

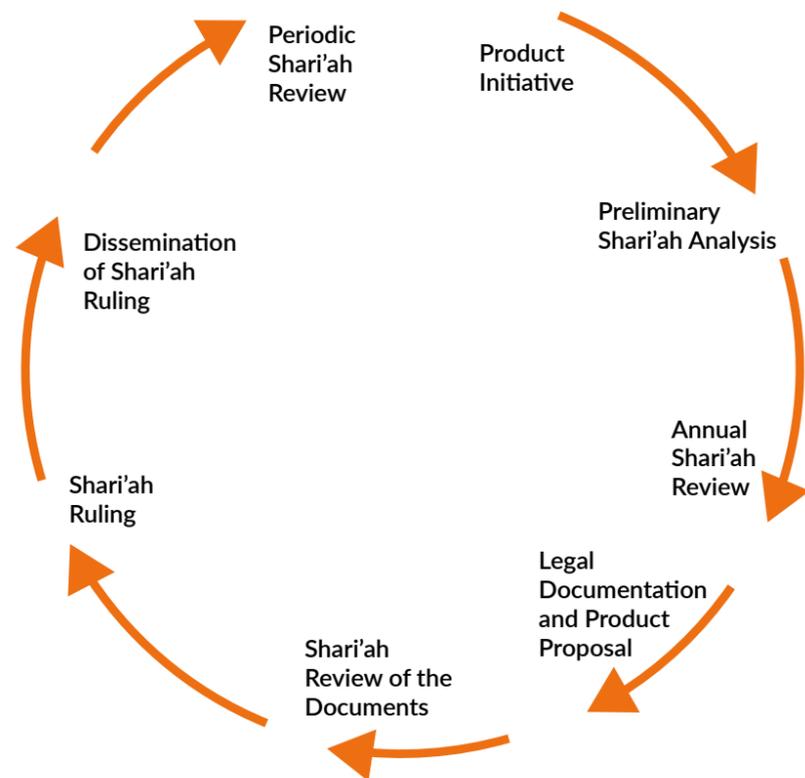
# HIDDEN TRAPS IN SHARI'AH DECISION MAKING

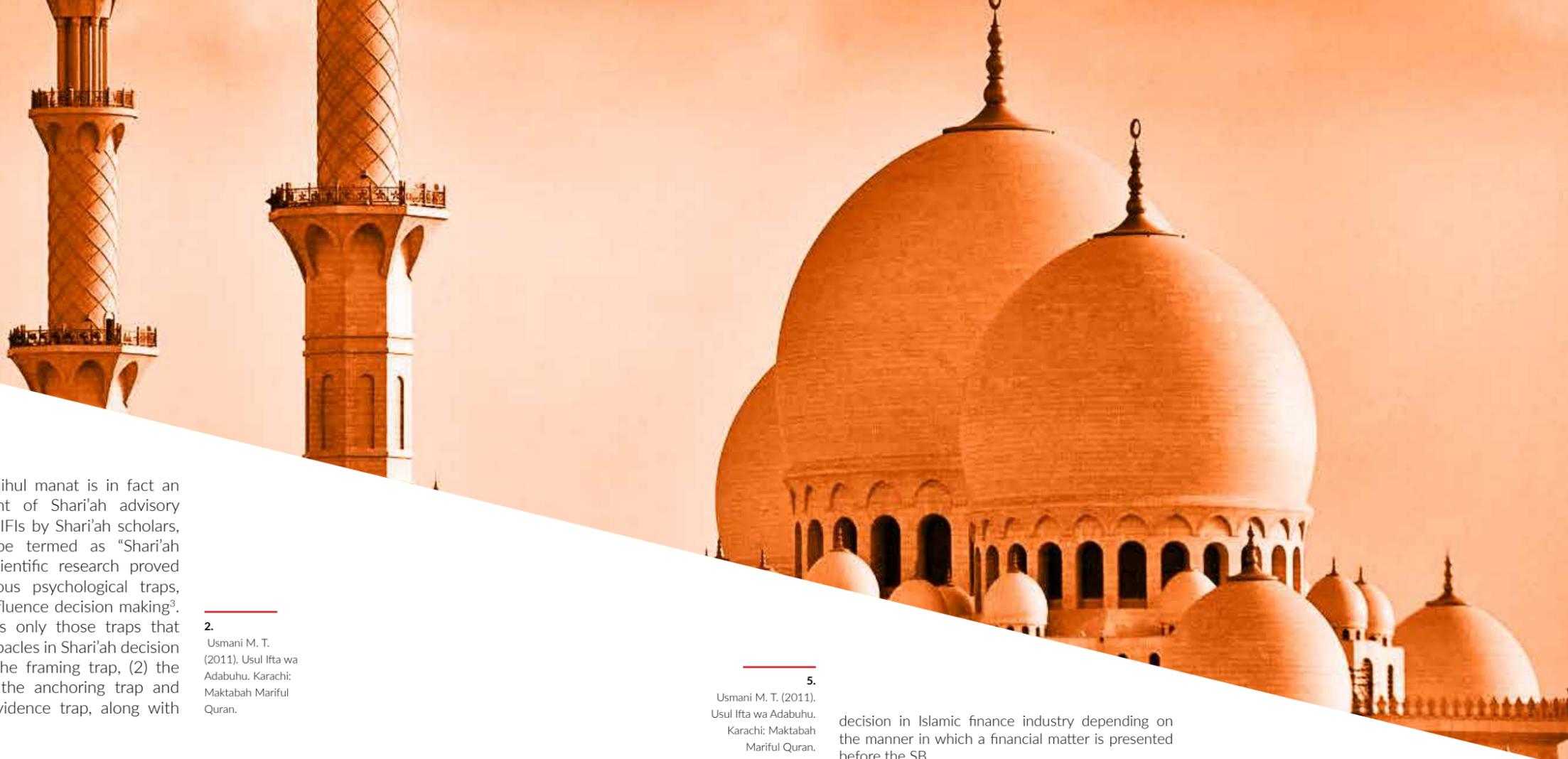
EHSANULLAH AGHA

The emergence of Islamic finance has introduced a new discipline known as "Shariah advisory services" (SAC). SAC adds a unique value proposition of religious law in the area of commercial life, where secularism rules almost unquestioned throughout the rest of the world. This phenomenon has emerged as a regulatory requirement to ensure Islamicity of Islamic

financial institutions (IFIs) by establishing an independent Shari'ah Board (SB). According to AAOIFI, "Shari'ah board is entrusted with the duty of directing, reviewing and supervising the activities of the IFIs to ensure that they comply with Shari'ah principles"<sup>1</sup>. The following diagram depicts the cycle of SB involvement in the business of an IFI.

**1.** As the sellers struggle to accept the reality of declining prices on time, they had to offer more discounts to sell the property.





One of the major responsibilities of SB is to issue a Shari'ah certification (fatwa) endorsing Shari'ah compliance of the products offered by the institution. Shari'ah scholars (SB members) pronounce the resolution through a collective ijtehad – a systematic logical approach adopted to apply legal ruling to a financial matter based on their interpretation of Shari'ah sources. From a juristical perspective, this is called "tanqihul manat". According to Sheikh Taqi Usmani, a leading Islamic finance scholar, the process of tanqihul manat requires a Shari'ah scholar to get the "right description" (tassawur al-mas'alah) by understanding financial nature and business model of the product and, then to apply the relevant Shari'ah ruling (al-ttakyif al-shari)<sup>2</sup>.

The exercise of tanqihul manat is in fact an important component of Shari'ah advisory services provided to IFIs by Shari'ah scholars, which simply can be termed as "Shari'ah decision making". Scientific research proved that there are various psychological traps, which significantly influence decision making<sup>3</sup>. This article highlights only those traps that potentially lead to debacles in Shari'ah decision making, namely (1) the framing trap, (2) the status-quo trap, (3) the anchoring trap and (4) the confirming-evidence trap, along with antidots tips.

2. Usmani M. T. (2011). *Usul Ifta wa Adabuhu*. Karachi: Maktabah Mariful Quran.

5. Usmani M. T. (2011). *Usul Ifta wa Adabuhu*. Karachi: Maktabah Mariful Quran.

6. Atallah, & Ghoul. (2011). The Wa'd based total return swap: Shariah compliant or not. *The Journal of Derivatives*, 4(5).

7. DeLorenzo, Y. T. (2007). The total returns swap and the "Shariah Conversion Technology" Stratagem. Retrieved from [http://www.failaka.com/downloads/DeLorenzo\\_TotalReturnsSwap.pdf](http://www.failaka.com/downloads/DeLorenzo_TotalReturnsSwap.pdf)

8. Samuelson, W., & Zeckhauser, R. (1988). Status quo bias in decision making. *Journal of Risk and Uncertainty*, 1(1), 7-59.

decision in Islamic finance industry depending on the manner in which a financial matter is presented before the SB.

A famous example of the framing trap could be a fatwa endorsing conventional insurance as attributed to a famous Egyptian Scholar Muhamad Abdahu. A French man explained to him that insurance is like a muḍarabah contract where one party provides capital and the other manages the fund. Later, he asked Muhamad Abdahu about its Shari'ah status. Muhammad Abdahu considered it a Shari'ah-compliant product based on the information presented to him. This was in reality "mis-framing" of the product<sup>5</sup>.

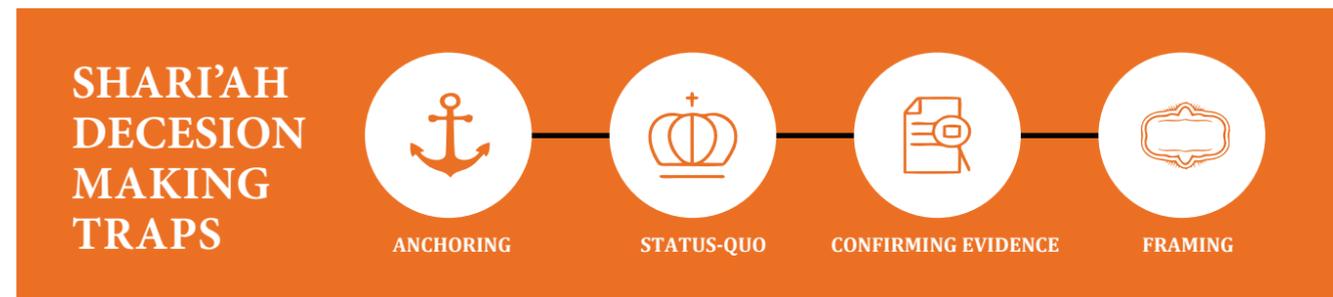
Another latest example in Islamic finance would be the case of Islamic total return swap proposed by a multinational bank in 2007 and was approved by some Shari'ah scholars. The proposed product was claimed to be a Shari'ah-compliant version of the conventional total return swap (TRS), which had been christened as the "wa'd" (unilateral promise) - based total return swap. The objective was to use non-compliant assets and their performance to swap its returns into a so-called Shari'ah-compliant investment portfolio<sup>6</sup>.

The product was presented to Shari'ah scholars in a way reflecting that the performance of non-halal fund is just used as a benchmark index for the Islamic investment fund, resembling the interest-based pricing mechanism (LIBOR) in Islamic banking products. However, its legality was heavily criticised by other scholars on the ground that wa'd is used as

a mere stratagem to halalize a prohibited income. The analogy (qiyas) between the use of LIBOR for pricing and the use of the performance of non Shari'ah-compliant assets for pricing is both inaccurate and misleading. The only similarity is that both are used for pricing. LIBOR is used to indicate the return, while the other is used to deliver the return.

Sheikh Yuosuf DeLorenzo categorically considered this Shari'ah decision as an unfortunate one (due to mis-framing)<sup>7</sup>:

"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."



### THE FRAMING TRAP

The first logical move in tanqihul manat is known in business management science as "framing the problem". It is like a frame around a picture that separates it from the other objects in the room. In Shari'ah decision making, framing creates a mental border that encloses a particular aspect of a situation to outline the key elements of it for in depth understanding. A mental frame enables the Shari'ah scholars to navigate the complex nature of a financial product, so they can avoid solving the wrong problem or solving the right problem in the wrong way.

Since majority of SB members (Shari'ah advisors) come from Shari'ah background, they typically rely on the information presented to them by the

management of an IFI (i.e. business and product development unit) as they normally do not possess practical exposure to analyse directly a complicated product. Therefore, the way a product is defined to them by the management actually shapes the potential Shari'ah solution that SB members select (of course with some exceptional Shari'ah minds who have developed throughout the years a phenomenal comprehension of financial markets).

A substantial amount of studies found that "framing" significantly impacts outcome of a decision. The framing effect is an example of cognitive bias, in which people react to a particular choice in different ways depending on how it is presented e.g. as a loss or a gain, positive or negative<sup>4</sup>. Similarly, there are evidences suggesting that framing influences Shari'ah

3. Hammond, J. S., Keeney, R. L., & Raiffa, H. (1998). The hidden traps in decision making. *Harvard Business Review*, 76(5), 47-58.

4. Paese, P. W., Bieser, M., & Tubbs, M. E. (1993). Framing effects and choice shifts in group decision making. *Organizational Behavior and Human Decision Processes*, 56(1), 149-165.

