Michał Kłaczyński, LL.M. (Harvard)

ISLAMIC FINANCE - PRINCIPLES

Profit at any cost

- Pillsbury v. Honeywell (Minnesota Supreme Court, 1971)
- Facts: Pillsbury (investor) requires access to list of stockholders and corporate records on weapons and munitions manufacture (civilians in Vietnam suffer from certain Honeywell products), so he can challenge the company business practice through general meeting of shareholders. Honeywell denies access to such data.
- Court decision: access rightfully denied, because the investor did not demonstrate any economic interest in stopping Honeywell from producing weapons.
- <u>*"His sole purpose was to persuade the company to adopt his social and political concerns, irrespective of any economic benefit to himself or Honeywell.*</u> This purpose on the part of one buying into the corporation does not entitle the petitioner to inspect Honeywell's books and records."

Prohibited investments

- Excerpt from a side letter to a Partnership Agreement for a major U.S. private equity fund (number of Middle East investors)
- *The Investor has advised the General Partner that the Investor's internal rules and regulations require it to refrain from investing in companies whose principal field of activity is: (i) production or sale of pork products or alcohol fit for human consumption, (ii) operating gambling establishments, (iii) manufacturing gambling machines, (iv) producing weapons or armaments, and/or (v) pornography*
- *The General Partner agrees that if the Partnership makes such a Prohibited Investment, the Investor shall be excused from its obligations under the Partnership Agreement with respect to the Prohibited Investment and the Investor shall be deemed to have a Permitted Excuse under Section [•] of the Partnership Agreement with respect to the Prohibited Investment.*

Legal framework

- Shariah is the core framework for Islamic finance.
- A set of rules and laws governing economic, social, political, and cultural aspects of Islamic societies.
- Originates from the rules dictated by the Quran, and explanations rendered by the Prophet Muhammad with further elaboration of the rules by scholars in Islamic jurisprudence.

Legal framework

- One of the world's main legal traditions
- Distinct schools of Islamic jurisprudence
- Equity and fairness
- Less formal court proceedings
- Not uniform - civil law jurisdictions (e.g., Turkey, Egypt, Lebanon) and common law jurisdictions (Malaysia, India, Pakistan)
- Focused mainly on family law, criminal law
- Islamic finance is the field most recognizable by the Western business people and lawyers

Major concepts: riba & halal

- ***Prohibition of usury -*** charging of interest (RIBA) is forbidden.
  - Basic concept of fairness: fixed interest rate in loans will usually lead to an unfair result (for the borrower in case of excessive interest rate, the rate or for the lender, if the rate is modest, but borrower makes high profit).
- ***Permissible activities –*** if a certain activity is forbidden in Islam, it is not permissible to be involved in economic transactions supporting such activity.
  - Prohibition of financing forbidden activities includes extending loans to, or investing in companies engaged in such activities.
  - Any economic activity is permissible unless explicitly prohibited by Sharia (i.e., the Quran and the Sunna)

Basic principles of Islamic finance

- Prohibition of interest
- Risk sharing
- Money as „potential" capital
- Prohibition of speculative behavior
- Sanctity of contracts
- Shariah-approved activities

Prohibition of interest

- Riba (literally "excess") is interpreted as "any unjustifiable increase of capital whether in loans or sales"
- Riba covers any fixed, predetermined interest tied to the maturity and the amount of principal (i.e., guaranteed regardless of the performance of the investment)
- The general consensus among Islamic scholars is that riba covers not only usury but simply the charging any "interest"
- This prohibition is based on arguments of social justice, equality, and property rights:
  - Islam encourages profits – creation wealth and distributing it among partners of a business venture (profits are determined ex post);
  - Interest, however is a cost irrespective of the outcome of a venture (profit/loss); thus interest (determined ex ante) may lead to one party benefit and loss of the other;
  - Fairness demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy represents the true productivity.

Risk sharing

- Since interest is prohibited, suppliers of funds become investors instead of creditors.
- The provider of financial capital and the entrepreneur share business risks in return for shares of the profits.

Potential v. actual capital

- Unless money is used together with other resources to undertake a productive activity it is treated as “potential” capital.
- Islamic law recognizes the time value of money, but only when it acts as capital, not when it is “potential” capital.

Prohibition of speculation

- Islamic law discourages excessive hoarding and prohibits transactions featuring extreme uncertainties (gharar) and risks.
- Disclosure of information and clarity as to contractual obligations are necessary.

Sanctity of contracts

- Islam treats contractual obligations and the disclosure of information as a duty.
- This feature of Islamic law is intended to reduce the risk of asymmetric information and moral hazard.

Shariah-approved activities

- Only such business activities that do not violate the rules of Shariah qualify for investment.
- For example - investments and benefiting from businesses dealing with alcohol, tobacco, weapons, pornography, gambling are prohibited.
- Usually such businesses are legal in Western countries, but are criticized on social policy and ethical grounds.

Michał Kłaczyński, LL.M.

Educated in the U.S. (Harvard) and Poland (**Jagiellonian).** Experience includes investments and commercial projects in CEE, Central Asia, Middle East, USA and in China. Cooperates with a private equity fund and an international law firm. Previously with a leading U.S. law firm in Boston and Warsaw offices. Teaches part-time at the **Warsaw School of Economics** (Poland) and the **University of Technology and Management** in Lahore (Pakistan).

Comments & questions:
mklaczynski@post.harvard.edu