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Crypto Lending

A Shariah Analysis

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GLOSSARY

Crypto Lending	A financial service allowing individuals to earn passive income by lending their cryptocurrency holdings to borrowers, facilitated by blockchain technology.
Blockchain Technology	A decentralized digital ledger system that records transactions across multiple computers, ensuring security and transparency in crypto transactions.
Riba	Exchange of one counter-value for another with a majhul (unknown element) in tamathul (similarity) according to the Shariah standard, where there is a delay in both counter-values or in one of them.
Bay' al-sarf	An Islamic finance principle governing the exchange of currency, emphasizing immediate transfer and avoiding deferred payments to prevent riba.
Riba al-fadl	A type of riba referring to an excess in exchange, such as an unequal exchange of the same commodity.
Riba al-nasi'ah	A type of riba that arises from deferring the delivery of one of the exchanged commodities, typically seen in transactions involving time delay.
Riba al-yadd	A type of riba that occurs when there is a delay in the immediate transfer of exchanged goods, specifically in currency exchanges.
Taqabudh	An Arabic term meaning the immediate transfer or possession in a trade or exchange, crucial in ensuring compliance with bay' al-sarf.
Shariah Compliance	Adherence to Islamic law, particularly in financial transactions, ensuring the absence of riba (interest), gharar (excessive uncertainty), and other prohibited elements.
Islamic Finance	A financial system guided by the principles of Shariah law, prohibiting riba and gharar, among other ethical considerations.
Digital Asset Market	The marketplace where cryptocurrencies and other digital assets are traded, often utilizing blockchain technology for secure transactions.
LTV (Loan-to-Value Ratio)	A financial term used in lending to represent the ratio of a loan to the value of the asset purchased or used as collateral. In crypto lending, LTV indicates the amount a borrower can receive relative to their cryptocurrency's value. Higher LTVs generally carry higher risks, especially if the collateral's value fluctuates.
Istihsan	Disregarding a Shariah ruling that is backed by primary Islamic sources and applying another Shariah ruling that is more convincing and stronger than the former, based on primary Islamic sources permitting the act in question.

INTRODUCTION

In the evolving landscape of digital finance, crypto lending has emerged as a groundbreaking way for individuals to earn passive income from their cryptocurrency holdings. This innovative financial service integrates traditional lending concepts with blockchain technology, creating new opportunities for both lenders and borrowers within the digital asset market.

However, Shariah concerns arise over the potential presence of riba (interest) in crypto lending transactions, as well as the implications of bypassing bay' al-sarf principles, which govern financial lending and currency exchange. The question of whether crypto lending may inadvertently lead to forms of riba, such as riba al-fadl (excess in exchange), riba al-nasi'ah (deferred term in exchange), or riba al-yadd (delay in the exchange), is central to understanding its Shariah compliance. Each of these forms of riba violates fundamental principles of Islamic finance, raising critical questions about the permissibility of these transactions for Muslim investors.

This paper will explore the mechanics of crypto lending and analyze its potential Shariah implications, identifying specific requirements and concerns that may arise. By examining these aspects, we aim to increase awareness and understanding within the Islamic finance community and advocate for potential solutions and further research by Shariah scholars on the crypto ecosystem.

WHAT IS CRYPTO LENDING?

Crypto lending represents a groundbreaking intersection between traditional financial services and blockchain technology, offering a novel way for cryptocurrency holders to earn passive income from their digital assets. At its core, crypto lending operates on a principle similar to traditional bank lending, but with a crucial difference: instead of dealing with conventional fiat currencies, these transactions revolve around cryptocurrencies.

In this innovative financial ecosystem, cryptocurrency owners can become lenders, allowing their digital assets to work for them rather than sitting idle in a wallet. Think of it as a digital version of how traditional banks use depositors' money to make loans, but in this case, the entire process is either managed through specialized crypto platforms or executed through smart contracts on blockchain networks.

The concept has gained significant traction in the decentralized finance (DeFi) movement, where it serves as one of the cornerstone applications demonstrating how traditional financial services can be reimagined in the digital market. Through crypto lending, investors can potentially earn competitive interest rates that often exceed those offered by conventional banking systems, while borrowers can access crypto assets without necessarily having to purchase them outright.

What makes crypto lending particularly interesting is its flexibility and accessibility. Unlike traditional lending systems that might require extensive paperwork, credit checks, and long processing times, crypto lending platforms can facilitate loans almost instantaneously, secured by smart contracts or collateral in the form of other cryptocurrencies. This democratizes lending and borrowing, making it accessible to a global audience regardless of their location or traditional banking relationships.

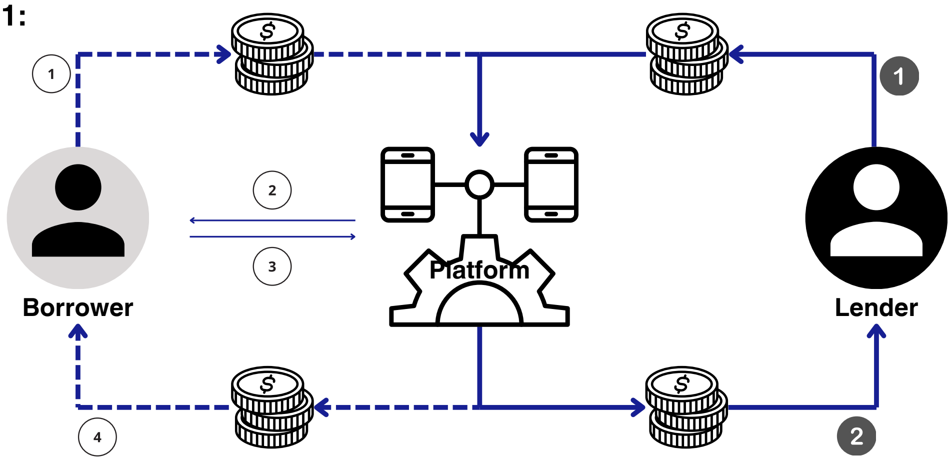
HOW DOES CRYPTO LENDING WORK?

The process of crypto lending is straightforward:

Deposit	Lenders deposit their cryptocurrencies into a lending platform.
Distribution	The platform makes these funds available to potential borrowers.
Borrowing	Other users can borrow these cryptocurrencies.
Repayment	Borrowers repay the loan plus interest within a specified timeframe.
Returns	Lenders earn compensation for lending their digital assets.

Crypto Lending Structures

Structure 1:



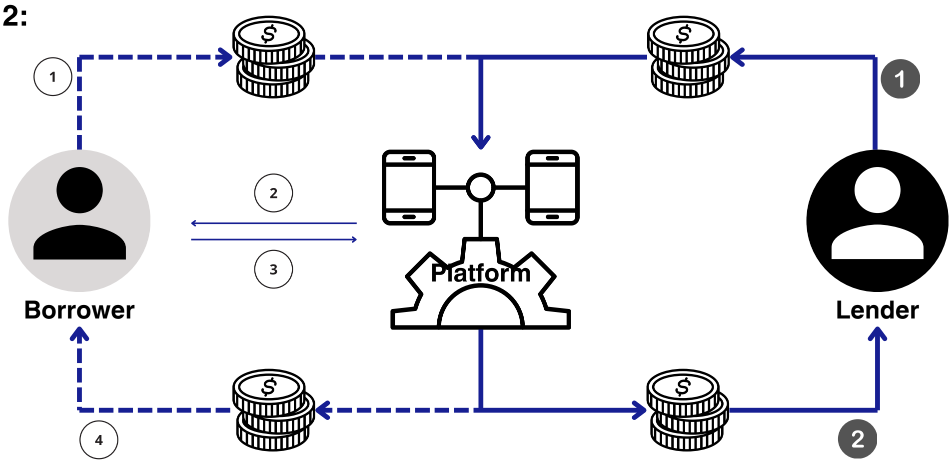
From the Borrower Side:

1. Deposit crypto assets as collateral
2. Receive lent crypto
3. Repays the borrowed cryptocurrency + interest
4. Receives collateral back after repayment

From Lender Side:

1. Deposit crypto
2. Receive deposit + interest

Structure 2:



From the Borrower Side:

1. Deposit crypto assets as collateral
2. Receive lent token
3. Repays the borrowed cryptocurrency + interest
4. Receives collateral back after repayment

From Lender Side:

1. Deposit fiat currencies
2. Receive deposit + interest

THE PROS AND CONS OF CRYPTO LENDING

The implementation of crypto lending within the DeFi ecosystem reveals a complex interplay of benefits and risks for its primary stakeholders. This analysis examines the multifaceted implications for both borrowers and lenders, providing insight into the practical considerations that shape participation in crypto lending markets. Below, we discuss the advantages and disadvantages of crypto lending for stakeholders, specifically from the perspectives of lenders and borrowers:

Borrowers' Position

PROS

Accessibility and Speed

- No credit checks required for loan approval
- Fast approval and funding process
- Available to borrowers who might not qualify for traditional bank loans
- Can be used for almost any purpose

Financial Flexibility

- Ability to access liquidity without selling crypto holdings
- Flexible loan terms
- Generally lower interest rates compared to traditional loans
- Maintain potential upside of crypto holdings while accessing their value

Collateral Structure:

- Straightforward loan-to-value (LTV) ratio system
- A clear understanding of borrowing capacity based on collateral
- Possibility of flash loans without collateral (for advanced users)

CONS

Asset Requirements and Restrictions

- Cryptocurrency must be collateralized to apply for a loan.
- Loss of trading rights over collateralized assets until loan repayment

Market-Related Risks

- Fluctuating LTV ratios may require additional collateral if the crypto value drops
- Risk of liquidation if unable to maintain required collateral levels
- Automatic liquidation triggers if LTV exceeds certain thresholds (typically 75%)

Platform Risks

- Less regulatory oversight compared to traditional banking
- Risk of losing crypto if the lending platform becomes insolvent, though it potentially remains accessible through the underlying smart contract.
- No federal insurance protection for deposits

Lenders' Position

Income Generation
- Opportunity to earn passive income from crypto holdings
- Generally higher interest rates compared to traditional savings accounts
- More flexible alternative to crypto staking

Security Measures
- Loans backed by collateral
- Ability to sell borrower's collateral in case of default
- Automated liquidation processes to protect principal

Investment Flexibility
- Various platforms and options available
- Ability to participate in different types of lending pools
- Option to choose between CeFi and DeFi platforms

Platform Risks
- Exposure to platform insolvency risks
- No federal insurance protection
- Vulnerability to smart contract failures in DeFi platforms

Market Risks
- Potential losses during market volatility
- Risk of insufficient collateral value during rapid market downturns
- Possible delays in liquidation during market stress

Institutional Risks
- Exposure to large institutional borrower defaults
- Limited control over lending terms with institutional borrowers
- Historical examples of platform failures (e.g., Voyager Digital, BlockFi, Celsius)

Shariah Analysis

Consideration of Cryptocurrencies as Fulus or 'Urudh

Historical Context of Islamic Currency Classifications

The Islamic financial system has historically recognized distinct categories of monetary instruments, primarily differentiating between nuqud (gold and silver currency), fulus (copper coins), and 'urudh (commodities/goods). Understanding these classical distinctions is crucial for properly categorizing modern cryptocurrencies within Islamic finance frameworks. In classical Islamic jurisprudence, fulus served as a supplementary currency, primarily used for smaller transactions when gold and silver currencies were impractical.

Contemporary Interpretations of Cryptocurrency Classification

- **Consideration as 'Urudh:** The Securities Commission Malaysia's Shariah Advisory Council, in their 233rd and 234th meetings (June-July 2020), provided an important resolution regarding digital currencies. They classified digital currencies without underlying assets as 'urudh, considering them as tradable assets rather than currency from a Shariah perspective. This classification notably exempts such digital currencies from the principles of bay' al-sarf (currency exchange rules).

- **Consideration as Fulus:** Another valid consideration is the classification of cryptocurrencies as a modern form of fulus. At Sharlife's 1st Independent Shariah Advisor Meeting (October 25, 2023), we conducted a comprehensive analysis of cryptocurrency classification. Our analysis concluded that while cryptocurrencies are recognized as al-mal (asset) within Shariah principles, they can be classified as either 'urudh or fulus. Based on our analysis, we view that cryptocurrencies may possibly be considered as fulus, a form of currency distinct from gold and silver from a Shariah perspective, which means they would not need to adhere to the principles of bay' al-sarf.

Applicability of Riba Terms and Conditions and Bay' al-Sarf Principles

Islamic scholars have long debated the classification of non-gold and non-silver currencies, particularly paper money, which is not physically tied to the intrinsic value of precious metals. This is relevant for cryptocurrencies, which similarly lack intrinsic value and are often backed only by technology and user acceptance.

Classical Views on Fulus:

Shariah Scholars	Views
Sheikh al-Sa'dī	Sheikh al-Sa'dī (1995) views paper money as distinct from gold and silver, as it lacks the 'illah (effective cause) of riba linked to weight and measure, classifying it instead as a commodity or fulus. This perspective permits transactions involving paper currency that include tafāḍul (differences in quantity) or deferred settlement, as it is not bound by the bay' al-sarf rules applicable to gold and silver. *[Abd al-Raḥmān al-Sa'dī. (1995). al-Fatāwa al-Sa'diyyah.]*
Sheikh Ḥasan Ayyūb	Sheikh Ḥasan Ayyūb elaborates that, in the Hanafi school of thought and one opinion within the Hanbali school, the basis of riba (usury) in transactions involving gold and silver lies in their weight or measure. Since paper money cannot be weighed in the same way as gold and silver, it cannot be analogized to these metals under the principle of riba. *[Aḥmad Ḥasan Aḥmad al-Ḥasanī. (1988). Taṭawwur Nuqūd fī Ḍau'i al-Syarī'ah al-Islamīyyah ma'a al-'Ināyah bi al-Nuqūd al-Kitābiyyah.]*
Imam al-Nawāwī	Imam al-Nawāwī notes that in the Shafi'e school of thought, the basis for riba in gold and silver is that they are considered jins al-athmān ghāliban (the dominant type of currency). Fulus does not possess this quality, even if used as currency in some countries, as it remains fundamentally distinct from gold and silver. *[Yaḥyā bin Syaraf al-Nawāwi. (n.d). al-Majmū'Syarḥal-Muhadhdhab.]*

Shariah Advisory Council of the Securities Commission Malaysia

The Securities Commission Malaysia (SC) provides specific guidance for digital currencies and tokens. For digital assets, riba considerations depend on the type of item backing the asset:

- Digital Currency Backed by Gold, Silver, or Currency: Such assets are treated as currency, meaning their trading is subject to bay' al-sarf rules, which require immediate (spot) exchange to avoid riba.
- Digital Currency Backed by Other Ribawi Items: If backed by ribawi items other than gold, silver, or currency, these assets are treated as amwal ribawiyyah (ribawi wealth), making their trading subject to Shariah rules for ribawi items, which include strict conditions to prevent riba.

For digital tokens backed by ribawi items, the trading must likewise adhere to Shariah's riba rules, focusing on appropriate asset exchanges to avoid any interest-based gains.

Sharlife's Independent Shariah Position

On October 25, 2023, the first Shariah Advisor Meeting at Sharlife Sdn Bhd established that cryptocurrencies qualify as al-mal within Shariah principles and can be classified either as 'urudh or fulus. Sharlife recognizes cryptocurrencies as fulus, a form of currency distinct from gold and silver. As such, cryptocurrencies are generally not subject to the strict bay' al-sarf requirements tied to ribawi items. However, digital tokens and coins backed by ribawi items must comply with bay' al-sarf principles, in line with the SC's guidelines.

Takyif Fiqhi: Understanding Crypto Lending Through the Lens of Securities Borrowing and Lending (SBL)

To provide a Shariah-compliant solution for crypto lending, an effective approach has been to align it with established financial structures. One such structure, Securities Borrowing and Lending (SBL), was approved for Shariah compliance by the Securities Commission Malaysia's Shariah Advisory Council (SAC) through the lens of ijarah (leasing) and istihsan.

Understanding the Shariah Framework of SBL

SBL is a widely accepted practice in financial markets that allows for the temporary transfer of securities from a lender to a borrower under a regulated agreement. In its 13th meeting on 19 March 1998, the SAC resolved that SBL could be made compliant with Shariah principles by adapting the ijarah (leasing) contract. While ijarah originally permits the use of an asset in exchange for payment, the SAC applied istihsan to make exceptions to traditional ijarah rules. This istihsan approach allows SBL to operate while maintaining the contractual relationship, even if the lessee temporarily surrenders the leased securities.

According to the SAC, istihsan provides a basis for recognizing SBL within Shariah law. In cases of SBL, for instance, istihsan allows for the continuation of an ijarah contract even if the borrower relinquishes control of the securities temporarily.

Crypto Lending as an Ijarah Structure: A Comparative Analysis with SBL

The adaptation of SBL principles to cryptocurrency lending is possible by analogizing crypto lending to an ijarah contract with the added principle of rahn (collateral). In this model, the cryptocurrency lender temporarily transfers the asset's use to the borrower, with the expectation that the digital asset will be returned or replaced in kind.

- **Alignment with Ijarah Principles:** Crypto lending, like SBL, can be structured as an ijarah contract where the lender receives payment for the temporary transfer of use rights, not ownership. For crypto assets not backed by ribawi items (e.g., gold, silver, or currency), this approach is permissible under Shariah, as it avoids any prohibited elements such as interest riba (interest) or gharar (excessive uncertainty). The lender is compensated for allowing the borrower access to the asset, which they must return upon maturity, similar to how an SBL transaction requires returning the borrowed security or an equivalent replacement.

- **Avoidance of Riba and Gharar:** One of the primary Shariah concerns in crypto lending is the prevention of riba and gharar. Crypto lending achieves compliance if the tokens or coins being used are not backed by ribawi items (such as gold, silver, or fiat currency) and if the concept aligns with the application of an ijarah (leasing) contract.

Differentiation in Compliance: Ribawi and Non-Ribawi Crypto Assets

Sharlife's recent Shariah Advisory Meeting (October 25, 2023) determined that while crypto lending is generally permissible, it hinges on whether the cryptocurrency is backed by ribawi items or non-ribawi assets. The inclusion of ribawi assets like fiat currency or gold backing introduces the requirement for bay' al-sarf (currency exchange) principles, Therefore:

- For Non-Ribawi Crypto Assets: Cryptocurrencies not backed by ribawi items can be lent out in a manner akin to an ijarah contract, without the stringent requirements of bay' al-sarf.
- For Ribawi-Backed Crypto Assets: Any crypto assets backed by ribawi items must adhere the terms and conditions related to ribawi items to avoid riba.

"Interest" in Crypto Lending: A Shariah Perspective on Contractual Intentions and Meanings

Crypto lending involves lending cryptocurrencies in exchange for a fee, often referred to as "interest". However, whether something is considered riba depends not just on the terminology used but on the actual intentions and structure of the contract. This approach aligns with the Shariah principle that contractual intentions and meanings hold more weight than the words used, following the legal maxim:

"العبرة في العقود للمقاصد والمعاني لا للألفاظ والمباني"

"In contracts, greater weight is given to intention and meaning than words and forms."

The Importance of Intentions in Islamic Contracts

In Islamic finance, the essence of a transaction is judged not by the names or labels applied to it but by its underlying purpose and actual terms. For example, if someone were to say, "I will gift you this book if you give me RM 20", this transaction would be considered a sale because, despite the use of the term "gift", a financial exchange is involved. Conversely, if a person states, "I sold my book for no price", it is regarded as a hibah (gift) since no monetary consideration is required.

This principle provides a framework for assessing crypto lending, where the term "interest" may be used, but its true nature can differ considerably. It can instead be understood as ujrah, a fee for services or asset usage, rather than riba.

CONCLUSION

The rise of crypto lending within the DeFi ecosystem represents a significant evolution in digital finance, merging the benefits of traditional financial practices with the innovation of blockchain technology. However, the practice also introduces unique challenges and considerations from a Shariah perspective. Through careful analysis, it's evident that crypto lending's Shariah compliance is not straightforward; it depends on the nature of the crypto assets involved, the structure of the lending transactions, and adherence to Shariah principles regarding riba (interest), gharar (excessive uncertainty), and asset classification.

The cornerstone of Shariah-compliant financial transactions is the prohibition of riba, which stems from the Qur'anic commandment against exploitative financial practices. A key element of this Shariah analysis has been the categorization of cryptocurrencies as either 'urudh (goods) or fulus (non-gold and non-silver currency). The Securities Commission Malaysia's Shariah Advisory Council has taken steps to categorize digital assets accordingly, providing a framework where cryptocurrencies, particularly those not backed by ribawi (interest-bearing) items like gold or fiat currency, are considered goods rather than currency. Consequently, this exempts them from the strict bay' al-sarf (currency exchange) rules required for gold and silver.

In alignment with this view, Sharlife's Shariah Advisor Meeting concluded that cryptocurrencies, generally classified as al-mal, can be considered fulus and thus do not necessitate compliance with bay' al-sarf regulations. This classification supports the notion that certain types of crypto lending, those involving non-ribawi cryptocurrencies, can be permissible when structured appropriately

Furthermore, crypto lending can be effectively compared to the Securities Borrowing and Lending (SBL) model approved for Shariah compliance by Malaysia's Shariah Advisory Council. By analogizing crypto lending to an ijarah (leasing) contract, where the lender temporarily transfers usage rights of the digital asset to the borrower, we align crypto lending with the SBL framework's principle of temporary ownership transfer. Importantly, SBL's Shariah compliance stems from ijarah, allowing the temporary surrender of ownership in cases of necessity or public interest. By applying this model, crypto lending transactions can avoid riba, maintain compliance with Shariah principles, and ensure that the borrower returns the crypto asset or its equivalent at the end of the loan term.

Nevertheless, crypto lending is not without inherent risks, particularly market volatility. The rapid fluctuations in cryptocurrency values introduce challenges related to collateral requirements. For borrowers, the risk of automatic liquidation due to falling collateral value can lead to financial loss, while lenders face the risk of exposure to insufficient collateral during market downturns. Furthermore, even with DeFi's automated solutions, crypto lending remains susceptible to platform-related risks such as smart contract vulnerabilities or platform insolvency. A comprehensive Shariah-compliant model would necessitate risk mitigation measures, potentially involving enhanced transparency around platform protocols and additional layers of takaful (Islamic insurance) or risk-sharing mechanisms to protect both lenders and borrowers.

In conclusion, while crypto lending poses Shariah challenges due to its inherent market risks, interest-bearing models, and regulatory ambiguities, it holds significant potential for alignment with Shariah principles when carefully structured. Models that avoid riba and gharar by treating the lending arrangement as an ijarah-based transfer of usage rights, combined with non-ribawi digital assets, provide a pathway for Muslim investors to participate in this innovative financial ecosystem. Platforms should focus on decentralized frameworks to ensure transparency, stability, and compliance, further enhancing their appeal as Shariah-compliant financial services. Through responsible design and adherence to Islamic financial principles, crypto lending could become a viable, compliant instrument within Islamic finance, bridging the gap between traditional and decentralized financial systems.

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