the monopoly of interpretation because *ikhtilāf* (or divergence of opinion) is constitutive of the Islamic legal framework, and *ummati rahma*[46], a blessing for the community.

This jurisprudential nature of Islamic law that Schacht seems to overlook, has nonetheless proved to be able to provide a remarkable flexibility and spirit of adaptation to the changing circumstances.

Professor Foster quotes a significant statement by the famous Hanbali jurist Ibn Taymiyya: «*men shall be permitted to make all transactions*

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[40] S. RAYNER, *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to Modern Legislation in Kuwait, Bahrain and the U. A. E. (Arab & Islamic Laws)*, New York, 1991, 101.

[41] Qur'an 5:1

[42] S. RAYNER, *op. cit.*, 100.

[43] M.H. KAMALI, *Principles of Islamic Jurisprudence*, Cambridge, 2005, *passim* and in particular Chapter 19. See for detailed information about categories of *ijtihad*, M. IBN ALI, *al-Ijtihad, Usuluhu wa-Ahkamuh*, Bayrût, 1977, 132.

[44] For a broader overview on legal interpretation refer to H.G. GADAMER, *Truth and method*, London, 2004.

[45] B. WEISS, *Interpretation of Islamic Law: the Theory of Ijtihad*, in *American Journal of Comparative Law*, 1978, p. 207.

[46] AL NAWAWI, *Sahih Muslim*.

they need, unless these transactions are forbidden by the Book or the Sunna»[47] which recalls the "residual rule of freedom of action", decreeing that all that is not forbidden is permitted[48]. Except for the literalist school of Zahirites, such principle was generally accepted by all the *madhabs* which shared the view that in absence of a specific prohibition all acts are permissible (*mubāḥ*)[49].

At the same time, since the scope of the prohibitions is derived from the legal interpretation of the Book and the Sunna, and interpretative activity is necessarily influenced by the context in which the interpreter operates, the realm of "the permissible" and of "the forbidden" is evolving in time and space.

In addition, scripturalism involves an option for taking the works of classic *mujtahids* as an exhaustive and wholly comprehensive description of Islamic legal doctrine and rules, regrettably to the detriment of an analytical approach to the role *ijtihād* played in Muslim societies during the period from which the "gates of *ijtihad*" had been allegedly closed[50]. The Islamic law as interpreted by Schacht is an embalmed set of rules fixed in the interpretation as historically,

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[47] N.H.D. FOSTER, *Islamic Commercial Law: an overview*, in *Rivista para el analisis del derecho*, 2006, II, 4.

[48] For an overview on such principle as inherent to all legal systems, refer to J. RAZ, *Legal Reasons, Sources and Gaps*, *The Authority of Law*, in J. Raz (eds.), Oxford, 1979, esp. 75-77.

[49] M.H. KAMALI, *Principles of Islamic Jurisprudence*, 276.

[50] Schacht clearly states that «*around 900 C.E., a consensus gradually established itself to the effect that from that time onwards no one might be deemed to have the necessary qualifications for independent reasoning in law, and that all future activity would have to be confined to the explanation, application, and, at the most, interpretation of the doctrine as it had been laid down and for all*.» (J. SCHACHT, *op. cit.*, 71-72) Coulson shared the same view. For him, the closing of the gate of *ijtihād* «*was probably the result of not external pressure but of internal causes, The point had been reached when the Muslim jurisprudence of the early tenth century formally recognized that its creative force was fully spent*.» (N. COULSON, *op. cit.*, 1964, 81). For an overall discussion on the issue of the closing of the gate of *ijtihād*, see W. HALLAQ, *Was the gate of ijtihad closed?*, in *International Journal of Middle East Studies*, 1984, 3-41. For a different perspective, *ex multis*, H. SALMAAN, *Is the Gate of Ijtihad Closed?*, 2008, available at http://www.salafimanhaj.com/pdf/SalafiManhaj_DoorOf Ijtihad.pdf; S.P.A. KARAMALI, F. DUNNE, *The Ijtihâd Controversy*, in *Arab Law Quarterly*, 1994, 238-257.

culturally and socially determined by classic jurists, indifferent to any change of times and society.
The different perspective adopted may lead to different conclusions. Indeed, the mere evidence that classical jurisprudence adopted a restrictive view on innominate contracts does not necessarily imply that it is an absolute and unchallengeable prescription of the *Sharīʿah*. Islamic contracts are required to respect Islamic precepts and God's limits (*hudud*, Q IV: 14). However, these limits do not exist *per se* but require an interpretative activity and legal interpretation is subject to continuous, evolving and historically determined outcomes.
Assuming that this dynamism is unrelated to *Sharīʿah*, the idea that the latter is a legal system based on sacred texts, morally guided and because God's will cannot by definition be changed, demonstrates only a lack of acknowledgment that every literal text, even God's will, does not speak for itself but needs human reasoning to be understood and to acquire a meaning.
As a matter of fact, a well-known anecdote in the Muslim word regarding 'Ali stresses the central importance that the activity of human interpretation acquires in giving consistency to the divine law. When, during the war against Mu'awiya, he tried to resort to arbitration for settling the dispute, the zealot group of Khawarijs rebelled, accusing him of betraying God's word, since his concession to refer the question of legitimacy to a negotiated settlement was a human usurpation of God's sovereignty. 'Ali gathered the people to discuss the issue and, touching the Qur'an, asked the sacred Book to speak and inform the bystanders of God's will. Then, by replicating to their exclamations on the impossibility for the Qur'an to speak, he claimed he wished to demonstrate that the Holy Book was mute in itself, so that human beings had to give effect to it, in accordance with their limited personal judgements[51].
If we properly assume *ijtihad* to be the exercise of legal reasoning on rules and facts, it will be hard to say that, since medieval ages, *ijtihad* has stopped, becoming forbidden to modern jurists[52]. The focus on the

[51] The tale is reported by K.A. EL-FADL, *The Human Rights Commitment in Modern Islam*, in *Human Rights and Responsibilities*, J. RUNZO, N. MARTIN (eds.), Oxford, 2003, 133 ff.
[52] In a seminal study on the condition of women in Ottoman *Sharīʿah* courts in Palestine and Egypt, Amira Sonbol discusses how *qāḍīs* made use of all tools provided

methodology of legal reasoning more than on the self-referential discussions relating to the possibility that - from a certain stage of Islamic legal history – absolute *mujtahids* (*mujtahid muṭlaq*) and *mujtahid muntasim* or *mujtahid fī al-madhhab* disappeared from the scene[53], facilitates our conclusions[54].

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by Islamic law legal theory in deciding specific cases. Principles of *istiḥsān* and *istihbab* provided *qāḍīs* with the flexibility needed to guide them in the choice of the preferable ruling to apply according to the sociocultural and economic context in which they operated. They were guided by two key principles: the sanctity of contracts and the protection of the weak, and particularly children and women. A. SONBOL, *Women in Shariah Courts: A Historical and Methodological Discussion*, in *Fordham International Law Journal*, 2003, 225-253.

[53] We agree with N. CALDER, *Al-Nawawī's Typology of Muftīs and Its Significance for a General Theory of Islamic Law*, in *Islamic Law and Society*, 1996, 157, where he points out the all the discussion on the limitation to *ijtihad* mainly depends on the perspective taken by the relevant *madhab*.

[54] As said above, *ijtihad* in legal usage refers to the striving of the jurist to derive principles and rules of law from evidence found in the sacred texts or source. It should be said that the possibility to still practice *ijtihad* in modern times has been highly debated among scholars. Taking aside the issue of the closing of the gate of *ijtihad* referred above, one of the questions to be addressed concerns the limits to be recognized to the exercise of *ijtihad.* Should *ijtihad* be applicable in the absence of definite and clear injunctions in the Qur'an? Or is *ijtihad* also allowed where there are such injunctions? Ancient sources are not clear on the point, nor it can be said that the same process of *ijtihad* should comply the rules elaborated by traditional *fiqh* (See R.A. CODD, *A Critical Analysis of the Role of Ijtihad in Legal Reforms in the Muslim World*, in *Arab Law Quarterly*, 1999, p. 114 ff.). Some scholars claim that for reforms in *Shari'ah* (even through *ijtihad*) to take place there must be un underlying religious legitimacy by the Muslim population that cannot be reached only by means of positive legislation (A.A. AN-NA'IM, *Shari'a and positive legislation: is an Islamic State possible of viable*?, in *Yearbook of Islamic and Middle Eastern Law*, 1999, p. 29 ff.) Recently, W. HALLAQ, *The Impossible State: Islam, Politics, and Modernity's Moral Predicament*, New York, 2012, p. 90 ff. clarified that Islamic law (whose the exercise of *ijtihad* is the most prominent part) cannot be but a jurists' made Law and on such grounds he rejects the viability of the modern State model for the Islamic societies. *Shari'ah* was surely more than a legal system and consisted of a set of institutions and practices dedicated to Islamic knowledge, including mosques, *qadi* courts, and theological and cultural centres like Al-Azhar. Institutions dedicated to Islamic knowledge underwent a process of transformation towards a modern-like educational system, with lectures, specified sequences of courses, and examinations. Once they disappeared, a whole system of knowledge, disconnected from specific institutions and practices, was dispersed. In modern Islamic societies then, the open issue is which body could have the monopoly of the interpretation of Islamic law and of *ijtihad* (the

This is why, for instance (opposing the opinion of the four classical schools on *ribā*) Muhammad 'Abduh, Grand mufti of Egypt, believed that only *ribā al jahiliyya* (pre – Islamic *ribā*) was totally forbidden, while *ribā al fadl* and *ribā al nasia* were simply to be considered presumably prohibited. While Sanhuri deemed *ribā al nasia* and *ribā al fadl* to be prohibited only to the extent that they fall within the scope of pre-Islamic *riba*[55].

The admission that legal reasoning (whichever form it takes) is coessential to Islamic law offers an image of *Sharīʿah* as a concept open to broad interpretations, where the efforts of the *mujtahid* and their results change alongside the social and historical background. Hard to be defined, *Sharīʿah* is an essentially contested concept in the proper meaning of analytical philosophy as elaborated by W.B. Gallie.[56]

This basic and intrinsic evolving nature that *Sharīʿah* shares with any other legal system should be taken into proper consideration when matters like freedom of contract and, in general, the flexible and anti-formalistic nature of Islamic law are addressed. Limits, precepts and rules shaping the idea of Islamic contractual law are open to evolution. In this evolution, the idea that *Sharīʿah* only offers fixed models of contracts and that freedom of contract can be exercised only within the framework of these models is questionable at best.

This is, indeed, the position of classical *uṣūl al-fiqh*, but it cannot be mistaken for an uncontested principle deeply rooted in the Islamic legal framework. Modern readings of the sacred texts entail new hints and meanings, which enable a further comprehension of Islamic principles in the field of contract law.[57] Overlooking such dimension limits an exhaustive understanding of the Islamic law and its mechanisms.

Parliament? A Constitutional Court?). An answer to the mentioned problems is far beyond the scope of the paper and involves an analysis that cannot be limited to the legal field. However, the advantage of Islamic finance law relies in the fact that it can work a supranational legal system, thus avoiding issues of political legitimation.

[55] N. SALEH, *Unlawful gain and illegitimate profit*, Cambridge, 1986, in particular Chapters 1 and 2.

[56] W.B. GALLIE, *Essentially contested concepts*, in *Proceedings of the Aristotelian Society*, 1956, 167-186.

[57] Al Suwailem's explanation of *gharar* recurring to the zero-sum game theory offers a good example of such approach (see S. AL SUWAILEM, *Towards an objective measure of gharar in the exchange*, in *Islamic Economic Studies*, 1956, 1-2).

3.2. *Siyāsa Shar'iyya*

A further insight on Islamic law capability to adapt and evolve is provided by *siyāsa shar'iyya.*

However, a common assumption among western scholars is that *siyāsa shar'iyya* cannot to be considered a proper part of Islamic law.[58] Schacht defines *siyāsa* as *«the discretionary power of the sovereign which enables him, in theory, to apply and to complete sacred law»*[59] thus drawing the boundaries between sacred law (which, in Schacht's terms, means *Sharīʿah*) and the exercise of discretionary power by a worldly authority which is excluded from the realm of the sacred.

From a technical point of view, *siyāsa* is the law enacted by the political power in its broader sense and it includes *qānūns,* administrative acts, regulations and codes adopted by public authorities. The recognition of the capacity of political power to pass decrees and rules within the framework of *Sharīʿah* emerged gradually in Islamic history as a consequence of the elaboration of the theory of *siyāsa shar'iyya* which guaranteed the rulers some discretion in the application of *fiqh* rules in order to purse public interest and protect people from anarchy *(fasād)*.[60]

Despite the semantics of the usage of *siyāsa* in the earlier Islamic literature was somewhat fluid,[61] Ibn Taymiyya has often been associated with the foundation of the theory due to his interest in setting out a guidance on how governance can and should abide by the dictates of *Sharīʿah*. In this perspective, he was undoubtedly aware that there were situations which were not expressly regulated under *Sharīʿah* doctrines and hence the gap had to be filled by the legitimate rulers. Indeed, his primary concern was to regulate such discretionary ruling

[58] A. SHALAKANY, *op. cit.*, 8.
[59] J. SCHACHT, *op. cit.*, p. 54.
[60] Ibn Nujaym (d. 1563), defines *siyāsa* as the action taken by a ruler in the view of pursuing a public interest in relation to a certain matter even if no textual evidence is found in support, see IBN NUJAYM, *al-Bahr al-Ra'iq*, Cairo, 1915, 20 ff.
[61] A history of the concept from the age of Al-Shafi'i is provided by M.K. MASUD, *The doctrine of siyasa in Islamic Law*, in *Recht van de Islam*, 2001, 7 ff.

power by identifying principles that enabled to set the bounds of that discretionary authority.[62]

During the Ottoman period, the higher political stability and force of the Caliphate gave momentum to the issuance of normative acts by the central authority.[63] *Qānūns* rested upon the Sultan's will and were justified on the principles of *siyāsa shar'iyya* elaborated further by Ibn Qayyim Al Jawziyya[64].

Interestingly, Heyd argues that despite many *qānūns* conflicted with norms of *fiqh*, nonetheless they received the approval of *sheikulislams* that tended to confirm them as *meshru'*, *i.e.* in compliance with *Sharīʿah.*[65] From a certain perspective, *siyāsa shar'iyya* is another example of law in practice distinguished from law in theory, and it should therefore be taken into consideration with *'urf* (custom) in order to have a more complete understanding of how Islamic law in practice varied from jurists' speculations.

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[62] IBN TAYMIYYA, *al-Siyasa al-Shar'iyya fi Islah al-Ra'i wa al-Ra'iyya*, Beirut, 1988, 101.

[63] Interestingly, a prospected codification of Islamic law had been discussed under the Abbasid rule. In his famous *Risala fi al sahaba* addressed to the Caliph Al-Mansur (712-775), the Persian thinker Ibn Al Muqaffa' proposed the codification of Islamic law as a solution to the issue of the variety of rules provided by the *madhabs* for the punishment of the same crimes, which he realized was as an obstacle to guaranteeing justice. His idea was a legal code to be imposed on all *qādīs*. Al-Mansur entrusted the Medinese jurist Mālik ibn Anas (l, d. 179/795) with the task. The latter rejected the offer for political reasons. See IBN AL MUQAFFA', *Risala fi al sahaba*, 42-43, cit. by M. TILLIER, *Legal Knowledge and Local Practices under the Early ʿAbbāsids*, in *History and Identity in the Late Antique East*, P. WOOD (ed.), New York, 2013, 190. It could be argued that the aim to centralize normative production was unlikely to be reached under the Abbasids since '*The caliphs and the ulama were in sharp conflict over matters of religious authority; the caliphs lost the contest and came effectively to be excluded from all say in matters of the law and in whatever else the ulama defined as their exclusive preserve; and, once in place, this model of separation essentially persisted for much of the medieval Islamic history*', M.Q. ZAMAN, *The Caliphs, the Ulama, and the Law: Defining the role and function of the caliph in the early Abbasid period*, in *Islamic Law and Society*, 1997, 2.

[64] See IBN QAYYIM AL-JAWZIYYA, *I'lam al-muwaqqi'ln 'an rabb al-'Alamin*, Beirut, 1993. Ibn Qayyim deemed legal rulings derived from the interpretation of the sacred texts by the jurists not part of the revealed law. Refer also to B. JOHANSEN, *Signs as Evidence: The Doctrine of Ibn Taymiyya (1263-1328) and Ibn Qayyim al-Jawziyya (d. 1351) on Proof*, in *Islamic Law and Society*, 2002, 168-193.

[65] U. HEYD, *Studies in Old Ottoman Criminal Law*, Oxford, 1973, 180-187.

Undoubtedly, *qānūns* had force of law, they were applied and were able to modify *fiqh* rules. They contributed in arranging the legal system applied to Muslims in Ottoman lands, operating always in compliance with *Sharīʿah*, being at the same time the legitimate manifestation of the legislative power recognised to the political authority that presented itself always compliant with the *Sharīʿah* ideals.

Even though some scholars argued that *siyāsa* is tantamount to a corruption of Islamic law[66] and that the political will was often embodied in rules emanating from political power which deeply diverted from *Sharīʿah* prescriptions, there are no clear theoretical justifications in excluding *siyāsa* from Islamic law history. *Siyāsa* therefore, contributes to the normative production of Islamic law granting flexibility and change.

As for freedom of contract, the acceptance of *siyāsa* (and codifications) in the framework of Islamic law broadens the actual possibilities of acknowledging the existence of a sound respect for freedom of contract in Islamic legal systems: for instance, article 10 of the Iranian civil code and articles 75 and 76 of the Iraqi civil code are quite clear in admitting freedom of contract in a way very close to civil law models[67].

4. *What is Islamic finance?*

[66] In W. HALLAQ, *The Impossible State: Islam, Politics, and Modernity's Moral Predicament*, cit., surprisingly, there is no reference to *siyāsa shar'iyya* as part of Islamic law.

[67] I am not maintaining that the civil codes enacted in the Arab countries are the product of *siyāsa shar'iyya*. To a certain extent, they were the consequences of the interaction with Western legal culture (and, French law for the most) in the modernisation process experienced by the Middle East from the end of 18th century. In this respect F. CASTRO, *La codificazione del diritto privato negli stati arabi contemporanei*, in *Riv. dir. civ.*, 1985, 387-447, identified three models relating to the introduction of Western private law in the Middle East: the Ottoman, the Egyptian and the North Africans. However, it can be said that *Sharīʿah* is still present as a normative reference in such legal experiences despite their backbone is prevalently Western-like. Hence, they cannot be easily taken aside from Islamic legal history as irrelevant. For a detailed description of the interaction between Islamic and Western law in the codification process refer to N.H.D. FOSTER, *Inter-polity Legal Conflict between Western Law and the Sharia: Some Thoughts on The Ottoman Model of Legal Transformation and Its Consequences in the Commercial Law of the UAE*, in *Yearbook of Islamic and Middle Eastern Law*, 2013, 1-49.

Compared to fluidity and adaptability to change which characterises Islamic law (implied in its theoretical premises and reached through a variety of legal tools), Islamic finance seems to be stuck on some narrowly conceptualised principles that determine its high degree of formalism and which are related to the cultural framework whereby Islamic finance, as a branch of Islamic Economics, has developed.

In addition, despite the fact that the long and rich tradition of Islamic jurisprudence is familiar with commercial and financial transactions, the relationship between Islamic finance and Islamic law is far from being clearly settled. Indeed, the latter is generally supposed to be the source of Islamic finance legal structures.

Since the majority of scholars argue over the inherent difficulties of reconciling a highly context-bound legal tradition with modern financial practices[68] or even over the feasibility to follow traditional *Sharīʿah* legal reasoning in modern times[69], very few seem to pay attention to the effective interplay between Islamic law practices and Islamic finance.

From this perspective, it can be observed that the ideological construction of an *alternative* has fully moulded the way Islamic finance represents itself and its content.

Islamic economists – who started writing on the theoretical underpinnings of Islamic economics in since the seventies – explained that the main pillars were fairness and equity[70], enshrined in sacred texts and foundations of a true Islamic way of life[71]. Purely ethical in their nature, these principles, to a certain extent, were thought to necessarily shape an economic system able to offer a third way between capitalism

[68] M.F. KHAN, *Setting Standards for Shariah Application in the Islamic Financial Industry*, in *Thunderbird International Business Rev*iew, 2007, 285; A. SHAHARUDDIN, *Defining Harmonisation of Shariah Rulings in Islamic Finance*, in *Arab Law Quarterly*, 2016, 292.

[69] See W. HALLAQ, *Can the Sharia Be Restored?*, in *Islamic Law and the Challenge of Modernity*, Y.Y. HADDAD, B.F. STOWASSER (eds.), Lanham, 2004, 42. See also W. HALLAQ, *Sharīʿa: Theory, Practice, Transformations*, Oxford, 2009, 396 ff.

[70] For a general overview, see U. CHAPRA, *The Economic System of Islam: a discussion of its goals and nature*, Karachi, 1971; T. USMANI, *An Introduction to Islamic Finance*, Leiden, 2001.

[71] T. USMANI, *Discourses on Islamic Ways of Life*, Karachi, 1999, 3 ff.

and socialism and to achieve social justice[72], guaranteeing at the same time the freedom of human beings and a fair distribution of wealth.

These considerably general and vague assumptions, grounded on a combination of both moral exhortations and juridical-economical rules derived therein, were presented as the conditions for a new and fairer economy. Moral principles, which varied from incitements not to indulge in luxury and not to hoard money just for money's sake[73] and critique against excessive individualism and injustice towards the poor[74] (all supported by quotations of Qur'anic provisions and teachings of the Prophet), were identified as marker of a new economics.

Islamic finance has been thought as of a set of legal and moral rules whose purpose is to pursue *maqāṣid al-Sharīʿah* and the perception that Islamic economics should provide a more just, and more humane alternative to the alleged wrongs of the global marketplace[75] has tipped the balance more towards the stressing of importance of social justice (as intrinsic *per se* to Islamic finance mechanisms).

However, praise to ethics is always combined with economic justifications in terms of major efficiency: justice and Pareto optimality go hand in hand[76]. Indeed, despite the lack of any unequivocal evidence, theoretical studies in Islamic economics claim that Islamic finance should be more resilient to financial crises as compared to conventional banking, while empirical studies are not yet conclusive [77].

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[72] A. HASAN, *Social Justice in Islam*, in *Islamic Studies*, 1971, 209.

[73] A. AJIJOLA, *The Islamic Concept of Social. Justice*, Lahore, 1977, 194-198.

[74] A. HASAN, *op. cit*., 215.

[75] U.F. MOGHUL, A.A. AHMED, *Contractual Forms In Islamic Finance Law and Islamic Inv. Co. of the Gulf v. Symphony Gems N.V. & Ors.: A First Impression Of Islamic Finance*, in *Fordham International Law Journal*, 2003, 153.

[76] M. AL-JARHI, *Reviving the Ethics of Islamic Finance*, MPRA Paper 66732, 2010, 19-22, accessible at https://mpra.ub.uni-muenchen.de/66732/1/MPRA_paper_66732.pdf.

[77] There is an extensive literature on the issue. Among the others, A. BELOAUFI, C. BOURAKBA, K. SACI, *Islamic Finance and Financial Stability: A Review of the Literature*, in *Journal of King Abdulaziz University: Islamic Economics*, 2015, 3-44; S. CEVIK, J. CHARAP, *The Behavior of Conventional and Islamic Bank Deposit Returns in Malaysia and Turkey*, IMF Working Paper, WP/11/156, 2011; M. FAROOQ, S. ZAHEER, *Are Islamic Banks More Resilient during Financial Panics?*, IMF Working Paper, WP/15/41, 2015; Z. ZEIDANE, *Islamic Finance, Consumer Protection*

If brotherhood and care of the needy as opposed to exploitation and greed of western capitalism are deemed its key features[78][79], legal prescriptions in finance will need to be forced in this direction. Taqi Usmani, in explaining the differences between the Islamic system and the capitalistic one, argues that the evils of the latter consist in having profit motif and private ownership not controlled by divine injunctions.

This has lead, in his opinion, to a huge concentration of wealth in the hand of few persons, a process caused by the practice of *ribā* [80]: in this sense, prohibiting *ribā*, Allah has opened the path to a society where, balance between interest of the individual and interest of the whole, distributive justice and equality of opportunities can be truly reached.[81]

As said, far from simply matching aspiration to social justice, prohibition of interest is also supposed to enhance economic efficiency. Indeed, along with moral considerations, it is generally explained that: *i)* charging interest allows lenders to claim wealth that is not theirs but that belongs to the whole society instead; *ii)* the poor would suffer in an interest-based system; and *iii)* the general inequality produced by an interest based system is an obstacle to Pareto optimality, and it therefore deprives society from a higher level of welfare[82].

The legal and economic normativity of the Islamic distinctiveness, therefore, conjointly moves from, and relies on, a pattern of injunctions articulated in prohibitions, obligations and responsibilities (prohibition of *gharar*, obligation of wealth redistribution (*zakat*) promotion of partnership based on the correspondence of profit and liability (*al-*

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and Financial Stability, IMF Working Paper, WP/15/107, 2015; M. ASUTAY, A.Q. TURKISTANI, *Islamic Finance: Risk, Stability and Growth*, Berlin, 2016.

[78] This is an element duly highlighted by M. SIDDIQUI, *Muslim Economic Thinking: A Survey of Contemporary Literature*, Markfield, 1981, *passim*.

[79] A. ZAMAN, *Re-Definig Islamic Economics*, in *Islamic Economics: Basic Concepts, New Thinking and Future Directions*, E. TAHA EGRI, K. NECMETTIN (eds.), Cambridge, 2015, 58-76. Cfr. also «*the ideal is not merely to give others from the surplus... of income over expenses but even to sacrifice and forego one's own share if the need of others is more urgent*» (U. CHAPRA, *The Economic System of Islam: a discussion of its goals and nature*, cit., 153).

[80] For an interesting reflexion on the meaning of *ribā* see M. EL GAMAL, *An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence*, in *Islamic Economic Studies*, 2001, 29-58.

[81] T. USMANI, *An Introduction to Islamic Finance*, cit., 10-11.

[82] M. AL-JARHI, *Reviving the Ethics of Islamic Finance*, cit., especially 19-22, where different positions are taken into consideration.

Kharāj bi al dhamān), just to mention a few) [83] where the moral, the legal and the economic perspective are often intermingled.

Firmly standing on such assumptions, the scope of Islamic finance is directed towards the creation of a system of commerce where the main insight is that ethics matters. However, notwithstanding the fact that Islamic finance proponents target the functional objectives of fairness and social justice, they overlook the fact that the interaction between ethics and law is not always plain[84].

In this respect, from the perspective of Islamic finance scholars, it is not clear if law should be a tool to achieve social justice or if abiding by the law guarantees *sic et simpliciter* the fulfilment of these goals. Indeed, it is commonly understood that a legal right is not necessarily "right" in the moral sense – *i.e.* it is not necessarily compliant with our idea of what "ought to be" – and that a man may be entitled to exercise a legal right even if such a right could be morally wrong.[85]

In addition, as Pound pointed out, «*when we have found a moral principle, we cannot stop at that. We have more to do than formulate it in a legal rule. We must ask how far it has to do with things that may be governed by legal rules*».[86] Properly, we need to find a way to adapt the legal machinery of rules and remedies to any consequential claim for unfulfillment and, even more, we need to identify how such machinery can be made effective in action when one of its precepts is formulated in terms of a moral principle.

All the above seems to be missing when Islamic finance law is put into practice and the lack of an appropriate, theoretically founded, methodological technique is striking. In other words, what emerges is that the preferred approach is claiming to pursue the aim of Islamic economics through adherence to the earliest foundations of Islamic jurisprudence.

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[83] T. KURAN, *Islam and Mammon: The Economic Predicaments of Islamism*, Princeton, 2010, 105-108.
[84] R. POUND, *Law and Morals -- Jurisprudence and Ethics*, in *North Carolina Law Review*, 1945, 185 ff.
[85] H. KELSEN, *Reine Rechtslehre*, Leipzig-Wien, 1934, 25-26.
[86] R. POUND, *The Limits of Effective Legal Action*, in *International Journal of Ethics*, 1917, 150.

The outcome is a decisive inclination towards a rigid formalism mistaken for the true essence of Islamic finance[87]. Indeed, Islamic finance is constructed around a bulk of axiomatic rules (prohibition of *ribā*, prohibition of *gharar*, enhancement of partnership, correspondence of profit and liability) that, through an *a posteriori* recreation, are traced back – despite the lack of any evidence – to a golden period and are artificially and univocally interpreted in a manner inconsistent with the sources and the methods of Islamic law[88], to the extent that it could be even questioned if Islamic finance is in any way related to Islamic law.

Then, it could be hypothesized that the strict compliance to their application that would entail that no kind of payment of interest is admitted and no kind of speculation can be pursued (despite one hardly being able to guess what speculation means under a legal or economic point of view), becomes more a matter of ostentatious differentiation than of implementation of Islamic law principles.

Flexibility is not alien to Islamic law as the functioning of *ijtihād* and the role of *siyāsa shar'iyya* demonstrate. Throughout its history, Islamic legal theory has also elaborated many secondary sources of law and of legal interpretation even if they have not been unanimously approved by Muslim scholars[89].

Even if their detailed examination is beyond the purposes of the article, such secondary sources are further evidence of the richness and depth of the development and articulation of Islamic theories of law. The broad realm of controversial sources includes, among others, *al-istiḥsān*, *sad al-zara'a*, *al-'urf* and *al-isteshab*. Literally, *al-istiḥsān* means considering something good, preferable and beautiful[90] and enables «*to depart from the existing precedent, by taking a decision in*

[87] H.A. HAMOUDI, *Muhammad's Social Justice or Muslim Cant: Langdellianism and the Failures of Islamic Finance*, in *Cornell Int. L. J.*, 2007, 97.

[88] N. SALEH, *op. cit.*, Chapter 2, provides a clear account of the questions that the interpretation of the prohibition of *ribā* have raised to jurists. See also A.A.A. SANHURI, *3 masadir al-haqq fl al-fiqh al-islami: dirasa muqaranah bi-al-fiqh al-gharbi*, 1967, esp. 178-194.

[89] Prevalently elaborated by the malikite *madhab*, by Imam Maliki and then further theorized by Abu Ishaq al-Shatibi (refer to M.K. MASUD, *Shatibi's philosophy of law*, New Delhi, 2009, 127-163).

[90] M.H. KAMALI, *Istiḥsān and the Renewal of Islamic Law*, in *Islamic Studies*, 2004, 561.

a certain case different from that on which similar cases have been decided, for a reason stronger than the one that is obtained in those cases»[91].

There is a considerable link, in substance and form, between *istiḥsān* and the ends and purposes of the *Sharīʿah* since the basic themes and philosophy of the *maqāṣid* are almost similar with those of *istiḥsān*[92] because they are both intended to promote justice and public wealth. Modern reformer jurists strongly relied on its extensive use as the preferred tool for reforming Islamic law[93].

Indeed, the principle of *istiḥsān* enables the jurist to abandon a strong precedent for a weaker precedent in the interests of justice, especially when the interpretation of a certain rule would lead to hardship for the believer and, conversely, such a departure from the ruling would be in line with the *maqāṣid al-Sharīʿah*.

Despite the above, no record of all this complex heritage is found in Islamic finance, in striking contrast with the emphasis on social justice and fairness which should be instead perfectly combined with the use of *istiḥsān* or with a modern approach to *ijtihād*.

On a closer view, Islamic finance and Islamic law seem therefore to have little in common in terms of theoretical and methodological structure. The former is an amalgamation of legal inputs where English law and international financial services law are combined with some *Sharīʿah* standards, which, however, are newly created principles «*based on the use of innovative structures that adhere to the rules of classical fiqh in form (albeit tenuously)*»[94].

In this sense, a major force – often marginalised by scholars – in shaping Islamic finance is the pressure from financial markets to

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[91] ALA 1-DIN 'ABD AL-'AZIZ AL-BUKHARI, *Kashf alAsrar 'an Usul Fakhr allslam al-Bazdawi*, Beirut, 1991, 4.

[92] M.H. KAMALI, *Istiḥsān and the Renewal of Islamic Law*, cit., 575.

[93] Muhammad 'Abduh deemed Islam superior to Christianity also because *maslaha* (which can be assimilated to *istiḥsān*) provided more sense of realism (See H. LAOUST, *Le Califat dans la doctrine de Rasid Rida*, Beyrut, 1938, 273. By way of example, a contemporary jurist like Mashood Baderin makes an extensive use of *maslaha* in proposing harmonisation between Islamic law and Internation human rights (See M.A. BADERIN, *International Human Rights and Islamic Law*, Oxford, 2003).

[94] J. ERCANBRACK, *The Standardization of Islamic Financial Law: Lawmaking in Modern Financial Markets*, in *American Journal of Comparative Law*, 2020, 3.

standardise financial products. Max Weber has taught us the significance for modern legal systems of law uniformity and efficiency in order to facilitate predictable and calculable decisions[95]. Such task has been mainly carried out by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which has taken ground as the most authoritative standard-setting organization in the Islamic finance industry[96].

The nature of the standardization process interacts with the formulation of standards that try to maintain a relationship with classical law. As acutely noted, however, the fact that the (alleged) Islamic jurists' interpretation of ancient rules is contextualized in modern markets and legal systems makes simply *fiqh* not a decisive factor in what becomes a *Sharīʿah* standard where, instead, market practice plays a higher role.

This makes Islamic Financial law a proper emergent system – as it has been said[97] – where its ideological underpinnings reiterate the notion that IFL reflects the practice of classical law, while in reality it

[95] M. WEBER, *Economy and society. Vol. 2: an outline of interpretive sociology*, Berkley-London, 1978, esp. 275-280.

[96] However, this standardisation process towards the creation of proper bulk of Islamic finance law rules and principles has not been generally perceived. See, by way of example, the English Court of Appeals' judgment in the case of Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain EC [2004] APP.L.R. 01/28, where the choice-of-law clause subjecting a transaction based on *murabahah e ijarah* contracts to the application of English law and «*to the principles of the Glorious Sharia'a*» was deemed not sufficient to question the validity of the agreements despite them bearing interests. In that respect, Judge Potter LJ, clarified that «*The general reference to principles of Sharia'a in this case affords no reference to, or identification of, those aspects of Sharia'a law which are intended to be incorporated into the contract, let alone the terms in which they are framed. It is plainly insufficient for the defendants to contend that the basic rules of the Sharia'a applicable in this case are not controversial. Such 'basic rules' are neither referred to nor identified. Thus the reference to the 'principles of...Sharia'a' stand unqualified as a reference to the body of Sharia'a law generally. As such, they are inevitably repugnant to the choice of English law as the law of the contract and render the clause self-contradictory and therefore meaningless*». The first instance Court had even classified *Shari'ah* as a «*socio-religious code of conduct*.

[97] Reference is to the seminal study of N.H.D. FOSTER, *Islamic Finance Law as an Emergent Legal System*, in *Arab Law Quarterly*, 2007, 170-188.

is a modern combination of market practices and legal reinvention of Islamic legal tradition.[98]

However, the unwillingness to detach from the narrative of Islamic Finance law as the replication of the commercial practices (and values) of classical Islamic age, produces, in my view, an outcome that is market-oriented and has, at the same time, a highly formalistic legal structure[99].

The pre-eminence of the formal details leads to a systematic inversion between the aim and the effective results that Islamic finance practices can produce. Indeed, despite the reliance on Islamic legal and moral imperatives, the compliance with *Sharīʿah* legal prescriptions – as interpreted in the context of Islamic finance – is stressed to such an extent that it appears to fall short in assuring a complete conformity to the proposed ethical spirit of Islamic economics.

Hence, the interdiction of *ribā* surely has a formal content but, at least from the perspective adopted by Islamic economics theorists, also a substantial or functional content, namely avoiding concentration of wealth and guaranteeing a just profit which does not exceed the fair balance between the parties.[100]

A transaction inspired by the principles of Islamic finance should therefore comply with the two dimensions together, fulfilling the form and achieving the scope.

4.1. *Murābaha or the way to formalism*

Murābaha is one of the most used financing contracts in Islamic finance and the prevalent form of financing in Islamic banks' asset side, reaching a 80%- 90% of the totality of financial instruments used in

[98] J. ERCANBRACK, *op. cit.*, 36.

[99] H.A. HAMOUDI, stressing such element, warns that the failings of Islamic finance are not necessarily due to formalism *per se* but to the type of logic-driven formalism that he detects as a consequence of a certain Langdellianism involving Islamic finance methodology. See H.A. HAMOUDI, *Muhammad's Social Justice or Muslim Cant: Langdellianism and the Failures of Islamic Finance*, cit., 95 n. 34.

[100] H.A. HAMOUDI, *Jurisprudential Schizophrenia: On Form and Function in Islamic Finance*, cit., 620.

until the nineties[101] and then settled at an average level of 50%-60% in some countries[102], while as of 2018, *murābaha*, according to the IFSB had an average combined 58.8% share in the financing mix of Islamic banking[103]. Its conventional equivalent can be considered the loan, nonetheless if we compare the structures of the two transactions, we can notice a significant difference of form.

Murābaha is a good example of the formalistic methodology that pervades Islamic finance law. The historic *murābaha* is described in the well-known jurisprudence book of Imam Mālik, al-Muwatta', and involves a simple sales transaction based on credit. *Fuqahā'* widely validated the practice which had a foothold in the Qur'ānic verse: «God has permitted trade [*implying credit sales*] and forbidden *ribā* [*implying usury*]»[104]. The classic *murābaha*, therefore, is a tool for commerce whose economic rationale employs the price elasticity of demand of the good being sold while taking into account the expected rate of return of the merchant[105].

In its pure form, historic *murābaha* is either a B2B or a B2C transaction whose rationale is to facilitate the demand for good by delaying payment. However, even if from an economic and legal point of view it can be classified as a financing, the legal subjectivity of the juridical person granting the extension of payment (a financial institution or non-financial company) in exchange for the purchase of the good is not indifferent to the legal characterisation of the transaction.

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[101] S. NAGAOKA, *Beyond the Theoretical Dichotomy in Islamic Finance: Analytical Reflections on Murābaḥah Contracts and Islamic Debt Securities*, in *Kyoto Bulletin of Islamic Area Studies*, 2007, 72-91.

[102] S.R. AJIJA, S. KUSRENI, *Globalization and Socio Economic Welfare of Muslim Countries: A Case Study of Indonesia and Malaysia*, in *European Journal of Social Sciences*, 2011, 329-343. N. ALSAYYED, *The Uses and Misuses of Commodity Murabaha: Islamic Economic Perspective*, MRPA paper, available at http://mpra.ub.uni-muenchen.de/id/eprint/20262, 2010.

[103] Data from the Islamic Financial Services Board (IFSB) available at https://www.ifsb.org/psifi_02.php (last accessed 16 March 2020). For M.D. MIAH. Y. SUZUKI, *Murabaha syndrome of Islamic banks: a paradox or product of the system?*, in *Journal of Islamic Accounting and Business Research*, 2020, still about 90 per cent of the total financings are concentrated on *murābaha*.

[104] Q2: 275

[105] M. RASHID, D. MITRA, *Price Elasticity of Demand and an Optimal Cash Discount Rate in Credit Policy*, in *Financial Review*, 1999, 113-125

We are indeed used to considering financial services and credit activities on a recurrent basis as reserved activities subject to specific regulatory requirements.[106] Therefore, credit sales carried out by traders and credit sales carried out on a large scale by financial institutions cannot be put on the same level.

When describing modern *murābaha* Nethercott indicates it as a transaction whereby a «*seller buys goods at request of a customer. The seller takes title in such goods. In turn, the seller enters in a sale contract with the purchaser to buy such goods at an agreed and disclosed profit in addition to the purchase price. The seller and the purchaser agree deferred payment terms [...]*»[107].

Compared to classic *murābaha*, modern *murābaha* is a three-party transaction where a financial institution (the seller) provides a customer (the client) with a good purchased by a supplier. In its structure, modern *murābaha* is a consumer credit transaction that has few things in common (not even the form) with the traditional credit sale agreement and a totally different function, if we consider the absence of financial markets in the Islamic medieval era. Substantially, it consists of a method of financing the acquisition of goods, and assets, whereby the bank is the seller and the client is the purchaser, it being fully comparable to a conventional consumer credit loan.

A few discrepancies can be observed. While in a conventional loan the client borrows money from the bank, it purchases the good and then it repays the amount borrowed in addition to the payment of a predetermined rate of interest, in simple *murābaha* the bank buys the good and then sells it to the client at the price plus a mark-up.

Formally, the transaction seems structured to satisfy all *Sharīʿah* requirements. There is an underlying asset (so there is no exchange of money for money, thus excluding the basis for *ribā*), the two transactions involved (purchase by the bank from the supplier – sale from the bank to the client) are not included in the same contract and, when combined, they are said not to provide different rulings and

[106] Section 4(1) of Directive 2006/48/EC defining a credit institution as a company «*whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account*».

[107] C. NETHERCOTT, D. EISENBERG, *Islamic Finance: Law and Practice*, Oxford, 2012, 138.

effects[108], no interest is paid to the bank and the bank suffers the risk of loss and damage for the good until the property is transmitted to the customer (in application of *al-Kharāj bi al-dhamān* principle so to justify the profit received by the bank).[109]

Similarly, the Islamic financial institution seems to face different risks under a *murābaha* transaction compared to a conventional one under a credit consumer loan. It is indeed subject to *i)* the risk of loss and damage with respect to the purchased good and *ii)* the risk of any delay in the payment of the agreed sum by the client for which no default interest can be requested. However, all these divergences disappear upon a closer look to practice.

In order to minimise the risk of loss and damage, Islamic banks *i)* require the customer to enter into a unilateral promise by means of which the customer undertakes to repurchase the good from the bank[110] and *ii)* enter into an agency agreement by means of which they appoint the customer as agent in purchasing the good. The customer buys the asset on behalf of the bank and then he immediately offers to purchase it from the latter.[111] In consequence, the time that the risk of loss and damage is borne by the bank is dramatically reduced. As for default risk, banks protect themselves by asking for security, generally in the form of a collateral, thus making the risk negligible.[112]

Even the veil of the interest-free transaction is easily pierced. The mark-up awarded to the bank under a *murābaha* is calculated pursuant

[108] Prohibition of combination of contracts when the combined contracts have conflicting objectives is one of the less clear *Sharīʿah* ruling on contracts. In principle, the prohibition should aim at preventing asymmetry of information and minimising the risk of use of legal ruses to attain ends prohibited under the law. It is hard to admit the *murābaha* does not fall within the scope of the rule. For an overview refer to M.B. ARBOUNA, *The combination of contracts in Shariah: A possible mechanism for product development in Islamic banking and finance*, in *Thunderbird International Business Review*, 2007, 341-369.

[109] M.A. EL GAMAL, *Interest and the Paradox of Contemporary Islamic Law and Finance,* in *Fordham International Law Journal*, 2003, 119.

[110] The effect is to mitigate the risk that the consumer will not repurchase the good. See H. QADRI, M. BHATTI, *The Growth of Islamic Finance and Banking: Innovation, Governance and Risk Mitigation, Routledge*, New York, 2020, 159 ff.

[111] T. USMANI, *An Introduction to Islamic Finance*, cit., 152.

[112] I. WARDE, *Islamic Finance in the Global Economy*, Edinburgh, 2000, 133.

to the LIBOR rate[113]. Therefore, banking *murābaha* is priced using a *ribāwī* index primarily and this is a consequence of the necessary global integration of capital markets[114]. From a purely economic point of view, it becomes hard to distinguish the Islamic product from the conventional one[115]. As in a conventional loan, indeed, the client receives an extension of money from a bank and he is required to pay back the same amount and a surplus called profit: the transaction is all around economically mimicking the interest on a loan.[116]

However, the structure of the *murābaha* transaction also faces major shortcomings. First, the duplication of contractual documentation for the purposes of entering into a single economic operation increases transaction costs, the risk of breach and the risk of potential litigation. In addition, in countries where such transactions are not recognized as a single operation, this may also create tax duplications. Furthermore *i)* a banking *murābaha* is generally more expensive than a *ribā wī* debt contract due to reduced economies of scale and the incremental expenses for paying *Sharī'ah* scholars for their approval; and *ii) murābaha* facilities are at the lowest rung of pareto-efficiency[117].

4.2. *The lost partnership*

The inconsistencies detected in the use of *murābaha* can be observed in most of the financial tools provided by Islamic finance institutions. Ijāra, takaful, ṣukūk, all can be assembled in such a way so as to resemble a *Sharīʿah* compliant product, achieving the same effects of a conventional one (in terms of profitability). It does not mean differences cannot be found. Surely, if an asset-backed *ṣukūk* is not structured like a normal bond, nonetheless, this will not prevent Moody's from rating it as a conventional unsecured bond in all

[113] A. SAEED, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation*, Leiden, 1996, 85.
[114] M.S. EBRAHIM, M. SHEIKH, *Debt Instruments in Islamic Finance: A Critique*, in *Arab Law Quarterly*, 2016, 190.
[115] B. S. CHONG, M. H. LIU, *Islamic Banking: Interest-Free or Interest-Based?*, in *Pacific-Basin Finance Journal*, 2009, 125–144; H. DAR, U. MOGHUL, *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance*, New York, 2005, 75
[116] Furthermore, interests can be limited to a certain amount (see. Art. 664 Italian Penal Code) while mark-up or profit have not potential limits.
[117] M.S. EBRAHIM, M. SHEIKH, *op. cit.*, 191.

respects.[118] Unsecured notwithstanding the need for any *ṣukūk* to have an underlying asset, consistently with the results of Dusuki and Mokthar who have clarified that only 2% of asset-backed *ṣukūk* in the market end up fulfilling the *Sharīʿah* requirement of realizing an actual sale of the relevant asset[119].

The second main feature of the foundations of Islamic finance (in addition to the interest-free economics), the value of partnership (*sharika*) and profit-and-loss sharing (PLS) as an alternative way of enhancing economic development, suffers from similar flaws. PLS is one of the main financing instruments in Islamic finance literature and likely dominates the theoretical literature on Islamic finance.

This participative intermediation is deemed to be the ideal Islamic financial technique and the true implementation of the principle that no one can claim any profit without incurring risk[120]. PLS doctrine is likewise associated with the promotion of moral values alongside with the promotion of higher economic efficiency.

On one hand, PLS is based on equity, justice and fairness in financial transactions. Indeed, according to Islamic principles, a financier can serve two purposes. It can either extend a loan to a debtor in need on humanitarian ground (therefore without aiming for any profit or charging any interest) or to share profits. Should that be the case, it is however also required to share losses[121]. Due to its rejection of speculation on ethical grounds, PLS is placed among the most important features of Islamic banking since it promotes risk-sharing between the provider of funds (investor) and the user thereof

[118] K. HOWLANDER, *The Future of Sukuk: Substance over Form?*, Moody's Investor Service, 2009.
[119] Refer to the analysis by A.W. DUSUKI, S. MOKHTAR, *Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based Sukuk as Implemented in the Islamic Debt Market*, in *ISRA Research Paper*, 2010.
[120] U. CHAPRA, *Toward a Just Monetary System*, Leicester, 1985, *passim*; M.N. SIDDIQI, *Islamic Banking: Principles, Precepts and Prospects*, in *Journal of King Abdulaziz University: Islamic Economics*, 1998, 43-60; S. AL SUWAILEM, *Financial intermediation in islamic economic*, in *Crise monétaire mondiale: origines et solutions d'un point de vue islamique*, AA. VV. (eds.), Jeddah, 2009, 60-92.
[121] T. USMANI, *An Introduction to Islamic Finance*, cit., 19.

(entrepreneur)[122] and it is considered an ideal way of financing in *Sharīʿah*.

On the other hand, Islamic scholars maintain that *mudarabah* and *musharaka* are able to help efficient mobilization of financial resources.[123]

Enhanced efficiency of PLS structures and their grounds on the sacred texts have been highly debated.[124] However, there is a considerable gap between the extensive role of profit-and-loss sharing in the theoretical debate and its real impact on the portfolio of Islamic finance institutions. The IFSB report for 2018 acknowledges that the combination of *musharaka,* dimishing *musharaka* and *mudarabah*, on aggregate data from 15 countries, account for a mere 5.2% of the overall services offered by Islamic Financial institutions.[125]

Therefore, while theorists keep on reaffirming that the essence of Islamic finance is the commitment to partnership, the real data shows that the share of PLS is marginal. Islamic banks tend to reduce PLS contracts specifically on their asset side[126] because indiscriminate recourse to *musharaka* and *mudarabaha* contracts as a pure form of equity financing is considered highly risky for a financial institution.

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[122] M. IQBAL, P. MOLYNEUX, *Thirty Years of Islamic Banking: History, Performance and Prospects*, New York, 2004, 136.

[123] H.A. DAR, J.R. PRESLEY, *Lack of Profit Loss Sharing in Islamic Banking: Management and Control Imbalances*, in *Economic Research Paper*, Loughborough University, 2000, 4-27.

[124] A.H. ISMAIL, *The Deferred Contracts of Exchange: Al-Quran in Contrast With The Islamic Economist's Theory on Banking and Finance*, Kuala Lumpur, 2002, 42 ff. is critical about the relevance of PLS in Qur'anic texts. For a general overview of the debate, refer *ex multis* to H. AJMI, H. AZIZ, S. KASSIM, W. MANSOUR, *Adverse selection analysis for profit and loss sharing contracts*, in *International Journal of Islamic and Middle Eastern Finance and Management*, 2019, 532-552; K. BEN JEDIDIA, H. HAMZA, *Profits and Losses Sharing paradigm in Islamic banks: Constraint or solution for liquidity management?*, in *Journal of Islamic Economics, Banking and Finance*, 2014, 1-17; A. HECHEM, A.A. HASSANUDDEEN, K. SALINA, M. WALID, *A Literature Review of Financial Contracting Theory from the Islamic and Conventional Overviews: Contributions, Gaps, and Perspectives*, in *Journal of King Abdulaziz University, Islamic Economics*, 2019, 25-42.

[125] See n. 108 above.

[126] Cfr. M. CIZAÇKA, *Islamic Capitalism and Finance: Origins, Evolution and the Future, (Studies in Islamic Finance, Accounting and Governance)*, Cheltenham, 2011.

The relevant reasons have been widely discussed. They are multifaceted and address different sides of PLS contracts: *i)* vulnerability to agency problems in terms of incentives for the client-entrepreneur to report to the financial institution less profit then those realised; *ii)* lesser capacity of equity financing to be used for funding short-term projects;[127] and *iii)* moral hazard and adverse selection problems caused by client-entrepreneur's inadequate competence in the management of the financed business or its dishonesty that can dramatically multiply monitoring costs.[128] PLS instruments are, in addition, not liquid since a secondary market for trading in Islamic financial instruments does not practically exist. In particular, then, *mudarabah* exposes the bank to the whole risk of financial loss in the financing of the project in striking contrast with risk-adverse behaviours of average financial institutions.[129] Partially, these arguments have been countered on speculative grounds[130] and a proposal for taking venture capital as a potential model for implementation of *musharakah* has been advanced.[131]

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[127] A. DAR, J.R. PRESLEY, *op. cit.*, 3-4; K. BEN JEDIDIA, H. HAMZA, *op. cit.*, 33.

[128] M.A. EL GAMAL, *Islamic Finance: Law, Economics and Practice*, Cambridge, 2008, 3.

[129] M.O. FAROOQ, *Partnership, Equity-Financing and Islamic Finance: Whither Profit-Loss Sharing?*, in *Review of Islamic Economics*, 2007, 81.

[130] Among those who encouraged the adoption of PLS agreements, R. MUDA, A. ISMAIL, *Profit-loss sharing and value creation in Islamic banks*, in *Journal of Business and Policy Research*, 2010, 262-281; N. SAPUAN, *An evolution of mudarabah contract: a viewpoint from classical and contemporary Islamic scholars*, in *Procedia Economics and Finance*, 2016, 349-358; E. ERNAWATI, *Risk of profit loss financing: the case of Indonesia*, in *Al-Iqtishad (Journal of Islamic Economics)*, 2016, 101-116; H. AHMED, *Incentive-compatible profit-sharing contracts: a theoretical treatment*, in *Islamic Banking and Finance: New Perspective on Profit-Sharing and Risk*, M. IQBAL (ed.), Cheltenham, 2002, 40-54; S. NABI, *Profit sharing, income inequality and capital accumulation*, *IRTI working paper*, 2012, 1-29; S. AL SOUWAILEM, *Optimal sharing contracts*, Work paper-Research and Development Al Rajh Banking and Investment Corp Presented, 2003, 57; H. AJMI, H. AZIZ, S. KASSIM, W. MANSOUR, *op. cit.*, where the authors suggest that economic players and policy makers should consider *Musharakah* financing with the aim to ensure financial inclusion and social welfare. It should be noted, however, that the results of their research were not compared to real data due to unavailability of the latter.

[131] See S. AL SOUWAILEM, *Venture Capital: a potential model of musharakah*, in *Journal of King Abdulaziz University: Islamic Economics*, 1998, 3-20 who does not

However, taking aside any *ad hoc* investigation on the intellectual soundness of the different views on the practicability of PLS instruments, the existing disproportion between the share they have in the theoretical framework of Islamic finance and the actual use they experience suggests a major flaw in the dominant literature.

This divergence of the "is" from the "ought" seems to support Hume's idea that one cannot deduce moral conclusions (ought being a peculiar expression of the moral language), from non-moral premises, that is premises from which the moral words are absent.[132] The ideological underpinnings of Islamic finance blur the lines between solutions and problems.

This explains why, despite any idealised configuration of the Islamic bank as a perfect equilibrium of PLS activities on both the asset and the liability side, the practice testifies that most transactions are in the areas of trade finance, mark up operations (*murābaha* and partially *diminishing musharaka*), and leasing (*ijāra*).[133] On the other side, such outcome, as unintended consequence, is quite in line with the aspiration of Islamic finance to be an alternative, since for such alternative being effective it has to compete on the financial markets and thus being profitable.

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provide evidences about solving moral hazard and asymmetric information problems through venture capital.

[132] D. HUME, *A Treatise on Human Nature*, Oxford, 2000, Section 3.1.1, '*Moral Distinctions Not deriv'd from Reason*': «*In every system of morality, which I have hitherto met with, I have always remark'd, that the author proceeds for some time in the ordinary way of reasoning, and establishes the being of a God, or makes observations concerning human affairs; when of a sudden I am surpriz'd to find, that instead of the usual copulations of propositions, is, and is not, I meet with no proposition that is not connected with an ought, or an ought not. This change is imperceptible; but is, however, of the last consequence. For as this ought, or ought not, expresses some new relation or affirmation,'tis necessary that it shou'd be observ'd and explain'd; and at the same time that a reason should be given, for what seems altogether inconceivable, how this new relation can be a deduction from others, which are entirely different from it ... [I] am persuaded, that a small attention [to this point] wou'd subvert all the vulgar systems of morality, and let us see, that the distinction of vice and virtue is not founded merely on the relations of objects, nor is perceiv'd by reason*»

[133] I. WARDE, *The Revitalization of Islamic Profit-and-loss Sharing, Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities*, Harvard, 1999, 204.

5. *Islamic finance law as an autopoietic system*

The Islamic Financial Services Industry Stability Report for 2019 drafted by the IFSB highlights that the total worth of the IFSI, which surpassed a landmark USD 2 trillion for the first time in 2017, has further increased to USD 2.19 trillion in 2018 (a remarkable achievement when compared to what it was in the early 1980s [134]) despite the improvement recorded in 2018 shows a slower pace of growth when compared to 2017[135].

The uneven economic performance is attributed to the effect of continuing trade tensions on investment sentiments, uncertainties arising from regional political impasse in the Gulf Co-operation Council (GCC) and Brexit, economic sanctions and consequential significant currency depreciation, as well as inflation and heightened foreign exchange exposure in a few jurisdictions with a significant Islamic finance system.

Growing economies like the Malaysian one, a certain rise of political Islam, a related commercial bourgeoisie[136] and a general request for an ethical finance, at the aftermath of the economic crisis, no more only among pious Muslims but also in Western countries, have created a certain degree of attractiveness.

As for the Islamic banking, which holds a share close to 72% of the whole Islamic finance financial services sector, in general, the total capital and Tier-1 capital adequacy ratios in most jurisdictions are evaluated as both stable and above regulatory requirements. However the average nonperforming financing (NPF) ratio of 4.9% is still higher than those of conventional banks in both the EU and the US, mirroring the global financing exposure of Islamic banks, with the highest NPF recorded in the manufacturing and household sectors.[137] Islamic finance is an established actor on global financial markets and the criteria for

[134] I. WARDE, *Les Principes Religieux à l'Épreuve de la Mondialisation: Paradoxes de la finance islamique*, in *Le monde diplomatique*, September 2001.
[135] The report is available at https://www.ifsb.org/ (last accessed on 18 March 2020).
[136] N. AYUBI, *Political Islam: Religion and Politics in the Arab World*, London, 2003, 135-138.
[137] Data extracted from the Islamic Financial Services Industry Stability Report for 2019.

judging its performances are the same applied for conventional institutions. Market fluctuations, global politics and global economics have a direct influence on yearly results of Islamic finance institutions, which fully-fledged market institutions.

The Islamic market has also recalled the attention of an increasing number of conventional banks, like HSBC or Deutsche Bank[138], that have all established specific Islamic finance branches provided with *Sharīʿah* boards.

This is a symptom confirming that Islamic finance can be a lucrative market. Islamic banks do profits and spend their efforts to maximize them and minimize the losses in the interests of shareholders[139], while such market-oriented trend is covered and justified by the formalistic compliance to *Sharīʿah* restrictions.

These restrictions are subject to vivacious financial engineering by *Sharīʿah* experts able to replicate conventional products in their substance[140] and then manipulate them in order to meet the regulatory requirements of the market authorities in the Western countries where they operate[141].

On the flipping side of the coin, any direct relationship between implementation of Islamic finance, improvement of distribution of wealth and enhancement of social justice is undemonstrated. A comparison between Gini indexes of the countries where Islamic finance has strong roots (Saudi Arabia, Iran, Sudan, Malaysia) and a G8 country such as Italy do not show any major difference.[142] Sweden Gini index is far better than Italy Gini index[143] despite both having conventional finance systems. Interest-free economics, therefore, is

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[138] Deutsche Bank won *The islamic deal of the year* in 2014 for its excellence in Islamic finance (see https://www.db.com/mena/en/content/1455.htm

[139] R.B. MUDA, *Profit-Loss Sharing and Economic Value Added in Islamic Banking Model*, in *Working Paper in Islamic Economics and Finance*, 2011, 1-22.

[140] H.A. HAMOUDI, *Muhammad's Social Justice or Muslim Cant?*: *Langdellianism and the Failures of Islamic Finance*, cit.

[141] Cfr. Interpretative Letter OCC#867 of the *Office of the Controller of Currency,* U.S. Department of Treasury «*similar to a conventional mortgage, if the customer defaults on the murābaha financing, will consider the property to be OREO and dispose of it in accordance* [...]».

[142] Saudi Arabia 45,9; Iran 40; Malaysia 41; Sudan 35,40; Italy 34,90. Data from World Bank.

[143]. For Sweden 29,20, World Bank data.

unlikely to be the key feature of the increase of social justice while others essential factors necessarily concur.

The ideological foundations of Islamic finance remain unshaken notwithstanding the mismatch between aspirations towards the establishment of a new economy and the reality of a financial industry which has achieved a well-settled position within the global market and a sufficient degree of competitiveness. Indeed, the consolatory idea that the present structure should only be a step[144] towards true Islamic finance is not supported by evidence since all signals indicate no change of trend. At the same time, the rigid formalism of the contractual structures implemented in order to comply with (whilst simultaneously circumventing) a prohibition of *ribāwi* transactions whose axiomatic interpretation has little in common with the theory and praxis of Islamic law is uncontested.

In this sense, reference to Islamic finance as a derivation – or a branch – of Islamic law is largely questionable. The panoply of the conceptual and legal tools of Islamic law have almost no impact on Islamic finance when compared to the extensive use made in the reformation of other fields such as Islamic family law and, as mentioned, different sources (English law primarily) and market forces converge in shaping its rules.

From this perspective, Islamic finance can be described as an autopoietic system, a form of system-building using self-referential closure which is self-justified and self-defined. If we defined autopoiesis as the organization of a system of reference in a way that the processes that are constituent to the system, and are necessary for the continuance of the system itself, are reproduced only with reference to themselves, [145] we can detect a key aspect of the Islamic finance system and its at least troublesome relation with Islamic law. Islamic finance has created by itself its theoretical foundations and its rules,

[144] T. USMANI, *An Introduction to Islamic Finance*, cit., 72.
[145] R. COTTERRELL, *Sociology of law: an introduction*, London, 1992, 66. Autopoiesis theory was formulated by the biologists H. Maturana and F. Varela in H. MATURANA, F. VARELA, *Autopoiesis and Cognition: The Realization of the Living*, Dordrecht, 1980 and further elaborated by the sociologist N. LUHMANN, *The Autopoiesis of Social Systems*, in *Sociocybernetic Paradoxes: Observation, Control and Evolution of Self-Steering Systems*, F. GEYER, J. VAN D. ZEUWEN (eds), London, 1986, 172-192.

therefore any external interference, firstly from Islamic law, may be regarded as a potential cause of friction.

Could Islamic finance be conceivable without its interest-free characterization? Notwithstanding that *ribā* prohibition as currently interpreted could be successfully challenged on the grounds of Islamic law, the question could hardly have a positive answer. *Ribā* (but the same could be said for *gharar*) is coessential to the Islamic finance narrative regardless of the structural inefficiency it could originate.

Likewise, it is coessential to the ideological mechanism of the *Homo Islamicus* with its deeply articulated moral attitudes,[146] altruistic, rightly guided, compassionate and cooperative, whose tailor-made model of economics is the PLS[147], even if forced to remain a pure intellectual speculation.

As has been demonstrated in the first part of this article, these elements were the product of a specific cultural *milieu* and the justifications on which Islamic finance has been constructed as the creation *par excellence* of the Islamic Economics. For these reasons, such justifications stand together and fall together with the same idea of Islamic finance.

Acknowledging the shortcomings of modern Islamic finance in reconciling the current practice with the Islamic legal tradition, an Author suggests a potential path to follow in order to keep together aspirations for social justice and financial activities. The proposal is to re-orientate Islamic finance towards a form of mutual aid likewise cooperative banks in Europe, where «*early credit unions and mutual savings was closely associated with churches and other religious institutions that sought to avoid usury by providing credit at affordable rates to community members, and to avoid profiting from the extension of such credit*».[148]

Despite the solution is carefully argued, it underestimates how formalism has been functional to the construction of Islamic finance as

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[146] T. KURAN, *On the Notion of Economic Justice in Contemporary Islamic Thought*, in *International Journal of Middle East Studies*, 1989, 171-191.

[147] D. RUDNYCKYJ, *Homo Oeconomicus and Homo Islamicus*, in *Revisited: Islamic Finance and the Limits of Economic Reason*, paper presented at the *8th International Conference on Islamic Economics and Finance*, Qatar National Convention Center – Doha, Qatar 19-21 December 2011, 9-12.

[148] M.A. EL GAMAL, *Islamic Finance: Law, Economics, and Practice*, cit., 173.

an alternative, serving the purposes of a distinctive mark. Formalism, maybe, is the true essence of Islamic finance law[149].

[149] J. ERCANBRACK, *op. cit.*, 36 has provided a really sophisticated analysis of process of standardization of the commercial elements of the *Sharīʿah* particularly showing how the interaction of market forces and of municipal legal system is favoring the development of a proper transnational legal system (as Islamic financial law can be deemed). He also clearly affirms that such a new legal system can easily make use of the all the tools and method that *Sharīʿah* has developed (an examination of *ḥiyal* would have been useful to this end in this paper) to continuously adapt to changes. We definitively agree on the point. However, the Author suggests that one of the main shortcoming of Islamic financial law scholars and stakeholders is the incapacity to recognize that "*classical law is no longer relevant in modern markets*" (*rectius*, the modern assumptions about what classic Islamic could have been - if ever existed one -). Such incapacity "*prevents IFL from becoming the legal system that its early theorizers had hoped it could be"*. We fear that such unwillingness to relinquish the (ideological) past – which results in formalism – could be deemed coextensive to the essence of Islamic financial law itself.