Some Recurring *Shari'ah* Violations In The Islamic Investment Agreements Used By International Banking Institutions

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A. Introduction:

The volume of Islamic Finance carried-out by conventional banks is growing every day. Unfortunately Sharia supervision on the practice of Islamic banking by these banks is inadequate. This is because Sharia experts who are well versed in English and equally knowledgeable in banking and law are quite rare. It is because of this when one violation occurs in a transaction and passes the attention of the *Shari'ah* supervisory, it keeps recurring. Many banks just copy the format of agreements used by others, assuming that the *Shari'ah* aspects of which had been adequately attended to by the previous user. Many Western law offices try to fill this *Shari'ah* expertise gap. However, only few lawyers were able to actually appreciate the intricate differences between *Shari'ah* and Western legal system beyond knowing the general principles.

The area where most recurring violations take place in the Islamic investment agreements used by international banking institutions is that of conditions in contracts. The subject of conditions in exchange contracts is a very profound area of Sharia

jurisprudence. Conditions in contracts, though left to the mutual agreement and consent of the parties, Nevertheless *Shari'ah* has its own rules and requirements in such conditions.

Firstly; no condition is allowed if it causes the contract to change in nature. In such cases the parties must follow the rules and requirements of the *de facto* contract not the declared one. For example, if it is a condition in a *Mudarabah* contract that the *mudarib* guarantees capital to rub-al-mal, then the *de facto* contract is loan not Mudarabah and hence parties must follow the *Shari'ah* rules for lending, namely no benefit should accrue to the provider of capital.

Secondly, *Shari'ah* is very keen on maintaining just exchange. Therefore, contracts must not be used as means for one party taking advantage of the other. Hence *Shari'ah* acceptable contracts are not manipulative. It is not permitted to include in a contract conditions that are not germane to the transaction involved.

Thirdly, it is a Shari'ah rule that exchange contract should always be separated. Merging two contracts together may cause

both to be void. One, therefore, has to be careful Vs conditions that may in effect be a contract within a contract. For example, if one sells an item to another with a condition that he lends him money, then both contracts are void, though if separated, both are valid and correct.

Fourthly, conditions that though in the contract elements such as uncertainty or ambiguity may not be permitted. For example, price in exchange contract should be specified and known to both party at the time of contract. If this is not satisfied the contract may be void.

B. The Indemnity Clause

Indemnity is a standard clause that appears in most trade and commercial agreements, particularly ones done internationally. Since an indemnity clause will usually have no mention of interest, it was assumed (or so it appears) that including such a clause in an Islamic banking agreement is permissible. Unfortunately the wording of most of the indemnity clauses seen by the writer actually renders these agreements void from *Shari'ah* point of view. Most of the confusion, I believe emanates from mixing up of indemnity and guarantee. In this part I will start by defining the

indemnity clause and the difference between indemnity and guarantee. Then examples of the indemnity clause will be presented. Thirdly, the Sharia aspects will be put forward.

B-1. Meaning of Indemnity:

An indemnity is different from guarantee in that the obligation of the guarantor in a contract of guarantee has the same content as that of the principal debtor. In an indemnity, such undertaking is independent, in its content and enforceability from the terms and volatility of that given by the debtor. For example if A says to B : supply goods to C and if he didn't pay you, I will. This would be a contract of guarantee. But if A says to B supply goods to C and I will see to it that you receive the price, then this is an indemnity.

An indemnity may involve one party in a contract indemnifying the other in respect of the others liability to that first party. It could also involve an insurance like arrangement where one party is indemnifying the other party to a contract in respect to the latter's liability to a third party arising from that contract.

Both indemnity and guarantee are a form of security. The reason for both is to give the other party protection against certain perils and liabilities. Nevertheless, indemnity is different from guarantee. A guarantee is provided by a party (Guarantor) against something the ownership of the other party on which (beneficiary) has already been established by the contract and hence it becomes a defined obligation on the other party. For example A sells his car to B on differed payment. The price becomes an obligation against which B will provide a guarantee from a third party or a collateral of sort. However, Indemnity is a form of insurance, the purpose of which is to make sure certain position is protected from the effect of outside variables that may impinge on the final outcome. In our previous example, if B protected A against the fall in the purchasing power of the sale price, this then is a form of indemnity.

B-2. Examples of indemnity clauses found in some Islamic banking agreements:

The first example is from a *Murabaha* agreement where the bank is selling equipment on a differed payment to a client in another country. The bank (creditor) wants the client (debtor)

not only to guarantee the prompt payment of amounts due, but also to indemnify against a number of possible obligations that may fall on the bank. It reads:

" 9.4 *If, by reason of (i) any change after the date hereof in any law or in its interpretation or administration and /or (ii) compliance with any request from or requirement of any central bank or other fiscal, monetary or other authority made after the date hereof (including, without limitation, a request or requirement which affects the manner in which the seller allocates capital resources to its obligations hereunder):*

(a) the seller incurs a cost as a result of its having entered into and/or performing its obligations under this agreement, any Purchase Agreement or any Supply Contract and/or assuming or maintaining a commitment under this agreement;

(b) the seller is unable to obtain the rate of return on its overall capital which it would have been able to obtain but for its having entered into and/or performing its obligations and/or assuming or maintaining a commitment under this agreement, any purchase agreement or any supply contract; or

(c) the seller becomes liable to make any payment on account of tax or otherwise not being a tax imposed on its overall net income) on or calculated by reference to the amount of its commitment or payments under this Agreement, any Purchase Agreement or any Supply Contract and/or by reference to any some received or receivable by it hereunder or thereunder, then the purchaser shall, from time to time and no later then twenty-one (21) days following demand therefore by the seller, pay to the seller amounts sufficient to indemnify the seller against (1) such cost, (2) such reduction in

> *such rate of return (or such proportion of such reduction as is, in the opinion of the seller, attributable to its obligations hereunder) or (3) such liability."*

The second example is also from a *Murabaha* agreement. It reads:

> *" The purchaser shall indemnify and hold [the Bank] the Collection Agent, their directors, officers, employees and agents harmless on an after tax basis from and against all expenses, claims, actions, liabilities, costs and proceedings which [the Bank], the Collection Agent or their directors, officers, employees or agents may incur, or which may arise, directly or indirectly, out or in connection with this agreement, each Contract of Purchase, holding or disposal of any Supplies or otherwise howsoever in connection with this Agreement ".*

It is quite apparent that the bank, in these two agreements, not only desires to assure the full payment of the amounts due by the

buyer of these equipments, rather wants to make sure that recovering its investment and return will be assured regardless of what happens.

B-3. Indemnity from *Shari'ah* Perspective

Indemnity, in its worst case, boils down to making one party liable for things that are neither under his influence or control, nor are related to the transaction itself. Such conditions are in clear violation of *Shari'ah* rules and they render the contract in the writer's opinion, void from *Shari'ah* point of view. However, not every indemnity clause is forbidden in *Shari'ah*. Infact, *Shari'ah* allows for certain indemnities. In the classical *Shari'ah* law books one finds what is called *"Daman Al-derak"*.

B-4. Why the indemnity clause:

From the stand point of law, the parties involved in a contract don't only create rights and obligations through the contractual relationship, but they also allocate between themselves, the risk of possible contingencies. They agree beforehand to allocate all or some of the loss. It is quite apparent that such allocation can only be done with a legal

framework that allows assignment of risk for monetary compensation. Within a legal system that allows such transfer, an indemnity clause of this nature creates no problem. This is because the parties could have entered in a separate contract designed solely for the transfer of risk for a price. However, such contractual relationship is doubtful from Shari'ah point of view. It doesn't make it any more permissible if was stated as a condition in a Murabaha contract than an autonomous contract.

C. Floating rate leases:

In conventional leases rental rates may be fixed, but they can also be variable by way of indexing the rental payments. In this case lease rates will be adjusted as an independent variable changes.

In most cases, these payments are related to LIBOR or a similar variable. This becomes especially necessary in contracts that are 5 years or longer, as the need of matching assets and liabilities for the lessor becomes a critical one. Unfortunately,

indexing rental rates to LIBOR is quite prevalent, even in agreement that are called Islamic.

An example from an actual "*Islamic*" lease agreement reads as follows:

> *"Profit: Three (3) months US $ LIBOR for the relevant lease period plus a margin of 5% per annum".*

Another example:

> *"Monthly rental payments will be made on an annual adjustable basis through the life of the lease payment will calculated according to floating SIBOR + 3%.."*

Lease is, from *Shari'ah* point of view, a sale contract. The sold object is the usufruct of the leased assets. Price is the periodical payment. Like any other exchange contract in *Shari'ah*, the price must be known at the time of contracting with any uncertainty or vagnenen. If such requirement is not satisfied, the

contract is null and void. Indexing the lease contract to LIBOR means that rental rates can only be known in the future as LIBOR itself is unknown. This is not permitted in *Shari'ah*.

C-1. <u>Hell or High Water clause:</u>

Conventional lease contracts often include what is known as Hell or High Water clause. Under such clause, the lessee is obliged to pay the full rental payments regardless of any event effecting the leased equipment. This provision provides assurance to the lessor that the lease payments will be made unconditionally.

An example from an actual *"Islamic"* lease agreement reads as follows:

> *"This Lease Agreement will provide for a "net" lease whereby all risks and costs of ownership, maintenance, insurance, repair and operation will be borne by the lessee"*.

As we mentioned earlier, the lease in *Shari'ah*, is a sale contract, where the sold items are the usufructs of an asset that will

survive the term of the contract. The lessor deserves his compensation, (i.e. The lease payments) only if such usufructs can be extracted in the same level contemplated by the contract. Hence, if the leased equipment is damaged to the degree that such usufructs are no longer generated, lessor is not entitled to rents. Clearly if the damage is caused by negligence or misuse of lessee, he is liable for such damages.

Furthermore, lease contract is based on trust. The lessee is entrusted with the leased assets which remain in his custody. Hence, the lessee can't be held liable except when it is proven that he failed to live up to expectation of honesty or that he breached the trust.

Therefore a condition of such description is not permitted from *Shari'ah* point of view. The problem becomes particularly acute in the case of full payment lease contract where the whole relationship then ceases to be lessor-lessee and becomes lender-borrower.