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of the  
International Construction Law Review

# APPLICATION OF ISLAMIC LAW IN THE MIDDLE EAST—INTEREST AND ISLAMIC BANKING

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## 1. INTRODUCTION

Contractors and banks intending to enter into construction contracts or financing transactions for projects in the Middle East are faced with questions of the application of Islamic law and the compliance of certain provisions of their contracts with *Sharia*. This article is in no way a comprehensive study of these immense issues. The writers were mainly motivated to write this article by questions put by Western lawyers and businessmen fearful of entering into contracts with Middle Eastern government entities, when a contract stipulates the application of national laws and national jurisdiction.

Such fears are often due to lack of knowledge of the laws of the Middle East countries and also partly because of the myth of Islamic law which many Western jurists and businessmen obtain from negative public media. However, banks and European contractors intending to enter into contracts, whether for financing or constructing projects in the Middle East, are well advised to raise legal questions and to seek legal advice as to the validity of certain contractual provisions and in particular those related to the charging of interest.

With this in mind, we shall present in part 4 of this article a short and general survey on the extent of the application of Islamic law in certain Middle East Arab countries, showing where and how far Islamic law applies. Related to the same issue, part 5 will deal with the concept of and the prohibition of interest under Islamic law. Part 6 is devoted to a short outline on Islamic Banking, referring to certain model contracts which have been used in financing construction and other projects. Prior to that, in parts 2–3, and related to the subject, a definition of Islamic law and a short background to Islam may be useful in order to introduce readers to a few of the terms used

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by Moslem jurists. We shall also attempt to remove a misconception existing between some European jurists and businessmen that there exists a single Arab or Middle East law. Instead, we shall refer to the common features of the Middle East Arab *laws* and not Middle East Arab *law*.

## 2. ISLAMIC LAW: SHARIA

Islam as a religion was revealed to the Prophet Mohammed in AD 610 in Mecca, Saudi Arabia. According to the Islamic faith Mohammed was sent as a messenger by Allah to complete the messages of previous prophets such as Moses and Jesus. Allah is the Arabic word for God, and the Islamic faith is based on the unity of God, that there is one and the same God for Moslems, Christians and Jews.

The Moslem's holy book is the *Quran*, which was revealed to the Prophet Mohammed and lays down the code of conduct and rules for the people to follow. The *Quran* also contains in many parts similar to verses to the Bible, especially with respect to the birth and life of Jesus and Moses. With certain differences the *Quran* considers Christianity and Judaism as religions of the same God or Allah, which Moslems should believe in. The *Quran* is the main and the first source of Islamic law, or so-called *Sharia* in Arabic. For Moslems, the *Quran* has laid down rules which cover a whole way of life. These rules are either of a binding and obligatory nature or recommended or advisable or forbidden and disapproved.

The second main source of *Sharia* is the *Hadith* or the sayings and deeds of the Prophet Mohammed as reported. Thus, Islamic law or *Sharia* is the body of rules and jurisprudence derived mainly from the *Quran* and the *Hadith*. Out of the interpretation, elaboration and study of the *Quran* and *Hadith* Islamic jurisprudence, or *Figh*, has developed.

There are four main Sunni schools of jurisprudence namely *Hanafi*, *Maliki*, *Shafii* and *Hanbali* schools. In addition to the Sunni schools, there exists a large *Shiat Jafari* school, which was founded by Jafar Al Sadiq, the grandson of the Prophet Mohammed.

The main sources of all schools of Islamic jurisprudence are the texts of the *Quran* and the *Hadith*. The primary differences between them stem from the different interpretations of the texts and from the secondary sources which they use for solving religious and legal issues.

## 3. MIDDLE EAST LAW OR LAWS

As indicated before, there is no single uniform Middle East or Arab law, nor is there one uniform legal system for all Arab countries, though most of the Arab countries have adopted the codified civil law system as opposed to the English common law system.

During the Ottoman Empire, before the First World War, the Ottoman Government compiled the jurisprudence of the Hanafi school in a uniform Civil Code called the *Mejella*, which was applied to Arab countries which were parts of the Ottoman Empire. The *Mejella* continued to be applied in most Arab countries after the fall of the Ottoman Empire, until each Arab country developed its own legal system and enacted a Civil Code.

With the partition of the Ottoman Empire, France and Britain took over different Arab countries. Under the rule of the Western colonial powers, the influence of Western laws particularly those of the French codified legal system and the French Civil Code grew in the Arab countries, and the legislative process of reconciling the *Sharia* and the Western laws gradually began.<sup>1</sup> Consequently, the direct application of Islamic law continued to decrease.

The Egyptian Civil Code of 1948 was the first and a successful product of the reconciliation process. The author of the Egyptian Civil Code, Dr Sanhuri, succeeded in reconciling and bringing together in harmony the principles of *Sharia* and the provisions of the European Civil Codes and in particular the French Civil Code.

Today, all Arab countries except Saudi Arabia and Oman have modern Civil Codes based fully or partly on the Egyptian Civil Code. Thus, one of the common features of the laws of the Arab countries is the similarity or even uniformity of the provisions of the Civil Codes. Another major common feature is the application of Islamic law in all Arab countries, whether directly or indirectly.

It should be understood from the above introduction that there is no single or uniform Arab or Middle East law, but the laws of Arab countries share many common features and similarities, which render a comparative view of those laws a matter of interest to lawyers.

In addition to the application of *Sharia*, the influence of the *Mejella* and the uniformity of the source of Arab Civil Codes as mentioned above, there are other common factors such as interchanges of judges and jurists between Arab countries, common history and common language, which all have created a common legal approach and jurisprudence between the Arab countries.

#### 4. THE APPLICATION OF ISLAMIC LAW

There is no single rule as to when and where *Sharia* applies; its application varies from one country to another and depends on the religious and social structure of the society, the legal system and the provisions of the constitution and the Civil Code of each Arab country. *Sharia* may apply either directly as a common law of the country, where there is no fully developed codified legal

<sup>1</sup> See Nabil Saleh, "How will *Sharia* Influence Middle East Contract Law over the Next 20 Years?", MEER, July 2001, p. 9.

system, or indirectly through the application of statute law based fully or partly on Islamic law, or as a source of law to fill legislative gaps when a particular statute lacks the necessary provisions.

- (a) In Saudi Arabia, where there is no Civil Code, *Sharia* operates and applies directly as a common law of the country, both in commercial courts as well as in courts for personal matters. Thus, no other law is applicable if it is contrary to *Sharia*. For a businessman who concludes, for example, a contract with a Saudi company, including provisions for interest, or for a group of banks which provide syndicated loans to a Saudi client, it is indeed advisable to see whether the terms of their contract are valid or enforceable under Islamic law. Parties should take the prohibition of interest under *Sharia* into account when negotiating an agreement. Even excessive penalty clauses in a contract may be held unenforceable by the Saudi courts, based on the general principles of *Sharia*. However, the direct application of *Sharia* remains confined in Saudi Arabia to areas of law where no legislation exists. Though *Sharia* is the common law of the country, Saudi Arabia has enacted a great number of statutes, the so-called “Regulations”, covering many fields of law including the Company Law, the Code of Commerce and the Tender Law.
- (b) In other Arab countries which adopted civil codes and the civil legal system, *Sharia* plays a lesser role and applies mainly in the field of the family laws such as, marriage and inheritance.

In these countries, family laws were enacted based on one or more of the Islamic schools referred to above, while commercial and civil codes are based on European and to some extent on Islamic law.

In the countries where a complete civil law legal system was founded, the *Sharia* domination or application in matters other than family law also varies depending on the provisions of the constitution and the civil code of the country.

The constitutions of most Arab countries, including Egypt, Syria, Kuwait, Bahrain, Qatar, UAE and Yemen, refer to *Sharia* either as: A primary source of law or *the* source of law. Consequently, and in cases of legislative lacunae, where the law lacks a provision, the *Sharia* principles are to fill the gap, either as the first source or as one of the sources of law.<sup>2</sup>

Where the constitution describes *Sharia* as “the” principal source of legislation, the hierarchy implies that all other laws and statutes must comply with the principles of *Sharia*. Whether this has been complied with is another question, as we shall see later.

The following is a short survey of specific provisions of the constitutions

<sup>2</sup> Prof W Ballantyne, *Essays and Addresses on Arab Laws* (Curzon, 2000), pp. 5–8 and 210–213.

and the Civil Codes of some Arab countries that have dealt with the application of the *Sharia*.

### Constitutions

#### *Egypt*

Article 2 of the Egyptian Constitution, which was amended in 1980, stated that: "The principles of the *Sharia* are *the* main source of legislation in the Arab Republic of Egypt. . . ."

The application of this article was tested when, in 1985, the rector of Al Azhar brought a case against the President and the Egyptian Parliament and others. Al Azhar contended that the provisions of the Civil Code granting interest, such as Article 226 of the Egyptian Civil Code, became unconstitutional in view of the amended Article 2 of the Constitution, which adopted *Sharia* as *the* main source of legislation. The court rejected this contention and decided that Article 2 has no retroactive effect so as to render existing laws unconstitutional, but the court claimed that Article 2 imposed an obligation on the legislature to bring all future laws into conformity with the *Sharia*.<sup>3</sup>

The Special Commission which prepared the amendment of the Constitution in 1980 reported that the purpose of Article 2 of the Constitution is: "to force the legislator to have recourse to the commands of *Sharia*, to the exclusion of any other source, in order to discover what he is searching for; then, if he does not find there an explicit ruling, he is to employ the *Sharia* resources of interpretive effort (*al-ijtihadiyya*) in order to arrive at the proper rules to follow and which do not transgress the foundations and general principles of *Sharia*." This principle was also confirmed in a ruling of the Egyptian Constitutional Court on 15 May 1993 that no legislation in the future should contradict the formal rules of *Sharia*.<sup>4</sup>

#### *Kuwait*

Article 2 of the Kuwaiti Constitution provides that: "The religion of the state is Islam and the Islamic *Sharia* is *a* principal source of legislation . . ." It should be noted that, according to this Article, *Sharia* is *a* principal source, and not *the* source of legislation.

In 1992, the Kuwaiti Constitutional Court dismissed a claim that the Kuwaiti Civil Code, which provides for interest, was unconstitutional and contrary to Article 2 of the Constitution. The court stated that Article 2 of the Constitution is a political directive to the legislator to adopt provisions of *Sharia* as far as possible. *Sharia* is a source, not the sole source and there is

<sup>3</sup> Dr Ahmed Mahmoud Saad, *Delay Interests, Comparative Study with Islamic Law* (Cairo, 1986), pp. 15–32 (in Arabic).

<sup>4</sup> See Oussama Arabi, "The Dawning of the Third Millennium on *Sharia*, Egypt Law" (2001) 16 *Arab Law Quarterly* 6–7.

nothing to prevent the legislature from applying other sources, other than *Sharia*.<sup>5</sup>

#### *UAE*

In the UAE the matter is somewhat ambiguous, because, while Article 7 of the UAE Constitution has the *Sharia* as a principal source of legislation, Article 75 of the Law of the Union Supreme Court of 1973 provides that the Supreme Court shall first apply *Sharia* and other laws in force if conforming to the *Sharia* principles. It may also apply custom, if such custom does not conflict with the principles of the *Sharia*.

Apart from the provisions of the Constitution, Article 1 of the Civil Code refers to *Sharia* as the first source of law in case of lack of any legislative provision. Article 3 of the Civil Code also stipulates that public policy rules are those which are not contrary to the basic principles of *Sharia*.

Furthermore, Article 27 of the Civil Code provides that in case of conflict of laws no law contrary to *Sharia* can be applied and public policy and morals are applicable.

Here, we have constitutional provisions where *Sharia* is recognised only as a source of law, while the Civil Code and the aforesaid law of 1973 of the Supreme Court establishing the highest court consider *Sharia* as the source of law.

The extent of the application of *Sharia* was raised in a number of cases in the highest court of appeal in the UAE. The court ruled in one case that the *Sharia* is the principal source of law, and above all other laws. But it is for the legislator to implement that when enacting new legislation,<sup>6</sup> as we shall elaborate later.

This and other similar cases in Arab countries demonstrate the difficulties and the conflict between the principles of *Sharia* and the secular laws. They also show how the courts avoided the application of *Sharia*, often on a doubtful legal reasoning, as will be explained below.

#### *Saudi Arabia*

In Saudi Arabia, the Basic Law of 1992 confirmed that *Quran* and *Hadith* are the sole sources of law and that all laws and regulations must conform to *Sharia*, which is the common law of the country. It follows that no foreign judgment nor any contractual provision which is contrary to Islamic principles may be enforced in Saudi Arabia.

Saudi Arabia follows the *Hanbali* School, one of the four Sunni Moslem Schools of Islamic jurisprudence, *Fiqh*.

<sup>5</sup> Prof Ballantyne, *op cit.*, n. 2, pp. 60–64.

<sup>6</sup> Dr A M Saad, *op cit.*, n. 3, pp. 15–31.

**Civil and commercial codes***UAE*

As stated above, Article 1 of the UAE Civil Code states that in cases when there is no provision in the Civil Code, the judge must first rule in accordance with the *Sharia*, giving preference to *Maliki* and *Hanbali* schools. In the absence of that, the judge shall apply rules of custom, if consistent with public order and morals.

*Jordan*

Article 2 of the Jordanian Civil Code stipulates that, in the absence of applicable law, the court shall apply the principles of *Sharia*, and, in the case of lack of any *Sharia* rule, the court shall apply rules of custom and then principles of justice, provided that the applicable custom is consistent with public order and morals.

It is worthwhile noting that the UAE Civil Code as well as the Jordanian Civil Code, have made *Sharia* the first source of law in the absence of an applicable provision in the law, unlike other Arab Civil Codes which refer to the application of *Sharia* only after and in the absence of a relevant provision of law and a rule of custom.

*Oman*

Article 5 of the Commercial Code of 1990 of Oman provided that, in the event that no provision exists, custom shall apply and, in the absence of custom, the judge shall apply the principles of *Sharia*.

*Egypt and Iraq*

Article 1 of both the Civil Codes of Egypt and Iraq contain similar provisions that, in the absence of any applicable legislative provisions, the court shall adjudicate according to custom and usage and, in the absence of applicable custom and usage, the court shall apply the principles of *Sharia* which are most consistent with the provisions of the law. In the absence of applicable custom or principles of *Sharia*, the general principles of justice shall be applicable.

*Kuwait*

Article 1 of the Kuwaiti Civil Code of 1980 stipulates that *Sharia* applies in case of absence of an express legislative provision and only after the absence of a relevant rule of custom. Thus, the Civil and/or Commercial Codes of Oman, Egypt, Iraq, and Kuwait have recognised the application of *Sharia* only after the absence of applicable rules of law and custom, whereas the UAE and Jordan Civil Codes render *Sharia* as the first source of law.

In cases where the Civil or the Commercial Code of an Arab state refers to *Sharia* as a source of law in absence of a relevant rule of custom and an express provision of law, a question arises as to whether it is permissible to apply a custom if it is contrary to public order and morals or the principles of *Sharia*.

All Arab Civil Codes provide that no law or provision of contract or custom is applicable if it is contrary to public morals and policy. Consequently, it may be said that any custom contrary to the express principles of *Sharia* may be considered as contrary to public order and morals and, therefore, not admissible, even when the Constitution gives custom precedence over *Sharia*. But, in practice, this may not always be the case.

### **Conclusion**

The foregoing review shows the complexity of the matter and uncertainty in the application of the law in relation to *Sharia*, especially when vital issues like questions of the validity of provisions of the law in relation to interest are involved.

However, there is a growing assertion of *Sharia* and Islamic identity in Middle East society as a result of the failure of national movements and the failure of regimes in the Arab World to satisfy the aspirations of the people to achieve social welfare and to pursue independent policies free from foreign domination. Such failures have led to frustration and resentment, and the assertion of *Sharia* became a way to assert the identity of Moslem societies.

This may in turn invite the Western lawyers to make themselves familiar with the principles of *Sharia* with the aim of finding bridges and similarities instead of pointing out only differences and diversities.

In the Moslem and Arab world, it remains a desire that unified legislation or a Civil Code may one day apply to all Arab countries, based mainly on the principles of *Sharia* as the *Majella*, the Civil Code of the Ottoman Empire, did before the First World War.

Having reviewed briefly the manner and the extent of the application of *Sharia* in certain Arab countries, we shall deal below with the prohibition of interest, called *Riba* in Arabic.

## 5. RIBA

In this part we shall attempt to outline the definition of *Riba* under the *Sharia*, followed by a short survey of the laws of some Arab countries which have prohibited or permitted charging interest.

In human history, regulation and prohibition of charging interest are as old as making laws. The Babylon Code of Law in 1750 BC laid down a number of restrictions and ceilings on the amount of interest.<sup>7</sup> Christianity and

<sup>7</sup> See Mekki I Lufty, *Legal Interests, A Comparative Study*, pp. 161–164 (in Arabic).

Judaism have also restricted or prohibited charging interest. That the practice has actually been different is another question.

Under Islamic law, charging interest or *Riba* is forbidden by verses of the holy *Quran*, and the *Hadith*. But the uncertainty and the difficulty lie in the lack of a precise definition of *Riba* and types of *Riba*. This difficulty is further deepened because of the many different opinions between the various schools of Islam.

### Sources of prohibition

The prohibition of *Riba* in the *Quran* came gradually and in stages, from discouragement and condemnation of *Riba* to final prohibition as laid down in the following verse of the *Quran*: “Allah permitted the sale and forbade *Riba*” (Verse 275, “The Cow”). The *Hadith* of the Prophet went further that: “Every loan which attracts benefit is *Riba*.”

The benefit which renders the transaction prohibited may be a sum of money or any goods of value.<sup>8</sup> Thus, the prohibition has a far wider meaning and application than prohibition of charging interest on loans. It is a prohibition of usury and any unearned accretion of the capital or the principal, whether it is in the form of interest or any benefit.

### Definition

*Riba* may be defined as “monetary advantage without counter value, an advantage which is stipulated in favour of one of the parties in exchange of two monetary values”.<sup>9</sup> It may also be defined as “any unjustified increase of capital for which no compensation is given”.

### The economic foundation

The basic concept of Islam is that wealth should not be hoarded or wasted, it should be put to productive use so that the owner, society and the less privileged may share the benefits. It follows that it is not permissible to leave money idle and charge interest or profit from the mere use of the money by another party without regard to risks, or profits, that that may generate. Usurers only seek profit, or interest without risk. This is contrary to the foundation of Islamic economy which is based on equity and equilibrium.

From this concept stems the principle of profit and risk sharing between the owner of the capital and the other party, i.e. the borrower. Thus, in contrast to conventional banking, the capital owner cannot claim both a fixed interest as well as a guarantee for the return of his capital.<sup>10</sup>

Also, *Sharia* does not consider money, as such, a commodity but as a means

<sup>8</sup> Dr A M Saad, *op cit.*, n. 3, pp. 90–91.

<sup>9</sup> Prof W M Ballantyne, *Commercial Laws in the Arab Middle East* (1987), pp. 122–124.

<sup>10</sup> Vogel and Hayes, *Islamic Law and Finance* (1998), p. 130.

of payment and as fixed neutral measure of valuation rather than a commodity by itself. Nevertheless, the owner of the capital may receive compensation on the basis of sharing profits and risks. The prohibition of trading with money plus interest aims at ensuring that money remains a stable value.<sup>11</sup>

These concepts also signify the basis of economic philosophy and Islamic banking. This underlines the difference between Western and Islamic banking systems, as we shall see later. In Islamic economy and banking, both profit-taking and risk-sharing go together.

Based on the above, *Sharia* prohibited usury, as well as transactions having unusual uncertainty and unknown perils called *Gharar*, such as gambling, because such transactions run contrary to the principle of balanced relationships or equivalence.

Though *Sharia* recognises the sanctity of contract, the prohibition of usury and contracts of *Gharar* together with some other principles of *Sharia* (such as unjustified enrichment) have created restrictions on freedom of contracting, which Islamic banking must observe in any banking transaction.

### Usury in debts

There are several types of usury, some of which are no longer in use.<sup>12</sup> Usury in debts or in loans, also called *Riba al-nasia*, is the most relevant type of usury practised today. It is a loan or exchange of goods with a condition that the borrower repays the goods or the loan later in addition to an increase in value. Thus, there are two main elements at least:

- (a) repayment at a future date; and
- (b) an increase on the principal given by the creditor.

Repayment of the principal may be:

- of the same kind whether measured or weighed or not, such as selling one ton of wheat for two tons of wheat delivered later, or such as lending £100 for £120 to be paid later; or
- of a different kind if measured or weighed, such as selling one ton of wheat for 2 tons of rice later, or selling one ton of wheat of a value of £10 for £20 paid later.

Prior to Islam, usury in debt was a common practice whereby the creditor provided the borrower money or goods and received from the debtor interest or an increase periodically, and the principal or the loan was to be returned in full at a future date, a practice called *Ribal al Jahiliya*.<sup>13</sup>

In short, usury in debt, i.e. an exchange of goods whether of the same kind or not for a delayed repayment with an increase, is prohibited by *Sharia*

<sup>11</sup> *Ibid.* p. 83.

<sup>12</sup> Dr A M Saad, *op cit.*, n. 3, pp. 94–97.

<sup>13</sup> Vogel and Hayes, *op cit.*, n. 10, p. 72.

according to the verses of the *Quran* and the *Hadith*. This includes interest charging on loans in banking transactions today. Every loan containing a provision for an increase above the capital is forbidden under *Sharia*.

It is worthwhile to note that though it is forbidden to agree to an increase in price or value because of delay in repayment, *Sharia* allows an agreement to sell goods on deferred payment for a price which is higher than the price of the same sale in cash. In this case, and contrary to the ordinary loan agreement, both parties are exposed to certain risks: the seller agrees on a fixed price to be received at a future date, thus accepting the risk if the market price increases at the date of payment. At the same time, the buyer accepts the immediate transfer of the property of the goods sold, thus assuming all the risks attached to such a transfer of property. Also, in a contract of sale, deferred delivery of goods or forward purchase, the so-called "Sale of Salam", is permitted for a lower price if the goods are specified, as an exception to the prohibition of the rules of *Gharar*.<sup>14</sup>

As to the effect of interest provisions on a contract, there exist different views. For instance, the *Hanafi* School considers that a provision concerning interest is null and void, but the remainder of the contract is valid. The *Hanbali* School considers a loan agreement with interest *ipso facto* null and void.

Below is a short survey of the provisions of some of the Arab civil and commercial codes dealing with interest followed by certain court decisions.

### **Interest under Arab civil and commercial codes**

The question as to whether charging interest is permissible or illegal has been dealt with by Arab civil and commercial codes in differing ways. It has also been the subject of many court decisions in most Arab countries. However, the outcome has nearly always been in favour of allowing the Western system of interest-taking to continue. This is in spite of the constitutional provisions in many Arab countries which declare Islamic law or *Sharia* as *the* main source (as in the Egyptian Constitution) or a main source of legislation (as in the Kuwaiti and UAE Constitutions), which we have referred to under part 4 of this article.

In general, the civil and commercial codes of Arab countries may be divided in two categories as to the manner of dealing with the question of interest:

*First:* The Egyptian Civil Code and those Arab codes which followed it closely, whereby charging interest is declared as legal by the relevant civil code whether in civil or in commercial matters.

Article 226 of the Egyptian Civil Code provides that: "If the object of an

<sup>14</sup> *Ibid.* pp. 76-77.

obligation is payment of a sum of money, the amount of which is known at the date of filing a claim, and the debtor delayed the payment, then the debtor shall pay the creditor as compensation for delay 4% interest in civil matters and 5% in commercial matters. Such interest shall be calculated as from the date of filing the case.” As we shall see later, Article 226 was the subject of a decision of the Constitutional Court of Egypt issued in May 1985.

Article 171 of the Iraqi Civil Code is identical to Article 226 of the Egyptian Civil Code, except that the Iraqi Civil Code stipulates that the object of the obligation must be known at the date the obligation arose instead of at the time of filing the claim as the Egyptian Civil Code requires.

Article 227 of the Egyptian Civil Code as well as Article 172 of the Iraqi Civil Code lay down the maximum limits for interest charged, and provide that the parties in a loan agreement or contract may agree on a rate of interest if it is below the maximum rate. Also, Article 231 of the Egyptian Civil Code, as well as Article 173 of the Iraqi Civil Code, have entitled the creditor to claim supplementary indemnity in addition to the interest if the creditor suffered loss or damage as a result of gross fault or cheating by the debtor. Similar provisions may be found in other Arab civil or commercial codes, such as in Article 114 of the Kuwaiti Commercial Code and Article 91 of the UAE Commercial Code.

Article 228 of the Egyptian Civil Code, as well as paragraph 2 of Article 173 of the Iraqi Civil Code, provide that, in order for interest to fall due, the creditor shall not be required to prove loss or damage.

The Syrian Civil Code, Articles 227–229, and the Libyan Civil Code, Articles 229–231, have laid down similar provisions as the Egyptian Civil Code, except that each Civil Code adopted a different maximum rate of interest, which the parties to an agreement must not exceed.

The Egyptian Civil Code, Article 232 and other Arab civil and/or commercial codes have prohibited charging compound interest.

The authors of the Arab civil codes which provide for interest appear to justify that on the ground that, in cases of delay of payment, interest amounts to compensation, because the creditor suffers loss due to lending his capital, or as a result of the delay of payment by the debtor, especially when the debtor fails intentionally to pay in time. Some writers have argued that interest in certain cases amounts to indemnification or compensation for losses suffered by the creditor. To reach to such a conclusion they have relied on the Islamic principle of “There shall be no unfair loss nor the causing of such loss”, among other arguments.<sup>15</sup>

*Secondly:* The Kuwaiti and UAE Civil and Commercial Codes distinguish between civil matters, whereby charging interest is not allowed by the Civil Codes, and commercial matters, whereby interest is permitted under the Commercial Codes.

<sup>15</sup> Dr A M Saad, *op cit.*, n. 3, pp. 253–275.

*Kuwait*

Article 547 of the Kuwaiti Civil Code states: “1. Loans shall be without interest. Any condition to the contrary shall be void without prejudice to the loan agreement. 2. Any benefit which the lender stipulates shall be deemed as interest.” However, Article 550 of the Kuwaiti Civil Code (similar to article 719 of the UAE Civil Code) goes further and states that no account shall be taken of any change in the value of money, i.e. fluctuation, decrease or increase of money.

Notwithstanding these provisions, Article 102 of the Commercial Code stipulates that “1. The creditor shall be entitled to an interest in a commercial loan unless otherwise is agreed upon. If the rate of interest is not stipulated in the contract, the rate due shall be the 7% legal rate. 2. If a rate agreed upon is stipulated in the contract, and the debtor delays settlement, the interest for the delay shall be calculated on the basis of the agreed rate.” Here it should be noted that Article 102 provides an assumption in favour of the creditor to receive interest, even when the agreement is silent.

Article 110 of the Kuwaiti Commercial Code lays down provisions similar to Article 171 of the Iraqi Civil Code and Article 226 of the Egyptian Civil Code by imposing 7% legal interest on the debtor who fails to pay in time.

Article 111 of the Kuwaiti Commercial Code lays down a maximum rate of interest similar to Article 227 of the Egyptian Civil Code and Article 172 of the Iraqi Civil Code.

According to Article 3 of the Kuwaiti Commercial Code, the Code applies to all commercial matters, including loan agreements and prevails over the provisions of the Civil Code.

Thus, we see here a straightforward prohibition of interest under the Civil Code in compliance with the *Sharia*, while the Commercial Code—as a special law—allows interest charging contrary to the principles of *Sharia*.

It is worthwhile recalling that Article 1 of the Kuwaiti Civil Code provides that *Sharia* applies in the absence of an express legislative provision, but only after the absence of a rule of custom, as source of law. Also Article 2 of the Kuwaiti Constitution declares that *Sharia* is a principal source of legislation, as explained above in part 4 of this article.

*UAE*

UAE Civil and Commercial Codes have adopted a similar approach to the Kuwaiti Codes in prohibiting interest under the Civil Code and allowing it under the provisions of the Commercial Code.

Article 714 of the UAE Civil Code of 1985 provides that: “If the contract of loan provides for a benefit in excess of the essence of the contract, otherwise than a guarantee of the rights of the lender, such provision shall be void but the contract shall be valid.”

Contrary to the above-mentioned provisions, Article 76 of the UAE

Commercial Code of 1993 states that a creditor may stipulate interest in a commercial loan agreement. If he fails to stipulate the rate of the interest, the current market interest rate shall apply not exceeding 12%. Here again, there is a presumption in favour of the creditor to claim interest, even if he fails to stipulate that in the agreement.

Article 88 of the Commercial Code has laid down provisions (similar to Article 171 of the Iraqi Civil Code, and Article 226 of the Egyptian Civil Code, imposing legal interest for delay in payment.

### *Jordan*

In Jordan the Civil Code did not deal with interest, but interest is charged in accordance with the provisions of an old Ottoman law as well as the 1988 Code of Civil Procedures.

### **Decisions of the courts**

Having reviewed briefly the provisions of the laws in some Arab countries dealing with interest, it is worthwhile to see how the courts in some Arab countries have dealt with the matter.

#### *Constitutional Court of Egypt—Decision of 4 May 1985*

In 1980 Article 2 of the Egyptian Constitution was amended to read that: “Islam is the religion of the State. . . . And the principles of the *Sharia* are the main sources of legislation.”

The Rector of the Al Azhar University filed a case against the President and others claiming that the provisions of Article 226 of the Egyptian Civil Code, which allow interest for delay in payment, were unconstitutional and contrary to Article 2 of the Constitution referred to above. The court held that charging interest is prohibited by *Sharia*, but Article 2 of the Constitution has no retrospective effect, and, therefore, Article 226 remained in force and was not affected by the amendment. Article 2 of the Constitution had not made *Sharia* directly the common law of the land and it did not directly apply, but it has imposed an obligation on the legislator to observe and apply *Sharia* principles in any future legislation.<sup>16</sup>

Thus, Article 2 of the Constitution is a limitation on the legislator to apply *Sharia* in respect of any future enactment and the laws enacted prior to the date of the amended Article 2 of the Constitution, such as the Civil Code, are not affected. Therefore, Article 226 of the Civil Code remains enforceable, though contrary to *Sharia*.

<sup>16</sup> Dr A M Saad, *op cit.*, n. 3, pp. 15–43.

This decision of the Constitutional Court is widely criticised as poor and not convincing. It is argued that the provisions of Article 2 of the Constitution and the prohibition of interest have become part of public order and morals and should be applied at least from the date of the enactment in 1980. The Constitutional Court has the duty and function to control and ensure that the application of the laws is not in contradiction with the Constitution. It has further been argued that the court might have done better if it had based its decision on the principles of the necessities and common interest of society to justify charging interest under the present economic regime.<sup>17</sup>

It has also been submitted that imposition of interest under Article 226 of the Egyptian Civil Code and similar provisions is compensation for loss suffered by the creditor due to the failure of the debtor to pay. The creditor does not stipulate interest under Article 226, but the obligation to pay interest arises after the failure of the debtor to pay. This is in conformity with the *Sharia* principles of *Theman*, that a person causing damage must compensate. In support of this opinion it is also said that: Islam encourages giving a loan without interest, but the debtor must act in good faith. The failure to repay the loan in time is intentional fault and amounts to bad faith. Therefore, the reasons, *illah*, behind the prohibition of interest are not present in such cases. Consequently, it is argued, imposing interest for delayed payment falls outside the prohibition of *Riba*.<sup>18</sup>

*Kuwait Constitutional Court—Decision of 28 November 1992*

An appeal was submitted to the Constitutional Court on the basis that Article 2 of the Constitution provided that *Sharia* is a main source of legislation and Articles 110 and 113 of the Commercial Code permit charging interest for delay in violation of the Constitution. Therefore, the appellant claimed that the court must declare Articles 110 and 113 unconstitutional.

The court held that Article 2 of the Constitution is a directive to the legislator to resort to *Sharia* as a source among other sources for legislation, but it does not prevent it from applying other sources of law when necessities arise. It imposes on the legislator only a trust to adopt the *Sharia* principles to the extent possible, it is a political directive to the legislator to adopt *Sharia*, but the legislator remains free to withdraw principles of law from other sources which the legislator finds suitable. The judge may not ignore an express provision of law such as those of Articles 110 and 113 and apply *Sharia*, but he may resort to the application of *Sharia* only when there is no express provision in the law.<sup>19</sup> *Sharia* is not *the* source and not the only source of law. Based on that, the court held that Articles 110 and 113 of the Kuwaiti Commercial Code permitting interest are constitutional.

<sup>17</sup> Dr A M Saad, *op cit.*, n. 3, pp. 36–37.

<sup>18</sup> *Ibid.* pp. 202–218.

<sup>19</sup> Prof W M Ballantyne, “Wither Arab Commercial Laws: Law of God or Mammon?”, MEER, January 2000, pp. 16–17.

It should be noted that certain aspects of the reasoning of the Kuwaiti court run parallel to the reasoning of the Egyptian *Al Azhar* case, except that the Kuwaiti court did not contend that Article 2 of the Constitution had no retrospective effect. However, in both cases, the court appeared to aim at one thing, that is, legitimising interest by all means.

*UAE Supreme Federal Court—Decision of 6 September 1983*

The defendant, a company, which borrowed a sum of money from a bank, claimed that *Sharia* has prohibited interest and especially compound interest. Therefore, the defendant had no obligation to pay the sums claimed by the bank. The appellant bank appealed to the Federal Court in Abu Dhabi against the decision of the lower court for the remaining sum of a loan and interest allegedly due from the company. The appellant contended that the court may apply the *Sharia* only in cases of absence of an express provision in the law as stated in Article 5 of the UAE Code of Civil Procedures, No 3 of 1970. Articles 61 and 62 of the Law expressly permit charging interest, therefore, the court cannot set aside the express provisions of the law and apply the principles of *Sharia* prohibiting interest.

The Federal Supreme Court held that *Sharia* prohibited interest, but at the same time made exceptions to the prohibition by the application of the *Sharia* principle of “Necessity permits what would be otherwise forbidden”. The court further argued that Islamic jurisprudence allows exceptions to a rule in the overwhelming interest of society. Based on the foregoing principles, *Sharia* recognised the sale of *Salam* and the contract of *Istisnah* as exceptions to rules which render the sale of a non-existing object invalid. Based upon these principles, charging simple interest should be considered as an exception to the rule of prohibition, due to necessities, requirements and the interests of the people. Consequently, the court held the provisions of Articles 61 and 62 of the Code of Civil Procedures of 1970 constitutional.

To the above reasoning the court added that the judge must respect the will of the parties and may not ignore the agreement of the parties except in exceptional circumstances. Thus, the court cannot set aside the agreement of the parties to pay interest unless the rate is in excess of the maximum legal rate or in cases of compound interest which the law expressly forbade.<sup>20</sup> Furthermore, the court held that the interest in this case amounted to compensation. Accordingly, the court rejected the contention of the defendant.

In another case, the UAE Supreme Court held that Article 714 of the Civil Code prohibits interest, but the Civil Code as such does not apply to commercial transactions, and that charging interest by banks is permitted under the Commercial Code.<sup>21</sup>

<sup>20</sup> Dr A M Saad, *op cit.*, n. 3, pp. 18–28; see also Hind Tamimi, “Interest under the UAE Law as Applied by the Courts in Abu Dhabi”, (2002) *Arab Law Quarterly* 50–53.

<sup>21</sup> Reported in MEER, March 1999, p. 5

The Civil Procedures Code of 1970 has now been replaced by a new Civil Procedural Law, No 11 of 1992 and Articles 76, 77, 88 and 409 of the UAE Commercial Code of 1993 leave no doubt that charging simple interest in commercial and banking transactions is permitted.

In conclusion, it appears from the above, that courts and legislators in Arab countries have succeeded up to now in paying lip service to the rules of the *Sharia* and have survived the conflict created by the application of the *Sharia vis-à-vis* the requirements of the modern secular legal and commercial systems.

## 6. ISLAMIC BANKING

Islamic financing and banking institutions have grown successfully within the last 20 years in response to a popular need in Islamic countries for free interest financing as well as the need of Western and American markets for new capital. The OPEC surplus made it possible for both sides to use a huge surplus money. However, the size of Islamic banking transactions remains small when compared to traditional banking, but it is steadily growing.

It is estimated that there are about US\$100 billion invested world-wide according to *Sharia* principles; a relatively small sum but significant considering the short period during which Islamic financial institutions and Islamic funds have existed. The use of Islamic investment funds and banking is not confined to the Middle East but has been adopted by a number of conventional banks in the USA and Europe.

We shall attempt below to outline the main features of Islamic banking and the differences to conventional banking as well as some of the tools used by such institutions as financing instruments.

### **General features**

Islamic banking refers to a banking and financing system which ensures that the financial transactions conform to the principles of Islamic law. The management of such financial institutions includes a board of Islamic scholars and advisers who examine each financial transaction to ensure compliance with *Sharia*.

In Islamic banking, both risk and profit go together and a depositor is deemed to be a shareholder, taking profits or sharing loss. The bank often acts as trustee on behalf of clients, whether depositors or borrowers, in accordance with the principles of *Sharia*.

The concept of Islamic financing aims not only at making profit, but also at achieving economic development and social justice—in comparison with a conventional banking system which is based on debts and interest.

The main differences between conventional banking and Islamic banking stem from the prohibition of *Riba*, and *Gharar*, or gambling transactions, by

*Sharia*, as stated above.<sup>22</sup> The prohibition of *Gharar*, gambling and aleatory transactions under *Sharia* led to restrictions on the activities of Islamic banks. These are transactions which are too speculative or based on unknown and uncertain events, with significantly high risks. These and other rules of the *Sharia* have shaped the types of financial transactions adopted by Islamic banks. Accordingly, Islamic financial institutions have developed certain contracting models based on the no-interest concept to satisfy the needs of the market.

The following are the most popular banking instruments or model contracts commonly known by their Arabic names:

### 1. Murabaha (trade financing)

A customer with traditional banking relationships wishes to purchase raw materials or goods for which it does not have the funds to pay the purchase price. It borrows the amount of the purchase price from the bank, which may take a charge or lien against the goods purchased and require the customer to repay the amount of interest. An Islamic institution cannot extend such a loan but it can help the customer to make the purchase by buying the goods from the supplier and then selling the same to the customer at a profit.<sup>23</sup>

The bulk of Islamic bank funds are operated through *Murabaha* contracts (a sale at a percentage mark-up). In this type of contract the customer orders the bank to buy goods according to his specifications from a supplier. The customer further promises to purchase these goods from the bank for cost plus a mark-up. In practice, the bank purchases the goods only when it is satisfied that the customer will purchase them. This second sale between the bank and its customer is usually on credit. By involving the bank as a seller, the customer can purchase the goods on credit and the bank can claim compensation for its services by demanding a higher sale price. Legally the customer is not just borrowing money for interest but buying goods on credit, which is permissible under Islamic law. In other words the transaction between the bank and its customer is a sale on credit and not a loan.

The critical difference between a *Murabaha* financing and traditional purchase financing is that the bank in a *Murabaha* must actually take the title to the goods in question and later transfer that title to the ultimate purchaser. This passage of title raises questions of defects in title, claims, risk of loss and insurance that must be carefully considered in negotiating and drafting any *Murabaha* contract. It is also important to determine where and under the law of which nation the title passes, for this will affect whether the title passes at all and whether the purchase and subsequent sale by the Islamic institution or the bank are events subject to transfer, *ad valorem*, or income taxes of any kind. To reduce the risks of the bank, in practice, the first and the second sale

<sup>22</sup> Vogel and Hayes, *op cit.*, n. 10, pp. 110 and 84–88. See also F Al-Omar and M Abdel Hag, *Islamic Banking* (1996), pp. 104–108.

<sup>23</sup> Vogel and Hayes, *op cit.*, n. 10, pp. 140–143.

takes place simultaneously when the title of the goods is transferred to the bank.

An important limitation of the *Murabaha* arrangement is that it requires three unrelated parties—the supplier, the Islamic institution or the bank and the ultimate purchaser or customer. In such transactions all parties carry certain risks and benefits.

### **2. Mudaraba (profit-sharing finance)**

If a company requires financing for a project, but not management or administrative assistance for a project or business opportunity, Islamic institutions or banks may use the *Mudaraba* contract, in which the Islamic institution or the bank provides the necessary financing and the company provides the work, and executes and manages a project.

Here there are two phases of transactions. In the first phase, the capital owner deposits his capital in the bank and the bank acts as the party investing the capital, i.e. as *mudarib*. In the second phase, the bank acts as provider of the capital and the company as a second *mudarib*—equivalent to a conventional borrower—which requires and uses the money for a project. The profit (if any) made by the company out of the project is divided according to an agreed proportion between the bank and the company. The Islamic bank later divides the profit again between the bank and the first capital owner. The bank may also charge fees for its normal services, but not interest.

Such transactions are governed by two basic principles, both derived from Islamic law. Instead of taking interest for lending money, capital providers are involved in a profit- and risk-sharing arrangement.

The first principle is that the return on capital cannot be fixed in advance but is equivalent to a proportion of profits. The capital provider and the *mudarib* who makes use of the capital both share the profit according to agreed proportions.<sup>24</sup>

The second principle is that the capital owner shares the risks of the project. Thus, if the project loses, the capital owner is liable up to the capital he invested, but not beyond that amount; the bank does not guarantee the return of the initial capital to the capital owner; and the company or the *mudarib* may lose his labour.

Thus, in contrast to conventional banking, the capital provider cannot claim both fixed interest and the assured return of his capital.

### **3. Musharaka (joint ventures)**

A company has a project or business opportunity that requires both financing and management assistance. It may find an Islamic institution willing to enter into a partnership or *Musharaka* arrangement whereby the company and the

<sup>24</sup> Vogel and Hayes, *op cit.*, n. 10, pp. 130–131.

Islamic bank are partners in the true sense, sharing equity, management, profit and losses, according to an agreement made between them. This is Islamic finance in a pure sense, in that it carries out the fundamentals of sharing and putting wealth to productive use.

The considerations in entering into a *Musharaka* arrangement are the same as the considerations in any joint venture or partnership. The parties must address the general questions of what the partnership is intended to do, how it will be managed, how the profits and losses will be shared and how the arrangement can be terminated.

Here, the bank may take a lower ratio of profits, but in cases of losses it becomes liable to its full equity ratio.

A *Musharaka* arrangement may be related to financing a particular project, whereby the agreement is terminated after completion of the project or it may be linked to a continuing project, in which case the bank receives its investment back progressively according to the project's ability to repay the initial investment and the agreed profit. The return is based on the revenue out of the project rather than interest.

These transactions ensure the observance of the *Riba* prohibition and the rule that, if money is lent to another party to use for a period of time, compensation for the financing may not be a predetermined amount guaranteed by the other party to the contract. Furthermore, such transactions are based on the notion of sharing profit and risks and on avoiding gains obtained without risk.

There are other instruments and model contracts developed by Islamic institutions to conform with Islamic principles such as a leasing contract (*Ijara*), whereby a company requests the bank to purchase certain machinery and to lease the machinery to the company for an agreed regular fee. These and other instruments used by Islamic banks have proved to be workable, for most modern transactions are capable of being broken down into sale, purchase, lease and joint venture agreements.<sup>25</sup> It should be noted that there are continuous efforts to develop new Islamic banking instruments which are in conformity with Islamic principles and, at the same time, realistic and profitable.

Islam prohibits interest, but at the same time commands legitimate and fair commerce and legitimate wealth creation. It does not restrict the freedom of contracting and trading as long as they conform to the general principles of *Sharia*. Islamic banking is still in the making and its future depends on its ability to find new ways of trading and investing.<sup>26</sup>

<sup>25</sup> See M J T McMillen, "Collateral Security and Financing Structures for *Sharia*—Compliant Project Finance", MEER, August 2001, pp. 7, 11–18.

<sup>26</sup> F Al-Omar and M Abdel Hag, *op cit.*, n. 22, pp. 124–126.