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Andreas Ernst

Promoting Islamic Finance and Islamic Banking -

A legal analysis of the potential for Islamic Banking products in Germany

Institut für Rechtspolitik
an der Universität Trier

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Das *Rechtspolitische Forum* veröffentlicht Ansätze und Ergebnisse national wie international orientierter rechtspolitischer Forschung und mag als Quelle für weitere Anregungen und Entwicklungen auf diesem Gebiet dienen. Die in den Beiträgen enthaltenen Darstellungen und Ansichten sind solche des Verfassers und entsprechen nicht notwendig Ansichten des Instituts für Rechtspolitik.

In recent years, Islamic banking has been one of the fastest growing markets in the financial world. Even to German banks, Islamic finance is not as 'foreign' as one might think. Indeed, several banks are already operating so-called “Islamic windows” in various Arab countries.
However, German banks are still reluctant to offer 'Islamic' products in Germany, despite the fact that approximately 3.5 million Muslims currently live there. Potential reasons for this reluctance include widespread misunderstanding of Islamic banking in Germany and prevailing cultural prejudice towards Islam
generally. The author seeks to address these concerns and to take an objective approach towards understanding the potential for Islamic banking in Germany. Legally, Islamic law cannot be the governing law of any contract in Germany. Therefore, the aim must be to draft contracts that are both enforceable under
German law and consistent with the principles of Shari'a – the Islamic law.
In this paper, the author gives a detailed legal analysis of the most common Islamic banking products and how they could be given effect under German law, while attempting to address widespread concerns about arbitration or parallel Shari'a courts.
This publication is one of the first legal analysis of Islamic banking products in Germany. As such, its goal is not to be the final word, but rather to begin the conversation about potential problems and conflicts of Islamic banking in Germany that require further investigation.

Andreas Ernst studied law at the University of Trier and completed the First Legal State Exam in 2008. After completing his degree in Germany, he was awarded a scholarship from the German Academic Exchange Service (DAAD) to pursue a Masters of Law in International Commercial and Business Law at the University of
East Anglia in Norwich, UK, where he graduated with distinction and was ranked second overall in his class.

Although Ernst is not a Muslim, his interest in foreign cultures and non-national law propelled him to study 'Legal Aspects of Islamic Finance' during his LL.M. coursework. Ernst ultimately wrote his dissertation on the potential for Islamic Banking in Germany, which he expanded upon in writing this publication.

To my parents:

Thank you for your support all these years.

You made this possible.

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PROMOTING ISLAMIC FINANCE AND ISLAMIC BANKING

A LEGAL ANALYSIS OF THE POTENTIAL FOR ISLAMIC BANKING PRODUCTS IN GERMANY

BY ANDREAS ERNST, LL.M.

Foreword – What is 'Islamic' Banking?

Although the term 'Islamic banking' has been in common parlance for quite some time, it is largely misunderstood and, in many ways, misleading. Because so many people in the Western world live in a cultural environment where Islam is still regarded as exotic, true understanding of Islamic culture is so rare that prejudices and misunderstandings about Islam have negatively affected any term or concept associated with it.

For example, it is self-evident that contemporary Western understanding of Islam is unfortunately informed by the news, which is often filled with misleading – or at least misrepresentative – characterisations about terrorism and fundamentalists. To make things even worse, these terrorists, who attract so much attention to themselves, use *Shari'a*, the Islamic law, as a justification for their horrific deeds.

This confluence of misunderstanding has lead to what is popularly described as 'Islamophobia'[1] in the Western world, which, simply put, is a general feeling that it would be better to stay away from everything that has to do with Islam. Not surprisingly, 45 percent of Germany's Muslim population believe that the German public dislikes Muslims.[2]

Indeed, some finance analysts are afraid to get involved with Islamic finance, because they fear that making a banking system

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1 Similarly: 'Islamic Finance braucht eine Lobby' *Pressemeldung* (Frankfurt 11.11.2008) <http://www.presseportal.de/pm/59290/1298586/iir_deutschland_gmbh/rss> Accessed 17.03.2011.

2 *Katrin Brettfeld/Peter Wetzels*, Muslime in Deutschland: Integration, Integrationsbarrieren, Religion; *BMI*, Einstellungen zu Demokratie, Rechtsstaat und politisch-religiös motivierter Gewalt (Berlin 2007) 13.

Shari'a compliant is tantamount to allowing fundamentalists to infiltrate Western financial institutions.[3]

For Islamic banking ever to take root in the West, one of the big challenges of the future will be to demystify the term *Shari'a*.[4]

To do so, the question we must ask ourselves is what is 'Islamic' banking actually about?

Put simply, it is all about doing business in a certain way, i.e. banking that is simply *Shari'a*-compliant.

When I began this paper, I thought banks would be eager to participate in my research regarding the legal conditions of Islamic banking in Germany. At that time, I had read many recent articles, promoting Islamic banking as 'the ideal way to overcome the credit crunch' and to prevent it from happening again. Additionally, I had heard about one or two conferences on Islamic finance that had already taken place; I assumed my research would be well-received.

So, I started to contact banks, scholars and authorities all over Germany, expecting to receive suggestions as to what information would be most relevant to them. Their response was seriously disappointing: Out of 16 banks that I have contacted, I received only one reply – and I wish to thank Mr. Kayatz from Commerzbank for doing so.

In addition to the meagre banking responses I received only a few other replies from scholars and authorities. Unfortunately nearly all of them either claimed not to be interested, not to have engaged into the topic or referred me to other sources and people.

Out of 42 emails, 36 remained unanswered.

Thus, at the outset, it is important to identify two main obstacles to my research:

First, even though the German banking industry likely knows very well that it should get involved into Islamic banking in order to se-

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3 *Irene Hell*, 'Banks move into Islamic finance' *BBC News* (Sharm al-Sheikh 09.06.2006), http://news.bbc.co.uk/2/hi/middle_east/5064058.stm, 17.03.2011; *Carsten Volkery*, 'Mit Allahs Hilfe durch die Krise' *SPIEGEL-ONLINE* (London 02.05.2009) <http://www.spiegel.de/wirtschaft/0,1518,621672,00.html>, 17.03.2011.

4 (n 1).

cure its place in a growing market, there is still a hint of Islamophobia that appears to hold it back.

Second, because the majority of Islamic finance supporters are obviously Muslim, I, as a non-Muslim, encountered a distinct reverse prejudice when seeking to discuss Islamic finance with them. It was as if they refused to take seriously a non-Muslim's interest in facilitating *Shari'a* compliant banking in a Western context.

To each of these groups, I would like to point out that we all want the same thing: to do business, to explore new markets and to make money. Whenever there is a demand amongst customers for the product range to be adjusted to their needs, the banking industry should try to fulfil these demands. So, if there is a demand amongst Muslim customers for new products that are compliant with *Shari'a*, the banking industry should at least investigate whether and when this demand can be fulfilled. Again, it's only about doing business in a certain way.

> *"Money has neither a smell nor a religion.*
> *Once an alternative is proven profitable,*
> *people get interested."*[5]

[5] *Imane Karich* in: *Asma Hanif*, 'Religion and money: Islamic Finance' *Religioscope* (18.03.2008) <http://www.religion.info/english/articles/article_371.shtml>, 17.03.2011.

A. Introduction

In the last thirty years, a new form of banking has evolved in Muslim countries around the world that long remained unnoticed in the Western world: Islamic banking.

Since then, it has developed into a fast growing market at rates of 15-20 percent per year and it shows no signs of slowing.[6] Some Western banks have started to recognise this potential and have begun to operate 'Islamic windows' in some Arab countries.

However, in Western and European markets, Islamic Finance never played a big role and banks did not bother to evaluate the potential in their own domestic markets.

Only the UK undertook some successful attempts to secure London's position as Europe's leading financial centre, both in the conventional system and the evolving Islamic finance market. Today, many conventional banks in the UK offer *Shari'a*-compliant products. The UK is also home to the first, wholly *Shari'a*-compliant bank in Western countries.[7]

No such attempts have been made in Germany, despite its Muslim population being twice as big as the UK's. However, in these times of economic downturn, people have started to get more interested in Islamic banking, realising that Islamic banks did not suffer as much as conventional banks did when the market crashed. Especially in economic circles, demand for more research and development has been on the rise.

Several studies have been performed which are trying to evaluate the market potential.

There are an estimated 3.2-3.5 million Muslims living in Germany.[8] Out of these, about 15-20 percent or 500.000[9] are said to be seri-

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6 *Booz&Company*, 'Islamic Finance verspricht großes Wachstumspotenzial für deutsche Banken' *Pressemitteilung* (München 22.07.2008) <http://www.booz.com/de/home/Presse/Pressemitteilungen/pressemitteilungdetail/41864791>, 17.03.2011.

7 *FSA*, 'Islamic Banking in the UK' (09.03.2006) <http://www.fsa.gov.uk/pages/About/Media/notes/bn016.shtml>, 17.03.2011.

8 'Islamische Finanzprodukte haben viel Zulauf' *FAZ* (Frankfurt 23.09.2008) 20; 'Bankgeschäfte ohne Zinsen' *FAZ* (Frankfurt 25.03.2008) 14; *Marianne Gajo*, ‚Bedarf für Islamische Bankprodukte' AG (2008) R408; *Benedikt Fehr*, 'Attraktiver Wachstumsmarkt – Islami-

ously interested in *Shari'a*-compliant banking products, with a potential market value of 1.2 billion EUR per year.[10]

While German banks are still reluctant and the market still undeveloped, the awareness of the potential is growing and the need for more research apparent. The purpose of this paper therefore is to contribute to this research process and further promote the development of Islamic banking in Germany. Its focus shall be on the law of obligations and the assessment of Islamic banking products under German law.

One of the main challenges in the development of *Shari'a*-compliant banking products is to draft the underlying contracts in a way that ensures both *Shari'a*-compliance and enforceability of the 'Islamic' contract in a secular court.

Despite the potential judicial misunderstanding, it is nonetheless possible to draft the documentation of most Islamic banking products in a way that any judge will be able to give effect to the parties' agreement including the underlying principles of *Shari'a* – without having any prior knowledge about Islam.

Therefore, this paper will first explore the religious guidelines for economy, the resulting provisions and prohibitions that affect Islamic banking and that require consideration.

Next, it will introduce the most relevant Islamic banking products and give an analysis of the structure and parallels in German law. Eventually, it will propose guidelines for the documentation under German law for each product.

Last but not least, it will address some general issues that both might have a deterrent effect or require further research and investigation.

Note:

For those interested, there is an annex at the end of this paper giving a short overview of the sources of *Shari'a.*

If you would like to discuss any of the issues in this paper, feel free to contact the author at AndreasErnst@gmx.net.

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sche Finanzprodukte haben viel Zulauf' *FAZ.NET* (23.07.2008) available at <http://www.faz.net/>, 17.03.2011.

9 'Anlageprodukte für Muslime' *FAZ* (Frankfurt 06.12.2007) 26; *Gajo* (n 8).

10 *Gajo* (n 8).

B. Religious guidelines for economy

The Islamic ideal for conducting business is based on general rules like fairness, mercy and leniency in times of hardship.[11] Islamic law provides the guidelines for a healthy and stable economy, promoting justice in transactions and trying to prevent the rise of legal disputes.[12]

It is not allowed to do any business that either contradicts the prohibitions of *Shari'a* or threatens to damage the moral health of the society.[13]

Nevertheless, market forces and market economy are recognised[14] and the pursuit of profit is accepted to the extent that it is not harmful to others or contradictive of any other provisions of *Shari'a*.[15] Such provisions impose certain restrictions on economic activities, but they are considered to be divine and 'cannot be removed by any human authority'.[16] There are explicit prohibitions, but it is equally important to make sure that the permissible contract is not for other reasons un-Islamic and therefore invalid.[17]

Despite popular misunderstanding, prohibitions are the exception in Islam – not the rule. Indeed, the general rule is that everything is allowed if it has not been expressively forbidden.[18] Trade is not only permitted, but encouraged.[19]

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11 *Barbara Seniawski*, 'Riba today: social equity, the economy, and doing business under Islamic law' (39 Colum. J. Transnat'l L. 2001) 701, 705.

12 *Mahmoud El-Gamal*, A Basic Guide to Contemporary Islamic Banking and Finance (Rice University, 2000) 34.

13 *Atif Hanif*, 'Islamic Finance – an overview' (IELR 2008) 9, 10; *Muhammad Usmani*, An Introduction to Islamic Finance (Arab and Islamic Law Series) XVI.

14 *Usmani* (n 13) XIV.

15 *Mohamed Lahlou/Joseph Tanega*, 'Islamic securisation: Part 1 – accommodating the disingenuous Narrative' JIBLR (2007) 295, 302.

16 *Usmani* (n 13) XIV.

17 *El-Gamal* (n 12) 1.

18 *Iqbal Khan*, 'Issues and Relevance of Islamic finance in Britain' (2009), various publications, here: IIBI <http://www.islamic-banking.com/iarticle_3.aspx>, 17.03.2011.

19 *El-Gamal* (n 12) 9/10.

Prohibitions

There are 7 fundamental prohibitions in *Shari'a* that most scholars agree on:[20]

- *Riba* (i.e. charging interest)
- *Gharar* (i.e. excessive uncertainty in a contract)
- *Maisir* (i.e. gambling and chance-based games)
- transactions in unethical goods and services
- compensation-based restructuring of debts
- trading in debt contracts at discount
- forward foreign exchange transactions

Riba and *Gharar* are the most important and most prominent prohibitions[21] and they are of particular relevance to financing under *Shari'a.*[22] *Maisir* shall be addressed shortly but its scope is actually covered by other prohibitions. However, the prohibition of undertakings in unethical goods and services may not be neglected as it bars certain businesses for investments by Muslims. It is therefore necessary to get a better idea of the meaning of these provisions.

1. Riba

Riba literally means 'excess' or 'addition'[23] and commonly refers to the charging of interest for lending money. Such is considered a capital sin in Islam[24] as money should only be an intermediary of goods.[25] It is regarded to have no intrinsic or time value, so that no money can be the subject-matter of trade except in some specific circumstances.[26] Any interest charged for a loan is regarded to

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20 *Mohamed Lahlou/Joseph Tanega*, 'Islamic securisation: Part II – a proposal for international standards, legal guidelines and structures' JIBLR (2007) 359, 361.

21 *Faisal Attia*, 'Do the distinctive features of contemporary Islamic finance lie in its form or substance?' BJIB&FL (2008) 599, 600.

22 *Reinhard Klarmann*, 'Construction and Lease financing in Islamic project finance' JIBLR (2004) 61.

23 *Attia* (n 21).

24 *Klarmann* (n 22).

25 *LMA*, Users Guide to Islamic Finance Documents (2007) 3; *Lahlou/Tanega* (n 20) 362.

26 *Attia* (n 21).

constitute social and moral injustice[27] and its prohibition is derived directly from the *Qur'an*.[28]

Instead, the lending of money should be a charitable contract, with the charitable amount being the decrease in the value of the money, arising from the devaluation occurring during the period of lending.[29] Consequently, any benefit to the lender deriving from a loan is considered *Riba* and illegal under *Shari'a*.[30] The Islamic principles on the prohibition of *Riba* are unequivocal.[31] Any inconsistency with this prohibition will render any transaction void.

2. Gharar and Maisir

The second key prohibition under *Shari'a* is the prohibition of *Gharar*, commonly translated as 'risk' or 'uncertainty'.[32] Historically, this prohibition is related to the prohibition of gambling (*Maisir*), seeking to protect the individual from exploitation as a result of his ignorance.[33]

This aim is considered to be applicable to any contract as the lack of control of fundamental terms in a contract or their ignorance can lead to a situation comparable to gambling.[34]

Therefore, any contract that contains uncertainty, especially in fundamental terms, may be invalid under *Shari'a*.[35]

However, the prohibition of *Gharar* is not as unequivocal as the prohibition of *Riba*, as it is recognised that no contract can be entirely free of risk.[36] Consequently, there are various levels of *Gharar*, referred to as major and minor *Gharar*.[37] Major *Gharar* must be regarded as the excessive level of uncertainty or risk,[38] distin-

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27 *Seniawski* (n 11) 706.

28 *Simon Grieser*, 'Die Grundstrukturen des Islamic Finance und Islamic Banking/Islamic Banking – ein Wachstumsmarkt für deutsche Banken?'(FLF 2005) 105; *Seniawski* (n 11) 702.

29 *Attia* (n 21).

30 *Attia* (n 21); *Seniawski* (n 11); *Klarmann* (n 22).

31 *El-Gamal* (n 12) 4.

32 Ibid 6.

33 *Klarmann* (n 22).

34 *El-Gamal* (n 12) 7.

35 *LMA* (n 25).

36 *El-Gamal* (n 12) 4.

37 *Attia* (n 21).

38 *Lahlou/Tanega* (n 20) 362.

guishable from minor *Gharar*, the inevitable level of risk in doing business, which does not render a contract invalid.[39] Still, the distinction can be difficult and there is a huge grey area with jurists reaching dissenting and contradicting conclusions.[40] Nevertheless, through thoughtful formulation of the contract, clearly identifying the fundamental terms and elements, major *Gharar* can be prevented.[41]

The prohibition of *Maisir* bans speculations, betting and gambling from the Muslim's life,[42] but its scope of application is limited in business, as most situations are already covered by the prohibition of *Gharar*. It is mainly the insurance market that conflicts with this prohibition as insurance contracts are compared to betting: will the customer have paid enough towards the insurance to cover the insurer's cost when the insured event occurs? Especially life insurances are morally questionable, as it could be regarded as a bet on death.[43]

3. Unethical goods and services

Investors that wish to undertake or offer *Shari'a*-compliant (*halal*) business will also have to take into account that certain types of businesses are regarded as unethical and therefore forbidden under Islam. Affected fields of business include the production and sale of alcohol, pork products or weapons and businesses involved in gambling or pornography.[44]

However, Islamic scholars have recognised that Muslims may be disadvantaged, if not completely barred, from a big part of world trade, if this prohibition were to be handled too strictly.[45]

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39 *Attia* (n 21).

40 Ibid.

41 *El-Gamal* (n 12) 7.

42 *Thomas Link*, 'Nach den Grundsätzen der islamischen Rechtsordnung' *FAZ* (Frankfurt 24.02.2006) 51.

43 'Gläubiger geraten in Teufels Küche' *FAZ* (Frankfurt 05.09.2008) 23.

44 'Immer mehr Banken entwickeln spezielle Finanzprodukte, die dem islamischen Glauben entsprechen' (29.03.2005) <http://www.islam.de/2828.php>, 17.03.2011; 'Mit Allahs Segen' *FAZ* (Frankfurt 13.10.2006) V13; *Jesper Stenberg Johnson*, 'Islamic banking and its implications for development' Company Lawyer (2009) 155.

45 *Hanif* (n 13) 10.

They have therefore softened the prohibition to allow investments in certain businesses that are not 100 percent *halal*, e.g. hotels that also sell alcohol to their guests. The conditions are that the primary business is *halal*, that the income from prohibited activities only amounts to a small share and that the amount of interest a company is obliged to pay under any loans does not exceed a certain percentage of the asset.[46]

C. Islamic Finance

Islamic Finance aims at offering new solutions for the engagement in financial activities that adhere to Islamic traditions and the rules of *Shari'a*,[47] thus making it possible for Muslims to do banking according to their belief. Besides the general rules of *Shari'a*, there are some more features of Islamic finance and business that need to be considered whenever a new product is developed or a contract drafted:

I. Money as a medium of exchange

As mentioned above, it is prohibited to trade in money. Any profit deriving from such trade is considered *Riba*.[48] *Shari'a* allows money only to be used as a medium of exchange[49] and each unit's value is always identical to another unit of the same denomination.[50] It is therefore not possible to make a profit through the exchange of money inter se.[51]

II. Asset-backed financing

The second feature is the requirement of all financing to be asset-backed.[52]

The parties to an agreement must link the finance to a tangible asset that is clearly specified.[53]

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46 Ibid.
47 *Klarmann* (n 22).
48 *Attia* (n 21); *Usmani* (n 13) XIV.
49 *Attia* (n 21); *Lahlou/Tanega* (n 20) 362.
50 *Usmani* (n 13).
51 *Attia* (n 21); *Usmani* (n 13) XIV.
52 *Usmani* (n 13) XIV.

It is a matter of certainty that all financing is permanently based on non-liquid assets.[54]

III. Shari'a provisions for the sale of goods

Shari'a also provides several basic rules that apply to sales contracts: At the time of the contract, the seller must actually own the commodity;[55] a requirement largely affected by the prohibition of *Gharar*:[56] It is generally not possible to have a sales contract on a commodity that the seller still has to purchase himself or that is not yet in existence, as this would mean that there is no asset to back the financing.[57] Furthermore, the price must be certain at the time the contract is concluded.[58] When the parties have reached an agreement, an amendment is not possible any time thereafter.[59] Last but not least, the contract must be 'instant and absolute'. This means that it is not admissible to have a sales contract based upon conditions or eventualities.[60]

D. The choice of law and legal enforcement in a secular system

After having laid out the principle provisions of *Shari'a* and their meaning for business undertakings and banking, the question arises as to how these principles could best be incorporated into a contract in order to ensure their legal enforcement in the secular German system.

As a non-national law, *Shari'a* cannot be made the governing law of a contract[61] and it may be doubted that German banks would agree to such a choice. It is equally improbable that they would agree to subject these contracts to arbitration, where non-national

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53 *El-Gamal* (n 12) 36.
54 *Attia* (n 21); *Usmani* (n 13) XV.
55 *El-Gamal* (n 12) 9; *Attia* (n 21) 601.
56 *Attia* (n 21) 601.
57 *Lahlou/Tanega* (n 20).
58 *Attia* (n 21) 601.
59 *Attia* (n 21) 601; *Lahlou/Tanega* (n 20).
60 *Attia* (n 21) 601.
61 *Palandt*, *BGB-Kurzkommentar* (70th Ed., Beck-Verlag, München 2011) Rom I 3.

principles like *Shari'a* could easily be given effect. Banks will focus on other issues like predictability and reliability rather than *Shari'a*-compliance. Especially while entering a new market, offering new and unknown products, the aim must be to ensure that the contract is revisable and enforceable by a German court.

I. Special clauses and standard terms

Nevertheless, freedom of contract enables the parties to introduce clauses into the contract that reflect any principles of *Shari'a* they are concerned with.[62] A *Shari'a*-board could be asked to provide assistance in developing such provisions and in establishing sanctions for non-compliance with fundamental principles of *Shari'a*.[63] Thoroughly done, such clauses could be used as standard terms and conditions in any Islamic contract.

Therefore, the main challenge would be to draft the documentation ensuring that the contract is *Shari'a*-compliant, while at the same time ensuring that the contract is enforceable in the secular court.[64]

There already are Islamic products that are used in Islamic banks and have been considered permissible. The next step is to take these products and draft a document governed by national law that mirrors the original product and its principles. Ideally, the contract should be enforceable both in secular courts and in *Shari'a* courts.[65]

II. The German legal system

The German legal system is a codified system, which means that law is not judge-made but set out in codes and statutes. Naturally,

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62 *Jason Chuah*, 'Private international law – choice of law – Islamic law' JIML (2004) 125, 126; Shamil Bank of Bahrain v. Beximco Pharmaceuticals Ltd and others [2003] 2 All ER (Comm) 849, 850.

63 *Jason Chuah* (n 62).

64 *Shirley Chiu/Robin Newberger*, 'Islamic Finance: Meeting Financial Needs with Faith Based Products' Profitwise News and Views (Chicago, 02/2006) 8, 12; *Abdul Jabbar Karimi*, 'Challenges facing Islamic banks' available at <http://www.nzibo.com/IB2/Challenges.pdf>, 17.03.2011; *Shameela Chinoy*, 'Interest-free banking: the legal aspects of Islamic financial transactions' (JIBL 1995) 517, 523.

65 *Chinoy* (n 64) 524.

not everything is or should be codified: especially in civil law, freedom of contract enables the parties basically to agree on whatever they want in whatever form they want.

Hence, the legislator has codified only the most important and most common types of contracts. Examples are sale, lease and service contracts, just to name a few. These regulations mainly function as catch-all provisions where the parties to a contract have not agreed on an aspect.[66] However, contracts hardly ever adhere to one of these 'standard' contracts but rather show elements of several types.

In case of any arising dispute, the court will seek to classify the contract at hand as one or a mixture of these stereotype contracts.[67] In mixed contracts, the court must decide the provisions of which 'stereotype' are most suitable to be applied to the relevant part of the contract.[68] Where it is impossible to divide a mixed contract into different parts with different applicable provisions, it has to be decided which standard type contract is predominantly influencing the overall contract.[69]

In order to have an Islamic banking contract enforced in a German court, it is important to take a backwards approach: analyse and classify the Islamic product, then choose the most suitable legal form to express the original structure and agreements. The legal provisions for the mentioned standard type contracts provide guidelines as how to draft the documentation.

Still, there are certain areas of law where freedom of contract is limited. In company law, the parties' choice is restricted to a range of standardised forms of partnerships and companies.[70]

The reason for this restriction is to ensure that third parties have a safeguard for their rights in dealing with partnerships, limited liability companies, etc.[71] Hence, the obligatory provisions mainly focus

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66 *Palandt* (n 61) Überbl § 311-15.

67 Ibid 24.

68 Ibid 24f.

69 Ibid 25a.

70 *Ulrich Eisenhardt*, Gesellschaftsrecht (13th Ed., Beck-Verlag, München 2007) para. 29; *Baumbach/Hopt*, Handelsgesetzbuch – Kurzkommentar (33rd Ed., Beck-Verlag, München 2008) Einl § 105-4.

71 *Baumbach/Hopt* (n 70) Einl § 105-3.

on the external relations of the partnership, regulating obligations and liabilities towards third parties and cannot be contracted out.[72]

The internal relations of the partnership, on the other hand, are hardly restricted and can be agreed as the parties' wish, e.g. profit and loss sharing agreements, contributions, etc. Extra care must therefore be taken in choosing the form of partnership for an Islamic product and many factors must be considered.[73]

Careful drafting is the key to solve most problems. Still, no matter how much one tries to draft a contract complying with the rules of *Shari'a*, it might nevertheless be necessary to make certain concessions in any non-Muslim environment like Germany.

E. Islamic banking products

In the following, the most common products of Islamic banking will be introduced. While there are some variations from bank to bank, the individual explanations used here will refer to widely accepted techniques. The standard products in Islamic banking can be divided into 2 categories:

I. partnership arrangements, where bank and customer share profit and loss:
   - *Musharaka* and
   - *Mudarabah*

II. credit sales arrangements, where standard contracts like sales or leases are combined with deferred payment arrangements:
   - *Murabaha,*
   - *Ijarah* and
   - *Istisna'*

After the general introduction of each product, a short legal assessment will follow to classify them under the most suitable 'standard type contracts' in German law. The findings shall be a reference for which legal provisions should guide the drafting of the corresponding documentation.

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72 *Eisenhardt* (n 70) para. 31.

73 *Baumbach/Hopt* (n 70) Einl § 105-7.

I. Partnership arrangements

1. Musharaka

In this mode of Islamic financing, there are two or more partners who pool together resources to jointly undertake a commercial venture.[74]

1.1. Contribution

All partners have to contribute to the venture at pre-agreed proportions.[75] While there is some dispute over the nature of the required contributions,[76] in practice it is accepted that they can both be in cash or in the form of commodities.[77]

1.2. Profit and loss sharing

Musharaka is guided by principles of joint decision-making and profit-sharing.[78] Profit sharing means that investors cannot ask for a fixed rate of return; instead it is dependent on the actual profit the business makes.[79] Any profit is shared at a ratio, which has to be agreed before the contract comes into effect and which does not necessarily reflect the ratio of contributions.[80] Usually, the entrepreneur will get a bigger share of the profit,[81] providing for him to receive his initial contribution plus a profit over time – thus replacing interest payments.[82]

Any loss must be shared in proportion to the initial contribution.[83] A different ratio is unacceptable and the potential loss is only re-

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74 *Mustafa Ashrati*, Islamic Banking – Wertevorstellungen – Finanzprodukte – Potenziale (Frankfurt School Verlag, 2008) 46; *MIGA*, 'MIGA and Islamic Finance' – Case Study (2008) 3.

75 *Ashrati* (n 74) 45; *LMA* (n 25) 7; *Gerhard Wegen/Johannes Christian Wichard*, 'Islamische Bankgeschäfte' RIW (1995) 826, 828; *Grieser* (n 28) 106; *Hanif* (n 13) 12.

76 *Usmani* (n 13) 8.

77 *Usmani* (n 13) 10; *Ashrati* (n 74) 46.

78 *Seniawski* (n 11) 723; *Hanif* (n 13) 12.

79 *Usmani* (n 13) 7.

80 *LMA* (n 25) 7; *Wegen/Wichard* (n 75); *Grieser* (n 28) 106.

81 *Wegen/Wichard* (n 75).

82 *LMA* (n 25) 7; *Wegen/Wichard* (n 75).

83 *LMA* (n 25) 7; *Wegen/Wichard* (n 75); *Grieser* (n 28) 106.

stricted by the amount invested. There is complete consensus amongst Muslim scholars that any other agreement would render the contract invalid.[84]

The reason for this is that in a partnership all partners shall bear the same risk of making profit or loss. It would be regarded as unjust, if an investor/creditor was allowed to claim a fixed sum of return, while the other party suffered a loss. Additionally, it would be considered unjust if the investor received only a small proportion when the other party made a huge profit with the help of his investment.[85]

Under the principles of Islam, *Musharaka* can therefore be described as the ideal mode of financing.

1.3. Management

As has been stated, all parties have the right to joint decision-making.[86] However, in practice the bank restrains itself to supervision and usually waives its right to actively participate.[87] The customer will then act as the manager of the enterprise and an agreement may be found to allow him a managing fee, independent of any profits returned from the enterprise.[88] It is only in the case of undue negligence that he loses his right to the fee.[89] Additionally, the bank shall only have a right to a maximum share of the profit correspondent to the ratio of its investment, if it merely acts as a sleeping partner.[90]

1.4. Practical use

At present *Musharaka* is often used to fund small businesses[91], both new and existing ones[92] and it generally is a long-term investment**.**[93] There is also a special mode of *Musharaka* that leaves

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84 *Usmani* (n 13) 8.
85 Ibid 1.
86 *Wegen/Wichard* (n 75); *Grieser* (n 28) 106.
87 Ibid.
88 *Wegen/Wichard* (n 75); *LMA* (n 25) 7.
89 Ibid.
90 *Usmani* (n 13) 10.
91 *Ashrati* (n 74) 50.
92 *Wegen/Wichard* (n 75).
93 *Grieser* (n 28) 106.

the customer with the sole ownership at the end: diminishing *Musharaka*.

Diminishing Musharaka

Diminishing *Musharaka* is usually used in the acquisition of real estate or the initial establishment of a business.[94] In this mode the financier and the customer first conclude a normal *Musharaka* and acquire the property for joint ownership.[95]

Any profit generated by the property is shared as pre-agreed. The customer will then use parts of his own profit to buy out the financier's shares over the time of the contract.[96] Thus, the financier's share in the investment will constantly decrease until the ownership has been completely transferred to the customer.[97] At this stage, the *Musharaka* will come to an end.[98] The shares of the bank are sold at a higher price than the original value, so the bank will get its initial investment plus a pre-agreed profit.[99]

Diminishing *Musharaka* is also used for house financing,[100] usually in combination with other Islamic products as will be laid out in more detail below.

1.5. Classification under German law

Musharaka is a classical partnership and could be framed as an 'Offene Handelsgesellschaft' (OHG), the ordinary business partnership in German law, regulated in §§ 105 ff. HGB.[101]

While there are provisions on contributions, profit and loss sharing and management, the parties are free to replace these and to introduce clauses into the partnership agreement that reflect the relevant provisions of *Shari'a*.[102]

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94 *Ashrati* (n 74) 49.

95 *Hanif* (n 13) 12.

96 *Grieser* (n 28) 106; *Hanif* (n 13) 12; *Wegen/Wichard* (n 75).

97 *LMA* (n 25) 8; *Wegen/Wichard* (n 75).

98 *Ashrati* (n 74) 49.

99 *Grieser* (n 28) 106; *Hanif* (n 13) 12.

100 *Ashrati* (n 74) 49.

101 HandelsGesetzBuch = German Commercial Code.

102 *Eisenhardt* (n 70) para. 229; *Hartmut Oetker*, Handelsgesetzbuch – Kommentar (Beck-Verlag, München 2009) § 109-1; *Baumbach/Hopt* (n 70) § 109-2.

The requirements of *Musharaka* refer only to the internals of the partnership, so they do not conflict with any obligatory legal provision under German law.

Regarding the relationship towards third parties, § 128 HGB regulates that all parties have unrestricted personal liability for the company's obligations.[103]

However, the final allocation of these costs is a question of internal regulation and may therefore be agreed on to be proportional to the initial contribution, reflecting the requirement for a valid *Musharaka*.

Another form of partnership that the parties could agree on is the 'Gesellschaft bürgerlichen Rechts (*GbR*)', regulated in §§ 705 ff. BGB.[104]

The *GbR* may not only be used in business partnerships, but for all partnerships that pursue a certain aim.[105]

As the provisions for the *OHG* and the *GbR* are highly similar and to a large extent identical, it is sufficient to state that the provisions would also allow the creation of a *Musharaka* partnership.

However, there is a restriction on the use of the *GbR* in business undertakings: if the company requires a professional structure and organisation due to the size and amount of undertakings, the *GbR* will automatically be converted into an *OHG*.[106]

In diminishing *Musharaka* agreements, too, it depends on whether a business or another asset shall be financed. The proper business form must be chosen accordingly.

As it is often used for home financing in the private market, the form of *GbR* is of more relevance in these contracts.

The subsequent sale of the bank's shares mirrors the ordinary sales contract under German law, '*Kaufvertrag*', regulated in §§ 433 ff. BGB. However, it is fundamental that the bank's share must not be sold in a single contract, but must be divided into several contracts, each at the time due. The right of the bank to re-

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103 *Ingo Koller/Wulf-Henning Roth/Winfried Morck*, Handelsgesetzbuch – Kommentar (5th Ed., Beck-Verlag, München 2007) §§ 128/129-5; *Baumbach/Hopt* (n 70) § 128-1; *Oetker* (n 100) § 128-1.

104 Bürgerliches GesetzBuch = German Civil Code.

105 *Eisenhardt* (n 70) para. 42; *Palandt* (n 61) § 705-20.

106 *Palandt* (n 61) § 705-6.

ceive a share of the profit derives from the co-ownership and the associated risks taken, so that it would be eliminated were the bank's shares to be transferred all at once.

Additionally, the first sales contract may only be concluded after partnership and joint ownership have been established: the bank may only sell the asset after acquiring ownership.[107]

In order to ensure that the customer will indeed purchase the bank's shares, a practice has developed to have him give a binding promise to do so. While the permissibility is disputed amongst Islamic scholars, it can by all means be said that this is a commonly accepted practice. In Germany, the solution would be to enter into a preliminary agreement, a '*Vorvertrag*', with both parties agreeing to undertake the sale of the shares in the future.

The '*Vorvertrag*' contains the obligation for both parties to enter into a main contract at the time stated and can be enforced through litigation. Thus, the bank has the security that the customer will buy its shares and the customer has the security that the bank will not sell them to someone else. However, this '*Vorvertrag*' may not be made a condition for entering into the partnership and should therefore be concluded separately.

2. Mudarabah

Mudarabah could be translated as silent partnership.[108] It is similar to *Musharaka* in so far as the bank and the customer again become partners in a business undertaking.

2.1. Contribution

Unlike in a *Musharaka* partnership, the client, called *Mudarib*, does not provide any funding.[109] Instead, he contributes his expertise, experience and his workforce, which he promises to use to generate a profit.[110] The partner, called *Rabb-ul-Mal*, provides all the finances for the undertaking as an investment. There are basically two situations for such an arrangement. First, the *Mudarib* has some sort of innovative idea that promises to generate profit, but

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107 *El-Gamal* (n 12) 9; *Attia* (n 21) 601.
108 *Ashrati* (n 74) 52.
109 *Chinoy* (n 64) 519; *Chiu/Newberger* (n 64) 10.
110 Ibid.

he lacks the funding. The financier aims to support this innovation and therefore provides the required funds.

Second, the *Mudarib* acts as an investment manager for others, using his professional skills. It depends on the agreement if he is free to transact and invest without any restrictions whatsoever or if the providers of the capital restrict the investment to certain kinds of trading or if they set a time-limit.

2.2. Management

The management fully lies with the *Mudarib*. The financier only acts as an investor and is excluded from all management, so he cannot make any interventions to the routine conduct of business.[111] However, the *Mudarib* does not get 'paid' a periodic salary for his management. Instead he is granted a pre-agreed share of the profit generated through the investment, but will remain with nothing if no profit is generated.[112]

2.3. Profit and loss sharing

Any loss is borne solely by the financier and can only be limited to the capital invested.[113] The *Mudarib* will only have lost his time and workforce.[114] He is liable for no financial loss or mismanagement, except for acting beyond his authority, negligently or through deliberate deeds.[115]

The profit is shared at a pre-agreed ratio between the investor(s) and the *Mudarib*.[116]

As the investors contribute all the capital, the manager will only get a rather small percentage, reflecting the risks taken.

2.4. Decreased Participation Mudarabah

Mainly where a bank finances the establishment of a new business, the agreement will commonly allow the *Mudarib* to gradually buy out the bank's investment and thus, acquire sole ownership of

111 *Chinoy* (n 64) 519.
112 Ibid.
113 Ibid.
114 *Ashrati* (n 74) 53.
115 *Chinoy* (n 64) 519; *Ashrati* (n 74) 53.
116 *Chinoy* (n 64) 519.

the enterprise (Decreased Participation *Mudarabah*).[117] In such a case, it is common to have the profit share of the *Mudarib* go to a separate account, from which it is deducted to pay back the foreign invested capital.[118] Thus, the investor's share decreases constantly until the initial investment has been fully paid back.

2.5. Practical use

In practice, the financial institution usually does not invest its own funds, but acts solely as an intermediary between the investors and the entrepreneur, who will invest the money provided according to his business plan.[119] This arrangement can generally be compared to an investment fund.

2.6. Classification under German law

The classification of *Mudarabah* gives rise to the question if the customer and the bank becoming 'business partners' necessarily means that a 'partnership' is agreed.

2.6.1. Service contracts

As the customer does not contribute anything but his expertise and his workforce, he could simply be a provider under a service contract ('*Dienstleister*').

Under a service contract in German law, the service provider is obliged to perform the service promised and the other party has the obligation to grant the agreed remuneration.[120]

Especially in the case of the *Mudarib* working as an investment manager for a group of investors, it becomes clear that this cannot be a real partnership. Instead the *Mudarib* is a businessman, offering a service – namely the investment of the funds – with the agreed remuneration being a percentage of any profit generated.

Therefore, this undertaking should be treated as a service contract, a '*Dienstvertrag*' (§§ 611 ff. BGB), under German law.

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117 *Wegen/Wichard* (n 75) 827.
118 Ibid.
119 *Ashrati* (n 74) 54f.
120 *Palandt* (n 61) Einf § 611-1.

2.6.2. Limited liability company

Where the financier and the *Mudarib* indeed wish to entertain a joint business, the translation of *Mudarabah* as 'silent partnership' might lead to the wrong conclusions in German law. A '*Stille Gesellschaft*' (engl. = silent partnership) as it is laid out in § 230 HGB requires all ownership to lie with the partner undertaking the business, while in *Mudarabah* the ownership of the capital and all assets acquired thereof remain with the investor.[121]

The solution would be to found a '*Gesellschaft mit begrenzter Haftung (GmbH)*', a limited liability company, regulated in the Limited-Liability-Companies-Act 'GmbHG'.

In this form, it is the company itself that enters into contracts and holds obligations and rights (§ 13 I GmbHG). Any loss and profit goes to the account of the company, all liability is limited to the company's assets (§ 13 II GmbHG).

Pursuant to § 5 GmbHG a minimum of 25.000 EUR nominal capital has to be contributed by the partners upon establishment of the company. The shares in the company are proportional to the initial contribution (§ 14 GmbHG).

There is only one partner necessary to establish a '*GmbH*', so that the bank could found this company alone or together with the *Mudarib*.

In order to comply with the *Mudarabah* requirements, the *Mudarib* would then be hired by the company as its managing director with a share of the profit agreed as payment instead of a fixed salary.

In the case where the *Mudarib* aims to eventually acquire ownership of the whole business himself, he can become a partner of the company for an initial contribution of only 100 EUR as required by law (§ 5 I GmbHG).

As it is permissible to sell shares of a '*GmbH*' (§ 15 I GmbHG), the *Mudarib* can also buy himself into the company any time later and gradually purchase the bank's shares.

A '*GmbH*' is also suitable as a special-purpose-vehicle, whenever the financial institution does not want to enter into a partnership itself, e.g. in order to limit its personal liability.

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121 *Usmani* (n 13) 13.

II. Credit sales arrangements

1. Murabaha

Historically, *Murabaha* is just a form of sale and means 'cost-plus sale'.[122] The seller agrees to provide a certain commodity, adding a profit to his cost.[123]

1.1. Murabaha as a financing method

In financing, the customer usually approaches the bank, asking it to purchase a certain commodity on his behalf and sell it to him at an agreed marked-up price with the payment deferred.[124] *Murabaha* is the financing tool that is closest to the interest-based conventional system as it does not completely deny the time value of money.[125] Still, any further postponement of the agreed repayment for an increase of the price or the instalments would constitute forbidden *Riba*.[126]

1.2. Structure

The structure of *Murabaha* as a financing method is surprisingly complex, as it entails several agreements that need to be concluded on a step-by-step basis.

1.2.1. Exchange of promises

After the customer has approached the financial institution and specified the commodity he would like to purchase, the financier and the customer will exchange promises, i.e. to sell the commodity, respectively to purchase once the bank has acquired it.[127] However, a majority of Islamic scholars is of the opinion that such a promise is not legally binding, but establishes only a moral obligation.[128]

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122 Ibid 37.
123 Ibid.
124 *Julie Patient*, 'Islamic Finance in the UK consumer sector' (JIBLR 2008) 9, 10; LMA (n 25) 4.
125 *Attia* (n 21) 601.
126 *El-Gamal* (n 12) 12.
127 *Chinoy* (n 64) 517; *Attia* (n 21) 601.
128 *Attia* (n 21) 601.

If that were to be true, the bank would have no guarantee that it will actually be able to sell the asset, taking a risk that would not be justifiable from an economic perspective. Hence, a minority of jurists, namely Maliki jurists, have said that a promise shall be considered legally binding, at least if it causes someone to incur at least some liability.[129]

This opinion has been adopted in a *Fatwa* issued by the First Conference on Islamic Banks in Dubai 1979[130] and was later confirmed by the Islamic Fiqh Academy in Jeddah.[131] Nowadays, this solution is common practice in the Islamic finance industry and the client's promise is considered to be binding.[132]

1.2.2. Agency agreement

Although the next step is non-mandatory, it is nonetheless advisable. To ensure that the commodity meets the specifications of the customer, the financier should make him his agent for the first sales contract.[133]

1.2.3. Sale No. 1

Next, the bank will have to purchase the commodity from the supplier. This is an actual sales contract and the financial institution will acquire ownership of the sold item.[134]

1.2.4. Sale No. 2

The next sale is concluded between the financial institution and the client, whereby ownership is transferred immediately and the payment of the marked-up price is agreed to be deferred.[135] Both the first and the second sale are usually concluded together, so

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129 Ibid.
130 Ibid.
131 *Usmani* (n 13) 52.
132 *Attia* (n 21) 601.
133 *Chinoy* (n 76).
134 *Attia* (n 21) 602.
135 *Rodney Wilson*, 'Islamic Investment Products In the United Kingdom' (2009) various publications, here: Institute of Islamic Banking and Insurance <http://www.islamic-banking.com/iarticle_4.aspx>, 17.03.2011.

that ownership only rests with the bank for a few minutes, if not seconds.[136]

1.3. Practical use

In practice, *Murabaha* is used for all kinds of financing, as it has the same effect as an ordinary credit. The only limitation is that exclusively ready assets may be financed through *Murabaha*, as it is a sales agreement and must adhere to the *Shari'a* rules on sales stated above.[137]

The biggest market for *Murabaha* financings in Germany probably lies in ready houses or car purchases. In a survey amongst Muslims in Germany, 60 % said they would be interested in *Shari'a*-compliant real estate financing.[138]

1.4. Classification under German law

Hence, drafting the product appropriately under German law is of special practical importance. The structure should reflect the different steps *Murabaha* is divided into and the different agreements it is subject to. As will be seen, the required agreements are not unfamiliar to German law:

- the exchange of promises could be documented as a '*Vorvertrag*' – a binding preliminary agreement, constituting a contract with the obligation on both sides to enter into a main contract at the time stated.[139] If one of the parties should refuse to do so, this obligation can be enforced through litigation.
- Agency also is a separate agreement, regulated in §§ 164 ff. BGB.
- Last but not least, the sales contracts must be concluded under observance of the provisions of §§ 433 ff. BGB.

Note that under German law, ownership is not transferred through the sales contract, but through a separate agreement. This is of special importance where real estate is sold. The contract requires certification by a notary and the purchase must be entered into the

136 *Attia* (n 21) 602.
137 Ibid 601.
138 *Gajo* (n 8).
139 *Bundesgerichtshof*, Appellate Report 12.05.06, V-ZR-97/05, para. 26.

land register. Only upon entry to the register is ownership transferred. This process may take several days to be concluded.

1.4.1. Alternative structure: contract under a suspensive condition

However, in the light of the dispute over the binding nature of such a preliminary agreement, the above might not be the optimal solution.

As has been shown, the dispute arises over the promise constituting a binding obligation before any other contract is concluded, thus making it a pre-condition for the sale contract between the bank and the original owner.

Hence, drafting the promises as a '*Vorvertrag*' mirrors this disputed arrangement and the parties take immediate contractual obligations. However, while this solution might be acceptable, it is the author's opinion that German law offers another solution that possibly reflects the principles of *Shari'a* better.

Under German law, it is possible to conclude a contract under a suspensive condition (§ 158 BGB), so that the agreement does not have any legal effect before the condition is fulfilled.[140] Only upon fulfilment of the condition does the contract become effective and gives life to the contractual obligations.[141]

Now, if the bank and the customer conclude a contract for the sale of the asset before the bank has purchased it from the original owner, the agreement is generally invalid under *Shari'a* law, because the bank cannot sell something it does not possess. However, the same contract could be concluded under the suspensive condition that the bank acquires ownership of the asset. Legally, this contract does not yet come into force and no contractual obligations are constituted, but for the event that the condition is fulfilled.

This way, the sale contract between the customer and the bank would not be made a precondition for the 'first' sale contract between the bank and the original owner, but the other way around. Only if the bank purchases the asset and acquires ownership does

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140 *Palandt* (n 61) Einf § 158-8.

141 Ibid.

the second contract become effective, constituting the obligations to transfer the property, respectively to pay the purchase price.

Moreover, this construction does not contradict the *Shari'a*-provision that a sales contract must be instant and absolute and may not be based upon conditions or eventualities. This provision merely refers to the case where the parties could conclude an effective contract, but still subject its validity to a condition.

Now in the case at hand, the parties cannot conclude an effective contract yet. In fact *Shari'a* requires the seller to acquire ownership first – the condition the contract has been subjected to. A conflict is therefore not apparent. If a sales contract can only be effective under the condition that the seller owns the asset, then how could a contract placed under this condition be defective?

This solution gives security to the bank that the customer will purchase the commodity and to the customer that the bank cannot sell it to someone else, both under the condition that the bank does indeed acquire ownership. The advantage of its structure lies in the fact that effective contractual obligations are not yet established, unlike in a '*Vorvertrag*', where there already is a contract with the obligation to contract.

However, note that this arrangement will only work where an asset is sold in a single contract. Where there are multiple sales to be concluded over shares, a different event would have to be agreed upon as a condition for every single contract.

Still, a lot of people will say this was the same as a '*Vorvertrag*', a preliminary agreement or a binding promise. Well, it is not. It is true that it has exactly the same effect, but as has been shown, legally there is a difference, even if it is minimal. This is actually what Islamic banking is all about: to find *Shari'a*-compliant alternatives that have the same effect as the conventional products.

1.4.2. Proposed structure

In summary, I therefore propose the following structure under German law.

1. Conclusion of a sales contract under the suspensive condition that the bank does acquire ownership of the specified asset, §§ 433, 158 BGB. The documentation will have to include all details of the second sale and the agreement on deferred payment as this is the final contract.

2. Optional agency agreement according to §§ 164 ff. BGB.
3. Conclusion of a sales contract between the original supplier and the financial institution (represented by the customer), §§ 433 ff. BGB.

2. Ijarah

Ijarah is the Islamic mode of leasing. The lessor grants the lessee the use and usufruct of an asset for a specified period of time for pre-agreed monthly payments. The ownership of the asset stays with the lessor throughout the period of the lease and he has to bear all costs deriving from it, like insurance or necessary maintenance; the lessee bears only the running expenses.[142]

It is not permissible to transfer all payment obligations to the lessee, but there is usually an (agency) agreement that the lessee may act on behalf and at the cost of the lessor.

2.1. Ijarah in financing

As a mode of financing, *Ijarah* can be counted as a medium-term source of finance.[143]

It usually contains an option to purchase the asset throughout or at the end of the lease.[144] Should the lessee decide not to take on this option, the financial institution can either sell the product or enter into a new *Ijarah* contract with the same or a new customer.[145]

However, in financing, the customer will commonly have approached the bank himself, indicating which product to acquire. In addition to this, the instalments and the purchase price are calculated in a way to ensure that the bank gets its initial investment plus a profit. At the end of the lease, the last payment to purchase the asset will merely be symbolic.[146]

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142 *Chinoy* (n 64) 521.
143 Ibid.
144 Ibid.
145 Ibid.
146 Ibid.

If the lessee is given a purchase option to an unspecified date, the purchase price will decline over time in order to reflect the monthly payments made throughout the lease.[147]

2.2. Practical use

In practice, the range of transactions *Ijarah* is used for is basically identical with that of *Murabaha*. The main difference is that in *Ijarah* the ownership of the asset remains with the lessor until full payment has been made.[148] While this might be helpful to secure the transaction,[149] there are some aspects that need to be taken into account. Along with the duties that arise with the ownership of the asset, the lessor also bears the risk of loss or any other reason making its normal use impossible. Plus, the lessee's obligation for payments will automatically end in such a case.[150]

2.2.1. Ijarah wa iqtina

Most transactions will be undertaken in the special mode '*Ijarah wa iqtina'*.

Instead of including an option, the purchase of the asset is made an obligation, with the monthly payments calculated towards the purchase price and ownership transferred automatically upon the last payment.[151]

However, the purchase price will not be any higher than the original price, as the bank generates its profit through the rent being paid. The monthly payment therefore includes two parts: one is for renting the asset and the other part is used to gradually pay back the original purchase price and buy the asset from the bank.[152] The rent is calculated on an annual basis, reflecting how much has already been paid back, and will cover all the bank's costs, including insurance and maintenance plus a profit.[153]

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147 Ibid.
148 *El-Gamal* (n 12) 14.
149 *Wegen/Wichard* (n 75).
150 *Usmani* (n 13) 74.
151 *Chinoy* (n 64) 521.
152 *Wilson* (n 133).
153 Ibid.

An *Ijarah* financing may offer a great deal of flexibility, depending if the customer has an option for prepayment or a fixed duration of the lease and instalments is agreed.[154] In the earlier case, the customer is free to decide if he will increase the monthly payments, thus paying back the bank's initial investment faster.

Prepayment will actually decrease the bank's profit as the rental payments decline faster. Moreover, the period of the lease until full repayment will be shortened. However, this is unlikely to happen, at least not for some time. Financing will have been chosen in the first place, because the customer did not have the necessary funds to purchase the asset himself.

2.2.2. Diminishing Musharaka and Ijarah

Last but not least, there is also the possibility to combine the Islamic products 'diminishing *Musharaka*' and '*Ijarah*' to be used in financing. Under such an agreement, the bank and the customer will acquire joint ownership of the asset.[155] The bank will then rent its share to the customer. However, this share is divided into units which the customer gradually purchases until he is the sole owner.[156] The rent is calculated depending on the size of the share that still belongs to the bank and decreases accordingly.[157] Again, the bank's profit is generated through the rental payments, the purchase price being the same as the original one.

2.3. Classification under German law

Trying to classify *Ijarah* under German law, it must first be noted that there is a difference between 'Miete' (rent) and 'Leasing'. 'Miete' is the standard term to describe contracts where an item is left with the other party for usage over a specified period of time.[158] In a 'Miete'-contract, the lessor bears all the risks of ownership like

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154 Ibid.

155 *Usmani* (n 13) 30.

156 Ibid.

157 Ibid 30f.

158 *Hans Brox/Wolf-Dietrich Walker*, Besonderes Schuldrecht (33rd Ed., Beck-Verlag, München 2008, § 10-2.

loss or damage and it is his duty to maintain the leased/rented asset at his own cost.[159]

In a 'Leasing'-contract, on the other hand, these duties are transferred to the lessee.[160]

This differentiation plays only a small role, as 'leasing' is defined as an atypical mode of 'Miete'[161] and most of the provisions are identical.

Still, as in *Ijarah,* the ownership responsibilities and risks may not be transferred to the lessee. The standard form of contract is 'Miete', regulated in §§ 535 ff. BGB. If the leased asset generates a profit or any other kind of return to be kept by the lessee, the contract will be 'Pacht' (§§ 581 ff. BGB). Again, basically the same provisions apply.

The financing arrangements of *Ijarah* are also common in Germany; the structures are clear and should be easy to draft.

Ijarah wa iqtina is identical to a '*Mietkauf*' (hire purchase), subsequent to the ordinary sales contract in § 433 BGB between the financier and the original seller. The common arrangements of these contracts are basically identical with the regulations set out under *Shari'a* and there are apparently no conflicts.

In the mode of '*diminishing Musharaka* and *Ijarah*', there are two options how it could be drafted under German law. One would be to actually enter into a partnership as indicated by the combination with *Musharaka*. However, if the purpose of the contract is solely to finance the asset for the customer, a partnership would be difficult to establish under German law. A partnership requires that the partners pursue a joint purpose ('*gemeinsamer Zweck*'),[162] while in the case of financing the aims of the parties are connected, yet not the same. It is subject to a case-by-case analysis as to whether there is a joint purpose that would justify a partnership, like purchasing an apartment complex in order to let or resell the individual units, with the agreement that one shall belong to the customer.

159 *Palandt* (n 61) Einf § 535-30.
160 Ibid.
161 *Brox/Walker* (n 156) § 15-10.
162 *Eisenhardt* (n 70) para. 42; *Palandt* (n 61) § 705-21.

Regardless these difficulties, it is not at all necessary to found a partnership in order to acquire joint ownership under German law. The bank and the customer can just purchase the asset together, each contributing as pre-agreed. Following the acquisition of joint ownership – be it within a partnership or not – the parties would have to conclude a '*Mietvertrag*' (lease contract) and several '*Kaufverträge*' (sales contracts) to gradually purchase the bank's shares.

Again, it is necessary to have several sales contracts, as ownership shall be transferred gradually, as otherwise the justification for the rent being paid would vanish. In order to ensure that the parties comply with their obligation to sell and respectively purchase the shares, the parties could conclude binding preliminary agreements ('*Vorverträge*') as set out above. The use of contracts under suspensive conditions would be difficult in this mode, as the condition would have to be connected to certain events.

3. Istisna'

Istisna' is another sales contract under *Shari'a*, which only recently emerged, although the Prophet is actually said to have used it.[163] Notably, it is the only exception to the rule that any product must be in existence before it can be sold[164] and can be described as a deferred delivery and payment arrangement.

In *Istisna'*, the manufacturer agrees to make a certain, specified product. The buyer agrees to pay the purchase price immediately or in instalments as the work progresses.[165]

In return, the purchase price will be lower than the price of a comparable ready product.[166]

3.1. Istisna' in financing

The customer will not always wish to purchase a ready asset, but he might want to have it produced at his own wishes and will require financing accordingly. In that case, the above shown financ-

163 *Grieser* (n 28) 107; *Seniawski* (n 11) 724.
164 *El-Gamal* (n 12) 17.
165 *Hanif* (n 13) 13; *Seniawski* (n 11) 724.
166 *El-Gamal* (n 12) 17.

ing tools for ready assets are not an option, especially with the prohibition to sell something which is not yet in existence.

Several Islamic banks have nevertheless offered *Murabaha* financing or other products commonly used for the purchase of ready assets.[167] Still, it cannot be seen how such an agreement could be *Shari'a*-compliant,[168] which is why these schemes will not be introduced into this paper.

As stated above, *Istisna'* is the only 'exception' allowing to sell something before it comes into existence. It should therefore be obvious that *Istisna'* must be the basis for any financing of assets yet to be produced as it is 'by nature a construction or manufacture sale'.[169]

Accordingly, all arrangements for the financing of future assets require the financial institution to first enter into an *Istisna'* with the original producer of the asset. In a second transaction the bank and the customer then enter into a financing agreement for the purchase of the asset.[170]

3.2. Practical use

In practice, financial institutions offer three different modes of *Istisna'* financing:

- parallel *Istisna'*
- *Istisna'* in combination with *Ijarah* and
- *Istisna'* in combination with diminishing *Musharaka*.

While these products have mainly evolved in house financing, they can be transferred to any situation that involves the production of new assets. Today, *Istisna'* is also used in big industrial projects or products like ships or aircraft.[171]

3.2.1. Parallel Istisna'

The obvious solution is to have two *Istisna'* contracts: one between the original producer and the bank and one between the

167 *Engku Adawiah*, 'Islamic house financing – issues and solutions' JIBLR (2007) 628, 631.
168 *Adawiah* (n 165) 630f.
169 Ibid 633.
170 *Hanif* (n 13) 13.
171 *LMA* (n 25) 9.

bank and the customer. The customer places an order with the bank for the production of an asset with all specifications.[172] If approved, the bank and the customer conclude an *Istisna'* sales contract with the bank promising to produce and deliver the asset. The bank then enters into a second *Istisna'* agreement, placing an order with the developer that mirrors the specifications in the first *Istisna'* contract, hence the term, 'parallel *Istisna'.*[173] The purchase price in the first *Istisna'* will be higher than in the second one and its payment will be deferred, thus generating the bank's profit.

3.2.2. Istisna' in combination with Ijarah

The second product used in practice is *Istisna'* in combination with *Ijarah*. Again, the bank enters into an *Istisna'* contract with the original supplier and places an order according to the specifications of the customer.[174] Upon delivery, the bank enters into an *Ijarah* agreement with the customer, leasing the asset for a pre-agreed rent and with the obligation to purchase.[175]

This arrangement is actually the same as an *Ijarah* financing for a ready asset, only that the bank also undertakes the asset to be produced.

3.2.3. Istisna' and diminishing Musharaka

Last but not least, *Istisna'* can also be combined with diminishing *Musharaka*, equally similar to the arrangement in ready asset financing. The customer and the bank enter into a partnership and jointly place the order under an *Istisna'* agreement with the producer, both contributing to the purchase price as pre-agreed.

Upon completion, it is the normal course of diminishing *Musharaka* as outlined above.

The bank will lease its shares to the customer for monthly rentals. In addition to that the customer undertakes to gradually purchase the bank's shares, until he is the sole owner.[176]

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172 *Adawiah* (n 165) 633.
173 Ibid.
174 Ibid 634.
175 Ibid 634.
176 Ibid 634f.

3.3. Classification under German law

The classification of *Istisna'* and its modes under the German legal system is very unspectacular. *Istisna'* simply matches the standard type contract '*Werkvertrag*' (contract for work and services), §§ 631 ff. BGB.

'Parallel *Istisna'* is basically identical with the German '*Generalunternehmerschaft*', which is mainly used for construction projects of any size. The customer enters into a '*Werkvertrag*' with the '*Generalunternehmer*' (general contractor) who agrees to undertake the construction. The '*Generalunternehmer*' then subcontracts the works to the actual manufactures, also using '*Werkverträge*'. This arrangement can easily be transferred to the case where a financial institution acts as the '*Generalunternehmer*'; however, the bank would be referred to as the '*Generalüberneh-mer*' as it does not undertake any construction work itself.

Similarly easy, *Istisna'* in combination with *Ijarah* under German law involves simply a '*Werkvertrag*' (contract for work and services) between the producer and the bank, followed by a subsequent '*Mietkauf*' (hire purchase) between the bank and the customer. As to the structure of *Istisna'* and diminishing *Musharaka*, it can also be referred to diminishing *Musharaka* and *Ijarah* in the sale of ready assets.

As laid out above, a partnership might be difficult to enter into, but this is not necessarily the case. The bank and the customer simply enter into the '*Werkvertrag*' together and acquire joint ownership upon delivery of the asset. The subsequent contracts would again be a '*Mietvertrag*' plus several '*Kaufverträge*' until the customer acquires full ownership. Nevertheless, it has to be noted that *Istisna'* is one of the most difficult contracts. Extra precaution needs to be taken as many conditions must be fulfilled in order to justify the exceptional sale of something non-existent.[177]

F. General issues

At this point, the reader will probably have realised that there are more issues arising in Islamic banking than simply the question of

177 *El-Gamal* (n 12) 17.

drafting. The bank engages in fields of business that it usually would not under the conventional system. It can be lessor, seller, manufacturer and shareholder in both business and real estate. There are many new obligations and issues like taxation, ownership liabilities and consumer protection that all become part of the bank's responsibilities. These and other general issues arise with and around the engagement in Islamic finance. The following shall provide an overview over the most common ones.

I. Warranties

Many difficulties arise when a bank steps into the relationship between the seller and the buyer as an intermediary.

One is that the bank is a merchant, on the hand causing consumer protection regulations to be applicable between the bank and its private customer and on the other hand limiting its rights in its contractual relationship with the commercial seller.

The bank will try to disclaim or limit any warranties it makes towards the customer, or else refer him to the original supplier. Can the end-user receive the benefit of recourse under the supplier's warranties?[178] As a minimum requirement, the bank will be responsible to act as an intermediary between the customer and the original supplier to ensure that the services under a warranty are provided.[179]

II. Ownership liabilities and insurance

Basically all *Shari'a*-compliant modes of financing require the bank to become the legal owner of the financed asset at some point. The bank is therefore exposed to the liabilities which may be incurred by the owners, such as liability for death, injury, property or environmental damages.[180]

Especially in *Ijarah* financings, the bank holds ownership for a long time, including the obligation to bear all costs deriving from the ownership.[181] As the potential for such liability has to be taken into

178 *LMA* (n 25) 10.
179 *Chinoy* (n 64) 523f.
180 *Chinoy* (n 64) 524; *LMA* (n 25) 10.
181 *Hanif* (n 13) 15.

account, protection through insurance should be considered.[182] However, conventional insurance generally conflicts with the prohibitions of *Gharar* and *Maisir* and is therefore regarded as impermissible.[183] The market for *Shari'a*-compliant insurance (*Takaful*) on the other hand is very small and not easy to obtain.[184]

Still, a financial institution cannot be expected to bear this risk without insurance. As long as *Shari'a*-compliant alternatives are not sufficiently available, the use of conventional insurance is one of the concessions that have to be made. So far, most *Shari'a*-boards have accepted this point of view.

III. Taxation

Under the law of most jurisdictions, duties arise in all commercial transactions, be they between merchants or between a merchant and a consumer. Compared to the conventional system where the bank only acts as an external creditor, there is an additional transaction in Islamic finance because the bank acts as an intermediary. This means that a financing arrangement that is normally taxed once will be taxed twice in Islamic banking.[185]

Additional issues include income and capital gains tax consequences for the financier;[186] however a detailed analysis of these provisions would exceed the scope of this paper and would benefit from future examination by tax lawyers and economists.

All that has to be said at this point is that these issues have already risen in other countries. For example, the UK has reacted by amending its tax laws to erase unjust double taxation for Islamic banking products.[187]

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182 *Chinoy* (n 64) 524.

183 *Hanif* (n 13) 15.

184 Ibid.

185 *Chinoy* (n 64) 524; *Hanif* (n 13) 15.

186 *LMA* (n 25) 10.

187 *Morrison/Foerster*, 'Update on the Development of Islamic Finance in the UK and the Regulation of Alternative Finance Investment Bonds (Sukuk)' *News Bulletin* (17.02.2009) <http://www.mofo.com/news/updates/files/090217IslamicFinance.pdf>, 17.03.2011; *Mushtak Parker*, 'UK promotes City as centre for global finance' *ArabNews* (27.04.2009) <http://www.arabnews.com/>, 17.03.2011.

It is obvious that such amendments will have to be made in Germany, too, if *Shari'a*-compliant and conventional banking shall be able to compete on an equal footing.

IV. Late payment fines

Another problem arises from the fact that *Shari'a* does not allow any charges that would reflect the time value of money: fines for late payments are impermissible. Actually, this is the worst form of *Riba* known in Islamic law, called *Riba al-jahiliyyah*, referring to the original case that an agreed repayment is postponed on the condition that the repayable amount is increased.[188]

However, in order to secure on-time payment by the customer, the opposite arrangement has been subject to discussion: is it allowed to offer a reduction of the repayable amount on the condition of prepayment?

Prepayment of a debt is permissible and does not conflict with any *Shari'a* rules. Still, an 'obligation' of the financier to provide a rebate is commonly considered invalid:[189] The debt would basically be sold to the debtor, thereby trading an amount of money for less than its value.[190] Such has been equally listed as *Riba*, although the prohibition has been relaxed by various judicial bodies in recent years.[191]

The *Shari'a*-compliant solution under the current circumstances is to have any prepayment on face value[192] with any discount on the deferred price remaining at the discretion of the financial institution[193] and only in the form of a forgiven debt.[194]

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188 *El-Gamal* (n 12) 5.
189 *LMA* (n 25) 19.
190 *El-Gamal* (n 12).
191 Ibid.
192 Ibid.
193 *LMA* (n 25) 19.
194 *El-Gamal* (n 12) 5.

V. Calculating the profit – using interest rates as a benchmark

It is common practice for Islamic banks to calculate their desired profit on the basis of the current interest rate, using a benchmark like LIBOR (London-Interbank-Offered-Rate).[195]

Thus, the marked-up price in *Murabaha*, the agreed profit in *Ijarah* and similar payments in Islamic finance will return the same amount of money that would have been generated in an ordinary interest-based credit arrangement.[196] Some Islamic scholars argue this was impermissible, as the entire agreement would be based on this 'interest-based' calculation, nullifying the differentiation to the conventional system.

Regardless of these critiques, this practice continues to be used and there are good reasons to assume that it complies with the principles of *Shari'a*.[197]

An example usually given to support this view is that of two merchants competing in the same business, only that one is offering *halal* products (like *halal* meat), while the other is not.[198] Trying to achieve similar profits and revenues, the offerer of the *halal* products might use the pricing of his competitor as a benchmark – no one would seriously argue that otherwise *halal* products would be rendered *haram* through such a price comparison.

In addition to this, the use of LIBOR as a benchmark is also in the interest of the customer. It gives the opportunity to control if the bank charges excessively over the margin of a comparable conventional product. Therefore, it can certainly be concluded that the use of the interest-rate as a benchmark is a practice that is acceptable under the principles of *Shari'a*.

VI. Shari'a-board supervision

As a matter of fact, all Islamic financial institutions offer the same range of basic products to their customers.[199] However, it is also a matter of fact that those products are not always and not in all de-

195 *LMA* (n 25) 5; *Ashrati* (n 74) 65; *Usmani* (n 13) 48.
196 *El-Gamal* (n 12) 14.
197 *Usmani* (n 13) 48.
198 Ibid.
199 *Karimi* (n 64).

tail the same,[200] due to the different groups of scholars the banks use for approval of their products and transactions. These groups of scholars are usually permanent bodies, called *Shari'a*-boards.[201]

How a *Shari'a*-board interprets provisions of *Shari'a* is mainly dependent on the individual affiliation of its members to one of the 5 major schools of thought in Islamic law.[202]

A *Shari'a*-board should therefore consist of representatives of different schools in order to achieve universally acceptable decisions.[203] Moreover, it must be emphasized that 4 of the major schools already agree in the majority of issues[204] and all Muslim scholars agree that Islam would prefer an equity-based and risk-sharing system to a debt-based one.[205]

The International Monetary Fund (IMF) found in a recent survey that many modern day scholars sit on a number of different *Shari'a*-boards, concluding that this promotes consistency to the interpretation of Islamic provisions and in the development of standards.[206]

However, this situation derives to a large extent from the shortage of qualified scholars, not only in Western but also in Muslim countries.[207]

Nevertheless, some people say that *Shari'a*-boards actually represent a risk factor:[208]

The members are appointed and paid by the banks they are supposed to supervise, in addition to being in an uncontrolled position for insider dealings.[209] It is inevitable that these problems will also arise in Germany.

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200 'Großbritannien testet den Markt für „Islamic Banking"' *FAZ* (Frankfurt 17.08.2004) 16; *Karimi* (n 64).

201 *Hanif* (n 13) 10; *Chinoy* (n 64) 518.

202 *Johnson* (n 44) 156; *LMA* (n 25) 4.

203 *Hanif* (n 13) 11.

204 *LMA* (n 25) 4.

205 *Johnson* (n 44) 156.

206 *Juan Solé (IMF)*, 'Islamic Banking Makes Headway' *IMF Survey Magazine* (19.09.2007) <https://www.imf.org/external/pubs/ft/survey/so/2007/RES0919A.htm>, 17.03.2011.

207 *Hanif* (n 13) 14; *Johnson* (n 44) 157f.

208 *Johnson* (n 44) 156.

209 Ibid.

Germany so far has no experience in Islamic banking and is highly dependent on foreign capacities. Hence, the equipment of a *Shari'a*-board with experienced scholars would be difficult.

However, it has to be noted that it is nowhere written that a bank must entertain a *Shari'a*-board if it wants to engage in Islamic finance, thus no obligation to do so exists. Nevertheless, it is a matter of credibility if a Western bank decides to offer *Shari'a*-compliant products.

Still, if a German bank would decide to engage into Islamic finance today, the establishment of a permanent *Shari'a*-board would not be necessary. For a start, the focus should be on the private banking sector in order to see how the new products are accepted. Of course, the products must be approved by a board of Islamic scholars, but it should be sufficient if standard form contracts were developed and used for certain types of undertakings.

The private customer is unlikely to insist on having his own transaction scrutinised by a *Shari'a*-board, raising the cost and prolonging the procedure. Plus, it is still up to the customer to decide if he regards the measures taken adequate to ensure *Shari'a*-compliance.

Currently, there are enough private *Shari'a*-boards that could be hired and guidelines have been published that have found approval by a broad consensus of *Shari'a* scholars (e.g. the standard principles by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)).

Should the potential in the German market turn out to be as big as assumed, the engagement can still be expanded and a *Shari'a*-board established.

G. Conclusion

The involvement in 'Islamic' banking does not necessarily mean that new products must be developed or new solutions found. Quite often, there are already standard modes of financing in the German banking system that actually are *Shari'a*-compliant. Others can easily be transformed into *Shari'a*-compliant products, by changing or adding a few clauses.

Furthermore, the German legal system provides for enough flexibility to transfer any of the common Islamic banking products into

an agreement that is enforceable in a German court and that still mirrors the *Shari'a* principles set out in the original product.

There is no need to subject any disputes arising under the contract to arbitration, where the outcome would be less predictable.

Therefore, I hope to have demystified Islamic banking and its products to some extent.

Islamic finance has nothing to do with some kind of unpredictable 'divine law'; instead it is about following some really down-to-earth rules when it comes to shaping the products.

However, a lot of the touched aspects are subject to further discussion:

Many areas of law and business have great influence on Islamic banking and it is obvious how much more work and research need to be done. Therefore, this should be regarded as some groundwork done, giving an overview and an introduction on the legal feasibility of offering Islamic banking products in Germany.

Annex – Sources of Shari'a

In its narrowest sense, *Shari'a* means Islamic law.[210] Islam, literally meaning 'submitting to the will of god',[211] provides rules for every aspect of a Muslim's life.[212] Such rules are basically grouped in two commandments: '*ibadat*' ('Love of God')[213], which are acts of worship and '*mu'amalat*' ('Love your Neighbour')[214], which are laws that deal with worldly affairs.

These commandments derive from the four sources of Islamic law that have been agreed upon by all the classical schools of Islamic law.[215] Those are the *Qur'an, Sunnah* (or *Hadith*), *qiyas* and *ijma*.[216]

The *Qur'an* and *Sunnah* are the two primary sources[217] and are referred to as revealed sources as they include the Divine law.[218] Both are textual resources[219] and constitute the fundamental and authentic sources of *Shari'a*.[220]

Ijma and *qiyas* on the other hand are not express sources of law, instead they are referred to as 'unrevealed sources' as they describe the interpretation of *Qur'an* and *Sunnah*.[221] They are rather methodologies that aim at expanding *Shari'a* to adapt to the changing circumstances in society.[222]

One must be aware that *Shari'a* is not a codified law, which leads to various interpretations of its rules and different conclusions as to what the law is.[223]

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210 *Attia* (n 22) 599.
211 *Hamid M. Khan*, "Nothing is written: Fundamentalism, Revivalism, Reformism and the Fate of Islamic Law", 24 Mich. J. Int'l L. 273, 4.
212 *Attia* (n 22).
213 *Feisal Abdul Rau*, "What is Islamic Law?", 57 Mercer L. Rev. 595, 3.
214 *Rau* (n 214) 4.
215 *Rau* (n 214) 6.
216 *Khan* (n 212) 7.
217 *Rau* (n 214) 5.
218 *Attia* (n 22).
219 *Rau* (n 214) 6.
220 *Attia* (n 22).
221 *Attia* (n 22).
222 *Attia* (n 22).
223 *Attia* (n 22) 600.

Thus, both *qiyas* and *ijma* seek to ensure that the expansion of *Shari'a* is carried out with intense deliberation and religious temperance.[224]

1. The Qur'an

The *Qur'an* is believed to be the revealed word of God[225] and therefore the most important source of Islamic law.[226] There are more than 6000 verses in the *Qur'an* of which about ten percent deal with matters of law.[227] Still, as most of these verses are of a general nature, there is a need for the other sources to help clarify the commandments of *Qur'an*.[228]

2. Sunnah

The *Sunnah* (or *Hadith*) is the second source in Islamic law and basically covers everything that is narrated about the life of the Prophet Muhammad.[229] It comprises his acts, his sayings and whatever he has tacitly approved.[230]

The Prophet is considered to have been divinely inspired in all that he said or did[231], so that following the example of the Prophet consequently means to obey the will of God.[232]

The Prophet's commandments to his companions are therefore considered to be equal to God's commandments[233] and compliment the *Qur'an*, where it remains silent.[234]

Thus, the *Sunnah* helps clarify the *Qur'an* and provides further guidance to the community.[235]

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224 *Khan* (n 212) 7.
225 *Attia* (n 22).
226 *Khan* (n 212) 7.
227 *Rau* (n 214) 6.
228 *Attia* (n 22).
229 *Attia* (n 22).
230 *Attia* (n 22).
231 *Attia* (n 22).
232 *Khan* (n 212) 8.
233 *Rau* (n 214) 6.
234 *Khan* (n 212) 8.
235 *Rau* (n 214) 6.

3. Ijma

Ijma can be translated as ‘consensus’ and is the first of the two sources of Islam that are referred to as the ‘unrevealed sources’.[236] It can be described as the consensus of all contemporary jurists of the Muslim community on a matter of *Shari’a*.[237]

Ijma has its religious justification in the saying of the Prophet: ‘My community will never agree on an error’.[238]

In the beginning, it was only the consensus of the first four Caliphs, the successors of the Prophet, which was required, later it was expanded to consensus amongst the companions of the Prophet, while today it requires the consensus of the jurists of a generation.[239]

Any dissenting opinion will preclude *Ijma* and the permanence of the law.[240]

The major effect of the required unanimous decision and the difficulty to reach such is that it leads to the discussion of different opinions, attempting to define *Shari’a*.[241] It has been stated, ‘variance of opinion is not only present in the law, it was, in fact, encouraged.’[242]

4. Qiyas

Qiyas means ‘analogy’ and is the fourth source of Islamic law.[243] It is used to expand the law, where the solution to a new issue cannot be found in the other sources.[244]

Qiyas is not considered to be new law, rather the identification of a divine cause behind a certain rule, which is also relevant to other situations that have not been explicitly addressed.[245]

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236 *Attia* (n 22) 600.
237 *Attia* (n 22) 600.
238 *Khan* (n 212) 10.
239 *Rau* (n 214) 6.
240 *Khan* (n 212) 10; *Attia* (n 22) 600.
241 *Khan* (n 212) 10.
242 *Khan* (n 212) 10.
243 *Rau* (n 214) 6.
244 *Attia* (n 22) 600.
245 *Khan* (n 212) 9.

The most prominent example is probably the prohibition of the consumption of alcohol:

While the relevant part of the *Qur'an* only speaks of wine not to be consumed, it was found to be clear that the reason for this law was its intoxicating effect. It has therefore been established by analogy that the consumption of all alcohol is prohibited.

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Institut für Rechtspolitik an der Universität Trier,
Im Treff 24, 54296 Trier, Tel. +49 (0)651 / 201-3443
Homepage: http://www.irp.uni-trier.de,
Kontakt: sekretariat@irp.uni-trier.de.

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