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Sharia Risk?

How Islamic Finance Has Transformed Islamic Contract Law

by

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Preface

This booklet was first offered as a lecture at Harvard Law School, in May 2008, while Dr. Bälz was a Visiting Fellow at the Islamic Legal Studies Program during the spring of 2008. Dr Bälz is a well-known scholar of Islamic finance and banking, as well as an attorney, and his insights stem from both a vast experience in law, most recently as a partner in Gleiss Lutz, one of Germany's leading law firms, where he specialized in corporate finance in the markets of the Middle East and North Africa (MENA), and from a solid educational background in Middle Eastern Studies. He presently is International Co-Director of the Regional Centre for Renewable Energy and Energy Efficiency (RCREEE), an international organization with ten member states from the MENA region, which is supported by Germany, Denmark, and the EU, and is based in Cairo.

Islamic finance is a burgeoning field, growing at a pace exceeding ten percent a year. Its basic tenet is that it must conform to Sharia rules, which have a strong basis in equitableness and social justice. Sharia strongly proscribes exploitative and unethical practices, including most famously making money without compensation, which underlies the prohibition of interest. The ethical nature of Sharia underpins the business of Islamic finance, yet ethics, along with legal rules, are subject to interpretation. The exact role the ethics of Sharia play in Islamic finance, the risk for those who bank in the sector, and the change that Islamic law has undergone through the practice of Islamic finance in today's global market are some of the points Dr. Bälz discusses in this probing paper.

It gives us great pleasure to publish this study as the ninth booklet of ILSP's Occasional Publications series, launched in 2000. For previous booklets, including "Moving Toward an Islamic Financial Regime in Pakistan," please access our website.

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Sharia Risk?

How Islamic Finance Has Transformed Islamic Contract Law

Kilian Bälz

This paper is about Islamic finance and Islamic law.[1] Islamic law normally is defined as the body of legal rules developed by Muslim scholars in interpreting the Qur'an and the Sunna, the religious texts of Islam. Islamic finance (or "Sharia finance," as American practitioners like to call it) denotes financial transactions conforming to Islamic legal principles. Islamic finance, since its inception nearly fifty years ago, has developed into one of the most significant growth areas in international banking. In addition Islamic finance—arguably—is the most important area of the application of Islamic contract law. What this entails is the subject-matter of the below text, most fittingly researched at Harvard, which was one of the first universities to set up a specialized research program in Islamic finance, producing some standard-setting publications in the field.[2]

Over the last decade, the Islamic finance industry has continuously evolved and developed. A recent study[3] suggests that some USD 500 billion are managed according to Islamic principles, with an annual growth rate of 15 to 20 percent. Today, Islamic financing transactions are not only offered by Islamic banks (financial institutions that claim to transact only Sharia-compliant business) but also by many, if not most, international banks which either have established Islamic banking subsidiaries (such as Noriba of UBS) or offer an Islamic product line through an Islamic "window" (such as Deutsche Bank, for example). Moreover, in geographical terms Islamic finance is no longer confined to the original strongholds in the Arab Gulf and Southeast Asia. Sharia-compliant transactions have spread across the globe, with multiple regional hubs including Dubai, Bahrain, and Kuala Lumpur. In addition, Islamic finance has spread to international financial centers such as New York and London (with the latter making substantial efforts to attract Sharia-compliant transactions[4]).

My aim is to show how the global success of Islamic finance has transformed Islamic contract law. Islamic law is fundamental to Islamic finance and Islamic finance has—correctly—been described as an application of Islamic law in modern financial transactions.[5] Today, however, the developments in the law of

Islamic finance are no longer confined to an adaptation, amendment, and revision of traditional Islamic legal concepts that are then applied to modern finance. Instead—and this is the argument of my paper—the changes must be seen as a by-product of the globalization of Islamic finance; they also must be analyzed and understood in the context of the jurisdictions in which Islamic financing transactions are implemented and, maybe more importantly, in the context of the law of international finance. Put differently, the underlying assumption of this paper is that Islamic law must be studied in the context in which it is applied, and with regard to Islamic finance the context cannot be reduced to the discourse among Islamic scholars. Instead, any analysis must also pay close attention to the global practices of international finance and to developments such as the rise of professional service firms (investment banks, accountancy firms, and multinational law firms) that formulate and administer these practices.

The developments in the field of Islamic finance, moreover, may also be relevant for debates of interest beyond the Islamic finance industry, taking the following into consideration.

1. The adaptation of Islamic law to changing politi-

cal, economic, and social conditions has been a central research topic in the scholarship of Islamic law, both with regard to pre-modern and modern times. As far as the developments since the mid-nineteenth century are concerned, however, most studies (including the seminal work of Anderson on *Law Reform in the Muslim World*[6]) emphasize the state and the courts as drivers of change. I want to add that in the area of Islamic finance there is also a significant influence from the globalization of business practices and from private actors, such as multinational investment banks, law firms, and accountancy firms. Legal change is brought about through the reception of contractual practices that evolve in the market and is not dependent on governmental intervention. The law of Islamic finance, thus, can add an important new aspect to the debate on how Islamic law has changed.

2. In recent years, globalization has challenged the traditional paradigm of comparative law, which has been occupied with comparing different legal institutions of different national legal orders (which, following Ulrich Beck, can be termed "container theory," according to which the nation state and its legal system are enshrined in a box[7]). Instead, the focus has shifted to *transnational legal practices*, rules produced in in-

ternational business (and not promulgated, but only supported by the state). From this perspective, international business law essentially consists of the rules defined by contract and standardized in business.[8] This perspective, I argue, is also of help when seeking to explain the law of Islamic finance. It allows a move away from the state-centered paradigm of legal change underpinning the traditional paradigm of law reform in the Muslim world. Possibly, however, some assumptions predominant in the debate on transnational law need to be revised as well (in particular the belief that transnational law is uniform and not susceptible to cultural pluralism).

3. The question of how the study of Islamic law can be integrated into the broader framework of *comparative law* has yet to be resolved. Mainstream comparative legal scholarship[9] is not genuinely interested in hosting Islamic law, for two reasons. First, following a certain tradition of European scholarship that can be traced back to Max Weber, Islamic law, labeled as a "religious law," is used as an antipode to "Western" legal development. The emphasis on the sacred nature of Islamic law and the—allegedly—peculiar way justice is dispensed (culminating in the catchphrase of "Kadi Justiz") only works if and to the extent the differences, and not the

commonalities, between Western and Middle Eastern legal orders are emphasized. Second, comparative legal studies are dominated by the idea of functionalism, i.e., the search for a functional equivalent between normative appearances in different legal orders; this makes a comparison of European and Middle Eastern laws difficult, as the social, economic, and political conditions are often quite dissimilar. I suggest that using a paradigm such as "transnational law," which is oriented towards a certain normative appearance as opposed to a function, may help to overcome this deadlock.

But let me for the time being return to Islamic finance and my proposition that Islamic finance cannot be explained exclusively as an "application of Islamic law." Instead, it must be seen as a contractual practice that evolved in international finance.

In my paper I want to focus on the following five points:

1. *The context in which Islamic finance operates.* Since the call to enact Islamic legislation and to set up Islamic "interest-free" banks emerged in the 1970s, Islamic finance often is discussed in the context of an "Islamization of the law."[10] Paradoxical as it may

seem, I believe that the contrary is correct. Islamic finance is part of a revival of Islamic religious ethics in international business that thrives in jurisdictions where law and religion are separated (such as Dubai, London, Kuala Lumpur), whereas in those jurisdictions that pledge to abide by Islamic legal principles (such as Saudi Arabia, Sudan, Iran, Pakistan), Islamic finance did not really take off.

2. *The way Islamic legal rules are applied in Islamic finance*. In Islamic finance, Sharia principles are applied as ethical principles and not as legal principles. Whereas the so-called Islamization of the law normally results in a secularization of Islamic legal rules, that is, they are codified in state-enacted laws, with regard to Islamic finance the contrary holds true: Islamic ethics are applied to financial transactions governed by some other law.

3. *In Islamic finance, Islamic law no longer is applied by Islamic scholars*. Islamic law can be defined as legal rules formulated by Muslim jurists on the basis of the Islamic legal tradition. In Islamic finance, however, the so-called Sharia process, in which a transaction is certified as conforming to Islamic legal rules, is increasingly institutionalized. This also has an impact on legal rules.

4. *In Islamic finance, a new system of precedent has emerged, consistent with the practices of international finance.* The system of precedent marks a clear departure from how Islamic law was administered in the past, drawing on new forms of standardization and other practices borrowed from the law of international finance.

5. *From a legal perspective Islamic law is no longer perceived as "law" but as "risk."* In financial transactions, law has the function to provide transaction security, that is, to safeguard that the transaction, if need be, can be enforced in court. In Islamic finance, the role of Islamic law is essentially different, as reference to Sharia rules can endanger the enforceability of the transaction.

1. Islamic Finance: The Global Context

Islamic finance has often been treated as one aspect of a broader "Islamization" of the law in the Middle East, which in turn is seen as a key aspect of Islamic resurgence.[11] The evolution of a powerful Islamic finance industry since the 1970s is taken as an indicator that the call to implement Islamic law, raised by political parties and groups of different "Islamic" orientation, not only resulted in the implementation of Islamic codes and legislation, but was also successful in the area of business transactions.

From today's perspective, this statement needs to be qualified. Although the call to Islamize the law and the financial system can possibly be traced back to the same historic roots, both trends have since developed independently. The civil and commercial codes enacted since the mid-1970s in the Arab Middle East (starting with the enactment of the Jordanian civil code in 1976 and followed by the Civil Code of the United Arab Emirates in 1985) arguably incorporate more Sharia elements than their predecessors. Islamic finance, however, has developed independently from legislative trends. This becomes obvious if one looks at the foundation of Islamic finance, namely, the ban on interest ("interest-free banking" is a popular definition of Islamic finance).[12] If commercial law had been successfully Islamized, there would be no need for Islamic banks offering Sharia-compliant transactions as an Islamic alternative to conventional banking. Islamic banking, as it is practiced in international finance today, therefore, thrives on providing an Islamic alternative in a non-Islamic environment.

In addition, from an empirical perspective, Islamic finance hubs tend to emerge in either Muslim jurisdictions that do not ban interest, such as Dubai or Bahrain, or in international financial centers, like London, that are actively promoting Islamic finance. The Islamic finance industry, therefore, seems to be attracted by financial centers that provide a reasonably liberal and stable regulatory framework, and not by jurisdictions that enforce Islamic legal rules in the area of business law, such as Saudi Arabia, Sudan, and Pakistan. Although an Islamic finance industry exists in these countries, too, it definitely lacks an appeal to international players.

This tendency, moreover, is underpinned by the more recent wave of reception of English common law in the Arab Gulf states: the new international financial centers in Dubai and Qatar (Dubai International Financial Centre, DIFC, and Qatar Financial Centre, QFC), for instance, were set up as offshore financial centers and operate on common law-based legal orders.[13] Effectively, most laws and regulations are based on English models, with some influence from the Far East (Hong Kong, Singapore) and other common law jurisdictions (e.g., Ireland). This development is accompanied by a large-scale move of professional services firms (law firms, accountants, financial advisors) to the new financial centers in the Middle East with the intention to make "Western-style" advisory services available to Middle Eastern clients. Investment banks advise clients on structuring transactions the way they are structured in the cities of London and New York; international law firms draft contracts conforming to global market practice; and accountants apply international financial reporting standards to local companies in order to prepare them for the international capital market. All these professional services firms operate on a business model based on transplanting international practices from New York and London to the emerging financial centers of the Middle East.

The global context of Islamic finance, therefore, cannot be reduced to the implementation of Islamic law. To the contrary, the recent Islamic finance boom has coincided with a globalization of contractual practices and their spread to the Middle East. In the Arab Gulf states, in particular, Islamic finance is thriving in an increasingly westernized business and legal environment.

2. Islamic Finance Does Not Mean to Apply Islamic Law

As mentioned at the outset, Islamic finance has often been described as an application of Islamic legal rules to modern finance. Compliance with Sharia principles is what makes Islamic financial transactions different from conventional transactions and Islamic transactions are underpinned by the "Sharia promise," the bank's pledge to the customer that the transaction entered into is lawful also from an Islamic perspective. I argue, however, that this is different from the call to apply Islamic law that underpins the promulgation of Islamized laws and codes. Whereas under official Islamization policies, Islamic legal principles are transformed into state law (and codified in Islamic codes and legislation), in Islamic finance, Islamic legal principles are introduced as a corrective ethical layer, which implies that Islamic law is in effect reduced to its ethical component.

Pre-modern Islamic law, in broad terms, employed two categories to rate human acts. One concerned its legal validity (ranging from *sahih* "valid" to *batil* "null and void") and the other its ethical or religious assessment (ranging from *wajib* "obligatory" to *haram* "forbidden").[14] Where Islamic legal rules have been enacted as state law, as is the case with Islamic codes, the rating normally is reduced to questions of legal validity. State law is only concerned with the legal dimension of the act in question and abstains from a value judgment—"it's the law". In Islamic finance, on the other hand, Islamic law is employed exclusively to find out about the permissibility of a certain transaction: the decisive question is whether the transaction is *halal* "permissible" (as opposed to *haram* "prohibited"). Legal validity (or transaction security, in the words of the practicing lawyer) would normally be provided by another legal order. In most Islamic financing transactions English law is determined as the proper law of the contract, the preferred law to govern international financial transactions. Hardly ever, if at all, does a choice of law clause make reference to Islamic legal principles.

The reduction of Islamic law to a system of business ethics has far-reaching consequences for the development of contract law, which becomes obvious upon comparison of a traditional restatement of Islamic legal principles, (such as the *Murshid al-hayran* of the Egyptian lawyer Muhammad Qadri Basha, first published in 1875) with the AAOIFI Sharia Principles as applied in Islamic finance. A restatement of contract law basically fulfils two functions: it provides rules that supplement incomplete contractual arrangements and it sets out remedies in the event things go wrong, e.g., if unforeseen events occur or one party does not fulfill its obligations. The law of Islamic finance, however, normally does not address these issues. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)[16] is a non-governmental organization based in Bahrain which, inter alia, is active in formulating "Sharia standards," guidelines for Islamic financing transactions. The AAOIFI Sharia standards are widely acknowledged in the industry. They differ, however, in an important point from a restatement of Islamic contract law: they do not provide "secondary rules" for unforeseen circumstances or non-performance of either party to the transaction, but only set out criteria that must be met by Islamic financing transactions so that they meet Sharia requirements. They only provide very limited guidance in case an agreement is incomplete and virtually none when things go wrong.

Islamic finance, thus, has the effect of reducing Islamic law to business ethics. The Sharia turns into a body of corporate social responsibility principles (although Sharia rules in Islamic finance are often applied in a more rigid and formalistic manner than CSR principles). In very blunt terms one could say that in Islamic finance, Islamic law is no longer applied as law.

3. Islamic Finance Does Not Mean that Islamic Law is Applied by Islamic Scholars

Sharia scholars play a central role in Islamic finance. They certify transactions with a fatwa confirming that it conforms to Islamic legal principles. In addition, as members of Sharia boards they advise the bank's management on Sharia matters and ensure the institution's compliance with Islamic principles. Complaints about scholars in the industry are plentiful: there are too few of them, not all of them are adequately trained in financial matters, they are too expensive, and they at times issue contradicting fatwas. In view hereof, it does not come as a surprise that issues of Sharia compliance are increasingly taken out of the hands of the scholars and transferred to other institutions. Let me give you an example:

Among the most controversial issues in Islamic finance are fixed income products. On the one hand, the prohibition of interest is the legal and economic foundation of Islamic finance. Islamic finance, as mentioned above, is often described as "interest-free" banking (although there may be other more adequate ways of characterizing Islamic finance, e.g., "profit banking," because a return is only justified if the investor takes a risk in the financed venture beyond the borrower's credit risk; or "asset-based" finance, as there is no trade in debt, so that securitization structures need to be underpinned by assets). These principles, however, are all at odds with fixed income products, where the investor receives a predetermined return. On the other hand, most investment managers would be keen to invest a large portion of a portfolio (up to 90%) in fixed income investments. To balance risk and return requires a limitation of venture capital-like investments (where the investor participates in the business risk) to a certain portion of the portfolio. Last year, Deutsche Bank came up with a new fixed income capital protected fund, based on the promise to sell and buy certain Sharia compliant securities.[17] I will not go into the details of the structure, the debate surrounding its permissibility or the legal aspects (the structure depends on the enforceability of unilateral promises, which is controversial from a Sharia point of view), but I will highlight instead how this innovation was brought about: One, it was developed by a consultancy, a subsidiary of Deutsche Bank (Dar al-Istithmar),[18] specializing in structuring Islamic transactions; two, the fatwa—that is, the argumentation why the product is permissible (although in obvious conflict with one central tenet of Islamic finance)—was produced by and large by the consultancy and later approved by the consultancy's

Sharia board; and, three, the fatwa was published in the form of a research paper and put on the Internet, with the aim of generating authority through transparency (the success of which in the concrete case is questionable). In effect, the Sharia process was taken out of the hands of the Sharia scholars. In addition, in form and substance, the fatwa process was rephrased to conform to a modern "research paper." From the perspective of traditional Islamic law, this was a rather unusual fatwa.

Even further reaching are the proposals to entrust the regulator with ensuring Sharia compliance. This marks a distinct break with the traditional division of labor in Islamic finance, where—also as far as Islamic financial institutions are concerned—the regulator would scrutinize compliance with the law and regulatory principles (compliance with consumer protection rules, maintaining of adequate reserves, application of proper accounting standards, etc.), but would not look into Sharia matters, which would be left to the scholars. More recently, several factors invite a revisiting of the issue: Sharia scholars often render advice to the institutions they supervise, which can result in a conflict of interest (comparable to the one that brought down the accountancy firm Arthur Anderson); the Sharia process is not always transparent, as there is no requirement to disclose the reasons and legal argumentation underlying a certain Sharia judgment; and the scholars are selected by the institution, which may endanger their independence. Taken together, these factors make it difficult for an outsider to evaluate the Sharia promise (which is of particular concern in the retail sector, because it is very burdensome—if possible at all—for the average consumer to obtain Sharia advice of his or her own). In view hereof, it does not come as a surprise that some regulators in countries with substantial Islamic markets more recently have moved towards enlarging their competencies to also comprise Sharia supervision or at least certain aspects of it (most notably Malaysia).[19] In these markets, Sharia compliance is deemed as one aspect of general compliance, falling into the responsibility of the regulator. The transfer of Sharia supervision to the regulator materially alters the division of labor—and power—between state and civil society in Islamic finance.

4. The Role of Global Investment Banks and Law Firms

Modern banking depends on standardized transactions. Standardized contractual practices facilitate the comparison of a transaction's financial terms. The absence of firmly established market practices has been perceived for a long time as one of the flaws of the law of Islamic finance. Islamic finance is at odds with developing market practices, and this for two reasons: Islamic financial transactions are implemented in many different, often less mature jurisdictions, some of which are civil law-based, like the UAE, and some of which are common law-based, like Malaysia; and the transactions are guided by different interpretations of the Sharia (in particular, scholars in Malaysia, Indonesia, and India tend to be much more liberal than their counterparts from the Arab Gulf or Pakistan). This has resulted in "Middle Eastern" and "Southeast Asian" market practices, which, in turn, are not unanimously accepted from the Sharia perspective (this became obvious earlier this year when a debate broke out regarding the question of whether the market practice of *sukuk*—Islamic bonds—are consistent with Islamic law).

In view of this, standardization efforts are a central concern in Islamic finance. In addition to formulating Sharia standards—such as the AAOIFI Principles mentioned above—which harmonize divergent interpretations of the Sharia, there are ongoing efforts to standardize transaction documents themselves. A system of precedent, as well as a more or less systematic collection of contractual forms (*shurut*), is not alien to the tradition of Islamic law at all. However, standardization in the Islamic finance industry today marks a clear break with the traditional administration of Islamic law. I want to exemplify this using the practice guide of the London Loan Market Association (LMA), arguably the most significant standard-setting organization in international finance (at least as far as Europe and the Middle East are concerned).[20] Last year, in response to the increasing importance of Islamic finance, the LMA published guidelines on how to use the standard LMA form when structuring Islamic loan agreements. It is intended to further develop the practice guide into an Islamic LMA form.

What is noticeable about this development are the following: (i) The Islamic model loan agreement will be based on the standard LMA form, which is widely used in international finance and will therefore be based on conventional loan documentation. (ii) The practice guide was drafted by lawyers from law firms active in international finance, not by Sharia scholars (most of whom would not possess the drafting skills for such a job) or a standard-setting institution owned by the Islamic finance industry (such as, for instance, AAOIFI or the Islamic Development). As a result (iii), the practice guide conforms in terms of style to the standard in international finance (which, in fact, holds true for most agreements in Islamic finance, at least as far as big ticket transactions are concerned).

In international finance, the law consists of contractual practices and the market practice, at times, can even prevail over mandatory legal provisions. The background to this development is the business model of London-based law firms, which essentially live off of exporting drafting services around the globe. Law, from this perspective, is what is written in the contract and Islamic finance, in this respect, is not different.

5. The Role of the Courts and the Emergence of the Doctrine of Sharia Risk

The globalization of Islamic finance had one unwanted side effect: the emergence of Islamic finance litigation. Once Islamic finance was no longer confined to a small like-minded community, borrowers defaulted and banks sued and enforced. A typical Islamic finance case is the Beximco case wherein a company entered into an Islamic *murabaha* loan agreement with an Islamic bank. When the bank asked for repayment, the borrower declined to settle the balance and claimed that the contract was in fact an interest-bearing loan that was only dressed up as an Islamic transaction. In view hereof, the borrower argued, the contract was void and there was no obligation to repay.[21]

This is not the right place to discuss the merits of the legal argumentation in detail.[22] Considering the way *murabaha* structures have developed over the last decades, there is, however, an issue of how to discern them from a conventional loan. Under a *murabaha*, the bank acquires a certain asset specified by the customer and sells it on to the customer with a profit ("mark-up") on deferred terms. Instead of granting a loan in money, the bank engages in trade, as it sells the customer an asset on deferred terms. From the Sharia perspective, the bank is required to acquire ownership of the asset and the risks attached to ownership in transit. In Islamic finance practice, however, the risks attached to ownership in transit of the bank are minimal if existent at all. First, the contracts normally provide for an allocation of risk that is similar to the one under a conventional loan agreement. And, second, instead of acquiring a specific asset, the bank often sells certain commodities to the customer, who immediately turns them into cash on the commodities exchange. This structure—called *tawarruq*—provides the customer with liquid funds and is thus even closer to a conventional loan structure. Permissibility of these structures from a Sharia perspective is not uncontroversial, to say the least—with the effect that there is always a chance that a fatwa will be issued according to which the transaction is not permissible.

The chance that an Islamic financing transaction is challenged on grounds that it does not comply with Islamic law is called "Sharia risk." Since the emergence of the first Islamic finance cases, the issue has attracted a lot of attention. Sharia risk illustrates the changed role of Islamic law in Islamic finance. In the world of finance, law (and lawyers) normally serve to make the transaction enforceable in court. Law provides transaction security. In Islamic finance, in contrast, the role of the Sharia is reversed. Sharia is a risk, which allows the transaction to be attacked on the basis that it did not conform to Islamic legal principles.

In order to mitigate Sharia risk, Islamic financing transactions normally contain a so-called "waiver of Sharia defense" clause. In this clause, although worded slightly different from one transaction to the other,[23] the borrower normally waives the right to bring any defense based on the non-compliance of the transaction with Sharia principles. In addition, the clause may also provide for an explicit statement on Sharia compliance, pursuant to which the parties agree to follow the interpretation of the bank's own Sharia board as far as the transaction is concerned. Often the borrower will acknowledge that s/he had the opportunity to seek Sharia advice of his/her own and is comfortable with the transaction from an Islamic-ethical perspective. As a result, Islamic financing transactions are no longer governed by Islamic law, but only by a conviction of the parties (not necessarily a shared one) that the transaction is compliant with Islamic business ethics.

Conclusion

The globalization of Islamic finance has transformed Islamic contract law. While most observers—in particular from the viewpoint of the conventional finance industry—are puzzled by the return of ethical or religious principles to the world of international finance, normally governed by the considerations of risk and return, in fact, globalized legal practices have secretly hijacked Islamic contract law: Islamic financing transactions are no longer governed by Islamic law and Islamic law is no longer applied by Islamic jurists. In the medium term, I expect the law of Islamic finance to develop into a semi-autonomous field of Islamic law such as the Anglo-Muhammadan law, which is based on certain Sharia concepts, but was transformed through its application by English-trained judges. As far as law reform in the Muslim world is concerned, Islamic finance has established a new category of "modern" Islamic contract law, where traditional Islamic legal concepts have been transformed through the practices of international finance and are phrased in the language of international commercial law.

This transformation, notably, has not been brought about by the state or the courts, but has gradually evolved through the practice of international finance. Whereas law reform in the Muslim world and Islamization policies alike are primarily state-driven, the development of the law of Islamic finance is market-driven and led by private actors: international investment banks, multinational law firms, and accountants. This brings me to the debate in legal studies regarding transnational law. The law of Islamic finance is a kind of transnational law. In contrast to other legal orders, in Islamic law the role of civil society in the law-making process has always been paramount and only more recently has the nation state claimed the monopoly to determine legal rules in the Muslim world. However, in Islamic finance this is merged with the modern appearances of transnational law, namely, that law is made through business practices. As a result, a global lex mercatoria of Islamic financial transactions has evolved.

From the perspective of comparative legal studies this finding is intriguing. Normally it is argued that law that is based on business practices and not on legislative activity of the nation state results in uniform global standards. There is a strong belief, in particular in the business community, that where contract is king and governmental intervention absent, the law will become harmonized (which, from the perspective of international business, is a desirable outcome). The law of Islamic finance, however, demonstrates that this is not the only and natural outcome, but that transnational law can produce divergencies of its own.

Endnotes

1 The paper is based on a public lecture delivered at the Islamic Legal Studies Program of Harvard Law School on May 1, 2008. Some references have been added. I gratefully acknowledge the institutional support of the Islamic Legal Studies Program in hosting me as visiting fellow in spring 2008 as well as the personal support and encouragement of the directors of the program, Baber Johansen and Peri Bearman.

2 Most notably Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk and Return* (The Hague: Kluwer Law International, 1998). The book is still the leading publication in the field.

3 KPMG, *Growth and Diversification in Islamic Finance*, found at http://www.us.kpmg.com/microsite/FSLibraryDotCom/docs/Growth%20and%20Diversification%20in%20Islamic-%20Finance.pdf (last visited May 5, 2008).

4 City of London, Press Release January 30, 2007, "City welcomes Government moves to promote Islamic finance," found at http://www.cityoflondon.gov.uk/Corporation/media_centre/files2007/15_07.htm (last visited May 6, 2008).

5 "Islamic banking and finance seek to apply the Islamic religious law (*shari'a*) to a sector of modern commerce." Vogel and Hayes, *Islamic Law and Finance*, p. 23.

6 London: Athlone Press, 1976.

7 Ulrich Beck, *What is Globalization?* (Cambridge, UK: Polity Press, 2000).

8 See, e.g., the contributions in Richard P. Appelbaum, William L. F. Felstiner, and Volkmar Gessner (eds.), *Rules and Networks: The Legal Culture of Global Business Transactions* (Oxford and Portland: Hart Publishing, 2001).

9 See, e.g., the chapter on Islamic law in Konrad Zweigert and Hein Kötz, *Einführung in die Rechtsvergleichung* (3rd ed., Tübingen: J. C. B. Mohr, 1996), pp. 296-305.

[10] This does not mean that both concepts, the call to implement Islamic law and to establish Islamic interest-free banks, had not been around before. However, only in the 1970s and 1980s did these concepts, for the first time, start to dominate the legal and policy discourse and were actually put into practice.

[11] See, e.g., the chapter "Muhammad Baqer as-Sadr and Islamic Banking," in Chibli Mallat, *The Renewal of Islamic Law: Muhammad Baqer as-Sadr, Najaf and the Shi'i International* (Cambridge, UK: Cambridge University Press, 1993), pp. 158-187.

[12] This is not the right place to unfold the debate whether the Qur'anic prohibition of *riba* is correctly interpreted as a ban on interest. Although this question continues to be debated among Islamic scholars, and historical precedents suggest that interest-bearing loans have, at least at times, been practiced in the earlier centuries of Islam, there is a broad consensus among practitioners of Islamic finance that Islamic law prohibits interest. Islamic financial products thus share the feature that they are "interest-free." One can therefore say that the prohibition of interest is the ethical and economic foundation of Islamic finance.

[13] See http://www.difc.ae/laws_regulations/laws/enacted_laws.html and http://www.qfccourt.com/ (both pages last visited May 2, 2008).

[14] See, e.g., the discussion in Baber Johansen, *Contingency in a Sacred Law: Legal and Ethical Norms in the Muslim* Fiqh (Leiden: Brill, 1999) pp. 69-70.

[15] Muhammad Qadri [Basha], *Kitab Murshid al-hayran ila ma'arifa ahwal al-insan fi l mu'amalat al-shar'iyya* (2nd ed., Cairo 1891).

[16] See http://www.aaoifi.com (last visited May 5, 2008).

[17] See http://www.deutsche-bank.de/presse/en/content/press_releases_2007_3347.htm (last visited May 5, 2008).

[18] See http://www.daralistithmar.com/ (last visited May 5, 2008).

[19] See http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/07_shariah_resolution.pdf (last visited May 5, 2008).

[20] See http://www.loan-market-assoc.com/ (last visited May 5, 2008).

[21] *Shamil Bank of Bahrain v. Beximco* [2004] EWCA Civ 99.

[22] For a discussion of the case and related cases, see Kilian Bälz, "Islamic Financing Transactions in European Courts," in S. Nazim Ali (ed.), *Islamic Finance: Current Legal and Regulatory Issues* (Cambridge, MA: Islamic Finance Project, 2005), pp. 61-75.

[23] A (concise) typical clause would read: "The transaction contemplated in this Agreement has been approved by [Sharia Board], whose ruling with regard to Sharia matters shall be final and binding for the Parties. Neither Party shall be entitled to raise any objections or defenses based on the basis that the agreement, the transaction envisaged therein or certain clauses contained therein, is not in compliance with the principles of the Islamic Sharia (Waiver of Sharia Defense)."