

## The Total Returns Swap and the "Shariah Conversion Technology" Stratagem

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### Summary

This study will look at Islamic values in financial decision-making by considering whether or not Shariah Supervisory Boards will approve any financial product that is delivered by ostensibly halal means, even if what is delivered by those means, the end product, is derived from non-compliant investments. This may be characterized as a quasi-philosophical question about means and ends. Yet, it is one that carries a myriad of practical implications and far-reaching ramifications for the growing Islamic financial industry.

This is a case study, and not a theoretical study. The focus of the study is a particular means or process for the development of products sometimes called "Shariah Conversion Technology". The reason for writing this paper is to draw the attention of scholars and industry experts to the importance of making a distinction between bringing returns from Shariah-compliant investments and bringing returns from non-Shariah compliant investments. If care is not taken, this "technology" represents a great danger to modern Islamic Finance. My own reaction to this threat, initially, was to suggest recourse to *sadd al-dhara'i*, the instrument in Islamic jurisprudence that blocks ostensibly legitimate means to illegitimate ends. On closer study, however, I have concluded that there is no need to resort to this instrument as the matter is simply one of distinguishing between what is truly lawful, halal, and what is truly unlawful, haram. In what follows, I will explain exactly what led me to this conclusion, and why I think it necessary to share my thoughts on the matter.

To date, I have shared this paper with only a handful of scholars and colleagues. In the coming months, however, Islamic banks and investment houses will look closely at products based on the "Shariah Conversion Technology" stratagem, and Shariah boards will be asked to deliberate and opine on the compliance of such products with the rules of the Shariah. My intention in circulating this paper is to contribute to a wider and more comprehensive understanding of this particular stratagem. At a time when Shariah scholars are increasingly being asked to opine on new and exotic products, I believe that due consideration must be given to not only the literal structure of products and processes, but also to their consequences for the future of Islamic Finance.<sup>1</sup> In other words, while up until now the Shariah supervisory boards of modern Islamic financial institutions have focused almost exclusively on the rules for transacting in compliance with the Shariah, it is now time for them to focus as well on the higher purposes of Islamic law or the *maqasid al-Shari'ah*.

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<sup>1</sup> In an article entitled "The Black Box Syndrome" which I wrote for the April 2007 issue of *Islamic Finance*, I wrote: "I would like to see more faith in what true and diligent Shariah compliance actually means to our industry. I am dismayed by quick fixes and shortcuts which in many cases circumvent the Shariah. The industry has proved time and again that adherence to the principles of Shariah can be profitable, and that such adherence does not spell hardship. We have no need of "black boxes" and of arm's length transactions that miraculously produce results by sacrificing the spirit of the Shariah to the letter of the law."

## Introduction

Recently, a financial stratagem known as "Shariah Conversion Technology" was developed, the purpose of which is to affect a total returns swap or to "Wrap a non-Shariah compliant underlying into a Shariah compliant structure."<sup>2</sup> In other words, the objective of the mechanism is to use non-compliant assets and their performance to bring returns into a so-called Shariah-compliant investment or investment portfolio. This point is key to the entire transaction, and for that reason it needs repeating. What the product proposes to accomplish is to bring to the Islamic investor returns from investments that are not compliant with Shariah principles and precepts. The questions that such a product immediately bring to mind are: How can Shariah boards approve such returns? Does the circumstance of direct or indirect delivery to the Islamic investor change the ruling? When the Shariah of Islam is understood to differ from other legal systems because it may be characterized as both positive law and morality<sup>3</sup>, is it possible to ignore the moral aspect of a financial transaction like this?

The means of delivery, a *wa'd* or promise, is widely seen to comply with Shariah norms. Since it is compliant, at least to the letter of the law,<sup>4</sup> some Shariah scholars have approved products that use a *wa'd* to deliver returns from non-compliant investments. By doing so, however, they have failed to consider the purpose of the transaction, they have failed to consider the movement of the cash and, most importantly, they have failed to consider the ramifications for the industry as a whole. At a very fundamental level, the reason for these failings is that they have not discerned the difference between the use of LIBOR as a benchmark for pricing and the use of non-Shariah compliant assets as a determinant for returns. In June of this year, 2007, a pioneering Islamic bank in the Gulf launched a principal protected note that was the first product using this "Shariah Conversion Technology" to be offered to the investing public. This was followed by another such product, also offered by a Gulf-based Islamic bank. Prior to this, the stratagem was used in structured products offered by multinational banks to institutional investors and the treasuries of Islamic banks and finance houses. All of these products have been approved and certified by Shariah supervisory boards. Not all of these products, however, bring to the Islamic investor returns from investments that are compliant with Shariah.

## A Few Explanations

Before examining the "Shariah Conversion Technology" stratagem from an Islamic legal perspective, however, it may be helpful to make a few preliminary remarks.

1. There should be no reason to object to the use of a *wa'd* on its own. The use of promises is a matter that the Shariah boards of modern Islamic financial institutions have studied in detail.<sup>5</sup> Therefore, it will not be necessary to discuss the definition of a promise, its purpose, or its legal characterization (in terms of *wajib*, *makruh*, etc.).

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<sup>2</sup> Quoted from a term sheet presented to the author by a multinational bank seeking approval for a structured product based on this stratagem. YTD.

<sup>3</sup> For a discussion of how the classical jurists of Islam assumed the role of "moralists-cum-jurists" within Muslim society, see Bernard Weiss, *The Spirit of Islamic Law* (Athens and London: The University of Georgia Press, 1998) pp.165-166.

<sup>4</sup> "...for the jurists, letter and spirit can never be in genuine conflict if by "letter" one means the clear, unambiguous pronouncements of the authoritative texts and if by "spirit" one means a divinely ordained principle derivable from those same texts." Weiss, op. cit., p.169.

2. The financial instrument that the *wa'd* structure seeks to facilitate is called a swap. Swaps are arrangements between counterparties to exchange cash flows over time, and they are very flexible. In conventional finance, the most popular forms of swaps are interest-rate swaps and currency swaps because these allow for the effective management of both balance sheets and risk profiles. In an interest rate swap, for example, no principal is exchanged between the counterparties; only interest is exchanged. The utility of a swap comes from the ease with which it is initiated and completed, as opposed to the numerous steps required to accomplish the same thing by other means.

3. LIBOR (the London Interbank Offered Rate) is the rate at which international banks charge one another for dollar denominated-loans in the London market and is therefore used widely as a reference for any floating-rate loan. Depending on the credit rating of the borrower, that rate may vary from LIBOR to LIBOR plus one or more points over LIBOR.

Before discussing the purpose of the "Shariah Conversion Technology" stratagem, the movement of the cash and, most importantly, the ramifications for the industry as a whole, it will be well to look at (1) how the "Shariah Conversion Technology" stratagem is actually employed, and then (2) at the difference between the use of LIBOR as a benchmark for pricing and the use of non-Shariah-compliant assets as a determinant for returns.

### **"Shariah Conversion Technology" Stratagem**

The stratagem developed for the exchange of non-Shariah-compliant returns for Shariah-compliant returns generally begins with the purchase by the Islamic investor of Shariah-compliant assets by means of a Shariah-compliant contract such as a salam sale or a murabahah. In most cases, the subject of these transactions will be commodities or base metals. Through such contracts, the bank can offer apparent Shariah compliance and nominal fixed returns of, say, 4-5%. Then, to give the investor the ability to enhance the returns from the investment, the bank arranges to swap the returns from the Shariah-compliant transaction with returns from another investment. The way it does this is by means of a promise, a *wa'd*. Effectively, what the promise says is that at maturity, or at the end of a certain period of time (generally three to five years) the counterparties promise to swap their returns.<sup>6</sup> The bank can then take the further step of protecting the principal invested by the Islamic investor by one means or another.<sup>7</sup>

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<sup>5</sup> The modified form of the classical murabahah sale has been the mainstay of Islamic banking for the past twenty or more years, accounting for as much as 70% of all Shariah-compliant transactions (until about five years ago). The modern version of the murabahah includes a promise on the part of the client ordering the purchase, al-Amir bi'l-Shira', that it will repurchase the goods acquired by the bank on its behalf. From a modern business perspective, it is essential for the bank that such a promise be considered binding. Thus, while the notion that a promise is binding was a minority opinion in the classical jurisprudence, modern Shariah boards have almost unanimously held the promise to be binding. Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (London: Graham & Trotman, 1995) pp. 51-54.

<sup>6</sup> The promise may also include a condition. For example, if the returns from the other basket of assets are greater than the returns from the salam or the murabahah, then the parties promise to swap.

<sup>7</sup> Such principal protected products are similar in design to conventional capital guaranteed products with the obvious difference that to be Shariah compliant the capital must remain at risk. Using structured products, banks can "protect" the capital without actually guaranteeing its return. Such

The benefits to the Islamic investor are obvious; the principal is protected, the returns will almost certainly be at least 4-5% (from the Shariah-compliant investment), and there is a strong likelihood that the assets in the other basket will outperform the Shariah compliant investment. The benefits to the bank may not be quite so obvious, but in fact they are far greater than the benefits to the Islamic investors as we shall see later in this paper when we "follow the money".

Most importantly, however, the Islamic investor is told that the investment is completely Shariah-compliant. This is because the money invested has been used for nothing other than the purchase of Shariah-compliant commodities by means of a Shariah-compliant contract like a salam sale. The return on the investment, if it comes from the salam sale, is clearly compliant with Shariah principles and precepts. And if the return comes from the other investment, by means of the stratagem employing a promise to exchange returns, those returns, so says the bank, may be considered legitimate, halal, even if the investment is non-Shariah-compliant. According to the Shariah boards that have approved such exchanges, the non-Shariah-compliant assets have been used to establish a price; and the promised exchange is for the value of the returns established by the performance of the non-Shariah-compliant assets. This, they reason, is no different than using LIBOR, an interest rate,<sup>8</sup> to establish the price for a murabahah or an ijarah. If the use of LIBOR has been nearly universally approved by Shariah boards, then the swap achieved by a promise, the "Shariah Conversion Technology" stratagem should also be approved.

### **LIBOR and How Returns are Determined**

Let us now consider the difference between the use of LIBOR as a benchmark for returns and the use of non-Shariah-compliant assets as a determinant for returns. Shariah boards have approved any number of less than ideal devices if they have been convinced that these will assist in promoting the industry in general. A good example is the use of LIBOR as a benchmark for pricing a murabahah or an ijarah when floating rates are to be preferred over fixed rates. In the absence of a viable and widely-published alternative, LIBOR has been used repeatedly; and will likely continue to be used until the industry can develop and then agree upon a benchmark, or a set of benchmarks, based on criteria of its own, i.e., Shariah-compliant criteria. In the final analysis, a benchmark is no more than a standard, and therefore non-objectionable from a Shariah perspective. If it is used to determine the rate of repayment on a loan, then it is the interest-bearing loan that will be haram. LIBOR, as a mere benchmark, has no direct effect on the actual transaction or, more specifically, with the creation of revenues.

In modern Islamic financial transactions, LIBOR has been used to facilitate the closing of literally hundreds, if not thousands, of Shariah compliant financings. It should be noted, however, that these do not involve interest. As explained above, LIBOR is merely a convenient and highly transparent measure of the financial

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products have been on the market for a number of years and have won the approval of many Shariah boards. Generally speaking, principal protection employs either options or dynamic allocations among baskets of assets with varying degrees of risk.

<sup>8</sup> LIBOR is the London Inter-Bank Offered Rate or the rate of interest at which banks in London offer to lend funds to other banks in London.

markets. Most importantly, the use of LIBOR as a benchmark for pricing in no way means that interest has entered the transaction itself. This is because LIBOR is a notional rate. The bank loans that determine this rate will under no circumstances become a part of the Shariah-compliant *ijarah* or *murabahah* transaction that is benchmarked to LIBOR. Finally, the money paid into an *ijarah* investment using LIBOR will never pass through to the banks whose rates contribute to the setting of LIBOR, and will certainly never finance, directly or indirectly, assets whose performance or credit rating will set that rate.

When a Muslim investor invests in a product that uses a promise to swap returns from a non-Shariah-compliant investment, however, the matter is quite different. For, while LIBOR is a benchmark used to set a price by marking value, the *wa'd* is used to actually deliver that price, even if it does so synthetically. By means of the "Shariah Conversion Technology" stratagem, the unwitting Muslim investor actually participates in the non-Shariah-compliant investment, however indirectly. This is because, when the investor agrees to exchange *murabahah* returns for returns from another investment, the investor indicates *qubul* or approval of the other investment. If that investment includes non-compliant assets and instruments, like conventional bonds or treasury bills, then the investor is approving the same and the transaction must be considered unlawful. Finally, and perhaps most significantly, the money paid into an investment employing the "Shariah Conversion Technology" stratagem will most certainly be used to finance the other investment(s), however indirectly. Therefore, even if the Muslim investor is not directly financing non-Shariah-compliant transactions, if the investment with the swap had not been made, those non-Shariah-compliant transactions would not have taken place. This will be clarified later when we consider how the cash in such a transaction actually moves.

The attempt to draw a legal analogy, *qiyas*, between the use of LIBOR for pricing and the use of the performance of non-Shariah-compliant assets for pricing is both inaccurate and misleading. The only similarity is that both are used for pricing. Where LIBOR is used to indicate the return, however, the other is used to deliver the return or, as we shall see, the other is the return. Therefore, it is simply incorrect to justify the swap of returns from non-Shariah-compliant assets by comparing the same to LIBOR and then saying that since the one is approved by Shariah supervisory boards, the other should also be approved.

### **The Purpose of the Transaction**

The purpose of the transaction was clarified by a spokesperson for the bank offering the product to the public who explained that it was designed to allow Muslim investors access to funds that operate in a non-Shariah compliant manner by "reflecting their performance." The euphemistic description of what the product aims to achieve, like the simplistic explanation of how the money in the investment remains exclusively in compliance with Shariah rules, is in my opinion a manipulation and, ultimately, a misrepresentation of the truth. The term sheet for one such product states unequivocally that its purpose is to "wrap a non-Shariah compliant underlying (asset) into a Shariah compliant structure." Nothing could be clearer. When this is the purpose, how can a Shariah board possibly approve? Does it matter if the structure and the transactional basis of these schemes are compliant with established Shariah rules if the end product is the result of prohibited investments? Does it really matter if that result is direct or indirect if the returns are from

investments that do not discriminate between right and wrong, halal and haram, good and harmful? What the public is invited to invest in is a basket that will "reflect" returns from anything from wineries, to pork futures, to casinos, to who knows what else? At the present time, the matter is in the hands of the investors, many of whom are institutional investors with their own Shariah Supervisory Boards; and it is still unclear as to how those boards will decide to view the matter. In my opinion, there can be only one response; and that is to reject the "Shariah Conversion Technology" stratagem and the investment products based on this stratagem.

### **The Movement of the Cash**

Before the reader begins to suppose that this discussion is more about *taqwa* and less about fatwa, or morality rather than law, let us now consider the movement of the cash. The Islamic bank that offers this product insists that the Muslim investor's money is invested in a Shariah-compliant product and that the returns are completely halal.<sup>9</sup> Their claim is that the investor's money is used to purchase a principal protected note, structured by a multinational bank, which invests in simple salam or murabahah contracts. The contract for the note includes an agreement, no more than a promise actually (sometimes termed "a purchase undertaking"), that if the returns from the salam are less than the returns from a particular index, or grouping of funds, then the structuring bank will pay the investor an amount equal to the returns from the index, or group of funds. To be more precise, if the non-Shariah compliant index or funds outperform the salam investment, the investor will earn returns that are better than the salam returns. Since the bank will pay investors with its own money,<sup>10</sup> the investors will not receive returns directly from the conventional index or group of funds (funds which may be using strategies that are non-Shariah-compliant, investing in stocks that have never been screened, and selling securities that they borrowed but never owned, to say nothing of investing in interest-bearing bonds, futures, or any of a host of derivative instruments). In fact, the Islamic bank is happy to point out that it is not investing in any of these prohibited things! And, technically, the bank may be right. However, as we shall see, the matter is not this simple.

When the Islamic Bank takes in the investor's money, what actually happens? Let's imagine that the investor, say an Islamic pension fund, places 100 million dollars in this product. The first thing that happens is that the Islamic Bank passes the money to the structuring bank. That bank will do two things. Firstly, it will invest 100 million, after deducting some fees for management, into salam or murabahah contracts. Then, using the salam as collateral, it will make a loan to an asset managing bank, one with a prime brokerage of its own that works with hundreds of different fund managers. The asset managing bank will then allocate that money to a selected group of fund managers. In the absence of any mandate to transact in compliance with Shariah, the asset managing bank will choose managers and strategies solely on the basis of performance; and from a risk perspective, this means that the bank will seek to

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<sup>9</sup> It is interesting to see that the Prospectus for one such product clearly states the following: "Security holders will have no individual or collective recourse to the Islamic Investment Account at any time." It also states that, "... payments to Security holders in respect of the Securities (subject to and in accordance with the Product Conditions herein) will be made irrespective of the *Shari'a* compliance or otherwise of the Islamic Investment Account and the Securities at any time."

<sup>10</sup> The Islamic bank's Shariah board was careful to point out, quite correctly, that it is generally of no consequence to the Islamic investor where the bank's money comes from. This, however, is not the issue here.

diversify its allocations. Of course, what this means is that some of the money allocated will certainly go to bonds, treasuries, debt instruments, and derivatives like futures, options, and swaps. Also, the loan made by the structuring bank to the asset managing bank will be made for interest at the same rate as the salam. In this manner, the asset managing bank suffers no gap between the salam swap rate and its borrowing costs. In the middle of the transaction, the structuring bank is fully secured for its loan because the rates for the salam and the loan are matched. This means that the structuring bank, likewise, takes no risk. The structuring bank will also earn fees for the notes it has structured for the Islamic bank.

The investor's money, that of the client of the Islamic bank, is placed in a Salam investment. By means of a note provided by the structuring bank, the investor's principal is protected as well. The client pays fees for both of these. Some fees go directly to the Islamic bank, others go to the structuring bank, to the asset managing bank, and to the managers of the various funds. In this transaction, the greater part of the returns are shared by the funds, the asset managing bank, and the structuring bank. The Islamic bank's earnings are significantly less than all these. The reason for detailing the money trail here is to point out how the investor's money, even though it remains in salam contracts, is actually put to work in ways that are clearly not in compliance with Shariah rules.

It may be argued that this will happen anyway; that it happens whenever an Islamic bank or institution has dealings with a conventional bank. This may be so. Ultimately, what the conventional bank does with its money, when it becomes the bank's money, is its own business. But the transaction we are considering here has direct, predictable and immediate consequences. In other words, the Islamic client's investment in this product triggers a series of transactions, none of which is Shariah-compliant. Moreover, these produce fees and earnings for other than the Shariah investor. Can the Shariah board of the Islamic bank ignore all of this, and approve the entire transaction because the first link in the series is basically a salam or a murabahah? Or is the Shariah board compelled to consider the transaction in its entirety?

Consider the parties to this series. There is an investor, an Islamic bank, a structuring bank, an asset managing bank, and a number of fund managers. Then consider how the money passes from one to the other, all the way to the fund managers. And then consider then how it passes all the way back. With each pass, more fees are added to the transaction. Consider also how the Islamic investor's money is the beginning point for the entire transaction. Without this initial investment, none of the rest will take place, no one will earn fees. It is this initial investment which ensures the participation of the structuring bank, the asset managing bank, and the fund managers because it is the initial transaction, the simple salam, which effectively creates and guarantees the capital. The irony is that no one, other than perhaps the unwitting Islamic investor, considers this transaction to be only a principal-protected note with a murabahah and a promise. On the contrary, this is a highly complex and profitable transaction involving several different parties at many different levels. In short, it is a golden opportunity for the banks because the money is virtually guaranteed and their risk is next to nothing. In short, the Muslim investor is assured that the investment product is Shariah compliant because the "Shariah Conversion Technology" stratagem, which involves a promise, apparently ensures that the Muslim investor's money never goes directly into anything prohibited. So, the Muslim investors' money may not be

invested directly into the part of this transactional series that is actually performing and earning returns. Instead, a mechanism is required to bring the returns from that product to the Muslim investor indirectly. It is also clear, however, that an asset managing bank would not be allocating money to managers unless that money came from somewhere. Between the Muslim investor and the fund manager there may be an indirect link, but the cause and effect relationship is nonetheless present. In a very real sense, the promise to exchange the returns from the non-compliant funds establishes a direct link between those funds and the investor. It also identifies the series as a single transaction. As such, then, it cannot be ignored by the Shariah board. The Shariah board must consider every step in the transactional series; and when this is done, the Shariah board must reject the product.

### **Ramifications for the Industry**

When a Shariah Board gives consideration to only one part of the transactional series, it is only natural that it should fail to consider the consequences of the product for the industry as a whole. It is an unfortunate shortcoming on the part of the Shariah board in this transaction that it has failed to consider the context of the offering. It is an even greater shortcoming when it fails to consider the consequences the product will have for the entire industry. When it is clear that a product cannot be offered in its own form or, in other words, when it cannot be offered directly, but must be offered by means of a stratagem that is basically a derivative like a swap, red warning flags should go up. In such situations, the Shariah Board must pay careful attention to the circumstances of the offering. If the circumstances can be found to justify such a product, then it may be possible to grant approval. If not, however, approval must be withheld. In the case of promised returns from a referenced basket of assets, the assets must be Shariah compliant in order for the returns to be Shariah compliant. It really cannot be otherwise.

If consideration is not given to the underlying assets, or to the assets referenced by the swap mechanism, it could spell the end of the need for authentic Islamic products, services, and methodologies. Why should a bank bother to spend the extra time and money required to make a securitization into a Sukuk? For less money and in less time, it can simply offer conventional bonds and then use the "mechanism" to match performance, appear to sanitize the money, and satisfy the investor that the investment is halal and lawful. If such a mechanism is available at lower costs, then why license an Islamic index for Shariah compliant stocks? Why use mutual funds that follow guidelines laid down by Shariah Supervisory Boards? Why bother with all the complex structuring and documentation that go into Shariah compliant real estate deals? Or infrastructure projects? Or private equity? Or home finance? Why expend the resources required to develop new and innovative Islamic financial products and tools? The "Shariah Conversion Technology" stratagem makes all of that unnecessary. At a very fundamental level, however, this mechanism seeks to make the haram halal. This is the nature of the threat to our industry. The fatwa giving blanket approval for this misguided stratagem may well be referred to as the Doomsday fatwa for Islamic Finance.

If the product described in this paper is successful, managers of all manner of funds, not just hedge funds, will never be motivated to do what is necessary to manage and invest in ways that comply with Shariah. But then why should they, if all they need to do is agree to swap returns? Asset managers can continue as before, buying and

selling interest-bearing bonds, debt-based derivatives, pork futures, bank, casino and brewery stocks. They can trade these however they wish, even by borrowing stocks and then selling them into the market without ever owning them, or by leveraging them and incurring interest on the leverage! In other words, Islamic investors will not know what managers are doing because an Islamic bank and its Shariah board have assured them that by means of a special "technology" their money will remain separated and pure.

### ***Sadd al-Dhara`i*: Blocking Ostensibly Legitimate Means to Illegitimate Ends**

When I first became acquainted with the details of the "Shariah Conversion Technology" stratagem (last year, when I was invited to approve it by a huge multinational bank), I had thought that the best way to combat it was to have resort to *sadd al-dhara`i*, the legal device from our classical jurisprudence that blocks ostensibly legitimate means when these are employed for illegitimate ends. In other words, in the same way that the digging of a well in the middle of a road may be declared unlawful for the reason that it may lead to great inconveniences and economic losses by those who travel the road, I thought that this mechanism might be declared unlawful by Shariah boards for the reason that its use may lead to prohibited investments. So, while a promise to exchange returns may be lawful, if the returns promised have been earned by illegitimate means (by funds that invest in Treasury futures, for example), then that promise may be declared unlawful as it has become a means, an ostensibly legitimate means, for illegitimate ends.

I am now convinced, however, that this transaction is prohibited outright; and that the application of *sadd al-dhara`i* in this instance is unwarranted. This is because of a subtle point of law regarding the application of when it is possible to resort to *sadd al-dhara`i*. The classical jurists have stated that whatever leads to involvement in the unlawful will either lead to the unlawful as a certainty or lead to the unlawful as a possibility. This product includes investments, even though they are entered into indirectly, that are clearly unlawful. Moreover, there is no doubt whatsoever that the transactional series leads inevitably, and repeatedly, to what is unlawful. That being the case, that what leads to involvement in the unlawful does so as a certainty and not as a mere possibility, then *sadd al-dhara`i* is inapplicable. There is no need to resort to *sadd al-dhara`i* because the transaction is clearly unlawful.

I quote, in what follows, from *al-Bahr al-Muhit, Kitab al-Adillah al-Mukhtalif fiha* by Badr al-Din al-Zarkashi, on the subject of *Sadd al-Dhara`i*: Blocking Ostensibly Legitimate Means to Illegitimate Ends.

Know that whatever leads to involvement in the unlawful will either lead to the unlawful as a certainty or lead to the unlawful as a possibility.

The first of these two (that it will certainly lead to commission of the unlawful) is not to be discussed under this heading. Instead the proper place for its discussion is under the heading of "That Which there is No Way to Escape the Unlawful Except by Avoiding It" The commission of such an act (whatever will certainly lead to involvement in the unlawful) is unlawful for the reason that whatever is required to ensure the performance of a required act is itself required. (And here the required act is that one avoid what is

unlawful; and what is required to ensure that it is avoided is avoidance of the act that will certainly lead to it.)<sup>11</sup>

To clarify this point, the stratagem we are discussing leads, without a doubt, to the unlawful. Obviously, if fund managers are given no guidelines to follow for Shariah compliance, they will surely make investments that are not Shariah compliant, they will surely manage their cash in ways that are not Shariah compliant, and they will surely transact in ways that are not Shariah compliant. The statements given to the press by the Islamic bank offering this product admit as much. This being the case, that the product leads surely to the unlawful, there is no need to resort to *sadd al-dhara`i* to prevent the proliferation of the product because the product is already unlawful, owing to its leading directly and without doubt to what is unlawful.

If there were some doubt about this, such that the product's leading to the unlawful was only a possibility, whether likely or unlikely, a strong possibility or a slight possibility, then recourse might be had by the jurists to the device known as *sadd al-dhara`i*. When the assets referenced by the "Shariah Conversion Technology" stratagem are known to be unlawful, however, the transaction is unlawful and there is no need for recourse to any legal device for its prohibition. This being the case, there is also no need to discuss the opinions of the various classical scholars in regard to *sadd al-dhara`i* and its use.

It is an established principle of Islamic Law that whatever is required to ensure the performance of a required act is itself required (ما لا يتم الواجب إلا به فهو واجب). When the avoidance of the unlawful is a requirement, if there is an act that will surely lead to the unlawful, then the avoidance of that act too is a requirement. It is for this reason that it is essential, *wajib*, to avoid or to reject, the stratagem and the product. This is because the stratagem is what allows the asset manager to deploy money gathered through this transaction, however indirectly, in funds that operate in ways that are non-compliant with Shariah, and that invest in businesses that are non-compliant with Shariah, ignoring all guidelines for Islamic investing that have been developed at great expense by businesses that respect the Muslim investor's need to transact and to invest only in ways that accord with the principles and precepts of the Shariah.

## Conclusion

As jurists, Shariah scholars are trained to look at texts and at classical models, especially in regard to transactions. If a question of law is not answered directly in the texts, jurists are trained to seek indirect answers, often by drawing parallels from the body of accumulated jurisprudence, or through recourse to legal maxims and principles. Then, while Islamic law may be characterized as both a moral and a legal system, the jurisprudence that has developed around modern trade and commerce relies almost exclusively on derived legal considerations; even if these may be characterized as legal means to moral ends.<sup>12</sup> Thus, it is difficult to suppose that

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<sup>11</sup> The author continues, "The second of these two, that it will possibly lead to commission of the unlawful, may be a likely possibility or an unlikely possibility, or a possibility in which both (likely and unlikely) are equal. Such a possibility may be termed "means," or *dhara`i*."

<sup>12</sup> Indeed, while the prohibition of *riba* may be characterized as a moral prohibition, the prohibition itself is a legal matter. Once the prohibition is incorporated into law, all *riba*-related issues become subject to legal classification and the element of morality is marginalized.

jurists will make decisions on the basis of purely moral or *maqasid*-related<sup>13</sup> considerations.

From a practical perspective, the best way to deal with this question may be to refer it to the Shariah Council of the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), the standard setting body for the entire industry. Since the stratagem that drives the product is based on a promise, or *wa`d*, which has applications in many modern financial instruments including the modern *murabahah*, AAOIFI might be requested to promulgate a standard dealing with every aspect of the *wa`d* and its uses.

The cynical stratagem described above presents Muslim jurists with a real challenge. If investor confidence is to be maintained, the industry must demonstrate its ability to regulate itself and insist upon the Islamic authenticity of all that it does, or allows to be done in its name. In the past few years, modern Islamic finance has proved itself to be viable, innovative, and profitable. The question it faces now is whether it can prove that it is moral and responsible.

والله تعالى أعلم، وهو ولي التوفيق والسداد...

### **Glossary of Arabic Terms**

*fatwa*: an opinion on matters of Islamic law, often employed by modern Islamic banks as formal certification for a financial product or service.

*halal*: lawful

*haram*: unlawful

*ijarah*: lease

*murabahah*: mark up sale on deferred payments

*qiyas*: legal reasoning

*sadd al-dhara`i*: blocking ostensibly legitimate means to illegitimate ends

*salam* sale: A forward sale of fungibles in which advance payment in full is made in return for a deferred delivery of specified goods.

Shariah: Islamic law

*sukuk*: Shariah-compliant securities

*taqwa*: one's being heedful of the Almighty

*wa`d*: promise

*wajib*: necessary, a legal characterization that performance of an act is necessary.

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<sup>13</sup> What I mean by *maqasid*-related are considerations having to do with the higher purposes of Islamic law, especially those related to the equitable distribution of wealth, the development of institutions, and the betterment of individuals and society. YTD.