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Currency Exchange, Its *Illah* and Implications

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Abstract

Foreign exchange is among the most important transactions in any economy. It can affect positively or negatively the relative price of domestic and foreign goods, which in turn has an effect on the country's economic growth, employment rate, inflation and balance of payments, among others. Yet, foreign exchange has remained a contentious issue among Muslim jurists and scholars. There are those who approve spot transactions but regard forward transactions as unlawful. Conversely, some scholars and jurists do not see any problem with the forward transactions if they are used for hedging purposes. In the context of the contemporary business environment, this contention requires pertinent research in need of revisiting the *illah* (effective cause/reason) for determining whether a given foreign exchange transaction is *Shari'ah* compliant. The present study has critically reviewed the major literature and *fatwas* issued in relation to foreign exchange. It has adopted content analysis to categorize these various views on the subject and preponderated the major ones relevant to modern business. The authors have concluded that the only possible *illah* to be considered for modern paper money is a *thummuniyah* (means of payment). The study concludes with recommendations and suggestions for future research.

Keywords: Currency exchange, *Illah*, Spot exchange, Forward contracts

1. Introduction

Foreign exchange is among the most important transactions in any economy. It can affect positively or negatively the relative price of domestic and foreign goods, which in turn has an effect on the country's economic growth, employment rate, inflation and balance of payments, among others. For example, speculation in foreign exchange or currency trading as witnessed in the 1997 Asian financial crisis had adversely affected the economies of the region and later spilled over to other parts of the world.

Yet, foreign exchange has remained a contentious issue among Muslim jurists and scholars. As it is a known fact that there are scholars who approve spot transactions and yet regard forward transactions as unlawful. Conversely, some other scholars do not see any difficulty with forward transactions if they are used for hedging purposes. This paper focuses on the major issues in foreign exchange from *Shari'ah* perspective. At the centre of these controversies is the issue of *illah* (causes or reasons) upon which a currency exchange is deemed *Shari'ah* compliant. The views that are appropriate to the development of modern *Shari'ah* businesses shall be preponderated. The paper is divided into five sections. The immediate section that follows provides an overview of foreign exchange from *Shari'ah* perspective. Section three discusses the *illah* for currency exchange. The implications of *illah* on spot, forward, futures and option contracts are discussed in section four. Some concluding remarks are provided in section five.

2. Overview of Foreign Exchange from *Shari'ah* Perspective

Foreign exchange or FOREX in short is the conversion of one country's currency into that of another. Historically, Muslim scholars have extensively discussed issues related to currency exchange. Responding to the rapid changes of financial markets periodically results in a number of debates and various *fatwa* (juristic opinions) among scholars. Shedding light on various opinions of contemporary Muslim scholars, and resolutions derived from many discussions on the subject matter will help in understanding the issues involved in contemporary currency exchange contracts. It will also help to comprehend the extent to which any particular exchange transaction complies with *Shari'ah* principles.

Currency exchange has existed since time immemorial although the types of money have varied. During the advent of Islam, Prophet Muhammad (peace and blessings be upon him) commanded Muslims to follow certain rules and principles when dealing with exchange contracts, which may involve currencies like gold and silver, or other commodities. The Prophet's command was reported in the following hadith (narration). The Prophet (peace and blessings be upon him) said:

> *"While exchanging gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, exchange like for like (in equal measure) and exchange on the spot. Whosoever paid more than what he received or demanded more than what he gave, verily he has dealt in riba. Both the payee and the receiver are equal in violating the Law of Allah"* (Muslim).

The majority of Islamic scholars consider any currency exchange transaction, whether it involves gold, silver or any monetary unit, to be governed by the rules of *bai' al-Sarf* (currency exchange trading contract). It is a *bai'* because it involves an exchange of *mal* with *mal*. In principle, the exchange of currency must follow the principles of hand-to-hand and in equal amounts in the case of homogenous currency, and only hand-to-hand in the case of different currencies being exchanged. The reason behind this principle is that in *bai' al-Sarf*. In currency exchange, Islam does not allow people to profit from using the currency they have received by taking advantage of the possession before giving in return for its counter value (Faruq and Hassan, n.d). This opinion is in line with the *fatwa* issued by the OIC Fiqh Council in its 11th session (14-19th, 1998), which states:

> *"It is not permissible in Shari'ah to sell currencies by deferred sale, and it is not permissible, still to fix a date for exchanging them. This is evidenced in the Qur'an, Sunnah and Ijma'".*

Violating this ruling would enable someone to indulge in *riba al-nasi'ah*, which is prohibited in Islam.

The currency exchange transactions during the time of the Prophet (peace and blessings be upon him) were basic forms. Over the years, the structure and transactions of currency exchange have transformed and today they have become more sophisticated, standardized and tradable. Due to globalization and liberalization, currency exchange transactions, which were previously conducted face-to-face, are now extended to transactions between companies and among nations involving large volumes of trade through other modern means. For example, according to Bank for International Settlement (BIS), average daily turnover in global foreign exchange was estimated at USD 3.98 trillion, as of April 2007 and almost USD 3.21 trillion from that amount is accounted for in the world's main financial markets (BIS, 2010). Foreign exchange markets provide the mechanism of exchanging currencies of different countries. This is crucial for international trade and other financing facilities all over the world. Needless to say, foreign exchange rates have been fluctuating. The market players are exposed to the risk of exchange rate movements. Their assets, liabilities or cash flows, which are denominated in foreign exchange, may change in value instantly due to this fluctuation. As a result, these market players turn to various types of hedging products or derivatives that are available at their disposal to mitigate this risk. These products are offered in the forms of foreign currency forward, futures, options and swaps, among others. The authors will discuss the implications of *illah* in currency exchange *illah* in section four. But firstly, the subsequent section will discuss the *illah* of currency exchange.

3. *Illah* (Effective Cause/Reason) for Currency Exchange

Illah is literally defined as illness, sickness or reason. For example, in the case of a sick man, it is assumed that the health condition of the man has changed due to the sickness that has afflicted his body. In other words, the sickness is the reason for the change in his health condition (Al-Shawkani, 1994). Technically, *illah* has several meanings. The majority of scholars however refer to it as an apparent and constant attribute that provides a suitable base for deriving Shari'ah ruling (Abu Zaharah, 2003). It is an apparent attribute since it is normally difficult to determine something concealed or hidden, such as intentions. Hence in commercial contracts, the expressed offer and acceptance becomes one of reasons for making the contract valid. Furthermore, the constant attribute of *illah* means it does not change with circumstances and does not vary from one individual to the other. For example, for a traveller (*musafir*) the *illah* for granting him prayer concession is the journey (*safar*) itself. Consequently, it does not matter whether the traveller is young or old, healthy or sick, travelling by car or on foot. So long as he or she is on a journey, he or she is entitled to the concession. On the other hand, there are some scholars who subscribe to the opinion that concealed or hidden attributes can also be the bases for *illah*. For example, Al-Razi (1979), opined that wisdom (*hikmah),* which is something internal and concealed is a permissible basis for deriving a *Shari'ah* ruling. Meanwhile, al-Ghazali (n.d.) was of the opinion that there can be more than one *illah* in a given situation as a basis for a *Shari'ah* ruling. Imam Al-Ghazali, one of the prominent Shafi'i scholar cites an example of a person who spoiled his ablution by touching his wife and urinating at the same time, in which case the *illah* for spoiling his ablution in this situation is more than one, which is touching and urinating, though either one would have been a sufficient evidence for *hukm* (*Shari'ah* ruling) to invalidate his ablution.

For the past several decades *illah* has been at the centre of conceptual variation among the opinions of Muslim scholars on the issues of money. One of the main issues is whether money should be treated as a commodity on which *riba* is not applicable or as gold and silver, which are *ribawi* commodities. There is no consensus among the scholars with regard to the *illah* for money. Some past scholars attributed the *illah* of currency exchange to weight and genus, and others regard the *illah* as the *thumuniyah* of the currency.

The Hanafis and one opinion among the Hanbalis argue that the *illah* for money is related to weight and measures when the commodities exchanged are of the same genus (*jins*). This applies in cases of measurable commodities like wheat for wheat in which there can be no excess in equivalent values because they belong to the same genus (*jins*) and moreover the exchange involves measurement. The exchange must also be done on the spot. Therefore, gold for gold or silver for silver can be exchanged but with the same weight and on the spot. In other words, in this transaction three elements should be observed: genus, weight and time. However, it is permissible for the weight to differ if the commodities being exchanged belong to two different geneses such as gold and silver, as long as they are exchanged on the spot. But when it comes to the case of gold *dinar* and silver *dirham* the *illah* here is about the unity of the genus (*jins*) and their weight. In summary, if none of the aforementioned elements (genus and weight) exists as *illah* then the exchange can be completed with or without excess, on the spot or on deferred payment. In other words this transaction does not involve *riba*. Accordingly, there are some scholars, such as Shaikh Tantawi and few others who exempt paper money from the aforementioned *illah* on the ground that the *illah* is restricted to gold *dinar* and silver *dirham*. And since paper money cannot be weight and does not contain gold it should not be considered as *ribawi* commodity.

On the other hand, according to Malikis and Shafi'is the *illah* in gold *dinar* and silver *dirham* is *thamaniyyah*. Besides it is also narrated from Imam Malik that if a piece of leather is used as money then it should be considered equivalent to gold *dinar* or silver *dirham* because of similarity in usage. Consequently, when this type of money is exchanged, the two contracting parties should be aware that they are dealing with a ribawi item similar to gold and silver. In contrast, some of Malikis and Shafi'is scholars support the views of Hanafis and Hanbalis schools that the Illah of money is confined only to gold and silver and cannot be generalized. This latter opinion would exclude most modern currencies that are neither gold nor silver (such as paper and electronic monies) from ribawi items due to the absence of *illah*, namely the genus, weight, measurement.

The *illah* for currency exchange has also remained contentious among contemporary Muslim scholars. At the centre of these contentions is the concept of money; whether modern forms of money should be equated with gold and silver, whether money is a commodity or medium of exchange, whether it is a public or private good and whether it is subjected to the ruling of *bai' al-Sarf*.

There are contemporary scholars (Kahf, 1994) who disagree with those who view money as a commodity. Money is not a commodity with inherent value, but rather a measure of value and a vehicle for acquiring tangible assets. Thus from an Islamic perspective, treating money as a commodity alters its basic purpose. Thus, Khaf does not view *fiat* money as a commodity and hence its exchange must be on the spot in the contract session. Ayub (2007) shares the same view. He says that currency exchange involving gold, silver or any other monetary unit are subject to the rules of *bai' al-Sarf*, which must be exchanged equal for equal and hand in hand in the case of homogenous currency, and hand to hand in the case of different currency. He cites Sheikh M. Taqi Usmani who affirms the view that money is not a commodity but a measure of value or medium of exchange. Usmani's view is supported by Toutounchian (2006), who argues that money should be allowed to perform its universal function as the "medium of exchange". He views money as a public good. Otherwise, if it is a private good then why do central banks in all countries take responsibility for both its quantity and management? Why is it not left up to the private sector to handle it? Furthermore, why is it then that money appears as a liability on all central bank balance sheets? (The learned scholar may not be aware that the US Federal Reserve is privatized). Other proponents of this view, for instance, Faruq and Hassan (n.d) opine that money has no intrinsic utility and therefore cannot be utilized to directly fulfill human needs as a commodity does. Moreover, money is liquid; virtually with no carrying or production costs involved. It has no substitute. They also pointed out that money in Islam, in contrast to the conventional system, is not viewed as a commodity since it does not, by itself, have any function. It is just a means of exchange and becomes useful only when it is exchanged for assets or used to buy services. Therefore, money cannot be bought or sold on credit. Thus, exchanging money for money does not create value added to the existing wealth unless it is used as a medium of exchange to generate new wealth. For this reason, Islam condemns speculative practices in the present conventional financial and foreign exchange transactions, which creates unnecessary risk (*gharar*) that results in the redistribution of the existing wealth rather than creating a new one. A major cause for the recent 2008 global financial crisis can be attributed to such speculative practices, which are against the teachings of the *Shari'ah*.

Meanwhile, there are some scholars who view the *fiat* money as commodity but see no similarity between it and the gold *dinar* or silver *dirham*. For example, Obaidullah (1999) argues that any contemporary currency should not be considered as gold and silver that were present during the time of the Prophet (peace and blessings be upon him). Rather, they should be seen as commodities upon which *riba* is not applicable. Furthermore, he stated that selling and buying of *fiat* money for other *fiat* money with deferred delivery is acceptable in Shari'ah because this money is not made of gold and silver, which are subject to the rules of *bai' al-Sarf*. Another scholar, Al-Sa'di (2003) strongly believes that *fiat* money cannot be compared with the gold *dinar* and silver *dirham* but can be compared with *fals* (money made of copper and usually mixed with other minerals like silver). He argues that the concept of Riba is not applicable on *fiat* money, which can be sold with deferred payment with differences. Ayub (2007) has gone further than Al-Sa'di in his argument asserting that *fiat* money can be compared not only with *fals* but even with any ordinary commodity and can be used in *salam* contract as well in which you pay one currency now and collect a bigger sum in different currency with deferred payment. These latter opinions have been criticized by several scholars.

3.1 Fatwas of *Shari'ah* Scholars on Paper Money

Pursuant to the different opinions of contemporary Muslim scholars on the *illah* of *riba* in paper money deliberated upon above, this section discusses Fatwas of contemporary Shari'ah scholars on the same issue. Fatwa is an Arabic word, which refers to a juristic ruling concerning Islamic law issued by an Islamic scholar. Fatwas generally contain the details of the scholar's reasoning, typically in response to a particular case, and are considered binding precedent by those Muslims who have bounded themselves to that scholar, including future Muslim scholars.

Wasil (2000), the former Mufti of Egypt, analyzed the opinions of eight scholars together with their arguments on the subject and arrived at several important conclusions. Firstly, the majority of the eight scholars extended by Analogy (Qiyas) the *illah* of the four consumable *ribawi* commodities (wheat, barley, dates and salt) mentioned in the famous Hadith to other commodities such as rice and sugar. These scholars, however, limited the Illah of Gold and Silver to the intrinsic value of the two commodities as the only measures acceptable, valid and legal for any other things. Furthermore, they said that if money were made of something with a value more than gold and silver it would still not have the same *illah* of the two metals. On the other hand, Wasil (2000) notes that none of the reliable books of all the Fiqh schools mentioned anything about the contemporary paper money textually or by analogy simply because paper money was not circulation at that time. However, Wasil (2000) believes that today's paper money should be considered legal, customarily acceptable and recognized as a ribawi commodity by analogy. Wasil's legal opinion on paper money is supported by the *fatwa* of senior Saudi scholars (2002). The majority of these scholars conclude that paper money without any doubt is a *ribawi* commodity. This is based on the fact that paper money is commonly accepted as medium of exchange and unit of account for goods. Therefore, all the rulings on gold and silver are applicable to paper money. Accordingly, in selling, buying, exchanging and lending, elements of riba on paper money must be avoided. Moreover, those whose wealth in paper money reached the *nisab* of gold or silver must pay *zakat*. Another scholar, Al-Salus (2004) who is also the deputy Head of the Assembly of Muslim Jurists in America provides a Fatwa that paper money should be treated as a *ribawi* commodity. Saudi Committee of scientific research and issuing *fatwas* (Abd Al-Razak, 2003) was asked whether *riba* could occur in the exchange of Turkish *lira* and Saudi *riyal* made of copper. The committee issued a *fatwa* that does not differentiate between the two forms of money or any other currencies as long as they were used as medium of exchange. The *fatwa* also affirmed that the rulings applicable to *ribawi* commodities such as gold and silver are applicable to these types of money as well. Ibn Uthaimin and Abdullah bin Jibrin (2006) were asked whether *riba* might occur when exchanging coins for paper money of the same currency with difference, for example nine Saudi *riyals* (coins) for ten Saudi *riyals* (paper money). They both said that they do not see any problem with such exchange as long as it was done hand-to-hand. They based their *fatwa* on the tradition of the Prophet (peace and blessings be upon him), which says: "if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand" (Muslim).

The opinion of Ibn Uthaimin and Abdullah bin Jibrin (2006) is very strange simply because even if particular coins differ from paper money in terms of their essence (the material they are made of) they still represent the same value and are both considered as equal money. For example RM 1 in coins is equivalent to RM 1 of paper money. Both currencies have the same purchasing power and any exchange between them must be done in accordance with the rules of Sarf. Perhaps the reason that made these two scholars to consider unequal exchange between coins and paper money of the same currency as permissible is because they belong to two different *jins*. However, it is well known fact that these scholars firmly regard both paper money and coins as *ribawi* commodities. For example, they do not allow Muslims to work in conventional banks because transactions in these banks are based on Riba. This inadvertently confirms that they consider paper money as a ribawi commodity. Hence, the exchange of nine Saudi *riyals* (coins) for ten Saudi *riyals* (paper money) constitutes *riba*.

There are variations in the opinions of several scholars and *fatawa* of many Sheikhs regarding the *illah* of paper money. Some are of the view that the Illah of intrinsic value is not present in paper money and therefore it should be considered just like a commodity. Other scholars consider the medium of exchange as the *illah* in paper money and thus any exchange involving paper money for paper money should typically follow the rules of Sarf. These variations of scholarly opinions raise several pertinent questions. Are the *ilal* (plural of *illah*), which have been extensively discussed by scholars over time, conclusive, or can they be expanded or even altered in the light of new developments? Are there evidences from the *Qur'an* and the *Sunnah*, which have clearly stated the *illah* for monies such as gold *dinar*, silver *dirham*, copper *fulus* and paper money, or must the *illah* be determined through *ijtihad*? It is well known that these *illal* have been derived through the *ijtihad* of previous *ulama* (scholars). It should be stated here that many contemporary researchers, unfortunately translated the concept of *thumuniyah* as "intrinsic value". That is why, their conclusion with regards the *illah* of paper money found to be inaccurate. Therefore, the important point we are stressing here is that the *illah* should be properly understood. Figure 1 below presents the rule of thumb that shows the relationships between currency exchange, *ilal*, kinds of currencies, types of exchange, time of exchange and the rulings.

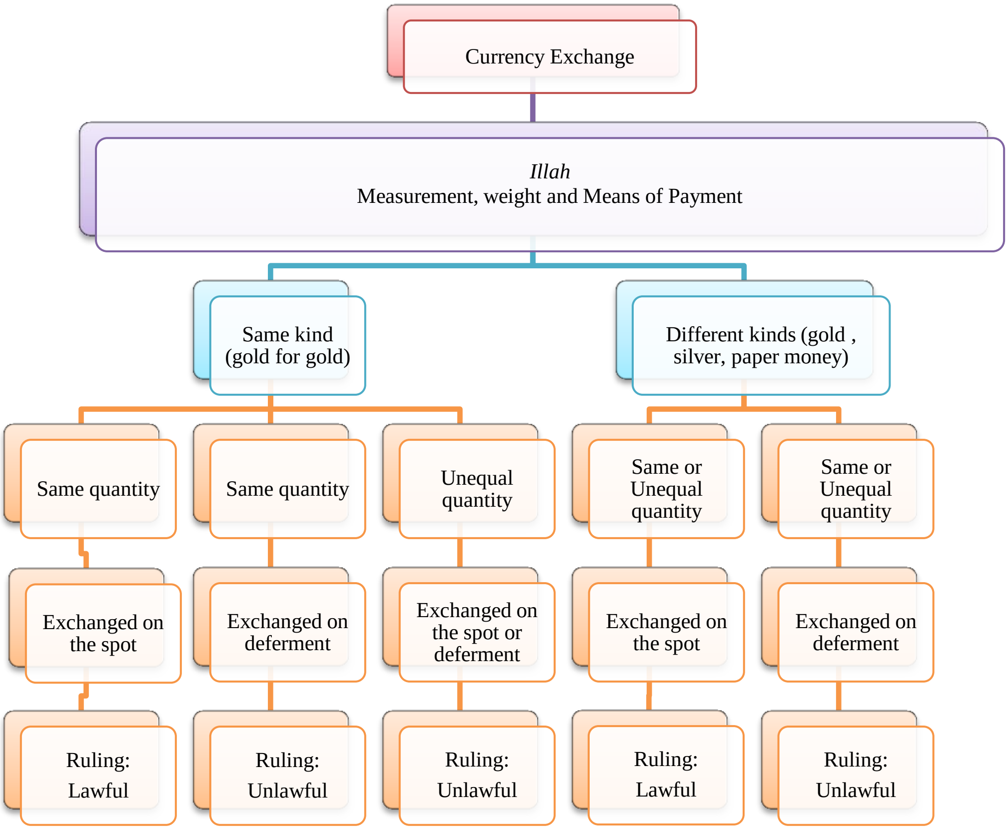

Figure 1: The Relationships between Currency Exchange, *Illah*, Kinds of Currencies, Types of exchange, Time of Exchange and the Rulings

4. Implications of *Illah* for Currency Exchange

This section will discuss the implications of *illah* for currency exchange on the spot contract.

4.1 Implications of *illah* for Currency Exchange on Spot Contract

The foreign exchange market mentioned previously is composed of different forms of exchange transactions. The basic form is the spot exchange contract. There is a general consensus among Islamic jurists that currencies of different countries can be exchanged on a spot basis at a rate different from unity (Obaidullah, 2001). The spot exchange rate is the rate by which currencies are sold for cash and immediately delivered. In other words, the rate is determined over the counter (OTC) (Adam, 2006). Meanwhile, the actual practice of spot markets often provide for actual delivery within 48 hours or two banking business days due to some practical reasons such as, for example, time differences among countries in the world (Obaidullah, 2001). On the other hand, Ebrhaim (2007) noted that spot exchange contract in conventional practice does not mean the transaction will be completed or settled simultaneously at the instance of the contract but rather in actual practice it is done within one or two business days. Thus, in most cases the party who forwards his currency to the other will receive no immediate reciprocal exchange of the other currency. Therefore, according to him the contract would fall under *riba'* transaction as it would violate the principle of executing the contract hand to hand as narrated in the hadith previously mentioned.

Khan (1988) has a similar view. He does not consider two-day lags as an acceptable action in practicing spot exchange. Such delay will incur some cost that can affect the exchange rate. Thus, according to Khan (1988) this opens a door for earning *riba'*. He came up with a suggestion to the problem by involving correspondent banks or agent of the same bank to execute the spot exchange on behalf of their banks with the other party who wants to do currency exchange. He cites an example of a bank in Kuala Lumpur that wants to exchange ringgit with Japanese yen involving a Japanese bank that is based in Tokyo. The bank in Kuala Lumpur will request its corresponding party in Tokyo to do the transaction on its behalf with the Japanese bank. This mechanism according to Khan (1988) will allow the transaction to be done on the spot without delay. Other scholars, however, view this position as too rigid. For example, Obaidullah (2001) is of the opinion that the time lag involved in spot transaction is a time lag between the deals date and the execution date. It is not related to the delivery of one currency in exchange of the delivery of the other currency. Meanwhile, Ayub (2007) in supporting the idea of the two days delay for clearing spot currency exchange puts a condition that the rate of exchange must follow the stipulated rate agreed upon during the day the exchange was finalized.

Another issue on the spot exchange market is about determining the spot exchange rate. Ebrahim (2007) cites Justice Mufti Muhammad Taqi Usmani as stipulating that if the currencies are of the same country, the currency exchange cannot be done at a rate different from their face value. However, if the currencies are of different countries, they can be sold on the spot at whatever rate mutually agreed upon by the contracting parties, which can be different from the market rate. Ebrahim (2007) extends the view that spot rate can vary from the official government and bank rates to the non-official and to the general market rates as long as the rate is mutually agreed upon by the contracting parties.

As mentioned previously, according to some researchers the *illah* (*thumuniyah*) in gold *dinar* and silver *dirham* – in contrast to paper money – is an intrinsic value. It shows that they do not consider any other forms of money other than *dinar* and *silver* as *ribawi* (usurious) commodities. However, if we are to interpret "*thumuniyah*" as "intrinsic value" then it would be contradictory, since paper money indeed does not have any intrinsic value, for it contains neither gold nor silver. If so, then the argument of those who claim that paper money is not a *ribawi* commodity would then be accepted. Moreover, we would conclude by analogy, as some researchers have done, that paper money may be lent at interest since it would not be a usurious commodity. However, if we rely only on the absence of an intrinsic value in paper money it will undoubtedly lead us to a wrong perception regarding the concept of *riba* and *ribawi* (usurious) commodities. Therefore, the authors take the liberty to say that one of the main reasons that caused researchers to have divergent opinions about the usurious nature of paper money relates to an inaccurate interpretation of "*thumuniyh*". *Thumuniyah* is about valuing commodities, as simply a means of payment. Hence, we conclude that not only currencies (paper money) are *ribawi* commodities but even if people were to widely accept any other types of commodities as means of payment the concept of *riba* would still be applicable to them.

Some people may ask, "What is the logic behind exchanging two types of gold say 10gm of 999 for 10gm of 916?" Yes, it is hard even to imagine that someone would agree to exchange a more valuable type of gold for the less valuable one. This is the exact (or literal) implication of the *hadith* of Prophet (peace and blessings be upon him). It is as if he (peace and blessings be upon him) was telling us that if you insist on exchanging gold for gold, then the only permissible way you have to consider is the weight (say 10gm for 10gm) of both exchangeable types of gold. Otherwise, if you don't want this type of exchange then you should first sell your gold (say 10gm of 916), add some money and then buy 10gm of 999. Thus it is permissible as long as you trade both metals on the spot. Another benefit of selling your 10gm of 916 to third parties is that you are actually involving more individuals in the transaction, which is in conformity with the *Maqasid al-Shari'ah*. Furthermore, how would we regard exchanging Malaysian *ringgit* (paper) for Malaysian *ringgit* (coin)? The answer is that the same rule is applied here as well. Why? Because both represent the same government currency and both have the same purchase value. If the exchange is done between different currencies (for example, a golden *dinar* for a silver *dirham*, or U.S. dollars for Malaysian *ringgit*, or indeed, U.S. dollars for a silver *dirham*, etc.) the equality is not a condition, however exchanging them on the spot is the only obligatory condition.

5. Conclusion

Foreign exchange is of fundamental importance in any economy. Islam provides guidelines to this exchange, which must be followed to avoid being dragged into *riba* transaction. Inaccurate or even incorrect interpretations in determining the *illah* of *riba* has lead people to unnecessary confusion and misunderstanding. Future studies need to examine how the violation of the concept of *illah* for *riba,* with regards to all other forms of debt and financial securities, could lead by default to the wrong conclusion. The study concludes from the findings that the *illah* of *thumuniyah* in paper money can only be interpreted as means of payment rather than an intrinsic value.

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