ISLAMIC FINANCIAL SYSTEM

Principles & Operations

ISRA الأكاديمية العالمية للبحوث الشرعية
International Shari'ah Research Academy for Islamic Finance

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Foreword

Bismillahirrahmanirrahim,

Assalamu'alaykum wa rahmatullahi wa barakatuh, and warm greetings.

Islamic finance began its modern history some 40 years ago. Since then, it has achieved impressive results and made inroads into the conventional financial system. During this period, Islamic finance has demonstrated its ability to compete with mainstream economic and financial systems. This was even more transparent during the recent financial crisis of 2007-2009 when Islamic finance showed a certain degree of resilience to the financial shocks and credit crunch.

The financial landscape, in the wake of the most recent global financial crisis, is indeed in need of appropriate reforms. There is a general consensus that we need to return banking to its basic functions, i.e., to provide financial services that add value to the real economy. This, in fact, represents the very essence of Islamic finance. The principles of the *Shari'ah* which underpin Islamic finance help explain its resilience during the global crisis.

While the inherent strengths of Islamic finance have contributed to its viability and resilience, foundations for the sustainability of Islamic finance as a competitive form of financial intermediation need to be continually strengthened. Efforts are therefore being focused on the further development of Islamic financial markets, financial infrastructure, research and development to support innovation, and enhancement of the *Shari'ah* and legal infrastructure as well as the regulatory and supervisory framework. Furthermore, the adoption of relevant advances in technology and development of human capital are also the keys to supporting the development of Islamic finance.

However, Islamic finance is still in its infancy and as such it faces many challenges. One of the biggest challenges for the Islamic finance industry is the lack of sufficiently skilled experts who possess a profound knowledge of *Shari'ah* rules and principles alongside a sound knowledge of finance. Hence, in order to ensure the sustainable growth of Islamic finance, it is essential to ensure continued human capital development in order to produce highly qualified professionals. Developing experts in this field will in turn result in continued innovation of new Islamic finance products and services and improvements to the existing ones in order to efficiently and effectively meet and serve the needs of society.

For this to happen, potential parties and the public in general should have access to information on Islamic financial services and products. An extensive and structured education programme is, thus, key to enhancing consumer and business awareness on the matter. In addition, all parties involved in Islamic financial transactions need to understand and appreciate the unique characteristics and features of all sectors of Islamic finance, which include Islamic banking, *takaful*, Islamic capital market and Islamic money market. Clear understanding of the conduct of Islamic financial transactions will lead to appropriate execution of Islamic financial contracts that truly reflect the *Shari'ah* tenets. Apart from leveraging on the advancement of information and communication technology (ICT) to effectively and efficiently disseminate information on Islamic finance, it can also circulate via books and other reading materials.

On this note, I would like to congratulate the team from the International *Shari'ah* Research Academy for Islamic Finance (ISRA) for publishing this comprehensive textbook. They worked tirelessly to meet a tight schedule placed before them. Indeed, all praise be to Allah, the Almighty, for the textbook, *Islamic Financial System: Principles and Operations*, is now published and it will add to the list of available references in the field of Islamic finance.

The aim of this book is to make a contribution towards the goal of nurturing and developing experts in Islamic finance. This publication is a comprehensive guide to Islamic finance, and it offers tools which are necessary for students to grasp and appreciate Islamic finance. The book covers more or less all aspects of Islamic banking and finance. It outlines *Shari'ah* rules and theoretical/philosophical aspects of Islamic finance, explains the conceptual tenets upon which Islamic finance is built such as *mudarabah*, *musharakah*, *murabahah*, *ijarah*, *wa'd*, etc. Finally, it explains the operational side of Islamic financial intermediation by providing the most up-to-date operational practices of Islamic banks, Islamic financial institutions, and Islamic money and capital markets around the world.

I would like to take this opportunity to thank Bank Negara Malaysia (Central Bank of Malaysia) for their continued support in developing a comprehensive and sustainable Islamic financial system. Without the visionary ideas and hard work of its staff, we would not be able to launch this book.

Furthermore, I would also like to express my heartfelt gratitude to Cagamas Berhad, the Malaysian national mortgage corporation, for sponsoring the project. Their financial support made it possible for ISRA to gather top experts in the field of Islamic finance to produce this milestone work in such a short time.

In the process of producing this textbook, many industry players and experts contributed their skills, knowledge, time and effort. The list would be a very long one if we were to mention all of them. However, I would like to thank all contributors, reviewers, ISRA staff and everyone involved, directly and indirectly, in the production of this book.

Vigorous commitment to strengthening the resilience of the Islamic financial industry, coupled with continued support from all relevant parties, will surely increase its potential to contribute to global financial stability and, in turn, enhance the prospects for global growth.

It is hoped that this priceless effort will serve as a quick guide and useful reference for students, academicians, practitioners, regulators, *Shari'ah* advisors and everyone who is interested in exploring the subject further. Indeed, the textbook title reflects prerequisites to comprehending Islamic finance in its totality. Thus, I firmly believe that this book can help more intellectuals and professionals be better informed about the Islamic financial system.

Wassalam.

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Preface

Many assert the rise of Islamic finance to have been as predictable as it has been meteoric. This is particularly true since there are an estimated 1.6 billion Muslims on the planet and the essence of Islamic finance, which requires all financial products to be structured and implemented in compliance with the *Shari'ah*, has offered this unique customer base the irresistible opportunity to conduct business according to their religious beliefs and prescriptions. However, facts show that Islamic finance does not only appeal to Muslims but also to non-Muslims alike.

Based on its core ethical values, the Islamic financial services industry has often been compared with the theme of ethical finance, corporate citizenship, corporate social responsibility and socially responsible investment. An additional element, however, guides the value proposition of the Islamic financial services industry: the religious factor. The premise of the Islamic finance paradigm is in fact founded on *maqasid al-shari'ah* (objectives of Islamic law) which establish the socially responsible vision and objectives of the Islamic financial system.

The Islamic financial services industry has developed from the early theoretical writings on interest-free finance in the 1940s-1960s into the growing global establishment of Islamic financial institutions (IFIs) in the 21st century. The early initiatives were based on the endeavours of Muslim economists who wished to live according to Islamic injunctions and ideals and to set up a financial system consistent with the *Shari'ah* (Islamic law) – a system of ethics and values founded on the teachings in the *Qur'an* and the *Sunnah* of the Prophet (peace be upon him (p.b.u.h)). Within the Islamic worldview, the *Shari'ah* is believed to set the guidelines on all aspects of human life. As such, *Shari'ah*-compliance is considered a prerequisite requirement for the fulfilment of economic and financial transactions within the Islamic faith – whether at the individual, institutional, governmental, or societal levels.

The goals of the Islamic financial system are often stated in socially laudable terms such as, promotion of economic well-being, poverty alleviation, fulfilment of basic human needs, optimisation in the utilisation of natural resources, fulfilment of spiritual needs, and promotion of universal brotherhood and economic and social justice. These goals inevitably have recourse to and are meant to further *maqasid al-shari'ah* which provides a framework encapsulating the promotion of human well-being through the protection and enrichment of faith (*din*), human self (*nafs*), intellect (*'aql*), posterity (*nasl*) and wealth (*mal*). It is for this purpose that the *Shari'ah* stipulates and advises people to adopt permissible and productive activities (*halal*) to promote public (*maslahah*) interest and reject prohibitive and harmful activities (*haram*) to prevent harm (*mafsadah*).

It is also in this respect that within the Islamic economic model, all stakeholders, whether investors, consumers, producers, suppliers, or traders, are attributed a socially responsible role. The expectation is that faith, which instils a concern for the afterlife, will influence an individual's level of personal motivation such that he behaves altruistically, and pursues his self-interest within the bounds of social interest. Therefore, unlike the individual who is guided by self-interest under the *homo-economicus* principle in neoclassical literature, the individual guided by the norms of Islam would exhibit altruism, humanism, and social responsibility. He is accordingly given the special name of *homo-islamicus* in the Islamic literature. Other philosophical notions of "human accountability before God", "man's role as a vicegerent on earth" and "promotion of socioeconomic justice" are further assumed to be the drivers which restrain self-interest, motivate individuals to make careful use of limited resources, care for the environment and fulfil their social obligations.

The individual within the Islamic paradigm is also expected to be socially responsible with respect to his finances. Islamic investors are concerned with not just *what* kinds of activities are being financed (i.e., the end products) but also with the *way* they are funded (i.e., the means of financing). They would seek the deployment of funds in *a halal* (permissible or lawful) way. This search for *Shari'ah* permissibility in one's decisions contributed in putting market pressure on businesses to produce and market *halal* products. Within the financial arena, it sets the basis for the development of the Islamic financial services industry.

The institutionalisation of the Islamic financial services industry that started in the 1970s was a means of fulfilling the socially responsible goals of the Islamic financial system. It is based on the following requirements:

- Abolition of interest (*riba*) which is perceived as an act of injustice and exploitation.
- Prohibition of dealings in *haram* (impermissible) products like pork, statues, idols and intoxicants.
- Adoption of other negative screening criteria in investment selection, involving elimination of uncertainty (*gharar*), shunning of alcohol, tobacco, drugs, pornography, prostitution, gambling, armaments, animal experimentation, genetic engineering, and financial exploitation.
- Prohibition of dealings in unfair practices such as price manipulation, greed, bribery, money laundering and involvement in activities that would cause environmental damage.
- Promotion of fixed return modes of financing, incorporating the concept of real exchange of goods and services and including the exchange of usufruct (services) generated by durable assets.

- Sharing of risk and profit between the investor (capital provider), the financial intermediary (Islamic bank) and the entrepreneur (user of funds) through financial contracts like *mudarabah* (passive partnership) and *musharakah* (partnership).

- Promotion of an entrepreneur-friendly project financing based on the soundness of the project, the business acumen and managerial competence of the entrepreneur, and expected long-term return on the project instead of relying on the creditworthiness of the entrepreneur. It thus promotes a more careful evaluation of the application of funds for equity financing.

- Promotion of moderation, balance and harmony in life, such as fair competition, honesty, justice, protection of the weak, safeguarding the public interest, financial and social inclusion policies, pursuit of genuine profits, protection of the market mechanism, abidance by the legal system, transparency in dealings, dissemination of reliable information, safeguarding of individual rights and obligations, sanctity of contracts and contractual obligations.

- Payment due to the poor (*zakat*) and voluntary charity (*sadaqah*) which help in the development of a social conscience through the sharing of one's resources with the underprivileged. Other voluntary charities, encouraged as an expression of man's gratitude to God for His grace, similarly has the economic impact of alleviating poverty while promoting social cohesion and harmony.

Today, based on the application of the above principles, the Islamic financial services industry has expanded globally with more than 550 IFIs, which operate in over 75 countries. Interestingly, the Islamic financial services industry is reported to be the fastest growing segment in the global financial system with enormous potential yet to be tapped. Despite the many challenges such as the global financial crisis and the political turbulence in the Middle East and North Africa, among the main centres for this niche and emerging sector, increasing populations and oil wealth offer the potential for substantial growth. So far, equities and products such as *sukuk* (financial certificates) are holding up in spite of the instability. There is also continuing demand for financing of infrastructure projects. On the high street, retail banking continues to grow too, as more Muslims in the Middle East and Asia, switch from conventional financial products to those that comply with their religious and ethical beliefs. Analysts mainly agree that the potential growth in these regions is great as only a small percentage of Muslims, approximately 12% of the 1.6 billion globally is currently patronising Islamic finance. Furthermore, the industry has witnessed expansion from its core regions to other parts of the world including Western regions. Countries like the UK, France, Spain, Luxembourg and Australia have been actively promoting and introducing Islamic financial products and services and considering ways to expand their involvement.

Admittedly, the industry has come a long way from the days it was challenged by Western analysts in the 1970s as a folly system based on a 0% interest rate. Still, the challenges faced are no less daunting in the light of our current politically and financially unstable world where again and again the industry is called upon to prove itself as a viable and competitive system. The recent financial crisis, for instance, has raised questions on the resilience of IFIs. The recent misinformation spread in the US claiming that Islamic finance is a misleading backdoor route to "impose the *Shari'ah*" and "support terrorism" is another kind of challenge which the industry has to deal with.

The Islamic financial services industry is also often faced with a number of other questions. This includes, among others, the questions of: why do the legal and regulatory practices governing IFIs vary across jurisdictions? Is there a need for the regulation of IFIs? What are the expected roles of *Shari'ah* scholars across jurisdictions? Nevertheless, there are signs that regulators, bankers and financiers are now more determined to address these issues. For example, the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Malaysian-based Islamic Financial Services Board (IFSB) have been forging plans to boost standardisation and harmonisation of *Shari'ah* products and services to make them more attractive to investors.

Despite the prospects for continuing growth, even the most optimistic proponent admits that Islamic finance should focus on development and innovation so that it can move away from products that look like replications of their conventional counterpart and towards those that conform to *Shari'ah* principles underlying its foundation both in letter and in spirit.

Rationale for the Book

As a result of these lollygags, there is a necessitous concern to enlighten stakeholders, such as the general public and banking personnel, about Islamic finance. Also, those particularly interested are students of economics, finance and business, who intend to study or take up a career in this growing industry. As future Islamic financial product initiators in this emerging industry, students should know what Islamic finance is, and what it is not. They should understand, among other things, the principles that underlie Islamic finance, the application of the principles of the *Shari'ah* in Islamic banking and finance instruments, the salient features and legal positions and functions of all *Shari'ah* sources considered in the development of Islamic financial products, the mechanisms of the Islamic interbank money market as well as the various Islamic modes of investment, financing and risk mitigating alternatives. Unfortunately, despite the relevance of these elements of Islamic finance, which remain unclear to most stakeholders, there exist only a few reference sources that acquaint them with the theory and practice of Islamic finance discussed in the layman's language. The provision of a comprehensive textbook targeted to cater for this concern is thus, a *sine qua non* to propel Islamic banking and finance to the next level.

In lieu of this, the International *Shari'ah* Research Academy for Islamic Finance (ISRA) was given the mandate by the Central Bank of Malaysia (Bank Negara Malaysia or BNM) to produce a textbook that could serve as a relevant source for students, practitioners and the general public alike. Generously enough, Cagamas Berhad accepted BNM's proposal to become the sole sponsor of the project as a part of its corporate social responsibility. This textbook is therefore, the outcome of ISRA's commitment to address the challenges faced in the Islamic finance industry, particularly in enhancing its talent pool and enriching its academic resources. Beyond the use by students, the book discusses various aspects of Islamic finance including current issues that are of indispensable relevance to bankers. The book covers important issues, including Islamic economics and the financial system, development of the Islamic financial system, Islamic financial markets, the concept of money and monetary policy, *Shari'ah* framework for Islamic finance, *Shari'ah* contracts for Islamic financial instruments, the Islamic money market, the Islamic debt and equity market, *takaful*, risk management and hedging instruments, opportunities, issues and challenges, and a recent issue of concern which has not been dealt with in most textbooks: the regulation, supervision and governance of the Islamic financial market.

Furthermore, in this textbook, an attempt is made to simplify and explain in clear terms, the contents discussed as much as possible. One unique feature of the book is that it has benefitted from scholastic diversity as virtually each aspect of the book entails a contribution by different researchers and scholars. It is the aspiration of ISRA that this book serves as beneficial material for all stakeholders in understanding the theory and practice of Islamic finance.

Organisation of the Book

The book's detailed theoretical and practical approach through discussions of the historical development, current state and future prospects of the Islamic financial system offers students and general readers a well-balanced overview of *Shari'ah* foundations, Islamic economics and the financial system, and instruments and operational mechanisms used by various financial institutions. The book consists of six parts, each dealing with certain areas that are of utmost importance for a proper understanding of the Islamic financial system and its operations.

Part 1: Overview of the Islamic Financial System (Chapters 1-4). The first part of the book provides an overview of the Islamic financial system, its value proposition based on *Shari'ah* teachings and *maqasidic* approach (Chapter 1). This is further extended by the discussion focusing on the Islamic worldview and the underlying principles of Islamic economics and the financial system (Chapter 2). The role of money, its functions and operations of monetary policy within the Islamic financial system is briefly discussed as well (Chapter 3). A discussion about Islamic finance would not be complete if the historical overview of its development was not provided. Thus, historical perspectives are provided to highlight the birth of the modern Islamic finance industry (Chapter 4).

Part 2: *Shari'ah* Framework and Principles for the Islamic Financial System (Chapters 5-7). Islam is a way of life and every aspect of human life is governed by the rules and regulations specified in the Holy *Qur'an* and *Sunnah* (tradition) of the Prophet Muhammad (p.b.u.h.), commonly known as the *Shari'ah*. Hence, an understanding of the *Shari'ah* framework for Islamic finance, its foundations, sources of law and prohibitions related to financial activities are crucial (Chapter 5). In addition, Islamic financial institutions use various instruments known as *Shari'ah*-compliant instruments that are in line with *Shari'ah* teachings and they are discussed in detail (Chapters 6-7).

Part 3: Islamic Financial Markets (Chapters 8-12). The focus of Part 3 is shifted towards financial markets and institutions operating within those markets. Islamic banks play an important role in every financial system and the same goes with the Islamic financial system. Students can better understand the Islamic banking operations and instruments by reading their applications within a market (Chapter 8). For the smooth operation of financial institutions, well functioning and efficient markets are needed. As a result, the book provides detailed discussions on the Islamic money market (Chapter 9), the *sukuk* market (Chapter 10), the Islamic equity market (Chapter 11), and Islamic insurance (*takaful*) in Chapter 12.

Part 4: Risk Management Principles and Mechanisms for the Islamic Financial System (Chapters 13-14). Whereas Part 3 focused on markets, instruments, and operations of IFIs, Part 4 discusses risks involved and how to deal with these risks within the *Shari'ah* framework. While Chapter 13 elaborates on the principles and best practices of risk management, Chapter 14 focuses more on risk management tools and mechanisms available to IFIs for their risk management.

Part 5: Regulation, Supervision and Governance of the Islamic Financial System (Chapters 15-18). In Part 5, due attention is given to regulatory, supervisory and governance issues that are relevant for the Islamic financial system. Regulatory and supervisory challenges are discussed in Chapter 15 together with relevant institutions that are established to regulate and supervise IFIs. Corporate governance has gained momentum in recent years. Due to their unique nature, IFIs are exposed to certain risks that fall beyond the conventional list and they require effective *Shari'ah* governance. Corporate and *Shari'ah* governance are, thus, the main concerns of Chapter 16. Legal framework and different jurisdictions under which the Islamic finance industry operates today are elaborated in Chapter 17. Due to the different jurisdictions and legal frameworks highlighted in Chapter 17, IFIs are faced with a number of issues including accounting, auditing and taxation that are discussed in Chapter 18.

Part 6: Moving Forward – Opportunities, Issues and Challenges (Chapter 19). While the Islamic finance industry is growing at a very high rate, it is a very young discipline. As a result, issues and challenges are inevitable. However, many opportunities are also available. Throughout this book, opportunities, issues and challenges are discussed in relation to every chapter with a particular focus on the topic of that chapter. In addition, Chapter 19 is intended to provide a holistic overview on opportunities, issues and challenges for the Islamic financial system as a whole.

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Part 1

Overview of the Islamic Financial System

Chapter 1

Introduction to the Islamic Financial System

Preview

Fifty years ago, Islamic finance was merely a dream for many scholars. However, since its inception, Muslim scholars have paved the way for Islamic finance and made it one of the fastest growing industries. Over the years, Islamic finance has become an increasingly substantial segment within the global financial market. During turbulent times, especially the 2007-2009 global financial crisis, Islamic finance showed some degree of resilience to financial shocks. Islamic finance, thus, is not only considered as a feasible and viable alternative for the conventional financial system but also a more efficient, productive and equitable way of financial intermediation. Hence, it is not surprising that this book focuses on this emerging alternative to traditional, conventional finance. What is a financial system after all? How is the Islamic financial system different from the conventional one? When did the Islamic financial system come into existence? What are its main components?

This book provides answers to these and other questions by examining historical developments of the Islamic financial system and its financial market structure. Furthermore, this book discusses how financial institutions (banks, insurance companies and other institutions) work and what their roles are in Islamic economy. The study of Islamic finance will provide you with an understanding of many exciting issues pertaining to this growing industry. In this chapter, we provide a road map of the book by outlining these issues and exploring why they are worth studying.

The emergence of Islamic finance as a new phenomenon within the long-established and deep-rooted conventional finance for the past four decades is of particular significance to Muslims whose lives are governed by the rules and values, prescribed by Islamic law and principles, also popularly known as *Shari'ah.*

Learning Outcomes

At the end of this chapter, you should be able to:

- Understand the main ideas behind the financial system, its components and main functions.
- Comprehend the basic principles of the Islamic financial system by understanding its integral parts, markets and institutions as well as underlying philosophy.
- Provide an overview of what will be covered in this book.

Why Study Islamic Finance?

If we ask someone what "finance" is, we will probably get a number of responses such as: "It is all about money." and "It concerns resource allocation, management, acquisition and investment." Whatever response we get, it will be more or less correct. This is because "finance" is a broad term and takes into account many aspects of the economy and financial system since it deals with matters related to money.

Now if we ask the question: What is 'Islamic finance?', many people will be taken by surprise. They would come up with diverse answers depending on their level of exposure and understanding. To some, Islamic finance is just another religious doctrine to provide financing for mosques, charities or funding for Muslim entrepreneurs. Unconvinced secularists as well as other critical observers would go further to argue that Islamic finance is a broader political agenda to transform the present state of the world or at least some aspects of it to accord more closely with the principles of Islam.

Increasingly, however, people have discovered that Islamic finance appears to be far removed from politics or philanthropic endeavours. In fact, Islamic finance practitioners including bankers, fund managers, economists and regulators would perhaps hesitate to categorise themselves a social or philanthropic movement. Instead, the rapid growth of Islamic finance since its first inception in the 1960s witnessed the growing concern and interest among Muslims and non-Muslims alike whether academicians, practitioners, professionals, or the general public towards establishing a more viable, robust and competitive Islamic financial system that may eventually become the best alternative to the conventional system in the future.

The emergence of Islamic finance as a new phenomenon within the long-established and deep-rooted conventional finance for the past four decades is of particular significance to Muslims whose lives are governed by the rules and values, prescribed by Islamic law and principles, also popularly known as *Shari'ah*. It is estimated that there are over 550 financial institutions worldwide, with assets in excess of US$1 trillion which adhere to Islamic finance principles, operating in 75 countries encompassing most of the Muslim world, along with Europe, North America and various offshore locations.

Therefore, for better comprehension of the subject matter, the expression "Islamic finance" suggests two significant meanings. The noun "finance" suggests that Islamic financial markets and institutions deal with resource allocation, management, acquisition and investment. It also inevitably deals with the fundamental issue in finance which is risk transformation and management. Therefore, Islamic finance is expected to essentially function similarly or at least produce the same economic effect to that of its conventional counterpart. However, the adjective "Islamic" implies some fundamental differences between Islamic finance and its conventional counterpart. Indeed, Islamic finance is built upon some distinctive and unique characteristics which are based upon certain principles underlined by *Shari'ah*. Some of the prominent elements constituting parts of its characteristics include: the prohibition of *riba* or pre-determined rate of interest, the prevention of *gharar* (ambiguity) in contracts, the prohibition of gambling (*maysir*), the prohibition of conducting economic or investment activities which are ethically and socially unacceptable albeit profitable (e.g., pornography, gambling, alcohol and prostitution), the prohibition of monopoly, the introduction of a religious levy or alms-giving (*zakat*), and co-operation for the benefit of society and development of all religiously legitimised (*halal*) aspects of business trade and investment. The *Shari'ah* rules and principles underlying the operation and activities of Islamic finance shall be discussed in detail in Chapters 5, 6 and 7 of this book.

Islamic finance is built upon some distinctive and unique characteristics which are based upon certain principles underlined by *Shari'ah*.

Shari'ah as the Bedrock of the Islamic Financial System

The emergence and rapid growth of Islamic finance today is a reflection of the comprehensiveness and completeness of Islam as a religion and a way of life. It is really represented as an integrated and holistic worldview covering various aspects of human living, economic activity, political behaviour and educational development. Each of these aspects of human living cannot be treated in isolation from each other. Whether at the level of worship (also known as *ibadah* which relates strictly to the pillars of Islam like prayer, fasting, alms-giving and pilgrimage) or that of mundane affairs (also known as *muamalah* which relates to economic, social, political and others), Islam is the carrier of a teaching which is entirely directed towards the collective and social dimension. It is to the extent that we can say that there is no real practice of religion without personal involvement and investment in the community.

The development of the Islamic financial system over the past few decades is a clear manifestation of the Islamic worldview which is represented by *Shari'ah* or Islamic law. Indeed *Shari'ah* is the bedrock of the worldview of Islam. It is that body of knowledge which provides the Islamic financial system and operation with its unchanging bearings as well as its major means of adjusting to change. Many times, reference to *Shari'ah* has been confined to the sphere of Islamic law while in fact, the boundaries of *Shari'ah* extend beyond the restrictive boundaries of law. Indeed many problems of contemporary Muslim societies arise from the fact that *Shari'ah* has been limited to the domains of law.

What Exactly is *Shari'ah*?

Shari'ah is an Arabic term which literally means "the way" or "a path to a watering-place", "a clear path to be followed" and more precisely, "the way which leads to a source".

Shari'ah is an Arabic term which literally means "the way" or "a path to a watering-place", "a clear path to be followed" and more precisely, "the way which leads to a source". From this notion, we can understand that *Shari'ah* is the path which the believer has to tread in order to obtain guidance in this world and deliverance in the next. Technically, the word *Shari'ah* was defined by Al-Qurtubi as the canon law of Islam, all the different commandments of Allah (subhanahu wa ta'ala (s.w.t.))[1] to mankind. Hence, the *Shari'ah* represents a body of Islamic teachings and system which were revealed to Prophet Muhammad (peace be upon him (p.b.u.h.)) through the revelation of the Holy *Qur'an* and later deduced from the Prophet's *Sunnah* — that itself represents a divinely guided lifestyle and whatever was reported about what the Prophet Muhammad (p.b.u.h.) said, did, or gave his tacit approval.

Although the *Shari'ah* is described as "Islamic Law", its boundaries go beyond the limited horizons of jurisprudence. Thus, the *Shari'ah* is a set of norms, values and laws that governs the Islamic way of life. In other words, the *Shari'ah* governs all aspects of Islam, including faith, worship, economic, social, political and cultural aspects of Islamic societies. It is a system of ethics and values; a pragmatic methodology geared towards solving today's and tomorrow's problems. All the prescriptions of worship and everyday injunctions are derived from the *Qur'an* and the *Sunnah* of the Prophet (p.b.u.h.). On the level of acts of worship, the said prescriptions are more often than not precise, and the rules of practice codified and fixed. The domain of everyday affairs be it political affairs, economic dealings, commercial transactions, social interactions, however, is more vast and flexible. This flexibility is still deeply entrenched and governed by fixed principles. Thus, we can find in the two sources a certain number of principles and orientations which the jurists (*fuqaha*) must respect when they formulate laws which are in tune with their time and place. This is known as *ijtihad*, the third primary source of Islamic law, which provides a link between the absoluteness of the points of reference, and the relativity of history and location (see detailed discussion in Chapter 5).

Islamic financial institutions must ensure that all their transactions are *Shari'ah*-compliant, not only in their forms and legal technicalities but more importantly, in their economic substance.

When applied to finance, much of these laws, rules and interpretations of the *Shari'ah* take into consideration issues of social justice, equity and fairness, as well as the practicality of commercial transactions. In a nutshell, Islamic financial institutions (IFIs) must ensure that all their transactions are *Shari'ah*-compliant, not only in their forms and legal technicalities but more importantly, in their economic substance, which should be premised on the objectives outlined by the *Shari'ah*, also known as *maqasid al-shari'ah*. Indeed, the Islamic financial system has the potential to become one of the sectors for realising the noble objectives of the *Shari'ah*, as it resides within a financial trajectory underpinned by the forces of the *Shari'ah* injunctions. These *Shari'ah*

1 *Subhanahu wa ta'ala* or its short version (s.w.t.) means "Exalted and Glorified is He."

injunctions interweave Islamic financial transactions with genuine concerns for a just, fair and transparent society, and at the same time prohibiting involvement in illegal activities which are detrimental to social and environmental well-being.

Value Proposition of the Islamic Financial System

The conventional financial system, especially in the light of its philosophical construct of capitalism built on a doctrine of self-interest, is not concerned about moral values, and is said to be a value-neutral system. This self-interest doctrine relies heavily on the assumption that human beings are rational in decision-making. Hence, it is argued that by satisfying individual self-interest, one will, in general, contribute to the economic development of society as a whole. As a result, the doctrine of *wertfreiheit* (freedom from value judgements), which was supported by the doctrine of self-interest, became a cornerstone of conventional economics.

On the other hand, Islamic finance falls within the scope of Islam as a *din* (religion) and cannot go beyond it. As mentioned earlier, *Shari'ah* means a path to a watering-place, a clear path to be followed based on a clear set of values and legal precepts. The teachings of the *Shari'ah*, thus, do not only apply to our relationship with Allah the Almighty (s.w.t.) but rather they encompass all aspects of human life, economics being no exception. As believers, Muslims are obliged to uphold the utmost sincerity, justice and moral values when dealing with other human beings. According to Ibn Taimiyyah, market order is seen as a "social and economic system governed by ethical values and legal precepts". In fact, the Islamic economic system is based on the following philosophical foundations:

Muslims are obliged to uphold the utmost sincerity, justice and moral values when dealing with other human beings.

1. *Tawhid* – God's unity and sovereignty
2. *Rububiyyah* – divine arrangements for nourishment and directing things towards their perfection
3. *Risalah* – prophethood and guidance
4. *Akhirah* – belief in accountability on the day of judgement and its implications for the life in this world and the Hereafter
5. *Istikhlaf* – man's role as God's vicegerent on earth
6. *Tazkiyah* – purification plus growth
7. *Kafalah* – social solidarity
8. *'Adalah* – justice
9. *Falah* – well-being or success in this world and the Hereafter

It is no surprise then that, in the aftermath of the 2007-2009 global financial crisis, many authors view the integration of ethics and values into finance as a necessary step forward in order to ensure better stability and functioning of the system. This is all in line with the principles preached by the proponents of Islamic finance. Indeed, many authors while acknowledging the similarities of functions between the Islamic and conventional financial systems, highlight fundamental differences between the two as well. Among the most prominent features that Islamic finance is advocating are value propositions which we are now turning towards.

Let us begin by saying that every economic system, Islamic or otherwise, is based on some foundational premises or values. Secular economics is value neutral, you may say, but even being value neutral is a value itself. By choosing reason as the only scientific instrument over the revelation, conventional economists have chosen their foundational principles based on which economic system to operate. As a result, this system is subject to changes whenever a need arises through social consensus, which – deprived from any religious or moral values – is more often than not driven by the whims, greed and self-interest of the people.

Contrary to conventional economics, Islamic economics and finance must observe the teachings of the *Shari'ah* whose basic teachings cannot be violated at any point in time. These basic teachings constitute the core elements of the faith that are best described as *maqasid al-shari'ah* or the objectives of the *Shari'ah*. Hence, Islamic economics is guided by the objectives of the *Shari'ah* whose main goal is to promote *maslahah*, or public interest, and prevent harm (*mafsadah*). For example, while protecting each and every individual in the society and allowing private ownership, Islam also wants to ensure that this is not done at the expense of society. Chapter 2 deliberates in detail on how the objectives of an Islamic economy are inspired by the objectives of the *Shari'ah* (*maqasid al-shari'ah*).

Inspired by the objectives of the *Shari'ah*, Islamic finance, therefore strives for justice, fairness, trust, honesty, integrity and a balanced society. In fact, Islamic finance is characterised by these ethical norms and social commitment as envisioned in the ethical and moral framework of the *Shari'ah*. The principles of *halal* (permissible) and *haram* (prohibited) provide a sort of moral filter for actions taken by every individual in the society, and form a legal framework for Islamic finance.

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This is clear from the morality and validity of contracts. In general, Islam promotes economically productive activities and genuine trade and business transactions on one side; while it calls for avoidance of interest-based transactions, no involvement in illegal and unethical activities and avoidance of speculative transactions, on the other.

Thus, IFIs are not allowed to finance any project which conflicts with the moral values of Islam such as production of alcohol, tobacco, pornography and casino businesses, due to their detrimental effects on society as a whole. While prohibiting usury (*riba*), excessive ambiguity (*gharar*), and gambling (*maysir*), Islam promotes *maslahah* by protecting the interests and benefits of all parties involved in the market. Charging interest, as practised by the conventional financial system, is unjust to both the lender and the borrower. It is an injustice to borrowers as they have to repay their debts irrespective of their financial situation and the outcome of their business venture. On the other hand, in cases when the return on investments is much higher than the interest rate charged, interest-based contracts are similarly unjust to the lenders who cannot enjoy the fruits of higher earnings. This is especially true for return on deposits whose rate is very low although banks may reap enormous profits from the utilisation of these deposits. This scenario is even more obvious in the under-developed world, where the borrowers are large companies and the lenders are usually small savers. In this case, banks generally collect the savings of all small depositors, and channel them to big companies which may earn huge profits, many times higher than the interest paid to the depositors.

Islam promotes *maslahah* by protecting the interests of all parties involved in the market and prohibits usury (*riba*), excessive ambiguity (*gharar*) and gambling (*maysir*).

Although there are no direct statements about the reasons for *riba* prohibition, reading from the *Qur'an* and *hadith* of the Prophet (p.b.u.h), Islamic scholars noted several reasons. For example, Siddiqi (2004) stated the following five reasons[2]:

1 *Riba* corrupts society – This is clear from the following verses 37-41 of *Surah ar-Rum*, where Allah (s.w.t.) says:

> *See they not that Allah enlarges the provision and restricts it, to whomsoever He pleases? Verily in that are Signs for those who believe. (37) So give what is due to kindred, the needy, and the wayfarer. That is best for those who seek the Countenance of Allah and it is they who will prosper. (38) That which ye lay out for increase through the property of (other) people, will have no increase with Allah: but that which ye give for charity, seeking the Countenance of Allah (will increase): it is these who will get a recompense multiplied. (39) It is Allah who has created you: further He has provided for your sustenance; then He will cause you to die; and again He will give you life. Are there any of your (false) "partners" who can do any single one of these things? Glory to Him! and High is He above the partners they attribute (to Him)! (40) Mischief has appeared on land and sea because of (the need) that the hands of men have earned that (Allah) may give them a taste of some of their deeds: in order that they may turn back (from Evil). (41)*

2 *Riba* implies improper appropriation of others' property – This unlawful appropriation of others' property is indicated in the verses 160-161 from chapter four, *Surah an-Nisa'* that reads:

2 For a detailed discussion about the reasons of *riba* prohibition see Siddiqqi (2004) pp. 41-45.

For the iniquity of the Jews We made unlawful for them certain (foods) good and wholesome which had been lawful for them; — in that they hindered many from Allah's way. — (160) That they took usury, though they were forbidden; and that they devoured men's substance wrongfully; — We have prepared for those among them who reject Faith a grievous punishment. (161)

3 *Riba's* ultimate effect is negative growth – In *Surah al-Baqarah*, verse 276, Allah (s.w.t.) claims that *riba* is subject to destruction (*mahq*):

Allah will deprive usury of all blessing (destroy it), but will give increase for deeds of charity: for He loveth not creatures ungrateful and wicked.

4 *Riba* demeans and diminishes human personality – It is clear from the verse 275 of *Surah al-Baqarah* that reads:

Those who devour usury will not stand except as stands one whom the Evil One by his touch hath driven to madness. That is because they say: "Trade is like usury, but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the Fire: they will abide therein (for ever).

5 *Riba* is unjust – That *riba* is unjust is indicated in the verse 279 of *Surah al-Baqarah*, which reads:

If ye do it not, take notice of war from Allah and His Messenger: but if ye repent ye shall have your capital sums; deal not unjustly and ye shall not be dealt with unjustly.

Chapter 2 will explain in detail the economic rationale for *riba* prohibition. All of the above rationale is meant to ensure justice within the society and in the market. It is not surprising then that the word "justice" (*'adl*) is mentioned in the *Qur'an* fifty-three times. Literally, the word *'adl* means to place things in their right and proper place. Hence, the objective is to establish equilibrium within the market and society where everyone receives his due share in terms of rights and obligations.

As briefly mentioned previously, Islam promotes economically productive activities and genuine trade and business transactions. The relationship between economic activities and the real sector in the Islamic financial system cannot be overstated. In fact, this relationship is considered to be the backbone of the Islamic financial system which promotes the stability of the overall system. By having a direct link between the financial sector and the real economy, the system moves away from the uncertainty of the financial sector to the relative certainty of the real sector. This is further strengthened by prohibiting excessive leveraging which was one of the main culprits in the global financial crisis of 2007–2009.

Furthermore, in the Islamic financial system, money is not a commodity as is the case in the conventional financial system and consequently, this promotes stability of the currency. This is particularly true, especially when the monetary flows which go through Islamic financial modes are tied directly to the flow of goods and services. Hence, there is limited space for a sudden and mass movement of funds as compared to the flow of interest-based short-term funds.

In the Islamic financial system, money is not a commodity as is the case with the conventional financial system.

The Islamic financial system also promotes principles of brotherhood and cooperation through partnership, equity-based financing and risk-sharing. As a result, the provider of funds (investor) and the user of funds (entrepreneur) are expected to help each other, co-operate and mutually share both benefits and shortcomings of the business venture. For example, in the case of *mudarabah* financing, the provider of funds (*rabbul mal*) and the entrepreneur (*mudarib*) share the profit according to an agreed ratio, while all losses are to be borne by *rabbul mal*. In Islamic finance, it would be injustice if – in the case of a loss – the *mudarib* is required to pay for the loss incurred as he has already lost everything (his opportunity to earn profit), unless the loss was caused by the misconduct of the *mudarib*.

In fact, Islamic finance is community-oriented and entrepreneur-friendly, emphasising on productivity and physical expansion of economic production and services. Hence, it shifts from the pre-dominant practice of focusing on financial collateral or financial worth of the borrower to the entrepreneur's trustworthiness and project viability and usefulness. Here, the concept of trust (*amanah*) comes into picture. This feature has important implications for the distribution of credit as well as the stability of the system. Iqbal & Mirakhor (2007) highlighted the importance of trust for the stability and performance of economics. Studies showed that countries with relatively high trust levels and strong institutions perform much better compared to countries with low levels of trust and weak institutions. They also pointed out that one of the important reasons why risk-sharing contracts were dominant during the Middle Ages was the mutual trust. As in many other disciplines, Western economics is greatly indebted to the development that took place in the Muslim world, especially Islamic Spain, during the Middle Ages. For example, Iqbal & Mirakhor showed that financing based on the principles of *mudarabah* was equally practised in Europe and it was known as *commenda*.

As a system shaped and governed by the values and philosophy of *Shari'ah*, Islamic financial system naturally promotes the highest level of *governance* and *transparency*. The principle of vicegerency of *khalifah* in Islam implies that man is not the absolute owner of the resources, but rather he is entrusted with them and may utilise them only for the betterment of mankind. Therefore, man is accountable to Allah (s.w.t.) for his conduct on earth. The concept of vicegerency thus entails a broader understanding of the concept of trust and responsibility of human beings. The concept of trust, in Islam, is inseparably linked with responsibility, implying that the wealth that is entrusted upon a human being is indeed a responsibility that he will be accounted for in the Hereafter. Thus, an individual's responsibility is to discharge his "trust" by spending his wealth in several limited ways. This puts a greater importance on the governance and transparency under the Islamic economic system. Furthermore, IFIs, due to their nature of operations, are exposed to unique risks that require additional *Shari'ah* governance, greater fiduciary duties and accountability, while at the same time upholding public interest (*maslahah*).

The principle of vicegerency of *khalifah* in Islam implies that man is not the absolute owner of the resources, but rather he is entrusted with them and may utilise them only for the betterment of mankind.

All in all, Islamic economics and finance is not a value-neutral system as is the case with the conventional financial system. It is worth mentioning here following statements by Muhammad Umar Chapra (1998, pages 104-105):

> Islamic economics is based on a paradigm which is not secularist and value-neutral. It treats all human beings as vicegerents of God and brothers unto each other. All resources at the disposal of human beings are trust and must be used for the well-being of all in conformity with the values provided by the *Shari'ah*. However, well-being in Islam is not a function of just material possessions and unlimited consumption. It is rather a function of the balanced satisfaction of both the material and the spiritual needs of the human personality. This can be done by actualising the *maqasid al-shari'ah* (goals of *Shari'ah*).

Functions of the Islamic Financial System

Islamic financial markets perform the essential economic functions of bringing together surplus fund units (SFUs) to deficit fund units (DFUs) which are deemed necessary for effective and smooth running of a financial system similar to that of conventional financial markets. However, as mentioned earlier, this economic function of channelling funds from households, firms and governments with surplus funds by spending less than their income to those with a shortage of funds because they wish to spend more than their income, need to be done through a *Shari'ah*-compliant manner. In other words, the whole process, instruments and activities of channelling the funds must follow the rules and principles prescribed by *Shari'ah*. In Chapters 6 and 7, we will study the various *Shari'ah* contracts and principles underlying the Islamic financial transactions.

In order to understand the benefits of a financial system, its markets and institutions, we can take a brief look at the evolution of markets. Consider a barter economy, for instance, where goods are exchanged for other goods and there is no formal marketplace. This barter process encompasses the simple exchange of one's goods or services for that of another. Under this scenario, if a farmer produces agricultural products but needs tools and equipment for cultivating the land, he would have to exchange his goods with a smith who eventually has the tools the farmer needs. Now, if the smith does not need the goods owned by the farmer, the farmer would have to exchange his goods with someone else who has goods which the smith may be interested in.

Obviously, finding someone who is in need of goods that we own, and at the same time exchanging our goods with goods of another person is a very difficult and time-consuming process. For this primitive market to operate, there is a need for what is commonly known as the *double coincidence of wants*. But this is not the only problem with barter economy. Setting up the exchange rate or the price of the goods to be exchanged is another problem. This is also referred to as *indivisibility of goods and services*. In addition, a *lack of a unit of account* (common standard of value) further exacerbates the problem with the barter economy. More on these issues can be found in Chapter 3 where the issue of money in Islamic perspective is also examined.

Now, with the development of financial markets, these and similar issues were solved. Instead of exchanging the goods, people started using money as the medium of exchange. The advent of money has not only facilitated the exchange of the goods and services, but it also helped individuals by way of saving their surplus earnings. Hence, the organised markets helped not only in the exchange of the goods but also in the exchange of money between the SFUs and DFUs by allowing individuals to specialise in the production of goods and services.

A financial system consists of markets and institutions actively engaged in the channelling of investable funds from surplus-income units to deficit-income units. There are mainly four principal players in a financial system: individuals, households, companies (firms) and governments who represent either DFUs or SFUs. Usually,

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- individuals;
- households;
- companies; and
- governments.

governments and companies are on the deficit side as they need funds for large-scale expansionary activities. The surplus side, on the other hand, is dominated by ordinary individuals and households who often spend their incomes over extended periods thereby putting aside some savings for investment or future consumption. The main objective of a financial system is therefore to mobilise large amounts of relatively small savings and pool them together to channel them for productive investments in the economy. This is done either directly through financial markets (stock exchanges, over-the-counter trading, etc.,) or indirectly through financial intermediaries (bank and non-bank institutions).

As for the Islamic financial system, the mechanism to mobilise funds from SFUs and subsequently channel those funds to DFUs must be done within the parameters stipulated by *Shari'ah*. This inevitably means the behaviour and operation of financial institutions and markets operating under the Islamic financial system need to comply with the rules and principles of *Shari'ah*. The financial institutions including Islamic banks (commercial and investment banks), *takaful* companies (Islamic alternative to insurance), mutual funds and other Islamic finance companies facilitate the flow between the SFUs and DFUs by developing instruments, techniques and products that not only meet the needs of depositors and customers but more importantly, comply to *Shari'ah*.

Now that we have briefly discussed the Islamic financial system, we will discuss more about the main types of Islamic financial markets.

Types of Islamic Financial Markets

As in conventional finance, there are many different types of Islamic financial markets with each market having its own purpose and objectives. Similarly, there are different classifications of these markets. For example, some investors want to invest for a short-term period, while others want to invest for a long-term period. Some are risk-loving, whereas others are risk-averse. Some prefer to borrow through debt market instruments, whereas others prefer to raise funds by issuing stocks. The most common types of financial markets are as follows:

Debt and Equity Markets

There are two ways for firms or government agencies to raise funds in a financial market: by issuing debt securities (bonds) or equity securities (stocks). Issuing a debt instrument is the most common method of raising funds. This debt instrument represents a contractual agreement whereby the borrower is obliged to pay the holder of the instrument a certain fixed amount of money at agreed intervals. The return to investors is in the form of interest income (coupon payments). Upon maturity, the principal amount will be paid to the investors. Depending on the maturity, a debt instrument can be a short-term instrument if its maturity is less than a year, intermediate-term instrument if its maturity is between one and 10 years, or long-term instrument if its maturity is 10 years or longer. Long-term debt instruments tend to bear more risk and are expected to yield a higher expected return than short-term instruments.

Essentially, the interest or coupon payments embedded in debt instruments like bonds clearly violate the *Shari'ah* principles. Under *Shari'ah*, loan contracts must always be interest-free. Any additional benefit to the lender in a loan contract either monetary or in kind is deemed as a form of *riba*, which is prohibited in *Shari'ah*. This prohibition is evidenced in many verses of the *Qur'an* as well as sayings of the Prophet (p.b.u.h.).

Exhibit 1.1 Prohibition of *Riba* in Loan Contracts

The stipulation of an excess for the lender in a loan contract is clearly prohibited as it is tantamount to *riba*, whether the excess is in terms of quality or quantity or whether the excess is a tangible item or a benefit, and whether the excess is stipulated at the time of the contract or while determining the period of delay for satisfaction or during the period of delay and, further, whether the stipulation is in writing or is part of a customary practice.

The principle that the *Qur'an* has given in verses 2:278 and 2:279 is that for loans, the creditor has the right to the principal amount only. Any amount, big or small, over and above the principal of loan or debt would be *riba*. The following provides some evidences from the *Qur'an* and *hadith* of the Prophet (p.b.u.h.):

***Qur'anic* Justification**

O you who believe! Be afraid of Allah and give up what remains (due to you) from riba *(usury) (from now onward) if you are (really) believers. And if you do not do it, then take a notice of war from Allah and His Messenger (p.b.u.h.) but if you repent, you shall have your capital sums (principal amount). Deal not unjustly (by asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums).* (2:278-279)

***Hadith* Justification**

From Ali (may Allah be pleased with him) said, that the Messenger of Allah (p.b.u.h.) said: All form of benefits (to lenders) derived from loan contracts are forms of riba.

Source: Ibn Hajar al-Asqalani. (1928). *Bulugh al-Maram min Adillah al-Ahkam.* Matba'ah al-Salafiyyah, p. 176.

Alternatively, debt securities in Islamic debt market is structured based on Islamic debt certificates like *sukuk* which actually resembles the features of conventional bonds representing debt or borrowed funds by the issuer. However, unlike bonds which are merely based on loan contracts that generate interest through coupon, *sukuk* rarely use loan contracts because there is no value-added return to investors from the contract due to the *Shari'ah* prohibition of *riba* in loan transactions. Instead, *sukuk* is structured based on a variety of *Shari'ah*-compliant contracts to create the asset and financial obligations that are to be represented by *sukuk*. For example, the asset or financial obligations between the issuers and the subscribers (investors) can be created via *Shari'ah* permissible contracts of sales, leasing, equity partnership and joint partnership. The return on investment is derived from the profits generated from these sales or leasing contracts as well as the profit-sharing mechanism in the partnership contracts. Chapter 10 discusses in detail the *sukuk* market instruments and operations which play an important role in the Islamic financial system.

Equity securities differ from debt securities in that the former represent partial ownership in the issuing entity while the latter have no such right.

The other way of raising funds for firms and government agencies is through the equity market by issuing equity securities (stocks). Equity securities differ from debt securities in that the former represent partial ownership in the issuing entity while the latter have no such right. Furthermore, equity securities tend to be riskier than most long-term debt instruments, but they also tend to have a higher expected return as well. Holding equity securities of any corporation has its own advantages and disadvantages. As the corporation grows and its value increases, holders of its stocks can earn a return from periodic dividends and a capital gain if they sell stocks. Holders of its stocks, however, can experience a negative return as well if the corporation performs poorly and if the stock price declines over time.

In Islamic equity market space, equity instruments must be structured based on the permissible rules and principles stipulated in *Shari'ah*. Moreover, since stocks represent undivided shares in the capital of a corporation, it is vital to ensure that the business activities of the corporations do not involve *Shari'ah*-prohibited and unethical activities such as gambling, selling of alcohol, pornography, violating human rights, environmental degradation, tobacco manufacturing and *riba*-based business activities. Chapter 11 explains the characteristics and salient features of the Islamic equity market and its operation.

Money and Capital Market

Maturity of underlying securities also plays an important role in distinguishing between markets. Short-term debt securities, with a maturity of less than a year, are traded in money markets. On the other hand, debt securities, with a maturity of greater than a year, are traded in capital markets. Similarly, equity securities, which are considered long-term securities with no particular maturity, are also traded in capital markets.

Hence, the money market is a financial market that facilitates the trade of only short-term debt securities (less than a year), while the capital market is a financial market that facilitates the trade of longer-term debt securities (a year or greater) and equity securities. Furthermore, money market securities are more widely traded and their prices have smaller fluctuations than capital market securities. This implies that the money market securities tend to be more liquid and represent relatively less risky investments.

Islamic money and capital markets represent an assertion of the *Shari'ah* principles in the money and capital market transactions where the market should be free from any elements or activities that are prohibited in Islam. The strict adherence to the *Shari'ah* principles also implies that all financial instruments used by transacting parties in the money and capital markets need to be Islamic in nature.

Islamic Money Markets

The purpose of an Islamic money market is to serve three main functions. Its first function is liquidity management. It serves as an avenue for IFIs to source daily funding or to invest in the short term. Access to money markets enables IFIs to maintain optimal liquidity thereby allowing them to meet the demands of their customers at any time. This therefore, allows the IFIs to cope with short-term pressures. It gives flexibility to the IFIs to face every liquidity situation that might arise due to different timing of cash inflows and outflows. The popular programme, which is used in practice for liquidity management is commodity *murabahah* which is essentially based on the contract of *tawarruq* (see Chapter 6 for a detailed discussion of the contract, and its application in Islamic money markets in Chapter 9). For non financial institutions, they use other money market instruments to manage the fluctuations in their working capital needs either by obtaining short-term funding or placement. Consequently, they will be able to enjoy low cost funding or investment returns with low risks.

Access to money markets enables Islamic financial institutions to maintain optimal liquidity thereby allowing them to meet the demand of their customers at any time.

An Islamic money market also serves as an avenue for secondary trading of money market instruments. Depending on the objectives, risk and return preferences of money market participants, they will either buy or sell money market instruments in anticipation of obtaining investment returns. The instruments available in the money market provide investors with different levels of risks, returns and maturity. Some of the more popular instruments include the Government Investment Issue (GII), Islamic Treasury Bill (ITB), Islamic Negotiable Instrument (INI) and Negotiable Islamic Debt Certificate (NIDC). Finally, a money market is used as a channel for a central bank to conduct its monetary policies. The mechanism is the same as in the case of the conventional model, i.e., the central bank undertakes open market operations by undertaking Repurchase Agreements and reverse Repurchase Agreements (REPOs). In Islamic money markets, this is known as Sale and Buy-back Agreements and Reverse

Sale and Buy-back Agreements. Chapter 9 elaborates on the Islamic money market's functions, operations and instruments.

Islamic Capital Markets

An Islamic capital market comprises two main components: the debt market and the equity market.

An Islamic capital market, as is the case of a conventional capital market, constitutes an integral part of the Islamic financial system. In general, an Islamic capital market comprises two main components: the debt market and the equity market. They are indispensable for the efficient mobilisation of resources and their optimal allocation. While generally being similar to conventional capital markets, Islamic capital markets differ in their core elements which are deeply rooted in *Shari'ah* teachings. As a result, Islamic capital markets offer instruments, such as Islamic equity securities and Islamic debt (bond) securities, among others, based on the *Shari'ah* principles that make them *Shari'ah*-compliant. Islamic capital markets play a complementary role to the investment role of Islamic banking thus creating a comprehensive Islamic financial system.

The growing awareness of and demand for investment in *Shari'ah*-compliant products and instruments around the globe has resulted in the creation of a flourishing Islamic capital market. Today, there are a number of Islamic capital market products and services, such as *sukuk*, Islamic stocks, Islamic bonds, Islamic funds, Islamic real estate investment trust (REIT), and Islamic risk management products. Chapters 10 and 11 of this book will enlighten the readers on various instruments used in an Islamic capital market, namely *sukuk* and other Islamic equity market products, respectively.

Primary and Secondary Markets

Whether we are dealing with short-term debt securities that are traded on money markets or longer-term debt and equity securities that are traded on capital markets, it is important to differentiate between the initial trade of securities and their subsequent resale on markets. Corporations and government agencies use a primary market to raise funds from initial buyers of a security, such as a bond or a stock. A secondary market is a financial market where existing securities are bought and sold.

Thus, an initial sale of a bond or a stock is a primary market transaction and with this transaction, the initial issuer of a security raises the funds. On the contrary, the sale of an existing bond or a stock is a secondary market transaction and this transaction does not provide funds to the initial issuer. Nevertheless, secondary markets play important roles in the overall financial system. First, it provides liquidity which represents a degree to which securities can be easily liquidated (sold) to raise cash. If a security is highly liquid, meaning that there are many willing buyers and sellers of the security, it means that its holder can easily sell it for cash without a loss in value. A holder of an illiquid security, on the other hand, may need to offer a large discount to a buyer, thus losing in value. Secondly, secondary markets provide necessary information to both savers and borrowers by determining the price of securities. The higher the price of a given security in secondary markets, the more funds can be raised by the issuing corporation in the primary markets.

Promoting vibrant and efficient secondary markets for Islamic finance remains one of the most challenging aspects of the Islamic financial system. This is due to the limited number of Islamic financial instruments and structures which qualify for secondary trading, especially debt-based securities. The issue of debt-trading or *bay' al-dayn* has always been a point of contention among past and present Islamic jurists. The most contentious aspect of debt-trading is whether the debt can be traded to a third party at a discounted value.

Organised Exchange and Over-the-Counter Markets

Trading of securities, either bonds or stocks, takes place mostly in secondary markets which can be further classified into two: exchanges and over-the-counter (OTC) markets. Organised exchanges are central locations where buyers and sellers of securities trade. These trades are mainly carried out through brokers and dealers who play crucial roles for the well-functioning of the secondary markets. Brokers are mainly agents of clients who act as intermediaries between buyers and sellers of securities, and for executing clients' orders, brokers charge commission fees. Dealers, on the other hand, stand ready to buy or sell securities for their own accounts. Examples of exchanges are the New York Stock Exchange, London Stock Exchange, NASDAQ, and Bursa Malaysia, to name a few.

Dealers at different locations use OTC or off-exchange markets to trade securities. Over-the-counter markets are highly competitive due to the fact that the buying and selling of securities are done through a computerised trading system. Usually, equities and bonds of large and well-known corporations are traded on exchanges, while equities and bonds of lesser known companies are traded in OTC markets.

Islamic Financial Intermediaries

Funds can move from surplus fund units (SFUs) to deficit fund units (DFUs) through direct finance. However, direct finance is normally less effective and efficient due to many reasons. First, the presence of information costs undermines the ability of a potential surplus fund provider to find the most appropriate deficit unit in the absence of intermediation. A financial transaction, particularly the need to acquire sufficient and correct information before transacting in the market naturally involves transaction costs such as a searching cost, screening cost, monitoring cost and enforcement cost.

Exhibit 1.2 Four Types of Information Costs

Search cost

What is meant by *search cost* is that potential transactors, for instance the lenders, must search, obtain information about, select, meet and negotiate with potential borrowers to contract. Insufficient information with regard to choosing suitable borrowers may result in the lenders failure to transact in the market.

Screening cost

It is the cost of evaluating borrowing proposals and at the same time verifying the information provided. This is necessary to avoid an adverse selection problem that may occur due to the lenders' inability to observe the attributes of borrowers and the contingencies under which they operate.

Monitoring cost

This is the type of cost which is necessary to reduce a moral hazard problem by ensuring that the borrower's actions are consistent with the terms of the contract and ensuring that any failure to meet the commitments as promised is for genuine reasons.

Enforcement cost

This is the type of cost which would be needed should there be a default on the loan granted. As a result action must be taken, especially in enforcing the contract.

Secondly, SFUs and DFUs have different liquidity preferences. It is typical for firms in the business sector to want to borrow funds and repay them in line with the expected returns if it is an investment project, which may not be realised for several years after the investment. By lending funds, savers are actually agreeing to forgo the present consumption in favour of consumption at some date in the future. Either the borrowing or the lending parties may change their minds due to unexpected events. Therefore, in the absence of intermediation, it is difficult to match different expectations and liquidity preferences.

The essence of financial intermediation is the interposition of a third party between the ultimate borrower and ultimate lender in the saving-investment process. A financial intermediary performs this service by matching up borrowers with lenders. It channels funds from areas in the economy where there is surplus to areas of the economy where there is deficit. This service promotes the ultimate aim of any market economy, which is to allocate most efficiently the economy's resources to their most highly valued use.

Unlike individual lenders, financial intermediaries like banks may enjoy informational economies of scope. Economies of scope is said to exist when two or more products can be jointly produced at a lower cost than if the same products are produced individually. Banks are said to gain from the information economies of scope since it can pool a portfolio comprising claims which have a lower individual default risk — but with the same expected return — than those loans which depositors could have otherwise chosen when acting as direct lenders of funds. Since banks deal with a bundle of funds, they can reduce the transaction costs per unit. Financial intermediaries like a bank may also reap the advantage of informational economies of scope in channelling the funds through lending and financing because they have access to privileged information embedded in the customers' accounts at the bank when making lending or financing decisions. The information advantage possessed by the bank partly resolves the issue of asymmetric information which poses as a major impediment and obstacle to the smooth running and effective and efficient flow of funds in the financial market.

Economies of scope is said to exist when two or more products can be jointly produced at a lower cost than if the same products are produced individually.

Exhibit 1.3 What is Asymmetric Information?

Asymmetric information is a situation in which a person has insufficient knowledge about the counterparties involved in the transaction to make an accurate decision. This problem subsequently gives rise to two other problems, the *adverse selection* and *moral hazard* problems. The former relates to the ex-ante asymmetric information problem that occurs before the transaction happens, while the latter is the ex-post asymmetric information problem that occurs after the financial transaction takes place.

Adverse selection in the financial market occurs when the potential borrowers who are the most likely to produce an undesirable (adverse) outcome – the bad credit risks – are the ones who will most actively seek out a loan and are thus most likely to be selected. Because adverse selection makes it more likely that financing might be made to bad credit risks, the financier may decide not to make any financing at the expense of good risks in the market place.

Moral hazard in the financial market is the risk (hazard) that the financing customers or borrowers might engage in activities that are undesirable (immoral) from the financier's viewpoint, because they create huge uncertainties that the channeled funds will be paid back. Since moral hazard reduces the probability that channeled funds will be repaid, financiers may decide that they would rather abstain from providing such financing.

The two scenarios explained above will somehow impede the well-functioning of financial markets.

Source: Mishkin, Frederic S. & Eakins, Stanley G. (2009). *Financial Markets and Institutions*. (6th edn.). New York: Pearson and Prentice Hall.

Banks, as the most important intermediary, also assume the role of delegated monitors which can efficiently centralise costly monitoring and avoid duplication of effort with respect to monitoring of borrowers by an individual lender. By means of diversification and the *law of large numbers*, banks have the comparative advantage to monitor a large portfolio of loans diversified by firms and markets. Monitoring financial contracts and activities, particularly debt contracts, is indispensable to prevent opportunistic behaviour of the borrower, both ex-ante and ex-post situations of financial contracts.

Exhibit 1.4 What is the Law of Large Numbers?

Law of large numbers is a special source of scale economies. According to this law, the increase in the number of different assets in a portfolio reduces the likely range of the prospective value of that portfolio, provided that the values of different assets in the portfolio are negatively correlated to one another, and provided that the number of assets reflects true diversification, so that when some assets happen to fall in value, others are likely to rise more or less simultaneously and offset at least some of the decline.

Source: Baumol, W.J. Economies of Scale in Financial Activities. In *The New Palgrave Dictionary of Banking and Finance* Newman, P. *et al.*

By pooling a large number of depositors and financing customers, financial intermediaries like Islamic banks can also overcome the problem of matching different liquidity preferences. This is because banks have the advantage of economies of scale, the reduction in transaction costs per value of transactions as the size (scale) of transactions increases, that transform illiquid assets into liabilities since they have the necessary liquidity. Therefore, liquidity is an important service of an Islamic bank that is available to its clients, and if it can offer this service at a lower cost than what would be incurred in the absence of a financial intermediary, SFUs and DFUs of the economies alike will definitely demand the services of a bank. For example, Islamic banks provide depositors with demand deposits that enable them to pay their bills easily. In addition, depositors can earn a share of profits on the investment accounts and still convert them into goods and services whenever necessary.

Banks and financial intermediaries in general can be perceived as facilitators of risk transfer in dealing with the increasingly complex maze of financial instruments and markets. Trading of risk in financial markets appear to have become central to the role of the intermediary. There are four main rationales for the interest in risk management that is evident in the market. These are managerial self-interest, non-linearity of taxes, costs of financial distress and finally, the existence of capital market imperfections. Banks function as a risk consolidation or transformation mechanism by exploiting the law of large numbers as they deal with large numbers of creditors and debtors, who act to a considerable extent, independently of each other.

Types of Islamic Financial Intermediaries

All financial intermediaries whether Islamic or conventional are generally classified into two broad categories, namely: depository institutions and non-depository institutions. Non-depository institutions are further classified into contractual savings institutions and investment intermediaries.

Depository institutions are financial intermediaries that accept mainly deposits (funds) from SFUs and provide these funds to DFUs through loans and purchases of securities. Islamic commercial banks are an example of depository institutions. Chapter 8 explains and deliberates on Islamic banking mechanisms and operations.

In addition to Islamic commercial banks, depository institutions also include savings and loan associations, mutual savings banks, and credit unions which are also known as thrift institutions. In general, thrift institutions are non-commercial depository institutions. Non-depository institutions, such as contractual savings institutions and investment intermediaries, also play an important role in financial intermediation and provide funds to DFUs. However, contrary to depository institutions, sources of funds for non-depository institutions are not derived from deposits, but rather from other sources. *Takaful* (Islamic insurance companies) and pension funds are examples of contractual savings institutions. These institutions collect funds on a contractual basis, either through premiums paid on insurance policies or through employer and employee contributions.

Table 1.1 Financial Intermediaries

Main Categories	Examples	Sources of Funds
Depository Institutions	Commercial banks Savings and loan associations Mutual savings banks Credit unions	Deposits Deposits Deposits Deposits
Non-Depository Institutions Contractual Savings Institutions	*Takaful*/insurance companies Pension funds	Premiums Employer and employee contributions
Investment Intermediaries	Finance companies Mutual funds Investment banks	Securities Shares Other financial institutions

Examples of investment intermediaries are finance companies, mutual funds, and investment banks. Finance companies raise funds by selling securities and channelling these funds to individuals and businesses. Mutual funds raise funds by selling shares to SFUs and using these funds to purchase diversified portfolios of securities. Investment banks do not collect deposits from SFUs but rather, they market and sell securities issued by the firms directly to investors.

Financial intermediaries, Islamic or otherwise, are crucial for the well-functioning of financial markets. Financial intermediaries, as discussed above, channel funds from SFUs to DFUs on one side and provide risk-sharing, liquidity, and information to market players on the other. All of this is done through the financial services and products that are developed by the IFIs.

As mentioned earlier, since Islamic financial intermediation is governed by *Shari'ah*, all processes and operations, particularly with respect to resource mobilisation and intermediation, are done in a *Shari'ah*-compliant manner. One of the most critical aspects of *Shari'ah*-compliant intermediation is the structuring of a comprehensive set of *Shari'ah* permissible instruments with varying financing purposes, maturities and degrees of risk, to satisfy the needs of a diverse group of economic agents in the economy.

There are mainly two approaches to developing modern Islamic financial instruments, namely: the adaptive and the innovative approach. Under the first approach, existing conventional services and products that are generally acceptable by *Shari'ah* are modified and further enhanced by removing any elements that are against *Shari'ah*. The second approach relies on the various *Shari'ah* contracts and these contracts are applied in order to provide new and innovative services and products to different clientele. Chapters 6 and 7 shall deliberate in detail the various *Shari'ah*-permissible contracts used in structuring Islamic financial instruments.

Requisites of the Islamic Financial System

The Islamic financial system, being an integral part of an overall Islamic economic system, requires a conducive environment that not only conforms to the rules and principles of *Shari'ah* but at the same time, enables it to work effectively and efficiently. The following are some essential requirements for a successful Islamic financial system.

Strong Risk Management Practice

Looking at the wide range of products offered as well as the fundamental roles of an intermediary played by IFIs, it is therefore argued that IFIs are not immune to risk exposure. Furthermore, the need to adhere to the principles of *Shari'ah* has exposed the nature, characteristics and magnitude of risks of IFIs, especially those inherent in the various modes of financing and to a certain extent different from traditional financial institutions. It is crucial that the potential risk exposure be understood and managed accordingly to ensure that IFIs continue to provide financial services to their clients in a safe and sound manner. Due to the fact that IFIs have become an integral part of the financial system in many countries, the soundness of their operations is therefore essential to maintain the level of robustness in the economy.

The overall perspective on risk and its management are embodied in the overall goals of Islamic law or *maqasid al-shari'ah*. The principle of *maqasid* would imply taking all the precautions to safeguard present and future wealth. As risk in economics represents the probable loss of wealth, it is not desirable in itself from an Islamic perspective. While risks are not desirable on their own, they must be undertaken to create wealth and value. From an Islamic perspective, economic activities are not judged by their inherent risks, but by whether they add value and/or create wealth.

Muslim scholars identify three types of risks from the Islamic perspective: essential risk, prohibited risk and permissible risk.

In line with the above discussion, Muslim scholars identify three types of risks from the Islamic perspective. First is the *essential* risk that is inherent in all business transactions. This type of business risk is necessary and must be undertaken to reap the associated reward or profit. There are two legal maxims associating return to essential risks form the basis of Islamic economic transactions. The first maxim states: "The detriment is as a return for the benefit (*al-ghunm bil al-ghurm)*" (Majalla Art. 87). This maxim attaches the "entitlement of gain" to the "responsibility of loss". This maxim is usually used to propose the preference for profit-and-loss-sharing (PLS) financing instruments. The second maxim is derived from the Prophetic saying "*al-kharaj bi al-daman*" stating: "Any return should be accompanied with liability" (Majalla Art. 85). The maxim asserts that the party enjoying the full benefit of an asset or object should bear the risks of ownership (Vogel and Hayes 1998). Note that linking returns to risks of ownership does not necessarily relate to PLS contracts. The principle points to the risks associated with ownership which are associated with sale and leasing transactions. For instance, the implication for a sale-based transaction is that the seller must bear all the risks associated with the object of sale and in a leasing contract, the lessor should be responsible for the asset leased out (Hassan 2009).

The second risk identified by Hassan (2009) is *prohibited* risk in the form of excessive *gharar*. *Gharar* is usually translated as uncertainty, risk or hazard, but it also implies ignorance, gambling, cheating and fraud. Generally, *gharar* relates to the ambiguity and/or ignorance of either the terms of the contract or the object of the contract. Thus, a sale can be void because of *gharar,* due to risks of existence and taking possession of the object of sale on one hand and uncertainty of the quantity, quality, price and time of payment on the other. Ibn Taymiyyah provides another perspective of forbidden *gharar* by equating it to activities leading to evil and unjustified devouring of people's wealth as in the case of gambling (Vogel and Hayes, 1998). Thus, transactions bearing gambling-like features are forbidden due to excessive *gharar*.

The final form of risk is *permissible* risk that does not fall under the above two categories. Examples of these risks are operational risks and liquidity risks. These risks can either be accepted or avoided. Chapter 13 explains the principles and best practices of risk management for Islamic financial institutions, while Chapter 14 explores Islamic risk management tools and mechanisms. In particular, the current use of Islamic financial derivatives shall be discussed in light of the various hedging instruments which are structured based on *Shari'ah*-approved contracts and instruments, such as, *inter alia*, *wa'd*, *tawarruq*, and commodity *murabahah*.

Effective Regulation of Islamic Financial Institutions

Like its conventional counterpart, the Islamic financial system is among the most heavily regulated sectors in the economy. The government regulates financial markets for many reasons. Firstly, to ensure soundness of the financial system due to the inherent systemic issues which have traditionally been central to the regulation of financial institutions due to the nature of their business and pivotal positions in the financial system, especially in the clearing and payment system. The potential systemic dangers resulting from bank runs further accentuates the rationale for efficient prudential regulation of financial institutions. Secondly, the economic rationale for financial regulation relates to market imperfections and failures. Since financial services are conducted in a competitive market environment with inherent information problems, externalities, conflict of interest, agency problems, etc., regulation is necessary to enhance stakeholders' welfare, both by reinforcing the degree of competition, and by making it more effective in the marketplace. Information and therefore disclosure requirements are an important part of this process.

Similar to conventional financial institutions, IFIs are not immune to systemic risk and "bank runs". By their very nature, Islamic banks also transform the term of their liabilities to have different maturities on the assets side of the balance sheet. At the same time, Islamic banks must be able to meet their commitments such as deposits at the point at which they become due. Thus, balance sheet management lies at the heart of confidence in both the conventional and Islamic banking operations. Customers place their deposits with an Islamic bank with the confidence that they can withdraw their deposits whenever they wish. If the ability of the bank to pay out on demand is questioned, all its businesses may be lost overnight. The importance of regulation, therefore transcends the individual institution, since any liquidity shortfall due to mismatch problems at a single institution may invoke systemic repercussions causing harm to the whole financial stability of a country.

Ideally, the revolutionary departure of the Islamic financial system from the conventional system is exemplified by a vision to move from a debt-based financial intermediary to an equity-based and risk-sharing arrangement. In other words, an ideal IFI is reflected through its balance sheet structure that is purely based on PLS contracts (*mudarabah* and *musharakah*) on both the assets and liabilities sides. In such arrangements, it is believed that the depositors who share the risk with the bank on the liabilities side will naturally absorb any adverse outcomes on the assets side of the bank's balance sheet. The value of the depositors' funds represents the real asset value of the banks. Thus IFIs, theoretically are deemed to be the best alternative to the conventional system due to their robustness and the potential stability that the system may provide. The focus of regulation will shift from protection of investment account holders (*mudarabah depositors*) to ensuring the integrity of fiduciary contracts.

An ideal Islamic financial institution is reflected through its balance sheet structure that is purely based on profit-and-loss-sharing contracts (*mudarabah* and *musharakah*) on both assets and liabilities sides.

However in practice, not all depositors are willing to face the financial risks inherent in Islamic financial activities. Risk-averse depositors are more attracted to a guaranteed principal repayment arrangement, at the same time content with minimal returns on deposits. Consequently, the nature of regulation for IFIs is similar to that of conventional banking except for certain peculiar characteristics such as distinct risk exposures and the nature of *Shari'ah* contracts. Chapter 15 elucidates the rationale and specificities of regulation and supervision framework in the Islamic financial system.

Sound Corporate and *Shari'ah* Governance

Sound corporate governance practices have become essential for efficient, viable and sustainable growth of the financial services industry. The issue of corporate governance has started to figure prominently in the public domain in the wake of increasing notorious mismanagement scandals involving different types of corporations including financial institutions like Barings and Bank of Credit and Commerce International (BCCI). The ultimate rationale of good corporate governance practice is to protect stakeholders from hazards arising from the inherent imperfection of financial market transactions. For IFIs, this issue becomes more acute, especially when corporate governance objectives include reassuring stakeholders that they are likely to receive a fair return on their investments and equally important, that business practices conform to *Shari'ah* principles.

The ultimate rationale of good corporate governance practice is to protect the stakeholder from hazards arising from the inherent imperfection of financial market transactions.

Meanwhile, *Shari'ah* governance is the very essence of the Islamic financial system in building and maintaining the confidence of the shareholders as well as the other stakeholders that all transactions, practices and activities are in compliance with *Shari'ah* principles. Realising the importance of this subject within the context of IFIs, Chapter 16 attempts to provide the necessary information on corporate and *Shari'ah* governance by discussing its theories and practices. The chapter shall examine the key elements and most important areas of corporate and *Shari'ah* governance as practised by IFIs.

A Supportive Legal Framework

An effective legal framework is essential in safeguarding public interest in the Islamic financial system. Indeed, such a framework is important to cater to the growth and sustainability of Islamic financial service institutions. For a legal framework to be considered effective, it should be able to uphold the rule of law, meet certain formal, institutional and procedural criteria and generally incorporate some important elements. First, there is the presence of legally binding rules. These substantive rules should be promulgated to the public in a transparent and appropriate manner. Any alteration to the rules should be guided by law according to disclosed and fair procedures. Second, the existence of appropriate processes of making, enforcing and changing rules. Third, the existence of well-functioning public institutions that apply the laws fairly and independently.

Establishing an effective legal framework for the Islamic financial system is one of its main obstacles since the existing legal definitions of banking and financial services often do not recognise Islamic financial transactions.

As for the Islamic financial system, establishing an effective legal framework means ensuring a harmonised interface between *Shari'ah* principles that form the backbone and *raison d'être* of the industry, and the existing legal framework. This is indeed one of the main obstacles since the existing legal definitions of banking and financial services often do not recognise Islamic financial transactions, due to their nature and mechanisms. Many constraints are to be expected if the country's general laws are to be applied directly to Islamic financial transactions, which may result in potential conflicts and adverse legal effects. The constraint is more apparent in non-Islamic jurisdictions, whereby the adjustments and management of tensions between civil or common law and Islamic law could certainly form a persistent challenge. In addition, whenever disputes arising from Islamic financial transactions appear before civil courts that apply Western-inspired laws instead of Islamic law, there is a high potential for anomalies or even contradictions to *Shari'ah* principles, simply due to the lack of appreciation or varying competence on the part of the legal and judicial personnel. The absence of a comprehensive codification of substantive laws governing IFIs may further exacerbate this problem.

Chapter 17 delineates the evolution in the development of the legal framework for Islamic finance in different jurisdictions and identifies the various factors that influence the development of various legal frameworks governing the Islamic financial system.

Robust Accounting Disclosure and Taxation Regime

Some of the key elements of regulation are accounting, auditing and taxation regulations. Indeed, in order for IFIs to operate effectively, efficiently and competitively, accounting, auditing and taxation play an important role. There are stringent reporting requirements for Islamic financial intermediaries. Their book-keeping must follow certain strict principles and their books are subject to periodic inspection and audit. Certain material information must be made available to various stakeholders to secure confidence and loyalty.

Moreover, proper taxation law for the Islamic financial system is needed to ensure that Islamic financial transactions are not disadvantaged compared to those of the conventional counterpart. The structuring of Islamic financial instruments which often comprise multiple transactions and additional parties compared to conventional instruments will inevitably invoke higher taxation. This implies higher costs of operation, making it difficult for IFIs to compete on a level playing field with their conventional counterparts. Furthermore, consumers pay additional cost just because they wish to meet their financial needs while complying with the *Shari'ah* rules and principles to which they subscribe. Hence, tax legislation has to be reviewed to achieve a favourable tax effect by way of providing tax neutrality for Islamic financial transactions. Tax neutrality is needed to put Islamic financial transactions on a level playing field with conventional transactions. However, changing legislation to cater to a specific transaction may not be the most feasible solution in some countries, especially where other issues such as cultural and religious beliefs come into play. Notwithstanding this, tax legislation is an area that needs to be looked into when developing Islamic finance in a country. Chapter 18 discusses the issue of accounting, auditing and taxation for IFIs.

Summary

1 Islam as a *din* represents a comprehensive and holistic worldview encompassing all aspects of human life. Thus, *Shari'ah* teachings are considered to be the bedrock of the Islamic financial system as *Shari'ah* teachings are not confined only to the boundaries of law. An Islamic economic and financial system broadly refers to financial market transactions, operations and services that are guided by rules and laws, collectively referred to as *Shari'ah* (Islamic law), which govern all aspects of Muslim societies from economic and social aspects to political and cultural aspects.

2 Based on *Shari'ah* teachings, the Islamic financial system promotes ethical values and hence is not value neutral as is the case with the conventional financial system. In brief, the values that the Islamic financial system is trying to promote are: *maqasidic* approach whereby public interest (*maslahah*) is promoted and harm (*mafsadah*) is to be prevented; promoting productive activities and genuine trade and business transactions that are related to the real sector of the economy; ethical values such as justice, fairness, trust, honesty, integrity and a balanced society; promoting brotherhood and co-operation through partnership, equity-based and risk-sharing financial instruments; and finally, promoting good governance and transparency.

3 A financial system, whether Islamic or conventional, consists of financial markets and institutions that are necessary for efficient operations of the financial system. The main role of a financial market is to channel the funds within an economy from SFUs to DFUs. This channelling can be done either directly or indirectly through financial intermediaries. The ease of channelling these funds within a financial system indicates the efficiency of the system and reduces idle resources by providing liquidity of financial assets.

4 Within a financial system, there are many types of financial markets with each market having its own purpose and objectives. These financial markets can be classified into the following markets: debt and equity markets, money and capital markets, primary and secondary markets, and organised exchange and over-the-counter markets.

5 Financial intermediaries are crucial for the well-functioning of financial markets. They match surplus fund units (SFUs) and deficit fund units (DFUs) on one side and provide risk-sharing, liquidity, and information to market players. This transfer of funds from lenders to borrowers through financial intermediaries is known as indirect finance.

6 All financial intermediaries are generally classified into two broad categories, namely: depository institutions and non-depository institutions. Non-depository institutions are further classified into contractual savings institutions and investment intermediaries.

7 Depository institutions are financial intermediaries that mainly accept deposits (funds) from SFUs and provide these funds to DFUs through loans and purchases of securities. Commercial banks, savings and loan associations, mutual savings banks, and credit unions are examples of depository institutions.

Contrary to depository institutions, sources of funds for non-depository institutions, such as contractual savings institutions and investment intermediaries, are not derived from deposits, but rather from other sources. Insurance companies and pension funds are examples of contractual savings institutions while finance companies, mutual funds, and investment banks are examples of investment intermediaries.

8 The Islamic financial system, being an integral part of the overall Islamic economic system, requires a conducive environment that not only conforms to the rules and principles of *Shari'ah* but at the same time enables it to operate effectively and efficiently. Some of the requirements for the well-functioning of the Islamic financial system are strong risk management practices, effective regulation of Islamic financial institutions, sound corporate and *Shari'ah* governance, a supportive legal framework, and a robust accounting disclosure and taxation regime.

Key Terms and Concepts

Islamic Finance
Surplus Fund Units (SFUs)
Double Coincidence of Wants
Debt
Islamic Money Market
Maqasid Al-Shari'ah
Primary Market
Essential Risk
Systematic Risk
Shari'ah
Deficit Fund Units (DFUs)
Lack of Unit of Account
Equity
Islamic Capital Market
Islamic Real Estate Investment Trust (REIT)
Secondary Market
Prohibited Risk
Islamic Financial System
Justice
Financial Markets
Shares
Sukuk
Shari'ah Governance
Financial Intermediary
Permissible Risk

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Review Questions and Problems

1 Briefly explain the fundamental differences between Islamic and conventional economics, i.e., the difference between the values upon which they are based.

2 Some argue that the *raison d'etre* of Islamic finance is the categorical prohibition of *riba* in the *Qur'an*. Do you agree? Explain.

3 Even though there is no direct explanation for the prohibition of *riba*, Islamic scholars have derived several reasons based on the *Qur'an* and *hadith*. Besides the five reasons given by Siddiqi, provide some economic justifications for the prohibition and evils of *riba*.

4 Explain debt and equity markets as a part of the overall Islamic financial market.

5 Compare and contrast an Islamic money market and an Islamic capital market with their conventional counterparts.

6 Define primary and secondary markets and highlight the importance of each market.

7 "While risks are not desirable on their own, they must be undertaken in order to create value." In light of the above statement, explain the three types of risks from the Islamic perspective. How does Islam perceive risk-taking, risk-sharing, and risk-transfer? Discuss.

8 Sound corporate and *Shari'ah* governance are crucial for the Islamic finance industry. What is the importance of *Shari'ah* governance? In your view, can we go without *Shari'ah* governance? Why? Why not?

9 Why is a supportive legal framework essential for a proper development of the Islamic financial industry?

10 Outline the major setbacks associated with the current tax treatment of Islamic financial instruments and its impact on the cost of structuring these instruments.

Chapter 2

Overview of Islamic Economics and Financial System

Preview

This chapter provides the necessary background of economics and financial theory that characterise Islamic financial markets and institutions. Arising from a statement of Islamic worldview, this chapter defines the objectives of an Islamic economy as the objectives of *Shari'ah* (*maqasid al-shari'ah*), in relation to the question "how does *Shari'ah* face up to the challenges of human well-being?" The *maqasid*-driven inquiry culminates in a three-stage development model that prioritises human wants justly and sequentially from Pressing Necessities (*daruriyyat*), to Needs (*hajiyyat*) and finally Embellishments (*tahsiniyyat*).

Inspired by *maqasid*, Islamic economics addresses three central problems: what to produce, how to produce, and for whom. This chapter brings forth the difference between Islamic and conventional methods of economic organisation with a special focus on how money capital finances economic activities. Thus, conventional interest rate financing is contrasted with profit-and-loss-sharing (PLS) financing, the primary Islamic alternative to the prohibited interest rate. The latter is just another name for usury that is strongly prohibited in the *Qur'an*.

Shari'ah copes competently with all aspects of life and is addressed to all mankind.

Learning Outcomes

At the end of this chapter, you should be able to:

- Appreciate the Islamic worldview in terms of a sense of justice and accountability in relation to the pursuit of socioeconomic well-being.
- Understand the objectives of an Islamic economy as part of the objectives of *Shari'ah* (*maqasid al-shari'ah*).
- Comprehend Islamic economics as a *maqasid*-driven inquiry into the three central economic problems: what to produce, how to produce, and for whom.
- Apply the economics of financing to the role of an interest-free Islamic financial system in the channelling of funds from surplus fund units (SFUs) to deficit fund units (DFUs).
- Understand the impact of transaction costs and economic information on the structure of the Islamic financial system.

Islamic Economics

Islamic Worldview

Generically, Islam means submission to One God, Allah (subhanahu wa ta'ala). This is the essence of all divine revelations since the creation of Adam, father of humanity, down to all the prophets including Noah (Nuh), Abraham (Ibrahim), Moses (Musa), Jesus (Isa) and finally Prophet Muhammad (peace be upon them).

> *The Religion (Al-Din) He has ordained for you is what He enjoined upon Noah and the one We have revealed to you, and what We enjoined upon Abraham and Moses and Jesus - to establish the Religion and not be divided therein* (*Al-Qur'an*, 42:13).

Thus, "religion" is indivisible when it relates to the assertion of monotheism or *Tawhid*. Moreover, *Tawhid* is not only about belief in God's existence but also about believing in God's contact with humans through the sending of Prophets. The ultimate objective of sending prophets is to prescribe norms of good conduct, thereby putting *Tawhid* at the heart of the worldview that Allah (s.w.t.) has created life for a well-defined moral purpose. In the *Qur'an*, it is clearly asserted that God's creation cannot be without purpose, "*Did you imagine that We created you for no purpose and that you will not be brought back to Us?!*" (*Al-Qur'an*, 23:115).

Tawhid is not only about belief in God's existence but also about believing in God's contact with humans through the sending of Prophets.

By contrast, polytheism or *shirk* (the antonym of *Tawhid*) involves not only idolatry worshiping but also denial of accountability to God through the Day of Judgement (i.e., in the Hereafter). As a matter of fact, God matters to people's social behaviour only if they believe in accountability to Him, whereas denial of such accountability creates a mindset heedless of God even though He is believed to exist. It is commonly cited in the *Qur'an* that *shirk* advocates do admit the existence of God as Creator and Sustainer but due to denial of the Hereafter, they hold no scruples against committing most injustices. *Shirk* is thus associated in the *Qur'an* with irresponsible pursuit of pleasure, adoration of wealth and tampering with the concept of justice. *Tawhid*, on the other hand, brings moral purpose to life through God-revealed commandments that set clear standards of justice to regulate the pursuit of life's pleasures.

Natural Sense of Justice (*Fitrah*)

The different messages embodied different versions of God's law (*Shari'ah*) to cope justly with different target populations at different times in history. Understandably, Muhammad's (peace be upon him) message is God's final word to humanity, which copes competently with all aspects of life and is addressed to all mankind. In congruence to all other prophetic messages, the final message of Islam maintains justice at the heart of *Shari'ah*. Not only does Allah call Himself the "Just" (*Al-'Adil*), but justice underscores the primary objective for sending prophets to mankind since the beginning of human creation. "*Certainly We sent Our messengers with clear arguments, and sent down with them the Book [Kitab] and the balance [Mizan] that mankind may keep up justice.*" (*Al-Qur'an*, 57:25). Commentators of the *Qur'an* have rightly defined the Book as the revealed text (i.e., the *Qur'an*) whereas Balance means the inborn human faculty, *fitrah*, that enables people to judge reasonably and prudently about justice/injustice, good/bad and true/false. In other words, God has empowered mankind with a natural sense of justice and moral judgment, regardless of their religious beliefs.

Little wonder, the Prophet (p.b.u.h.) immensely appreciated incidents of natural justice even where they had arisen in the pre-Islamic days of ignorance (*jahiliyyah*). He has reportedly said, "The best among you in *jahiliyyah* are the best among you in Islam *itha faqihu*" that is, if they have true knowledge of *Shari'ah*. The attached phrase, *itha faqihu*, falls in harmony with the Islamic worldview since Muslims cannot depend entirely on their natural sense of justice without that of *Shari'ah*. This is precisely the required link between Balance and Book in the above demonstration. Undue reliance on human sense of justice without regard to *Shari'ah* is indeed the main source of most of modern life's problems.

Nonetheless, the natural sense of justice often conforms closely to the *Qur'an* as, for example, in the pre-Islamic tribal Alliance of Fudul (*Hilf Al-Fudul*). This remarkable Alliance aimed at restoring justice to Arab pilgrims who once had their belongings looted on the way to the Ka'bah in Mecca. Although the organiser of the Fudul Alliance was a pagan (*mushrik*), Muhammed (p.b.u.h.) took an effective part in that Alliance before being prophet. Yet, Muhammed (p.b.u.h.) recalled that Alliance with great appreciation after being prophet, expressing firm willingness to rejoin the same had it been reconvened. In many ways, the Prophet's own tradition opened up Muslims' minds to tap all the useful experiences and learn from institutional practices that are liable to enhance socioeconomic life in accordance with the *Qur'an*.

In many ways, the Prophet's (p.b.u.h.) own tradition opened up Muslims' minds to tap all the useful experiences and learn from institutional practices that are liable to enhance socioeconomic life in accordance with the *Qu'ran*.

Satisfaction of Human Wants

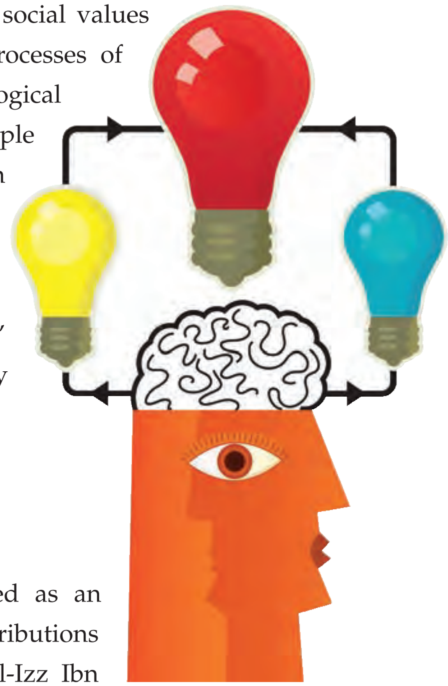
The primary propeller of economic development is the people's pursuit of "well-being" in the sense of satisfying ever-changing human wants. This challenging pursuit invokes the collective participation of governments, private institutions, social organisations, families and individuals, all working in harmony for one common good. Allah (s.w.t.) says in the *Qur'an*: "*[He is the One] Who created life and death to test you as to which of you is best in deed.*" (*Al-Qur'an*, 67:2). Viewed from the perspective of social wellbeing, the "*best in deed*" are those contributing directly or indirectly to better living standards, better public services and more equitable distribution of wealth, whereas wrongdoings cover all harmful and counterproductive practices.

After all, Muslims are encouraged to enjoy the beauties of worldly life while abstaining from prohibited things and activities that have proved harmful medically and socially, e.g., alcoholic drinks, fluid blood, pig meat, extra-marital affairs, selfish behaviour and unjust economic transactions (usury, *gharar*, gambling, etc.). "*Say, 'Who has forbidden the adornments of Allah which He has produced for His servants and the good [lawful] things of provision?' Say, 'They are for those who believe during the worldly life [but] exclusively for them on the Day of Resurrection' ...*" (*Al-Qur'an*, 7:32). Therefore, groundless prohibition of what Allah (s.w.t.) has liberally availed to his servants is as sinful an act as the groundless permission of what Allah (s.w.t.) has strictly prohibited. "*O you who have believed, do not prohibit the good things which Allah has made lawful to you and do not transgress. Indeed, Allah does not like transgressors.*" (*Al-Qur'an*, 5:87)

"O you who have believed, do not prohibit the good things which Allah has made lawful to you and do not transgress. Indeed, Allah does not like transgressors." (*Al-Qur'an*, 5: 87)

Objectives of an Islamic Economy

As briefly indicated in Chapter 1, objectives of an Islamic economy are part of the *Shari'ah* objectives – the *maqasid al-shari'ah* – as consistently derived from the *Qur'an* and the Prophet's (p.b.u.h.) tradition (*Sunnah*). In brief, the economic objectives of *Shari'ah*, or the economic *maqasid*, is the answer to the question "How does *Shari'ah* address the overall objective of well-being?" It takes the term "well-being" to stand for the state of satisfaction of human wants from the socioeconomic perspective. Unlike the focus of jurisprudence on the state of legitimacy or legal issues in inter-personal transactions and contracts, the domain of *maqasid* relates to how *Shari'ah* addresses vital areas of human socioeconomic life in the face of constantly changing modes of livelihood. The domain of *maqasid* is particularly important in coping with the modern industrial world where social values and institutions undergo complex and ceaseless processes of change. Islam acknowledges institutional and technological development as a continuous endeavour to enable people to make the best of God's natural endowments on land, sea and the open space. "*And He has subjected to you whatever is in the heavens and whatever is on the earth...*" (*Al-Qur'an*, 45:13). This section demonstrates key strategic elements of *maqasid* that govern Muslims' pursuit of socioeconomic well-being in constantly changing socioeconomic environments.



Maqasid and the Three-Stage Development Strategy

Objectives of *Shari'ah*, the *maqasid*, were developed as an independent field of inquiry through seminal contributions of leading Muslim scholars, notably, Al-Ghazali, Al-Izz Ibn

Abdelsalam, Ibn Taymiyah, Ibn Al-Qayim and Al-Shatibi. Among these, Al-Shatibi's work is particularly groundbreaking as it has effectively crystallised *maqasid* into a distinct discipline of intellectual inquiry. His widely acclaimed book *Al-Muwafaqat* is remarkably inspiring in the projection of *Shari'ah* objectives through an elaborate scheme of core values shared by almost all human societies irrespective of religion, culture and history. This is particularly relevant to the key question: "How does *Shari'ah* address the overall objective of well-being?" The answer to this question will emerge shortly through a three-stage development model that starts from the satisfaction of Pressing Necessities (*daruriyyat*), to the satisfaction of Needs (*hajiyyat*) and finally, towards the satisfaction of Embellishments (*tahsiniyyat*).

Exhibit 2.1 A Brief Note on *Maqasid al-Shari'ah*

The "Objectives of *Shari'ah* (*Maqasid al-Shari'ah*)" is a vast topic which is beyond the scope of this chapter. Here, we have been particularly concerned with the relevance of this subject to Islamic economics in the way to introduce the principles of Islamic finance. *Shari'ah* scholars, in general, hold the primary objective of *Shari'ah* as promoting human well-being from the perspective of the Islamic worldview.

Al-Ghazali (505H/1111CE) brings forth the key ingredients of human well-being in his book *Al-Mustasfa: "The very objective of the Shari'ah is to promote the welfare of human beings, which lies in safeguarding their Religion, Selves, Minds, Progeny and Wealth. Whatever ensures and safeguards these five fundamentals serves public interest and is desirable. Whatever hurts them is against public interest and its removal is desirable."* (*Al-Ghazali*, (1356/1937) as cited in Chapra, (2000) p.118).

The above key ingredients are the tenets of *Shari'ah* objectives (*maqasid*) as elaborated further by Al-Shatibi through his analysis of Pressing Necessities (*daruriyyat*), Needs (*hajiyyat*) and Embellishments (*tahsiniyyat*). Al-Shatibi represented Pressing Necessities as the core objective of *Shari'ah*, or "the structural element of socioeconomic well-being" as described in this chapter. This follows from his statement that "The Necessary objectives of *Shari'ah* (*daruriyyat*) are the basic foundations [*asl*] for Needs and Embellishments ... [therefore] if it is proved that Embellishments are subordinate to Needs and Needs are the subordinate to Pressing Necessities, then Pressing Necessities are the ultimate objective [*al-matloob*]" (*Muwafaqat*, Vol. 2, p.13).

In particular, Figure 2.2 on page 41 is an embodiment of Al-Shatibi's assertion that "Every element of Needs and Embellishment is a subservient to one foundational element of Pressing Necessities" (*Muwafaqat*, Vol. 2, p. 19). Viewed from the socioeconomic perspective, each foundational element of Pressing Necessity (religion, self, mind, progeny and wealth) stands for one strategic basis of human well-being, whereas Needs and Embellishments branch off from each of these strategic bases to contribute appropriately towards improving the overall quality of life. This is the crux of *maqasid* as explained in the present chapter.

In Al-Shatibi's terms, Pressing Necessities (*daruriyyat*) are the minimal requirements of barely sustainable human livelihood even though hardships can be suffered in their satisfaction. The role of Needs (*hajiyyat*) is hence to remove hardship and extend conveniences (*tawsi'ah*) in the satisfaction of Pressing Necessities whereas Embellishments (*tahsiniyyat*) introduce further refinements towards excellence in quality. Hence, rather than describing Islamic economic development as a one-off basic needs' strategy, the *maqasid* scheme accommodates the idea of ever-changing human wants so long as the process of economic satisfaction remains well governed sequentially and justly in accordance with the three-stage development model.

Al-Shatibi follows earlier Muslim scholars in classifying Pressing Necessities into five key elements:

(1) Religion

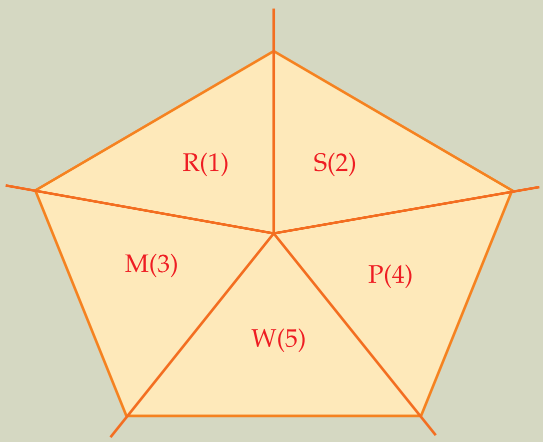
(2) Self (for human life)

(3) Mind

(4) Progeny and

(5) Wealth

He argues that the five key elements given above are recognisable in all creeds. Figure 2.1 presents these elements through a regular pentagon showing the priority order of each element. [1] Thus, Pressing Necessities are the structural elements of "well-being" whereas Needs and Embellishments emerge as complementary extensions and refinements to Pressing Necessities rather than independently defined elements. This is presented in Figure 2.2 where Needs and Embellishments emerge as outright extensions for each structural element of Needs.



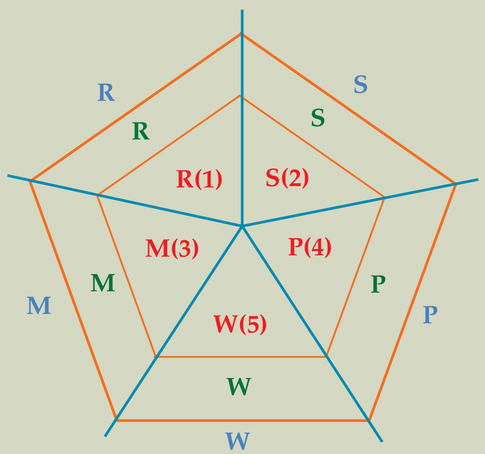
Note: Religion (R), Self (S), Mind (M), Progeny (P) and Wealth (W) in order of strategic importance

Figure 2.1
The Five Pressing Necessities of *Maqasid Al-Shari'ah*

Pressing Necessities are comparable to the bare structure of a multi-storey building consisting of rooms, ceilings, floors, doors, windows and nothing more. This structure is still habitable for households, though with enormous hardship and frustration. Needs are therefore comparable to the introduction of habitable conveniences like water pipelines, electrical connections, toilet/bathroom, kitchen, wall plastering to cover bricks inside

1 "This order will shortly prove to make good strategic sense, as it is the order presented by Al Ghazali and tends to be most commonly adopted in the literature."

the rooms and perhaps heating and/or air-cooling devices. Embellishments are all the additional refinements to enhance the quality of the building like the introduction of colourful paintings, wall and ceiling decorations, tiled or laminated floor, sophisticated electric appliances and a beautiful backyard garden. This example helps to explain how imbalances may result from failure to comply with the strict sequential process of Pressing Necessities, Needs and Embellishments. For example, failure to satisfy Pressing Necessities (e.g., shallow foundations, fragile bricks or loose mortar) will ultimately yield a vulnerable building structure unable to uphold any conveniences (e.g., water pipelines) or quality refinements (e.g., wall decorations). Architectural planning (e.g., organisation of rooms, halls, utilities, ventilation, etc.) is also a Necessity since bad planning will render subsequent conveniences and refinements largely pointless. On the same stroke, Needs must precede Embellishments in as much as wall-plastering must precede wall decoration, or more basically, in as much as Needs to hire a good architect must precede Embellishments in the planning and implementation of a high quality building.



Note: Inner pentagon stands for Pressing Necessities, bigger pentagon for Needs, and outer part for Embellishments

Figure 2.2
Pressing Necessities as Structural Elements Amplified by Needs and Embellishments

The architecture of socioeconomic well-being is similarly planned from the *maqasid* perspective in terms of five structural elements (Religion, Self, Mind, Progeny and Wealth) proceeding *sequentially* and *justly* from the satisfaction of Pressing Necessities to Needs, and finally to Embellishments. This is the essence of the three-stage development strategy. "Religion" is the strategic vision of well-being, "Self" is the overall socioeconomic goal, Mind is the productive human resource, "Progeny" stands for inter-generational continuity, and Wealth is the material economic resource. Needs are intermediate targets to empower the strategy of well-being beyond the satisfaction of Pressing Necessities whereas Embellishments are secondary targets to enhance the quality of well-being. To bring forth the logical consistency of the above prioritisation in Pressing Necessities and the complementary roles of Needs and Embellishments, the importance of each element in the overall strategy of well-being will now be explained.

Religion: The Vision of Well-Being

Religion comes first because it is the worldview as defined previously, and hence, the socioeconomic vision of well-being governing the satisfaction of human wants. *Shari'ah* is the Muslims' vision of well-being against other socioeconomic visions derived from alternative religions, belief systems or philosophical outlooks of different human societies. Therefore, having a comprehensive coverage on all social, economic and political aspects of life is not essentially a point of uniqueness of Islam. All belief systems share the same claim of comprehensiveness. Rather, it is the previously defined worldview which distinguishes Islam from other belief systems and philosophical outlooks. Differences in worldview are described in literature as *paradigmatic* differences.

Recalling the fact that Needs and Embellishments are complementary qualifications of Pressing Necessities, this applies equally well to Religion. Needs and Embellishment take such an effect on Religion as long as the worldview of *Shari'ah* extends through *ijtihad* to encompass new ideas, rules, measures and values to match rising economic wants in the everlasting endeavour to satisfy additional Needs and Embellishments. The history of Islamic scholarship is a good testimony of how *Shari'ah* has consistently expanded along the Islamic worldview to accommodate newly arising methods and styles of livelihood, and how it acknowledged new social customs (*a'raf*, plural of *'urf*) over the last fourteen centuries. Finality of Islam has meant that *Shari'ah* must remain relevant to all places and times through open provisions of *ijtihad*. Again, what characterises Islam from other religions is a worldview embedded with a clear sense of direction and moral purpose. By contrast, heedless pursuit of desire and adoration of wealth in purely secularist societies empties socioeconomic well-being from moral purpose and clear sense of direction.

Self: The Central Goal

"Self" is human life which is the goal of well-being as implied by the verse: "*It is He who created for you all of that which is on the earth ...*" (*Al-Qur'an*, 2:29). Human life takes the second position after Religion because vision must precede the goal. In particular, all provisions for Self must comply with the *Shari'ah* vision that human life has to be regarded with honour and dignity. The *Qur'an* says: "*We have certainly honoured the children of Adam and carried them on the land and sea and provided for them of the good things and preferred them well over much of what We have created*" (*Al-Qur'an*, 17:70).

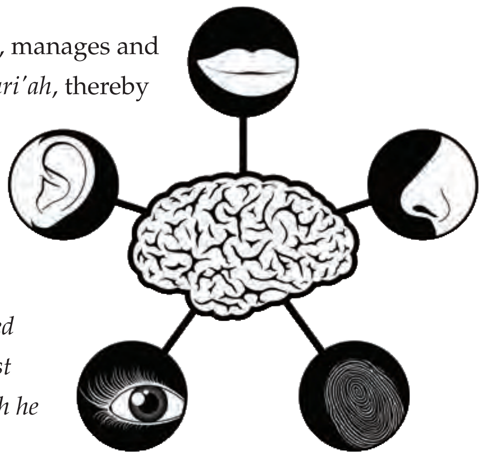
Therefore, provisions for Self must transcend the mere animal survivalist strategy to include balanced nutrition, suitable shelter and clothing, protection from disease, literacy and access to an income-earning activity. According to *Shari'ah*, these basic items make up for the absolute Necessity that must be satisfied before moving towards Needs and Embellishments. Notably, prevalence of extreme poverty when luxurious consumption prevails elsewhere is a stark discrepancy from the three-stage development model. At the same stroke, removal of hardship (*haraj*) and introduction of better conveniences (*tawsi'ah*) in living standards through Needs must precede the introduction of quality refinements through Embellishments.

However, it is practically impossible to set universal standards for Necessity in human life. The qualitative boundaries between Pressing Necessities, Needs and Embellishments are constantly shifting, so earlier standards of Needs or Embellishments may qualify as Necessity standards in the future. The crux of technological progress is to keep re-defining hardship and convenience in an endless effort to make life easier than before. As the set of "minimal standards" comprising Necessity develops through time, this technological process brings forth remarkable changes in social customs and calls for a fresh outlook at the architecture of well-being. For example, having a mobile phone was an Embellishment thirty years ago but now it is a social Need. No matter how boundaries are placed, the objective of *Shari'ah* is to maintain the abovementioned three-stage development model whereby human wants get satisfied sequentially and justly from Pressing Necessities to Needs and finally to Embellishments.

The objective of *Shari'ah* is to maintain the three-stage development model whereby human wants get satisfied sequentially and justly from Pressing Necessities to Needs and finally to Embellishments.

Mind: The Human Resource

Mind is the human resource that thinks, evaluates, plans, manages and produces the goods (*tayyibat*) of well-being subject to *Shari'ah*, thereby taking third position after Religion and Self. *Shari'ah* is an outright address to the human mind which is the focal centre of social and family reasonability in all human cultures. The first five verses revealed to Muhammad (p.b.u.h.) have been a call for meaningful literacy: "*Read in the name of your Lord who created, – created man from a clinging substance. Read and your Lord is the most Generous, Who taught man by the pen. Taught man that which he knew not*" (*Al-Qur'an*, 96:1-5).



Education – religious, moral and technical – is therefore a Necessary requirement for the Mind. Regardless of academic formality or scientific sophistication, the primary objective of education from early childhood up to a later age is to produce socially responsible and economically productive individuals. This is the essence of a well-balanced human resource strategy that seeks to create leadership qualities and develop technical skills in the pursuit of socioeconomic well-being. Needs and Embellishments in human resource development are simply the means to upgrade Necessary education towards further knowledge and greater sophistication. As human societies develop to higher economic horizons, skill building becomes all the more challenging. Education would then transcend sheer memorisation and understanding of received knowledge towards more analytical, imaginative and creative competencies in order to tap God's endowments on earth in line with the *Qur'anic* verse: "*And He has subjected to you whatever is in the heavens and whatever is on the earth – all from Him …*" (*Al-Qur'an*, 45:13).

From the Islamic perspective, human resource development is not only about the building of economic skills to qualify society members for productive jobs, but it is about creating well-behaved and socially responsible generations.

This all depends on the state of economic development because the utilisation of God's endowments must fall in tandem with the three-stage development for the satisfaction of Pressing Necessities, Needs and Embellishments. From the Islamic perspective, human resource development is not only about the building of economic skills to qualify society members for productive jobs, but it is about creating well-behaved and socially responsible generations. This also includes financial responsibility as it will emerge shortly under the fifth structural element, Wealth.

Progeny: Intergenerational Continuity

Progeny comes next in order to account for intergenerational continuity of socioeconomic well-being subject to *Shari'ah*. This brings forth the importance of family as the core educational circuit in human society to transfer a sense of direction and moral purpose to new generations. Adherence to the institution of marriage and maintenance of strong family values are therefore Necessary elements for intergenerational continuity. The social outcome is the maintenance of moral responsibilities of family members towards each other (husband versus wife, children versus parents, and children versus children), towards extended family members, and towards society at large. The possible prioritisation of these moral responsibilities into Pressing Necessities, Needs and Embellishments underscores the fact that they are not equally important. For example, marriage is an utmost Necessity for intergenerational continuity whereas one's duty towards the larger society is a matter of intergenerational Embellishment. Similarly, caring for one's own children is a Necessity whereas caring for members of the extended family is a Need. Intergenerational responsibilities depend, not only on the family, but also on social and government institutions in lobbying people's support. The guiding principle is the *Qur'anic* verse: "*Let the one of means spend according to his means: and the one whose resources are restricted, let him spend according to what Allah has given him. Allah puts no burden on any person beyond what He has given him*" (*Al-Qur'an*, 65:7).

Wealth: The Material Economic Resource

Finally, material economic resources must run abundantly in the economy to activate human resources in the pursuit of wellbeing and intergenerational continuity. Wealth stands for all material economic resources (land, natural resources, energy, semi-finished goods, equipment, machinery and money) that support human resources in the production process. Coming in the last position is not an indication that wealth is the least important Necessity. Rather, it is because wealth is subservient to the satisfaction of Pressing Necessities, Needs and Embellishments in the ongoing pursuit of well-being. This is the common standard of national economic planning which normally sets out from the statement of strategic visions, down to socioeconomic goals, human resource targets, and finally budgetary questions about required economic resources. Wealth is therefore the means to achieve goals and targets rather than an end of its own. The Prophet (p.b.u.h.) condemned those who adore wealth for its own sake, saying: "*Miserable is the servant ('abd) of Dinar and Dirham.*" Wealth adoration deviates radically from the Islamic worldview in two ways. First, it invokes an act of *shirk* and empties wealth from moral purpose. Second, it accentuates concentration of wealth only into a few hands, thereby inflicting grave injustices and causing serious imbalances in the socioeconomic pursuit of well-being.

Shari'ah recognises and fosters all customary rights of private property under the provision that wealth is a trust from Allah (s.w.t.) to test how his servants deliver moral and social obligations through the management of their wealth. "*Believe in Allah and His messenger, and spend out of what He has made you vicegerents*" (*Al-Qur'an*, 57:7). This is one major reason why the *Qur'an* forbids entrusting private property to immature/irresponsible people (*sufaha'*) who mismanage wealth. "*Do not give the sufaha' your wealth that Allah has given you to maintain; [but] feed and clothe them from it, and speak kindly to them*" (*Al-Qur'an*, 4:5). This point brings back the above role of the Mind which now reemerges as the focus of financial responsibility. To avoid waste, wealth management in the Islamic perspective requires striking the right balance between enjoyments of Allah's bounty for oneself and delivering incumbent moral obligations toward family and social causes. "*And do not make your hand chained to your neck or extend it completely and [thereby] become the blamed and insolvent*" (*Al-Qur'an*, 17:29). Wastage of wealth is a grave sin, particularly when misallocation of resources in luxurious spending reflects extreme shortages of important social services like housing, public health and education.

The Production Possibility Frontier is a useful tool of economic analysis showing how alternative allocations of scarce economic resources may produce alternative goods or groups of goods.

To see how imbalances in the satisfaction of human wants may lead to grave injustices, reference to the Production Possibility Frontier (PPF) brings Needs and Embellishments as two alternative groups of goods. These are shown, respectively, on the horizontal and vertical axes of the PPF in Figure 2.3 and Figure 2.4. The PPF is a useful tool of economic analysis showing how alternative allocations of scarce economic resources may produce alternative goods or groups of goods — in this case Needs versus Embellishments. Assuming resources are fully utilised, production of more Needs is only possible through the production of less Embellishments, which is the essence of the Law of Scarcity in economics. Figure 2.3 is obviously nonconforming to the Islamic worldview as it represents a critical imbalance favouring the production of more Embellishments than Needs due to wealth concentration into fewer hands. By contrast, Figure 2.4 is more in line with the Islamic worldview since it allocates more resources to the production of Needs than to Embellishments. Now, this begs the question about the practical approach whereby an economy embarks on the balanced three-stage development model.

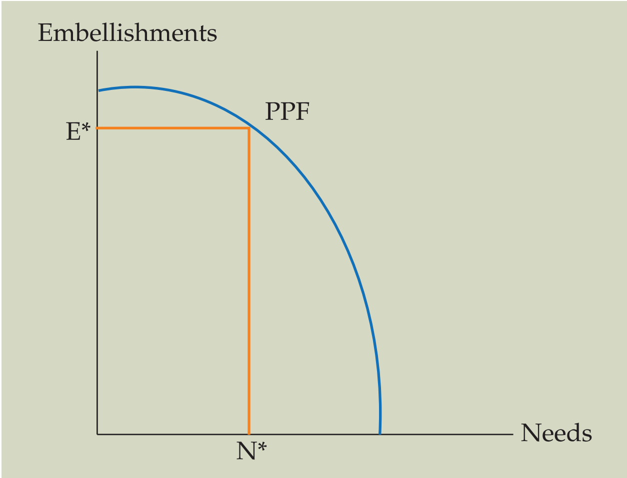


Figure 2.3
More Embellishments (E*) Satisfied at the Cost of Less Needs (N*)

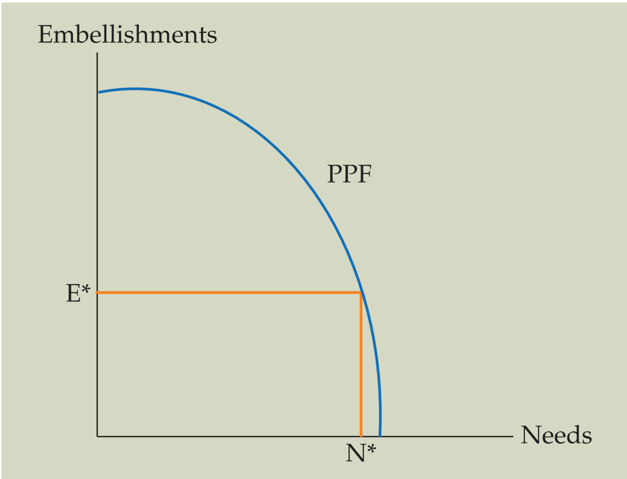


Figure 2.4
More Needs (N*) Satisfied at the Cost of Less Embellishments (E*)

Why Islamic Economics?

The *maqasid* model answers the important question of "how does the Islamic worldview help prioritise Pressing Necessities, Needs and Embellishments of human life in the ongoing pursuit of socioeconomic well-being?". In this context, *maqasid* offers a vital source of inspiration for the ideal characterisation of an Islamic economy, but the real challenge is how to approach this ideal as closely as possible. A series of questions will thus arise on how *maqasid* differentiates an Islamic economy from alternative economic systems in terms of policies, mechanisms and institutions, and what are the roles of governments, markets, social institutions and individuals in this pursuit? These are typical questions that give rise to "Islamic economics".

To address the above questions, two sources of disciplinary knowledge are needed, economics and *Shari'ah*. Traditionally, *Shari'ah* scholarship has focused mainly on the detailed jurisprudence of economic transactions to ensure validity of business contracts (*fiqh al-mu'amalat*) rather than analyse the impact of such dealings on the economy as a whole. The latter marks the domain of Islamic economics which transcends jurisprudential concerns to more subtle issues about economic mechanisms, institutions and policies in a way that empowers the Islamic economy towards the fulfilment of *maqasid*. The modern industrial environment has brought with it unprecedented socioeconomic problems affecting human well-being well beyond the traditional *Shari'ah* scholarship, even though the core principles of Islamic economics originated in the works of early *Shari'ah* scholars who laid down the foundations of *maqasid* and utility theory (e.g., Ghazali, Ibn Taymiyyah, Shatibi). Islamic economics is therefore, a newly emerging discipline that takes the lead in resolving newly arising economic issues from the viewpoint of *maqasid*. In other words, Islamic economics has emerged to satisfy new Needs in relation to the Mind, the productive human resource.

The Three Central Economic Problems

Regardless of ideological contentions, economics comes into play when three central problems are addressed, namely:

1 Production decision (*what* to produce?);

2 Management decision (*how* to produce?); and

3 Distribution decision (*for whom* to produce?)

Inspired by the above *maqasid*, the Islamic economy has its own worldview, institutional setting and mechanisms to address these questions. By contrast, capitalist and socialist systems act under different worldviews, institutional settings and mechanisms to handle the same central questions. There is, yet, one common

The Law of Scarcity implies that economic resources are limited, relative to human wants.

denomination that embeds the above three questions regardless of worldviews. It is the Law of Scarcity. Briefly stated, this law implies that economic resources are limited relative to unlimited human wants, hence, having rival claims in the endeavour to satisfy human wants. Assume there are two commodities, A and B, and that their resources are fully utilised. It is only possible to produce more of commodity A by producing less of commodity B. Therefore, society must decide on how to prioritise the production of rival commodities as they compete for limited resources.

Production Decision (*What* to produce?)

This question is not only about the nature of goods to be produced but also about the authority to make the decision of production — government, market or a combination of both. The first part of the question invokes the Law of Scarcity as economic resources compete for the production of Pressing Necessities, Needs and Embellishments. Thus, the *maqasid* solution is to prioritise the process of resource allocation such that the production of Pressing Necessities comes first to satisfy minimal standards, then the production of Needs to remove hardship and extend conveniences, and finally, the production of Embellishments to improve the quality of life. Any deviation from this prioritised process leads to resource misallocations from the perspective of socioeconomic justice (e.g., satisfying more Embellishments than Needs as in Figure 2.4), which deviates from the Islamic worldview.

Free trade prevailed before the revelation of Islam and continued to prevail thereafter except for the prohibition of usury (interest on borrowed money) and prohibitions of trade malpractices through the Prophet's (p.b.u.h.) traditions.

The second part of the question invokes the impact of *maqasid* on production decisions which involve an interplay of market mechanism and the role of government. Free trade prevailed before the revelation of Islam and continued to prevail thereafter except for the prohibition of usury (interest on borrowed money) and prohibitions of trade malpractices through the Prophet's traditions; e.g., *gharar*, etc. The verse, "*And Allah has permitted exchange and forbidden usury (riba)*" (*Al-Qur'an*, 2:276), has fundamentally acknowledged the free market as an authoritative vehicle to translate buyers and sellers preferences about "what to produce/at what price" into legitimate transactions. This has underscored the Prophet's (p.b.u.h.) tradition not to interfere with the market's pricing unnecessarily. The Companions once complained of soaring prices to the Prophet (p.b.u.h.); asking him to fix market prices but he firmly prompted, "*Prices are fixed by God. He alone contracts and expands the means of livelihood, and I wish to meet my Sustainer having no claim of injustice being made against me in respect of blood and wealth.*" Thus an ethical value has been conferred to market prices even at time of soaring prices, thereby yielding far-reaching implications to the pivotal role of the free market in an Islamic economy.

However, unless carefully regulated and supervised, the free market is bound to harbour many injustices and create artificial shortages through the greed of monopolists and reckless speculators. A question was once asked to Ibn Taymiyyah on how rising prices conformed to justice. Ibn Taymiyyah responded: "*Causes of rise and fall in price are not always due to acts of injustice. Rather, this is due to shortages in the production or supply of a particular good. If the latter increases and desire for it decreases, then the price will fall. And if production [khalq] falls and desire increases, the price will rise.*" Note that *desire* stands for "demand" while production [*khalq*] stands for "supply". He then elaborated on situations where rising prices resulted from acts of injustice to deem firm corrective policies through the state.

Therefore, the state has an important role in regulating market behaviour through corrective policy if the need arises. *Hisbah* was one such important regulatory body in Muslim history. It monitors and corrects market behaviour on a daily basis. More generally, an Islamic state can utilise discretionary policy tools to influence the structure of national output through tax/subsidy interplay, for example, through subsidising the production of minimal Pressing Necessities and Needs while taxing the production of Embellishments. The role of *zakat* and *waqf* as complementary roles to fiscal tools will be explained shortly under the third central question.

Management Decision (*How* to produce?)

This question invokes wide ranging issues in relation to production organisation, factor participation, financing and technology. Production organisation is basically about how factors come under a single firm to engage in production. There are three factors in standard economics, namely: labour, capital and land, although "entrepreneur" is often added as the fourth factor. An entrepreneur is the owner and manager of the firm who hires factor services at fixed prices (wage/salary for labour, interest for capital and rent for land) to produce a specific output and then sell it at profit (residual income that remains after deducting all factor and input costs). The entrepreneur's objective is to sell output at maximum profit which signifies the largest possible difference between total revenue and total costs. Briefly, this is the organisational kernel underlying conventional corporate structures in the modern industrial world (public corporations, private limited liability companies, partnerships, etc.). Although equity is a legal requirement of corporate ownership, the hallmark of capitalist firms is external debt financing from capital markets where creditworthiness prevails as the yardstick of success in business.

There are three factors in standard economics, namely: labour, capital and land, although "entrepreneur" is often added as the fourth factor.

Although creditworthiness in capital market has an important role to play in an Islamic economy, prohibition of usury (*riba*, to be explained shortly in detail) has emphasised risk-sharing through *mudarabah* and *musharakah* rather than external debt financing as the organisational kernel of an Islamic corporate structure. *Mudarabah* arises when the provider of capital, the *rabbul mal*, finances another party, the *mudarib*, in any profit generating activity. Rather than stipulating a fixed rate of return on capital, the *mudarabah* contract stipulates an agreed profit-sharing ratio whereby the *rabbul mal* and the *mudarib* share the would-be profit between themselves. Alternatively, *musharakah*

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arises when two or more parties contribute capital to do business against an agreeable profit-and-loss-sharing ratio (PLS ratio). These organisational modes must be clearly distinguished from fixed return financing modes (e.g., *murabahah* and *ijarah*) which, incidentally, predominate at the level of Islamic banking operations. Not only should owners of money capital be rewarded through PLS, but other productive factors (e.g., labour, land) should also be able to opt for profit-sharing rather than fixed reward. The immediate appeal of profit-sharing and PLS financing is to dilute the entrepreneur's profit maximisation objectives and to directly marry capital with labour in the production of real goods and services, which is manifestly lacking in conventional corporate structures.

Organisation, financing and technology are manifestly interrelated in one major way. Conventionally organised firms draw heavily on interest-bearing capital markets to finance productive activities while PLS organised firms depend significantly on equity financing. This makes up for the fact that conventional firms are more vulnerable to destabilising forces in relation to labour force employment than PLS firms. To maintain creditworthiness in the capital market, profit-maximising entrepreneurs must avoid situations of financial distress and prove their capability to pay back principal and interest at all costs, at all times. The first line of defence in the face of financial distress or imminent threat of insolvency is employment reduction, which often accounts for the adoption of ruthless cost-minimisation strategies in terms of wage cuts, employment cuts and continuous recourse to labour-saving technology. Labour-saving technology lies at the heart of cost-minimising/profit-maximising capitalist firms as it underlies the long-term declining trend of labour/capital ratios in developed economies. Worse still, profit-maximising entrepreneurs are tempted to avoid real production altogether and live without labour headache if money capital is readily accessible for profitable investment in secondary market speculative activities.

The first line of defence in the face of financial distress or imminent threat of insolvency is employment reduction, which often accounts for the adoption of ruthless cost-minimisation strategies in terms of wage cuts, employment cuts and continuous recourse to labour-saving technology.

By contrast, the driving force of PLS corporate financing is profitability rather than capital market creditworthiness. Profitability is a function of productivity and consumer satisfaction whereas technological development under the PLS system is more akin to quality improvement in output than labour-saving strategy. Admittedly, the PLS system is not the major driving force of Islamic banking and corporate firms in real practice. Hence, to reap the economies of the PLS system, Islamic financial institutions (IFIs) are faced with the challenge of distancing themselves as much as possible from predominately debt-based regimes to equity-based ones.

Distribution Decision (For *whom*?)

Factor compensation and concern with socioeconomic justice crop up mainly through this central question. At the outset, it is worthwhile defining justice as "equal treatment of equals and unequal treatment of non-equals". Obviously, it is unjust to compensate two workers unequally if they put in equal effort for the same job. Again, it is unjust to compensate two workers equally if they put in unequal effort for the same job. Justice does not mean charging an equal price for different items of goods even if they differ only qualitatively (e.g., rice, bee honey, cameras). To the extent that the market mechanism displays genuine differences in value (due to true differences in human effort and quality of goods), free markets do not violate socioeconomic justice. However, as mentioned above, markets have to perform under constant supervision to guard against manipulation of prices, creation of artificial shortages, contrivance of phony quality differences and all potential sources of injustice.

Markets have to perform under constant supervision to guard against manipulation of prices, creation of artificial shortages, contrivance of phony quality differences and all potential sources of injustice.

Market-determined distribution reflects the compensation of factors that have contributed to production depending on the underlying corporate structure that combines the productive factors. Conventionally, market compensation involves four income categories: wage for labour, interest for capital, rent for land and profit for entrepreneur. Yet, due to the prohibition of interest on capital, the corresponding categories of Islamic corporate structure have only three categories: wage, rent and profit. Money capital shares the same income and profit with the entrepreneur on a PLS basis thereby giving room to favourable distributional consequences in terms of employment and labour-friendly technology.

Money capital shares the same income and profit with the entrepeneur on a profit-and-loss sharing basis thereby giving room to favourable distributional consequences in terms of employment and labour-friendly technology.

More to the point, the market is not the ideal vehicle to affect just income and wealth distribution patterns. On one hand, markets deliver private goods (food, clothing, shoes, etc.) rather than public goods that are consumed "collectively" by all members of the society (e.g., national defence, police service, public health). On the other hand, market-determined distributions reflect historical imbalances in wealth and capital ownership that help to perpetuate inequality in the economy. The market mechanism is therefore quite helpless in both cases thereby giving way to the power of the state to take the lead in the production of public goods, alleviation of wealth inequalities and eradication of poverty. Conventionally, this is the realm of public finance where governments rely on tax weapons and fiscal spending to produce public goods and resolve poverty problems.

An Islamic state can have similar recourse to corrective distribution policy through taxation and fiscal policy but there are two built-in stabilisers derived from the *Qur'an* to help nip problems of poverty in the bud. The first stabiliser is the function of *zakat*, the third Pillar of Islam, which channels funds from the rich (subject to certain rates) and re-distributes the proceeds to the poor, the needy and other *Qur'an*-designated causes. The second stabiliser is the institution of *waqf*. As a matter of fact, taxation played only a marginal role in the early Muslim state because of the vital role of *waqf* institutions in poverty elimination and the financing of public goods. Mobilising large-scale voluntary donations, the *waqf* institution shouldered the financing of major public schemes that are currently financed through taxation and fiscal spending (schools, hospitals, roads, The role of *waqf* in the history of the Islamic state has manifestly underscored the moral thrust of the *Qur'an* on Muslims' economic behaviour, as more than 60% of the *Qur'an* is an ardent exhortation on Muslims to spend liberally in the way of Allah (s.w.t.).

street lighting, etc). The role of *waqf* in the history of the Islamic state has manifestly underscored the moral thrust of the *Qur'an* on Muslims' economic behaviour, as more than 60% of the *Qur'an* is an ardent exhortation on Muslims to spend liberally in the way of Allah (s.w.t.).

The above discussion drives home "freedom from poverty" as a strategic "public good" to ensue socioeconomic stability, in as much as "national security" is a strategic public good to ensue social and political stability. Freedom from poverty must therefore command an equal claim on the public financing of an Islamic state as the other strategic public goods (national defence, security, public health, etc). This point will now be brought to clearer focus through the role of non-market behaviour in the economics of *riba*.

Economics of *Riba*

Riba, the Arabic term for usury, underwent a process of gradual prohibition in the *Qur'an* as it had been deeply entrenched in the pre-Islamic trade practices of the Arabs. Even after ultimate prohibition, disaffected dodgers alleged that *riba* was a normal mode of trade: "*... that they say: 'Exchange is like usury,' but Allah hath permitted exchange and forbidden usury …*" (*Al-Qur'an*, 2:275). Interestingly, modern financial markets echo the same pre-Islamic allegation as the interest rate prevails as "price" of money in money and capital markets. The objective of this section is two-fold: firstly, to explain how trade differs from *riba* and secondly, to demonstrate the far-reaching implications of *riba* prohibition in the pursuit of a just socioeconomic order.

Sales *riba* is defined by reference to a special group of *riba*-prone commodities mentioned in the *hadith* of the Prophet (p.b.u.h.): "*Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal and hand to hand. However, if the commodities differ, then you may sell as you wish provided that the exchange is hand-to-hand.*"

The focus here will be placed on what *Shari'ah* scholars call loan *riba* (*riba al-qard*) or *riba al-Qur'an* since it has been prohibited by the *Qur'an*. This is precisely the counterpart of the banking interest rate whose prohibition is the point of departure of Islamic banking from conventional banking. There is yet another class of *riba* called sales *riba* (*riba al-buyu'*) or *riba al-Sunnah* as it has been prohibited by the *Sunnah* but it is not particularly relevant to banking and financial markets except in relation to currency exchange. Sales *riba* is defined by reference to a special group of *riba*-prone commodities mentioned in the hadith of the Prophet (p.b.u.h.): "*Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal and hand to hand. However, if the commodities differ, then you may sell as you wish provided that the exchange is hand-to-hand*" (*Sahih al-Muslim*). However, it is beyond the scope of this section to discuss different criteria adopted in the jurisprudence as to how *riba*-prone commodities extend beyond the reported items. More discussion on *riba* will be dealt with in Chapter 5.

Trade, Money and *Riba*

Let us now turn to address the first question, of how interest on money capital – the *Qur'anic* concept of *riba* – differs from exchange or trade in the context of the verse mentioned in the previous page (*Al-Qur'an*, 2:275). Emphasis on trade as the main source of economic prosperity is well epitomised in the Prophet's (p.b.u.h.) *hadith: "God has placed nine tenths of income (rizq) in trade,"* which, as a matter of fact, is a fairly accurate description of reality if wealth generated from trade capital is compared to that generated from pure labour. Trade is highly commendable, not only due to the wealth it generates, but also due to the scope of economic interdependence it extends among human nations. Since time immemorial, immense benefits have been accrued to nations and societies from increased economic interdependence. Economic interdependence enabled people to specialise in different lines of productive activities, thereby facilitating the acquisition of other people's production through exchange and allowing for the development of better quality output. The verse "*Allah has permitted trade*" is an explicit acknowledgment of the benefits of exchange or trade. The *Qur'an* and the Prophet's (p.b.u.h.) exemplary guidance have laid down the criteria for "legitimate" and "illegitimate" trade practices. "*O ye who believe! Eat not up your property among yourselves in vanities: But let there be amongst you traffic and trade by mutual good-will: Nor kill (or destroy) yourselves: for verily Allah hath been to you Most Merciful!*" (*Al-Qur'an*, 4:29).

On the other hand, money is the most powerful lubricant, it is the medium of exchange that facilitates the flow of trade from all over the world. This underlies the reason why the absence of money in barter economies deprives people of the benefits of exchange, hence rendering barter economies primitive, poor and extremely underdeveloped. Being the "medium of exchange" is therefore the primary function of money from an Islamic perspective. There are other important functions of money: a standard of value, a unit of accounting and a store of value, all of which have evolved from the primary function of money as a medium of exchange.

From an Islamic perspective, being the "medium of exchange" is the primary function of money. Other important functions of money are a standard of value, a unit of accounting and a store of value.

After all, money is not real wealth. It is a means to generate wealth through trade. This fundamental point was featured as a major theme of *The Wealth of Nations*, 1776, where Adam Smith criticised the Mercantilists for confusing the concept of money with that of wealth. This crucial misunderstanding, Adam Smith argued, underscored the Mercantilists defence of protectionism against free international trade. The Mercantilists defended protectionism under the misconception that the acquisition of gold through exportation of goods meant more national wealth, while the spending of gold through importation of goods meant less national wealth. Colonialism flourished

Colonialism flourished under Mercantilist thought mainly due to the abstention of European countries from trade between themselves, and acceleration of rivalry over external markets in other parts of the less developed world.

under Mercantilist thought mainly due to the abstention of European countries from trade between themselves, and acceleration of rivalry over external markets in other parts of the less developed world. The seminal contribution of *The Wealth of Nations* has been to assert the mutual benefit of free trade and warn against the diseconomies of protectionism.

However, the author of *The Wealth of Nations* has run short of admitting the abuse of money in *riba* transactions whereby money gets swayed from its normal course as sheer facilitator of trade to being "priced" as an object of trade in "money markets". The interest rate as the alleged price of money has accounted for a market of money that generates more money through lending as opposed to the real market of goods and services that generates more wealth through real exchange. Living purely on interest income, money traders damage the flow of trade in two ways:

1 Withdrawing money from the flow of trade in goods and services

2 Acquiring undue command over the real wealth created through trade

In the first incident, a large portion of money supply becomes disengaged as the medium of exchange in the flow of trade. In the second incident, a large portion of wealth goes to money traders even though they are the very agents who hampered the creation of wealth. Ironically, money traders remain well-rewarded under the interest-based system rather than penalised! The simple rationale why the interest rate arises in the first place is the fact that money-lenders find it easier to sustain command over real resources by capitalising on the power of money rather than taking part in productive activities. It drives home the prohibition of interest as the right remedy against withdrawal of money from the flow of trade and the dysfunctional role of money traders. Money-lending in the Islamic perspective remains restricted within the charitable jurisdiction of *qard hasan* where the lender gets back the principal loan and nothing more in return.

Money-lending in the Islamic perspective remains restricted within the charitable jurisdiction of *qard al-hasan* where the lender gets back the principal loan and nothing more in return.

Interest is prohibited not only because money must remain a medium of exchange to facilitate trade but also because money is not a leasable asset. Money belongs to the category of perishable/fungible objects (such as petrol and rice), which must be consumed or used up in the process of being utilised in production or consumption (e.g., petrol is burnt to energise machinery, rice is eaten as food, money is spent to buy goods). By contrast, the leasing of durable assets (ships, buildings, equipment, etc.) generate usufruct (asset service) without being used up or consumed in the utilisation process. *Ijarah* is the Islamic concept of leasing, where the price of usufruct generated by the durable asset is the lease value (*ujrah*) payable by the lessee (*musta'jir*) to the lessor (the *mu'jir*). This reduces *ijarah* to a legitimate sale transaction in real trade – sale and purchase of usufruct – involving lessor (owner of asset) and lessee (hirer of asset). Scholars of jurisprudence have, thus, classified *ijarah* as a special sale contract along the *Qur'anic* verse "*Allah has permitted exchange.*" Although leasable assets are not consumed in the process of being utilised, they gradually depreciate through ordinary wear and tear. The lessor deserves the lease value not only for bearing such wear and tear in his asset, but also for his liability to fix up the asset if it fails to generate usufruct due to inherent defects in the asset. In other words, the lessor remains the owner of the asset with all the obligations that befall ownership while the lessee maintains the "hand of trust" (*yad amanah*) on the asset.

The reason why fungible/perishable objects, including money, do not qualify for *ijarah* is that it is impossible to use them without acquiring full ownership of them (e.g., to burn energy, eat rice or spend money, you must own them). Without transference of ownership, it is impossible to borrow people's money for the sake of satisfying your own private needs. All schools of Islamic jurisprudence have rightly defined the lending of fungible objects (including money) as a legitimate mode of ownership transference provided that no interest on the principal loan is paid. Such interest-free lending is called *qard hasan* as it belongs to the class of charitable transactions. Voluntary giving is an obvious means of ownership transference but this is rarely practised because it places no reciprocal obligation on the taker to compensate the giver. Lending from an Islamic perspective, which must be *qard hasan*, is the alternative form of ownership transference, which deliberately imposes reciprocal obligation on the borrower to compensate the lender through an equivalent transference of the borrower's ownership at some future time.

The reason why fungible/perishable objects, including money, do not qualify for *ijarah* is that it is impossible to use them without acquiring full ownership of them (e.g., to burn energy, eat rice or spend money, you must own them).

The last point bears far-reaching implications to the theory of factor productivity and the legitimacy of interest in the organisational set-up of modern industrial firms. Productivity of a factor is the contribution the factor makes to the production of a firm, which applies clearly to labour, land and physical assets acquired through *ijarah*. However, money capital provides no claim on productivity to lenders because borrowed money is no longer under the lenders' ownership. Rather, it is under the borrower's (i.e., entrepreneurs) ownership. Parting with ownership, money-lenders cannot claim any contribution to the firm on an equal footing with productive factors and therefore the interest rate is not a legitimate measure of capital productivity. Perhaps, the most sensible interpretation of the interest rate is the one given in classical economics as the price of "waiting", which has absolutely nothing to do with productivity. Truly, lenders may wish to be rewarded for "waiting" but the price of "waiting" is itself the price of money with all the dysfunctional consequences as discussed above. This explains why lending in Islamic jurisprudence is a purely charitable act.

Distributional consequences of *riba* elimination

This relates to the second question about the impact of *riba* prohibition on the pursuit of socioeconomic justice. At the outset, attention must focus on two complementary and successive *Qur'anic* verses that make up for the complete package of *riba* elimination:

1 "*But Allah hath permitted trade and forbidden usury*" (*Al-Qur'an*, 2:275); and

2 "*Allah will deprive usury of all blessing, but will give increase for deeds of charity*" (*Al-Qur'an*, 2:276).

The first verse defines the impact of *riba* prohibition on market institutions whereas the second verse brings forth non-market institutions to ensure the ultimate success of the complete package. The role of market/non-market interplay in achieving socioeconomic justice has already emerged in relation to the third central question of economics ("*for whom*") where non-market institutions of an Islamic state proved to consist of government and a voluntary "third" sector. The three-sector set up of an Islamic state underlies the vital role of *waqf* institutions in poverty elimination and the financing of public goods since taxation played only a marginal role in early Muslim states. The complete package of *riba* elimination also engages the market/non-market interplay to realise the desired socioeconomic order. Therefore, it is worthwhile reviewing the impact of *riba* elimination in terms of the above two verses.

The three-sector set up of an Islamic state underlies the vital role of *waqf* institutions in poverty elimination and the financing of public goods since taxation played only a marginal role in the early Muslim state.

Distributional implications of the first verse

The first verse, "*But Allah hath permitted trade and forbidden usury*" (*Al-Qur'an*, 2:275), relates to the impact of interest rate elimination on the market sector, which has been the subject matter of the section "*Trade, Money and Riba*". Permissibility of trade has been viewed as an acknowledgement of economic interdependence among nations as the legitimate means to generate prosperity and well-being. Attention has also been drawn to the damages that *riba* inflicts on the regular flow of trade. On one hand, *riba* sways money from its normal course as a medium of exchange and facilitator of trade to being an object of trade. This abuse of money gives money-lenders massive command over real wealth without them taking part in productive activities. Thus, the distributional impact of *riba* prohibition within the market context is to guard against dysfunctional emergence of money traders and to realign income distribution in accordance to productivity contribution. On the other hand, money-lending is a means of ownership transference invoking reciprocal obligation on the borrower to compensate the lender through an equivalent transference of ownership at some future time, thus depriving money-lenders from productivity claims, and therefore, the interest rate is not a legitimate measure of capital productivity.

Riba sways money from its normal course as a medium of exchange and facilitator of trade to being an object of trade. This abuse of money gives money-lenders massive command over real wealth without them taking part in productive activities.

Nonetheless, money capital is an important factor of production if ownership risk rests with capital suppliers and hence "profitability" becomes the yardstick of return on capital. This is particularly in the case of *rabbul mal* in *mudarabah* and the partners of *musharakah* where capital suppliers enjoy the status of equity holders in an industrial firm. This model has been contrasted with the standard capitalist industrial organisation of productive factors in relation to the second central question of economics: "*How to produce?*" The hallmark of capitalist firms is shown to be external debt-financing as opposed to pure equity-financing in PLS firms. Creditworthiness in capital markets has thus emerged as the driving force of profit-maximising capitalist firms, thereby triggering aggressive cost-minimisation policies through wage and employment-cuts and steady recourse to labour-saving technology. By contrast, the driving force of PLS financing firms is profitability of investment projects. This invokes cost minimisation as Islamic prudence to avoid economic wastage rather than an axe to shatter labour employment. Equity capital under the PLS organisational structure is less exposed to financial strain, and therefore more employment-friendly compared to capitalist firms.

Distributional implications of the second verse

The second verse, "*Allah will deprive usury of all blessing, but will give increase for deeds of charity*" (*Al-Qur'an*, 2:276), relates to the non-market implication of interest rate elimination. This verse strikes squarely at the primary motive that drives wealthy people to become wealthier — the adoration of wealth. Capitalising on the power of money through *riba* is indeed the easiest way to become wealthier but adoration of wealth is also possible through temptations of profitable trade in legitimate markets. Wealth adoration, irrespective of source, empties wealth from moral purpose and accentuates concentration of wealth into a few hands, thereby deviating radically from the Islamic worldview. From an Islamic perspective, wealth is a trust from Allah (s.w.t.) to test how his servants deliver moral and social obligations through the management of their wealth.

Wealth adoration, irrespective of source, empties wealth from moral purpose and accentuates concentration of wealth into a few hands, thereby deviating radically from the Islamic worldview.

On the other hand, *riba* elimination is not only about recovering the function of money in trade but also as a strong reminder of public duty. The second verse is the reminder. People fervently engaged in wealth creation are often under the temptation to slide into twisted means including the prohibited *riba*. Thus, the second verse stands out as a constant reminder of people to counteract the temptation of *riba*-driven wealth through the deliberate revival of an opposite motive — charitable-spending. Effectively, it marks a safe "charitable margin" to guard the legitimate trade-driven motive of wealth creation from relapsing into a *riba*-driven motive. Although market trade is the legitimate alternative to prohibited *riba*, the verse has deliberately counter-acted the wealth motive by non-market charitable motives. It resonates with another verse of the *Qur'an* that states: "*That which you lay out for increase through the property of other people, will have no increase with Allah: but that which you lay out for charity, seeking the Countenance of Allah: it is these which will get a recompense multiplied*" (*Al-Qur'an*, 30:39). This verse explains the concept of *riba* as the act of pooling one's wealth with that of others with the objective to achieve growth, which is the same concept of interest-bearing deposits in commercial banks.

It is worth noting that charitable spending as mentioned in the two verses has no relationship with the special nature of *riba* that prevailed in the old days. Nonetheless, the viewpoint that modern interest rate differs from old time *riba* emerged historically from theological debate in the Christian Church about the nature of prohibited usury in the Scriptures. For many centuries, the Church upheld the opinion that usury was the same thing as banking interest until Calvin, a Protestant Bishop, broke out the revolutionary opinion that they are two different concepts. Usury prohibited in the Holy Scriptures, Calvin argued, involved exploitation of the rich to the poor who otherwise needed charity for the necessities of life, whereas banking interest are related to production financing of economically powerful business firms. However, this is not the opinion of Muslim scholars for two reasons. On one hand, economics of *riba* does not change through time or space. Money-lenders always have the same motive to secure principal and interest by dealing with trusted and economically powerful parties (profiteering traders and wealth owners) rather than default-prone borrowers. On the other hand, the pre-Islamic practice of *riba* was testimony to the fact that old-time *riba* is the same as the modern interest rate.

Considering the fact that taxation played only a marginal role in the financing of public goods of early Muslim states, reference to charitable spending in the last two verses is a definite call on public spending. In essence, Islamic finance is irreducible to the realm of marketable goods and services. The last two verses have succinctly defined public duty as an integral part of *riba* elimination. For many centuries, the moral thrust of the *Qur'an* instigated voluntary spending as a major source of public financing, which echoed remarkably in the financing of major public goods (hospitals, schools, roads, etc.) through socially responsible *waqf* foundations. This is a similar legacy developed in Christian societies. Almost every social development in the UK until the 19th century is believed to have originated in voluntary organisations. By the end of the 20th century, the contribution of voluntary organisations in the UK stood at nearly 5% of its gross domestic product (GDP). Now, under the rubric of a "third" sector, charitable initiatives are earnestly invited to supersede conventional tax-financed methods in the provision of certain public goods. A consensus is building gradually among Western policy-makers to devolve the financing of many public services from government budgets to the third sector, as featured lately in the political debate in the UK around the appeal of "big society" as opposed to "big government".

Almost every social development in the UK until the 19th century is believed to have originated in voluntary organisations. By the end of the 20th century, the contribution of voluntary organisations in the UK stood at nearly 5% of the GDP.

However, freedom of Muslim economies from poverty — both absolute and relative, is the challenge that warrants the immediate attention of Islamic finance. Freedom from poverty is not only a key public good from the *maqasid* perspective but also the most demanding to help lift contemporary Muslim economies from the dips of poverty to the horizons of prosperity. Only then, would Islamic finance have responded to *maqasid* as well as recovered the true function of money in trade, which is the way forward through the complete package of *riba* elimination.

Economics of the Financial System

Now, let us turn our discussion to the Islamic financial system as an offshoot of Islamic economics and the overall objectives of the Islamic economic system as explained in the preceding sections. As briefly mentioned in Chapter 1, the basic function of a financial system, whether Islamic or conventional, is to channel the funds within an economy from surplus fund units (SFUs) to deficit fund units (DFUs). The financial system consists of markets and institutions actively engaged in the channelling of investable funds from SFUs to DFUs. At any point in time, SFUs are those with current incomes in excess of spending plans, whereas DFUs are those with spending plans in excess of current incomes. Potentially, all financial system players including individuals, households, companies and governments, are either deficit or surplus fund units depending on how cash flows and spending plans are matched at any point in time. Nonetheless, DFUs are mostly governments and companies that wish to embark on large-scale expansionary activities, thus requiring large scale fund raising programmes. Surplus fund units could be ordinary salaried households who often spend their incomes over extended periods thereby putting aside some savings for an investment or future consumption.

The financial system consists of markets and institutions actively engaged in the channelling of investable funds from surplus fund units (SFUs) to deficit fund units (DFUs).

The main objective of a financial system is therefore to mobilise large amounts of relatively small savings and pool them together to channel them for productive investments in the economy. This is done either directly through financial markets (stock exchanges, over-the-counter (OTC) trading, etc.) or indirectly through financial intermediaries (bank and non-bank institutions), see Figure 2.5.

In a nutshell, a financial system is a complex set of financial institutions and markets that bring together lenders and borrowers consisting of banks (commercial and investment banks), insurance companies, mutual funds and other finance companies. In addition to facilitating the flow of funds between the SFUs and DFUs, financial institutions also develop instruments, techniques and products that meet the needs of both lenders and borrowers. Central banks carry out monetary policies through financial institutions in particular, and the financial system in general. Thus, a financial system is crucial in supporting the economic growth of a country in terms of producing goods and services, and creating employment.

Central banks carry out monetary policies through financial institutions in particular, and the financial system in general.

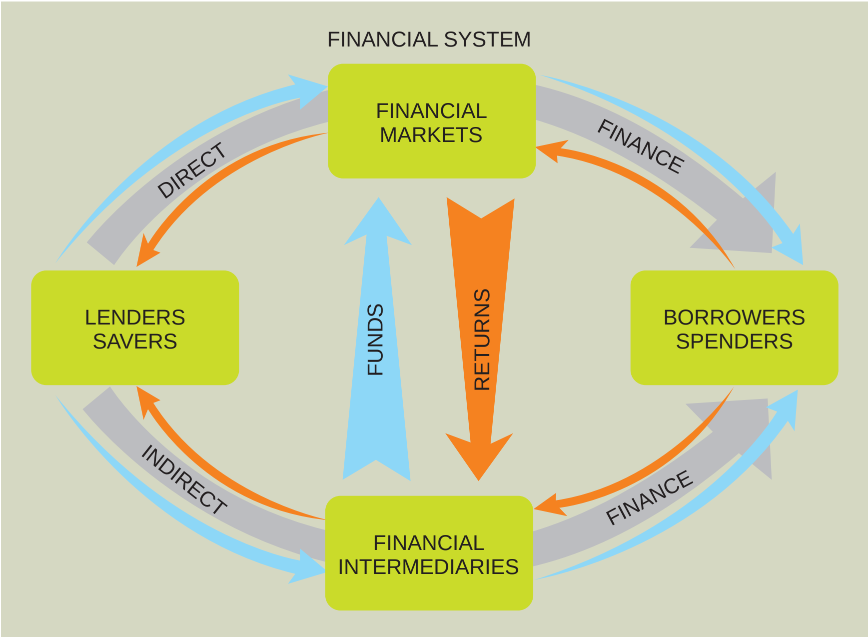


Figure 2.5
Flow of Funds through the Financial System

Modern financial systems are typically demand-driven. Those demanding the funds, usually governments and companies, acquire investable funds through the sale of well-structured financial securities (equities, bonds, etc.) or borrowings from financial intermediaries (banks, insurance companies, pension funds, etc.). The concept of the financial system seems to conform closely to *maqasid al-shari'ah* since it avails DFUs of the needed funds while catering valuable benefits to investors through income growth prospects and wide ranging financial intermediary services. From the *maqasid al-shari'ah* perspective, there is indeed a viable proposition in mobilising investable funds, pooling them together and making them available for productive purposes, directly or indirectly. Yet, a host of *Shari'ah* issues and far-reaching economic implications are bound to arise in relation to:

1 Marketable financial securities as instruments of fund raising and income growth

2 The nature of financial intermediary services and modes of service delivery

The next section addresses economic implications in relation to markets. The nature of financial intermediary services emerges later in relation to the Islamic structures in a financial system. More technical details about securities and intermediary services are dealt with in subsequent chapters.

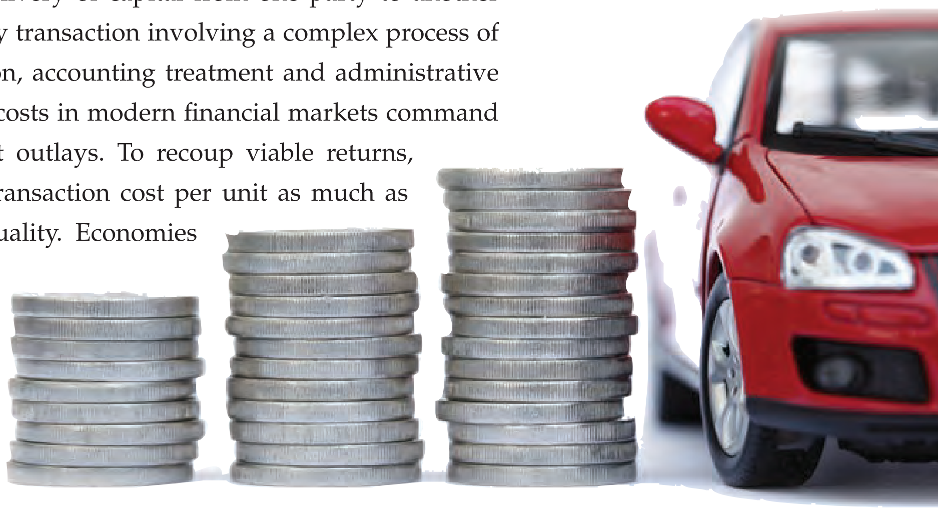
The Structure of the Islamic Financial System

As highlighted in Chapter 1, the structure of the Islamic financial system is similar to the structure of the conventional financial system. In other words, the Islamic financial system comprises financial institutions (Islamic banks, Islamic insurance (*takaful*) companies, Islamic mutual funds and other finance companies) and markets that also bring lenders and borrowers together. Likewise, Islamic financial institutions (IFIs) and markets facilitate the channelling of investable funds from SFUs to DFUs. However, under the Islamic financial system, Islamic financial markets, institutions and instruments operate in line with *Shari'ah* rules and principles that will be discussed in greater detail in the second part of the book, *Shari'ah* Framework and Principles for the Islamic Financial System.

The main factors that seem to govern the structure of financial systems, Islamic or otherwise, are transaction costs and economic information. This section explains how transaction costs and economic information account for the leading role that financial intermediaries play in channelling funds from SFUs to DFUs.

Transaction Costs

Basically, channelling of funds is the delivery of capital from one party to another for investment purposes. Yet, it is a costly transaction involving a complex process of financial structuring, legal documentation, accounting treatment and administrative follow-up. Not surprisingly, transaction costs in modern financial markets command considerable claims on total investment outlays. To recoup viable returns, investors are therefore keen to reduce transaction cost per unit as much as possible without sacrificing financial quality. Economies of scale should achieve this objective through the possibility of pooling large blocks of financial transactions under single management, thereby reducing transaction cost per unit to much lower than what is otherwise possible through separately managed transactions. This explains the leading role of financial intermediaries in facilitating the flow of funds from SFUs to DFUs in modern financial systems. Transaction cost per unit is indeed the main factor that bars small investors from dealing directly with security markets.



Due to economies of scale, financial intermediaries are able to achieve two major services that are impossible for individual investors to achieve through direct contact with DFUs: asset transformation and risk transformation.

The need for asset transformation arises from the fact that SFUs often prefer lending short to secure more liquidity while DFUs prefer borrowing long. This is sometimes called the *constitutional weakness* of financial markets. To match the needs for both parties, banks get in the middle to transform relatively liquid liabilities into relatively illiquid assets. In other words, banks behave like factories that process short-term liabilities into long-term assets. Obviously, this introduces balance sheet risk in the normal operations of banks, hence giving rise to the importance of prudent banking regulation in the financial system.

Financial intermediaries are in a far better position to manage investment risk through diversification and spreading as compared to what individual investors can achieve.

Risk transformation involves reducing investment risk through the transformation of single transactions into a large portfolio of transactions. Again, financial intermediaries are in a far better position to manage investment risk through diversification and spreading as compared to what individual investors can achieve. This is particularly manifested in the role of mutual investment funds.

Economic Information

The financial system revolves around financial information not only through internal legal structures of financial securities but also through external market information, which can be the initial trigger for trading parties to enter into financial transactions. Buying security from the issuer, after all, means surrendering money to the financee, which is usually unaffordable without the financier having due trust in the financee. Trust, on the other hand, requires market information about past track records, current financial position and the future investment prospects of the financee. Without informed trust, SFUs would be extremely reluctant to allow funds to flow to DFUs. An efficient financial system is one that performs this objective with utmost ease and speed, which is the reason why "information efficiency" is the normative criterion for success or failure of financial systems. Economic information is indeed the lifeblood of the financial system, and the factor that explains much of a financial system's institutional structure.

Islamic Financial Markets

Islamic financial markets uphold the important role within the Islamic financial system as conduits of funds between SFUs with DFUs within the interest-free realm of *Shari'ah*, thus distinguishing itself from conventional markets that operate on the basis of interest. As is the case with the conventional financial system, there are different types of markets within the Islamic financial system, which we have briefly described in Chapter 1: debt and equity markets, money and capital markets, primary and secondary markets, organised and OTC markets, etc. Nevertheless, the emphasis in this chapter is placed on the broad division of financial markets into money markets and capital markets. Islamic money markets, debt markets and equity markets will be dealt with in Chapters 9, 10 and 11 respectively. This section describes Islamic financial markets in terms of marketable financial instruments.

The sale of a financial security at a price is tantamount to signing a legal contract between the *financee* (issuer of security) and the *financier* (holder of security), while "price" is simply the amount of money handed over by the financier to the financee. The financier hands over the money against legal proof, the security, to document terms and conditions agreed by the two parties. In terms of contractual structure, conventional securities fall into two broad categories: bonds and equities. Bonds are debt securities through which bondholders lend money to bond issuers with the added provision that both principal and interest income are guaranteed to bondholders. This is clearly non-Islamic since it involves payment of interest.

Equities are profit-and-loss-sharing securities (PLS securities) through which equity holders participate in the profits realised by equity issuers but without guarantee to either principal or return. Thus, equities seem to have very close affinity to *mudarabah* where the financier behaves as *rabbul mal* and the financee behaves as *mudarib*, except for special provisions arising from the legal characterisation of public corporations (treatment of company as legal person, limited liability of equity holders, perpetual nature of company and trade in equity), which, again, are all acceptable in *Shari'ah*. This section relates to the economics of the financial system rather than the technicality and legality of financial securities, which is handled in detail in chapters on *sukuk* and the Islamic equity market.

Economics of the financial market relates not only to the impact of interest rate elimination but also to the impact of *gharar*, another prohibited element in financial contracts. *Gharar* refers to "excessive" uncertainty in relation to price, quantity or quality of goods in an exchange contract. It violates the fundamental *Shari'ah* condition that parties to a sale contract have full knowledge of the price and goods, qualitatively and quantitatively, and are able to make due delivery thereof. It is also a matter of economics to ensure that welfare generates from trade. Thus, ownership of goods in addition to the ability to deliver goods are fundamental *Shari'ah* conditions of sale contracts. *Gharar* is best exemplified in jurisprudence by the "sale of birds in the sky" or "sale of fish in the sea" among other traditional forms. Nonetheless, uncertainties may arise from the nature of certain products (e.g., watermelons), or due to special circumstances, e.g., recourse to customary approximations in the sale of loose bunches (apples, oranges, etc.) called *bay' al-juzaf* in Islamic jurisprudence. It may indeed prove impossible to eliminate all *gharar* from sale contracts. Hence, "excessive" *gharar* is the problem that warrants judicious assessment in various situations.

Gharar refers to "excessive" uncertainty in relation to price, quantity or quality of goods in an exchange contract. It violates the fundamental *Shari'ah* condition that parties to a sale contract have full knowledge of the price and goods, qualitatively and quantitatively, and are able to make due delivery thereof.

Excessive *gharar* in financial markets arises from three main sources:

1 Uncertainty within the financial structure of the security
2 Lack of key information that governs the contract between the issuer and holder of the security
3 Lack of important external market information about marketable securities

The first relates to the basic structure of a security where uncertainty constitutes the key source of value to issuer and holder. This is typical of financial derivatives that are defined in terms of other securities for risk-hedging purposes rather than fund raising. Conventional markets are rife with different brands of *gharar*-prone derivatives that accommodate zero-sum gambles, e.g., options, futures, and swaps. The second arises from failure to satisfy key contractual conditions in the structure of a security that is otherwise *Shari'ah*-compliant, e.g., failure to stipulate profit-sharing ratio in a *mudarabah*-based security. The third arises not from the structure of marketable securities but from lack of market information to guide prudent sale and purchase of *Shari'ah*-compliant securities. This follows from the fact that a financial security, although *Shari'ah*-compliant, is an information-loaded asset.

Conventional markets are rife with different brands of *gharar*-prone derivatives that accommodate zero-sum gambles, e.g., options, futures, and swaps.

Real goods and assets are acknowledgeable, qualitatively and quantitatively, through physical contact but the only means to acknowledge financial securities is through information sifting. Securities are therefore vulnerable to *gharar* unless traders in financial securities probe into financial information regardless if it relates to the basic structure of securities or to external market circumstances. This predicates the importance of a sound information system to support dealers as well as regulators. Sound information systems ensure that financial markets do not deviate significantly from the economic fundamentals of an economy, as well as enabling regulators to interfere in a timely manner to keep financial markets on track in case of any looming risks in the financial system.

Islamic Financial Institutions

Financial institutions, alongside financial markets, play a major role in achieving the goals of a financial system. In fact, IFIs are the main agents of the financial system through which the *maqasid* of the Islamic financial system are achieved. *Maqasid*, as elaborated before, differ significantly from the objectives set forward by the conventional financial system. Although IFIs perform the same functions as their conventional counterparts, these functions are carried out in accordance with the rules of *Shari'ah*. Next, we will discuss further the role of IFIs.

The Role of Islamic Financial Institutions

In this section, we will discuss the role of financial institutions as financial intermediaries while in the next section, we will discuss instruments that facilitate this process within the Islamic financial system. As mentioned in Chapter 1, financial intermediation performed by IFIs is fairly comparable to financial intermediation performed by conventional financial institutions. To recapitulate, there are several roles played by financial institutions, whether Islamic or conventional. One of the most important roles played by financial institutions is to provide a link between lenders and borrowers of funds. Without financial institutions in place, it would be difficult for SFUs and DFUs to match directly in the market, or at least this matching would not be as efficient as it is through the intermediation of financial institutions. In the process, financial institutions collect relatively small savings from individuals, households and institutions and transfer them to deficit units, mainly businesses, for investment and production purposes.

Nevertheless, channelling of funds between SFUs and DFUs is not the only function of financial institutions. Financial institutions also gather and process information about the economic conditions of markets as well as market players. This, in turn, leads to efficiency in financial markets by reducing the cost for raising funds in the market and maximising the return on investment. Absence of financial institutions would make the channelling of funds between SFUs and DFUs very costly (as pointed out earlier) due to the complex process of financial structuring, legal documentation, accounting treatment and administrative follow-up. This is where financial institutions come into play. Through pooling a large number of savings and financial transactions under one management, financial institutions benefit from economies of scale whereby the cost per transaction reduces significantly as the number of transactions increases, and thus directly contributing to the efficient functioning of a financial system.

Absence of financial institutions would make the channelling of funds between SFUs and DFUs very costly due to the complex process of financial structuring, legal documentation, accounting treatment and administrative follow-up.

In addition to matching the SFUs and DFUs between borrowers and lenders, financial institutions also provide two important services through asset transformation and risk transformation between market players. While SFUs prefer lending short, DFUs prefer borrowing long. This is where the asset transformation service provided by financial institutions comes into the picture. In the process, financial institutions transform relatively short-term liabilities into long-term assets.

However, this asset transformation is not risk free. In fact, different market players have different risk profiles and preferences. This is especially true for the last couple of decades when deregulation, liberalisation, complexity and volatility of financial markets, resulted in the search by financial institutions for new products that would facilitate the mitigation, transfer and sharing of risks. Nevertheless, financial institutions are in a far better position to efficiently manage risks arising from both the liabilities and assets sides.

Distinct Features of Islamic Financial Institutions

In Chapter 1, we have highlighted that basically all financial institutions are generally classified into two broad categories: depository institutions and non-depository institutions (refer to Chapter 1 for a brief description on these institutions). Under the conventional financial system structure, SFUs provide funds to DFUs through financial institutions by charging interest. On the liabilities side, financial institutions pay interest to savers/investors, and on the assets side, they charge borrowers a relatively higher interest rate. The spread between the interest paid and interest charged is the profit of the financial institution. Since the charging and paying of interest is prohibited in Islam, financial intermediation under the Islamic financial system has some distinct features. To avoid interest, Islamic financial institutions use various contracts that are in line with *Shari'ah* teachings, better known as *Shari'ah*-compliant products. Islamic financial institutions thus, use equity, as well as debt-based financial instruments for the mobilisation and use of funds.

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Due to the differences in the nature of financial institutions and the way they engage their clients, especially long-term relationships in profit-and-loss sharing arrangements, there is a greater need for monitoring the entrepreneurs' activities. This, in turn, may imply higher costs and unique risks that are not present within the conventional financial system. In general, financial institutions are exposed to several risks related to both the liabilities and assets sides of the balance sheet. These risks include interest rate, exchange rate, and liquidity risks that are related to both sides of the balance sheet. On the other hand, credit, market, and operational risks are related to the assets side of the balance sheet only. However, IFIs face certain risks that are associated with specific business models and Islamic contracts used in financial intermediation. Apart from the mentioned risks, IFIs are faced with the rate of return risk, displaced commercial risk, fiduciary risk, *Shari'ah*-compliance risk, and reputation risk, among others. In Chapter 13, we will discuss these risks in greater detail.

Unlike deposits placed in conventional commercial banks whose principal and return is assumed to be guaranteed, Islamic banks and financial institutions are not able to guarantee return on capital and profit. This is especially true for deposits and investments that are based on *mudarabah* and *musharakah* principles, while the principal amount of deposits placed with an Islamic bank based on the principle of *amanah* are guaranteed by the bank without any guarantee on the profits of those deposits.

Every *Shari'ah* advisory board consists of *Shari'ah* scholars who are well versed in *Shari'ah* teachings. The existence and role of the *Shari'ah* advisory boards is a unique feature of Islamic financial institutions.

Yet another distinct feature of IFIs is the existence of the *Shari'ah* advisory boards. Every *Shari'ah* advisory board consists of *Shari'ah* scholars who are well versed in *Shari'ah* teachings. The existence and role of the the *Shari'ah* advisory board is a unique feature of IFIs whereby their approval is needed before the introduction of any new product.

Islamic Financial Instruments

Characteristics of Islamic Financial Instruments

Economic activities within a financial system are performed by different economic agents who, more often than not, come into contractual relationship with other agents in pursuing their economic activities. This contractual relationship is usually defined through a financial instrument which is seen as a contract with terms, conditions, risk and return profiles defined.

The creditor-debtor relationship is the feature of commercial financial contracts based on interest, where interest is seen as both the price of an underlying product or credit and cost of money. However, paying and charging interest is against the principles of *Shari'ah* and thus cannot be used within the Islamic financial system.

As pointed out earlier, financial institutions channel funds from SFUs to DFUs and provide risk-sharing, liquidity, and information to market players. All of this is done through various financial instruments. While conventional financial intermediation is done through instruments that are interest-based, Islamic financial intermediation and instruments must be free from prohibited elements. From the *Shari'ah* point of view, every contract is considered to be legal and lawful as long as it does not contain any prohibited elements, such as *riba*, *gharar* and *maysir*. However, investing in companies that are free from these elements but are producing alcohol, tobacco and pork is not allowed since alcohol, tobacco and pork are not allowed (*halal*) in Islam as well.

From the *Shari'ah* point of view, every contract is considered to be legal and lawful as long as it does not contain any prohibited elements, such as *riba*, *gharar* and *maysir*. However, investing in companies that are free from these elements but are producing alcohol, tobacco and pork is not allowed since alcohol, tobacco and pork are not allowed (*halal*) in Islam as well.

Nowadays, it is hard not to find an Islamic alternative product for most of the products offered by conventional financial institutions. However, while they are similar in nature and functions performed, Islamic financial intermediation differs significantly when it comes to the underlying contracts and mechanisms used. In fact, it is these underlying contracts that distinguish the Islamic mode of intermediation from the conventional one. To illustrate this further, consider the following example: An IFI, in this case an Islamic bank, can use several contracts for the mobilisation of funds. In particular, it can use contracts such as *mudarabah*, *wakalah* and *wadi'ah* for the mobilisation of funds. While Islamic banks have at their disposal a relatively small number of contracts/ instruments for the mobilisation of funds, they have a greater spectrum of instruments for the utilisation and investment of funds. Thus, for investment purposes, in addition to *mudarabah*, they can use instruments based on *murabahah*, *salam*, *ijarah*, *istisna'*, *musharakah*, *ju'alah*, *rahn*, and so on. Each and every contract has its own features and characteristics that affect the nature of the contractual relationship between the parties involved. On the contrary, a conventional bank will simply pay interest to its depositors on one side and collect interest from business investments on the other. Usually, the interest charged is higher than the interest paid, and this is known as the interest

Islamic financial instruments may look like a mirror image of conventional ones, but their underlying features, contractual relationships, mechanisms and implications are not identical.

rate spread which represents a profit to the bank. In short, although Islamic financial instruments may look like a mirror image of conventional ones, their underlying features, contractual relationships, mechanisms and implications are not identical.

As highlighted in Chapter 1, there are mainly two approaches to developing modern Islamic financial instruments, namely an adaptive and innovative approach. Under the first approach, existing conventional instruments that are generally acceptable from the *Shari'ah* point of view are modified and further enhanced by removing any prohibited elements that may hinder the validity of the instrument. On the other hand, *Shari'ah* scholars are actively involved in searching for new and innovative instruments that are based on the various *Shari'ah* contracts mentioned previously.

Uses of Islamic Financial Instruments

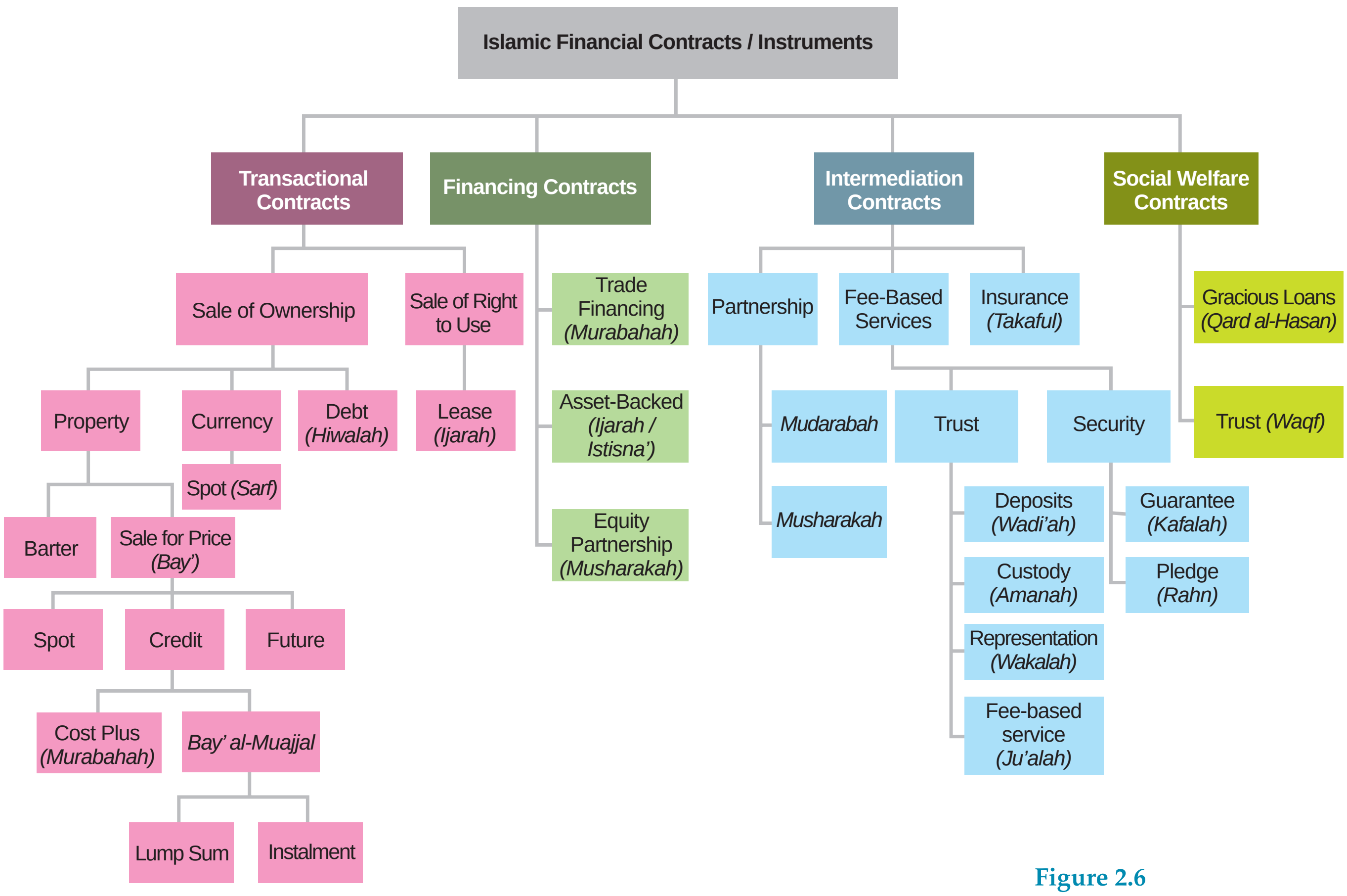
Islamic financial instruments are generally used for similar purposes as their conventional counterparts. The fundamental difference between the two types of financial instruments is the underlying *Shari'ah*-compliance applicable to Islamic financial products. The abovementioned example illustrates that the Islamic bank can use contracts such as *mudarabah*, *wakalah* and *wadi'ah* for the mobilisation of funds. In the case of *mudarabah*, a depositor acts as *rabbul mal* and the Islamic bank as *mudarib*. *Shari'ah* scholars have also allowed certain freedom to the *mudarib* who is allowed to form partnership(s) with third parties. This model is known as the two-tier *mudarabah*, which is also the basis for modern Islamic banking. In the case of *wakalah*, which means representation, an agent (*wakil*) acts on behalf of the principal. The difference between *mudarabah* and agency (*wakalah*) is in the freedom and control of funds by the agent. The *mudarib* (manager of *mudarabah*) has full control and freedom to use the funds provided by the capital supplier (*rabbul mal*), while the agent (*wakil*) has limited freedom as he acts only in accordance with instructions given to him. Finally, deposits placed under the principle of deposit (*wadi'ah*) are considered to be a trust with a trustee, a bank, for safekeeping. The depositor allows the bank to utilise his funds without expecting any returns. However, since these deposits are placed for safekeeping, the trustee is obliged to return them to the depositor upon demand.

The most widely used contract on the assets side is *murabahah*, which refers to a cost-plus sale, whereby a financial institution buys a product such as a commodity, equipment, raw material, etc., and sells it to a client.

On the assets side, various contracts are used for many purposes. The most widely used contract is *murabahah*, which refers to a cost-plus sale, whereby a financial institution buys a product such as a commodity, equipment and raw materials, and sells it to a client who could be an entrepreneur. The price of the goods sold is equal to the cost of the goods plus a profit margin agreed by both parties. The payment is usually delayed to a future date and it can be made either in lump-sum or by instalments. Hence, this instrument can be used for providing short-term working capital or as a letter of credit for financing export-import related trade financing.

Islamic financial instruments are also used for fund management services. In this case, for example, *mudarabah* and *musharakah* can be used. In the case of *mudarabah*, the capital provided by participants (*rabbul mal*) will be entrusted to a *mudarib* or a fund manager who will manage the fund according to his expertise without undue interference of the *rabbul mal*. The profit realised at the end of the period will be shared between capital providers and the fund manager according to the agreed profit-sharing ratio. In the case of *musharakah*, however, the fund manager will also contribute capital to the fund, thus making him a partner. The difference between the *mudarabah* and *musharakah* models lies in the way the loss is treated. Under the *musharakah* model, the loss is to be shared according to the capital invested, while in the case of *mudarabah*, the loss is completely borne by *rabbul mal*, unless it is proven that the loss is due to the fund manager's negligence.

Details of these and other instruments, their characteristics and different uses are discussed in Part Two and Three of this book, especially in Chapter 8 which discusses Islamic banking operations and instruments. Figure 2.6 shows a chart of various Islamic financial contracts/instruments.



Source: Adapted from Iqbal, Z., & Mirakhor, A. (2007).

Figure 2.6
Islamic Financial Contracts

Summary

1 The Islamic worldview originates from the concept of *Tawhid* (Oneness of God) which accounts for clear standards of socioeconomic justice and accountability in the pursuit of socioeconomic well-being.

2 The objectives of an Islamic economy are part of the *Shari'ah* objectives (*maqasid al-shari'ah*) in relation to the focal question: "How does *Shari'ah* face up to the challenges of human well-being under constantly changing modes of livelihood?"

3 The five Pressing Necessities of *maqasid* (Religion, Human Life, Mind, Progeny and Wealth) constitute the basic structural elements that uphold the satisfaction of Needs and Embellishments in socioeconomic well-being.

4 Islamic economics is a *maqasid*-driven inquiry into the three central economic problems: what to produce (production decision), how to produce (management decision), and for whom to produce (distributional decision).

5 As a medium of exchange, money facilitates the creation of real wealth through trade in goods and services. This primary function enables money to serve other functions such as a unit of accounting, standard of value and store of value.

6 Interest rate is another name for usury that is strictly forbidden in the *Qur'an*. Islamic finance is largely about seeking legitimate alternatives to interest rate financing.

7 Money-making through lending at the interest rate hampers the creation of real wealth in two ways: first, through the withdrawal of money from real trade to money markets, and secondly, through giving undue command on real wealth to money market makers.

8 The function of a financial system, whether conventional or Islamic, is to channel funds from surplus fund units to deficit fund units directly (through open security markets or OTC markets) or indirectly through financial intermediation (banking and non-banking institutions).

9 The structure of the financial system is significantly influenced by transaction costs and economic information. This explains the leading role of financial intermediaries which enjoy economies of scale and the ability to overcome problems of moral hazard-adverse selection resulting from informational asymmetry.

Key Terms and Concepts

Islamic Economics
Pressing Necessities
Riba (Interest)
Wealth
Financial System
Financial Instruments
Transaction Cost
Ijarah
Shirk
Maqasid Al-Shari'ah
Needs
Interest Rate
Scarcity
Financial Intermediary
Equity
Mudarabah
Murabahah
Economic Information
Worldview
Embellishments
Profit-and-Loss-Sharing (PLS)
Production Possibility Curve (PPC)
Financial Markets
Bonds
Musharakah
Tawhid

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Review Questions and Problems

1. Explain how *Tawhid* develops a sense of justice and accountability from the socioeconomic perspective.
2. What is the focal question that links the objectives of an Islamic economy with *maqasid al-shari'ah*?
3. Explain the difference between jurisprudence and *maqasid al-shari'ah* and why the latter is needed?
4. Define the concept of Pressing Necessity from the viewpoint of *maqasid* and how it upholds the concepts of Need and Embellishment?
5. Does *Shari'ah* regard the fifth Pressing Necessity element, Wealth, as the least important element among the five Pressing Necessity elements of *maqasid*? Justify your answer.
6. Using the three-stage development model, describe how the third Pressing Necessity element, Mind, may develop gradually from minimal standards to more progressive targets.
7. Why do we need Islamic economics when the Islamic jurisprudence of economic transactions already exists?
8. Some writers believe that Islamic economics is more about “economic needs” than “economic wants”. Do you agree?
9. With the aid of a diagram, explain the law of scarcity and how it embeds the *maqasid*-oriented three-development model.
10. What is the *riba* which is prohibited in the *Qur'an*, and why is it judged differently from legitimate trade?

Chapter 3

Money and Monetary Policy

Preview

This chapter is divided into two main sections. The first section discusses the concept of money while the second discusses monetary policies. Money is very important for any economy. Through money, players in an economy are able to buy whatever goods and services they need without the hassle of bartering. Nonetheless, the concept and issues regarding money can be complex at times. This section basically discusses money as an important concept in economics and finance, and attempts to provide the reader with a basic foundation in it.

In order to appreciate the process of monetary policy and how the Islamic financial system can be a part of the process, the three main monetary instruments and how they influence the money supply in a nation practising the fractional reserve banking system are described, followed by a discussion on the monetary transmission mechanism. We then bring up some issues related to monetary policy in the Islamic financial system.

Learning Outcomes

At the end of the chapter, you should be able to:

- Comprehend the concept and functions of money in the economy.
- Comprehend the relationship between money and the real economy, how it encourages trade and exchange in the economy and thereby increases people's standard of living.
- Understand the applicability of the time value of money in Islam.
- Have a basic intuition of what makes good money in Islam and whether the gold (dinar) is important in Islamic finance.
- Explain the process of monetary policy and highlight elements of existing processes that may be compatible or incompatible with Islamic principles.
- Discuss various aspects of what may constitute an Islamic monetary policy process.
- Distinguish between various transmission channels and pinpoint the consequences of monetary policy action on economic agents as well as the economy.
- Link monetary policy action and its final objectives through the operations of the Islamic financial system.

The Concept of Money

Introduction

Exchange, which entails the process of give-and-take in the transfer of goods and services with others, has played a vital role in the history of mankind. It is in fact, as old as man himself. The reason for its importance is rather simple: self-sufficiency as a way of life is not really practical. Just imagine if each one of us had to handle everything on our own – grow grains, vegetables and fruits, sew our clothes, educate ourselves, provide ourselves security and shelter, etc. Since one's knowledge and skills are limited, one can only enjoy limited things, in limited quantities and in limited qualities if one were to produce everything on one's own. Hence, exchanging goods and services with others is an important process which paves the way for the improvement of one's standard of living or even one's well-being, particularly by obtaining and benefiting from the consumption of goods and services of production that we have no knowledge of.

Interestingly, the way exchanges occur, the purpose for which they occur and the extent to which they dominate economic interactions between humans have evolved in many significant ways. The influencing factors were many – social institutions, technological and economic development, to name a few. The history of economic exchange started by means of simple direct exchanges, i.e., primitive barter trade between two parties. Such a barter process encompasses the simple exchange of one's goods or services for that of another's. It is a very crude form of exchange in which one gives up something less desired for something more desired.[1] In essence, an exchange involves the transfer of ownership since in exchanging things, claims on property rights are exchanged. In societies that do not focus on private property rights or individual well-being but instead on communal property as well as communal well-being, or in economies with only a limited amount of exchangeable goods and services, primitive barter may be a well enough exchange and distribution mechanism. However, for larger societies with loosened social ties, more focus on individual well-being, as well as having a large amount of goods and services for exchange, primitive barter is likely to be deficient as the supporting exchange mechanism. An efficient exchange system produces more gains by allowing individuals to specialise in the production of goods and services. By devoting one's energies and skills to the production of say only one commodity, not only are the productivity and quality enhanced, but the need for exchange increases drastically as well. Primitive barter with its simple and direct exchange mechanism may not be able to support such a system. The reasons for this inability can be summarised as follows:

Money allows people to specialise in what they do best, it removes problems associated with barter and increases trade and business transactions.

1 Economists would say giving up something of lower marginal utility in exchange for something of higher marginal utility.

1 **Double coincidence of wants** – This refers to the situation where one is likely to find it difficult to find a counterparty who is offering what one desires and at the same time is willing to accept what one is offering in exchange. Imagine a furniture maker who wants a chicken, and hence approaches a poultry farmer to make an exchange. The first problem is that the farmer might have no need for new furniture, and hence might not be willing to accept such a trade. If the furniture maker has nothing else to offer the farmer, then an exchange might not take place at all.

2 **Indivisibility of goods and services** – Continuing with the above example, say even if the farmer wants new furniture, the exchange ratio of furniture for one chicken might not be acceptable to either or both the parties. For example, the value of a chicken may be equal to a quarter of the value of the furniture, but how does one exchange fractions of furniture? Cutting the furniture into smaller pieces would adversely impact the farmer's supposed utility. Hence, the farmer's incentive for exchange is dampened.

3 **Lack of a unit of account (common standard of value)** – Beside the problems of double coincidence of wants and the indivisibility of goods and services, another problem that could impede exchange in a primitive barter marketplace as diversification of products grows, is that of pricing. With a limited amount of products, this problem might not be apparent. For example, in an economy with, only four different types of goods to be exchanged, six "exchange rates" need to be set. Nevertheless, a market offering ten goods and services would have to establish 45 exchange rates. For one hundred goods, it would be a staggering 4,950 prices, or exchange rates.[2] For the thousands of goods as we observe in today's markets, the number of required prices would be very huge.

Specialisation allows more goods and services to be produced and exchanged, thereby increasing the standard of living for all.

However, primitive barter was never used extensively. This was because societies introduced the concept of money, however primitive the money might have been, in order to solve the problems of barter exchange and to facilitate trade. Money had emerged as early as records and archaeological findings go back into mankind's history. Shells, feathers, stones, leather and many other items as well as various recording

2 The formula for the number of required prices, or exchange rates is $C^n_r = n!/[(n-r)!r!]$ where n is the number of different types of goods and services and r = bilateral groups of 2. The formula $C^n_r = n!/[(n–r)!r!]$ can be explained as follows. Say there are four products — rice, wheat, apples and dates. In a barter system, we have to give the exchange rates between each two items, i.e., how much rice for one unit of wheat, one unit of apple, one unit of dates … how much wheat for one unit of apple, one unit of dates … and how many apples for one unit of dates. Hence there are six exchange rates for the four products. We get it from the formula as follows: $C^4_2 = 4!/[(4–2)!2!] = 24/(2 \times 2) = 6$.

A good monetary system is a mechanism by which markets are efficiently and perfectly cleared.

methods have been used as ways and means of simplifying the exchange process. Yet, barter would make a comeback at times – whenever the monetary exchange mechanism failed to perform, people would resort back to various forms of barter. For example, during the Middle Ages, barter gained significance because of a general shortage of coinage. As a result, serfs paid manor lords by means of hours of labour, while the nobility made payments in military service. But one does not have to look that far back to get an example of practised barter. In the 1970s, the US saw a revival of barter due to the high inflation rate at that time and in the early 1990s, the Russian population had to resort to barter due to a total breakdown of their national currency system when the Soviet Union collapsed. Farmers were then exchanging their food products for industrial products, workers were paid using food obtained from the farms, or even using the factories' output itself. Barter reached such an acceptance that even taxes were collected in kind. Also, during the 1997 East Asian Economic Crisis, Malaysia resorted to barter in international trade due to a shortage of foreign reserves. Indeed, barter is practised even in instances when the monetary exchange mechanism performs well, for example, as a means of avoiding income taxes.

Money has evolved from items like cowry shells, stones, leather etc., to gold and silver, to paper currencies and electronic money.

Modern money essentially performs the same role as primitive money, but with more effectiveness and efficiency. However, like primitive money, modern monies are nothing more than tools for facilitating exchange and might be described as the *mechanisms by which markets are perfectly cleared*, or in other words, a mechanism which speeds up and simplifies the process of producing and exchanging goods and services. This is a very important role to note. Thus, even though money is very useful for enhancing the real output of a society or nation by allowing the producers and service providers to maximise their output and easing the process of exchange, money on its own may have no beneficial use for anyone. Imagine being stranded alone on an isolated island and being offered with two choices: having US$1 million, or having a couple of chickens, some tools and seeds. The logical choice would be the second option since the US$1 million would prove to be useless and worthless on an isolated island. Hence, a monetary system is the reflection of the goals and objectives of a society and as a result, it is important to have and implement a monetary system which is reflective of those goals and objectives. In today's era of democracy, that would be maximising one's ability to exchange his output against the output of others at a minimum cost, and in religious circles, for example Islam, it would mean to have an overall *riba*-free system as well.

The origin of money was a natural evolutionary process in which market participants developed primitive and later on, modern types of money. However, some writers stressed on the role of authorities, whereby the way exchanges took place was enforced by some central authority, be it *tribal* chiefs, sovereigns or in modern times, governments. Since different paths of development took place at different times and places, a universal theory of the origin of money could be misrepresented. Yet today, more or less all countries use the same kind of money, namely fiat money, the quantity and policies of which are controlled by central banks or monetary authorities. Fiat money is money not backed by and redeemable for gold or anything of value.

Functions of Money

Money is used most of all to solve the problems which are associated with primitive barter, namely the aforementioned double coincidence of wants, indivisibility of goods and services and lack of a unit of account. Accordingly, the most important functions of money are to serve as a unit of account and a medium of exchange. However, depending on what is being used as money, it could also serve as a store of value and a standard of deferred payment. These are elaborated below.

Medium of Exchange

The most important function of money is its function as a medium of exchange. Hence, some authors would define money as anything that is used as a means of making payments. Once an object ceases to circulate in the exchange process, it ceases to be money. Gold is an excellent example. It once played the role of money in all civilisations but is now rarely used as money. In a monetary system in which gold coins circulate and are used in making payments, the coins are defined and included in the stock of money. However, gold, not in the form of coins, but put to other uses, for example industrial purposes, is not considered money. Many items might be used to perform this function, and indeed many have been. The criteria upon which the performance of a chosen monetary medium should be evaluated are the easiness and effectiveness of its supporting role in the exchange process. If it is difficult and expensive to obtain money or if it circulates at a slow pace or in a limited scope, it might be claimed that such a medium is not effective and efficient in performing the function as a **medium of exchange**, and therefore alternatives may need to be sought. A good medium of exchange is one that allows everyone to exchange his or her goods and services fast and at a minimum cost.

Fiat money is money that is not backed by and is not redeemable for gold or anything of value.

Unit of Account

As mentioned earlier, pricing in primitive barter is very cumbersome and makes exchange impractical and almost impossible in a market with a huge amount of goods

and services. Hence, one of the most important functions of money lies in its role as a unit of account. The effect of such a function is that instead of having to price each of the goods and services against each other in bilateral "exchange rates", the market simply expresses all the prices in terms of the monetary unit. In our earlier example, a market with one hundred goods needs to express 4,950 exchange rates or prices, but with money, it needs to quote only one hundred prices, i.e., one for each of the goods in the monetary unit. Hence, money is essentially a universal pricing tool. Not only is it useful for pricing one's goods, but it is also useful to obtain information from the market on the value of one's output. Just by looking at the price one would be able to assess the desirability of one's offerings. Hence, a good unit of account is one which enables the market participants to express the value of their products and services in a way that reflects their relative desired value against other goods and services. Additionally, a good unit of account is one which allows market participants to extract information on the current demand and supply situation.

Store of Value

Money needs to be a good store of value as well. The reason is, an item being used as money is indeed a temporary storage of value in the exchange process. Therefore, if one exchanges a chicken for money, for example, then one transforms the value of the chicken into monetary form. After obtaining the money, one may want to transform its value back into real form by exchanging it for other desired goods and services. To illustrate this function clearer, imagine a neighbour who borrows from you a kilogramme of sugar. You will make sure that the dish in which you give the sugar has no holes, for otherwise the sugar would seep through the holes and thereby the neighbour might lose all the sugar and end up just owing you without actually having obtained any benefits at all. The same rule is to be applied to money as well. Money must be able to preserve its value in the exchange process and thereby allow one to obtain the same value back when the money is transformed back into real goods and services. If the purchasing power of money is eroded over time, then that money has not been a good store of value.

Since inflation is a measurement of the purchasing power of money, it is therefore used as a measure to estimate the performance of money as a store of value. If the general price level is stable, which is equivalent to low or no inflation, we can say that money has been a good store of value. However, if we note a chronic increase (or decrease) in the price level, then it can be said that money has not been a good store of value. Therefore, money is a good store of value if the aggregate price level of goods and services measured in that money value is stable.

Exhibit 3.1 Money as a Store of Value

A 10 sen coin in 1970 could buy one a cup of tea in Malaysia. In 2010, it could at best get one only a glass of water. Indeed, in many restaurants a glass of iced water now costs 30 sen or more. Has the ringgit been a good store of value during that period?

Standard of Deferred Payment

Money is not only useful for spot transactions, but also in specifying future payments for current purchases, i.e., buying now and paying later. This function is the result of money playing the role as a unit of account and store of value. Consequently, the success of money in executing this function is directly related to its success in performing the other two mentioned functions.

Types of Money

Given that money is a mechanism for facilitating exchange, different types of money emerged and functioned throughout the history of mankind. To claim that only a particular type of money is the true and right one would be like claiming that only cars are the true and right means of transportation, thereby ignoring buses, bicycles, trucks, trains and others as viable means of transportation. As different types of vehicles existed and still exist, with different features for different needs, so do different forms of money, adjusted for different social and market conditions, subject to the technological advancements of the time in question. For example, paper money could not have been introduced massively before the invention of the printing press that enabled the mass production of homogenous notes and the acceptance of money as a medium of recording debt. Similarly, electronic money could not have been used before the invention of the computer, Internet and usage of money as information medium. More important than the types of money are the objectives and functions it plays in society and the kind of exchange models it supports. Given the wide variety of possible monies, it might be said that *money can be anything that is widely used and accepted for making payments*.

Money can be anything that is widely used and accepted by people for making payments.

Throughout history, different monetary systems and monies have existed and circulated parallel to each other. However, due to the effects of globalisation, a standardisation of the monetary system has emerged. Thus, the current interest-based

fiat money system under the control of monetary authorities like central banks is being implemented worldwide. However, it must be noted that just a century ago neither fiat money nor central banking were the standards of the day. The Federal Reserve of the US, the most powerful central bank in the world today, was enacted only in 1913 and the US dollar only became 100 percent fiat with the breakdown of the Bretton Woods system in 1971, a system that will be explained later. Thus, even though it is being instituted globally, central banking and fiat money are not the only available option, but rather one out of the many possible options of how a monetary system can be organised. Therefore, existing systems should not be viewed as given and unchangeable, but rather, must be subject to performance evaluation in order to justify their usage. As with a car, if it breaks down too often or if it simply does not perform as required, one would look for an alternative car or even consider other methods of transportation. In a similar manner, the monetary system should be put under examination, and if the results are not satisfactory, alternatives should be considered. Accordingly, many communities have introduced complementary currencies, particularly in their localities, in order to boost local trade and exchange.[3] Even the usage of national currencies is not a historical standard. Gold and silver coins circulated for centuries all over the world, and with such money one did not worry about getting stranded in some foreign land. In contrast, most national monies of today are only useable within the issuing country. Having Malaysian ringgit in Canada would be of little use, unless one is able to exchange it. Today, only a handful of national currencies are recognisable internationally, such as the US dollar, euro, British pound and the Japanese yen.

Because of the wide variety of money, only those that performed the four basic functions will be discussed here. The reason is that such money is very close to what we use today as money, but do keep in mind that what is being discussed here neither covers all that existed nor all that currently exist. The three different types of money discussed here are commodity money, metallic money, and fiat money.

Commodity Money/Commodity Monetary Standard

In line with our general explanation of money, commodity monies might be defined as commodities which are used to facilitate the exchange process. In such a monetary arrangement, it would be either the commodity itself that circulates and changes hands (and hence the term "commodity money"), or notes that are being issued

3 One small town called Lewes is among the latest to join a growing number of towns to issue its own regional currency. Readers who wish to obtain further information on complementary currency might refer to www.complementarycurrency.org.

against, and are redeemable for a particular commodity (what is termed as "commodity monetary standard"). The redeemable function is important for this purpose. Historically, various commodities have played the role of money. In the Far East, 17th century feudal Japan had a much developed system of rice currency. As we today use our national currencies to express wealth, debts, contracts, payments and settle taxes, so did the Japanese but using rice. Of course, the Japanese did not carry bags of rice around while shopping. Instead a system of rice notes was implemented in which large landowners played the role of issuers in addition to keeping large storehouses at which the notes were redeemable.

But rice as a monetary form was not limited only to the East. In the Far West too for example, South Carolina in the US enacted in the 18th century a law that made rice an acceptable means for paying taxes. Before tax collections, the government would issue "rice orders" to its creditors, which were redeemable from the government after taxes were collected in the form of rice. These rice orders, however, did not remain in the hands of the creditors but were circulated as money. The wide acceptance and usage even resulted in long-term contracts being denoted in terms of rice. Virginia on the other hand, chose another commodity as money. The Virginia Tobacco Act of 1713 created something which came to be known as the most advanced form of commodity monetary standard in the American colonies. The creation of money was directly in the control of the planters who would bring their tobacco to public warehouses, where it was weighed, graded, and stored and for which the planters would receive in return, paper notes that were ownership titles to the tobacco. As with rice orders, these tobacco notes were circulated as money and were redeemable for tobacco on demand. The payment media were nevertheless not limited to one commodity only. Numerous commodity monies were issued and existed concurrently as acceptable media of exchange.

Rice had played the role of money in 17th century feudal Japan. They used notes that were redeemable for rice. Similarly, the states of South Carolina and Virginia in the US had used rice notes and tobacco notes, respectively, as money.

Metallic Money

Commodity monies described earlier, however, posed some problems. The first is the expense involved and the difficulty in transporting them, the second was the storage costs involved and the last and perhaps the most significant is the variation in the qualities of money. Debtors would particularly find it attractive to use low-quality commodities to settle their obligations. That of course was the desired outcome for debtors, but not for creditors. Eventually, precious metals that are more homogenous in nature, particularly gold and silver, came to dominate as money over other commodity monies. Gold and silver were commodities

found very desirable to play the role as money. In order to perform the previously mentioned four functions of money, i.e, medium of exchange, unit of account, store of value and standard of deferred payments, a commodity chosen as money must have the following characteristics:

1. **Divisible** – The money can be easily divided into smaller homogenous units, as well as can be merged back into bigger units without loss of value.
2. **Fungible** – All monetary units are of equivalent value.
3. **Weighable, measurable, or countable** – The lowering of the quality of money should not be possible or at least easily detectable.
4. **Stable value over time** – The money can be held for relatively long periods of time without loss of purchasing power.
5. **Durable** – The money should last for long periods of time without being spoilt or destroyed chemically due to weather, heat, pressure, etc., or biologically, due to bacterial activity and so forth.
6. **Homogenous** – The money if divided into smaller units would contain similar matter, such that one part should not be favoured over another. For example, if rice were used as money, a scoop of rice from one part of the sack should be valued the same as a scoop from another part.
7. **Mobile** – The money should be easily movable from one place to another.

Gold and silver fulfilled the above requirements as no other commodity did. Accordingly, these two metals came to be the most famous and enduring commodity standards in history, lasting for centuries until the Bretton Woods system collapsed in 1971. Perhaps precisely because gold and silver performed well as money, many opposed their usage as money. The reason is a monetary medium with such stability in preserving value influenced the society that chose to use it, not only positively but also negatively. Hoarding of money became a common motive for rich individuals, while the greater population was chasing after it for their survival. The German scholar Silvio Gesell advised against metallic monies, or specifically gold as money, claiming that:

> The gold standard and beggary are inseparable. … If men continue to love display and to spend part of their increase of income in buying the products of the goldsmith's art; and if gold continues to be the raw material for the medium of exchange – the prosperity of mankind as a whole is impossible.
>
> Gesell, 1918.

Gesell had specifically pointed out a contradiction in the functions of money, namely that it is supposed to act as a medium of exchange, and hence as a facilitator of exchange, but at the same time it is being used as a store of value, i.e., as a savings medium. When money is saved as a store of value, it hinders the flow of exchange by reducing the amount of money available for exchange purposes. Not only did he criticise the role of money as a savings medium but also its dependence on commodities; the supply of which depends on external factors – for example, gold and silver supply depends on new discoveries, while rice, tobacco and such depend on the weather, soil fertility, etc.

Fiat Money

The ancient Greek philosopher Plato is among the first influential philosophers to propose a system of token money. Today, we all use it since our national currencies are indeed tokens not backed by commodities. And yet, as simple as it sounds, the idea of token money could be rather confusing. Here's the question that arises: is money itself a commodity or is it a commodity that becomes money because it performs all the required functions? Or does money actually have nothing to do with commodities at all, but rather, is a more sophisticated accounting and debt recording system? Pursuant to this argument we shall examine two scenarios, one in which fiat money is a commodity and the other in which fiat money represents only a sophisticated debt recording system.

Fiat money as a commodity

Many scholars are of the opinion that money has to be a commodity itself in order to perform its functions. The reason is that money in its function as a unit of account is used to express the value of goods and services, and hence, so goes the argument, money must have its own intrinsic value against which all others can be measured. However, practical experience shows that fiat money works without having any connection whatsoever to any commodity. Many came to the conclusion that money is itself a commodity. As a car is produced for transporting people and goods, so is money an item produced to facilitate exchange. In a similar fashion, as various resources are used to make a car, so are some of the resources used for the production of money. Consequently, as the value does not really depend much on the resources used to produce the car, so should the value of money not depend on the value of resources used to produce it but rather on its ability to perform the required functions of money (the cost, of course, may vary based on the resources used, but not the value obtainable in the market which depends mostly on the utility derived by consuming the goods). As a result, the idea emerged that instead of using valuable metals which can be used for other purposes, money could be produced from "worthless" paper or low value metals like copper and in the present digital age, even out of abstract computer digital entries. However, such monetary mechanisms require monopoly authorities over their production. The reason is that free market access to the supply process of money would result in an overproduction of monetary units since the cost of producing them

Exhibit 3.2 *Shari'ah* Resolutions on Paper Currency

The Islamic *Fiqh* Academy of the Muslim World League

B.D./2/3 7/1406

Resolution No. 6

Regarding Paper Currency

All praise is for Allah (s.w.t.), alone, and may Allah (s.w.t.) bless and send peace upon the prophet after whom there is no other, our Prophet Muhammad (p.b.u.h.), and upon his family and companions.

The Council of the Islamic *Fiqh* Academy has read the research presented to it on the subject of paper currency and the rules that apply to it in *Shari'ah*. After a thorough discussion among its members, it decided the following:

First: the original money is gold and silver. The '*illah* (ratio legis) [for the rules] of *riba* on the purchase and sale of gold and silver is their nature as counter values for any exchange (مطلق الثمنية). That is the most authentic position of *Shari'ah* jurists on the issue.

Jurists do not restrict media of exchange to gold and silver, although these metals are the most basic of them.

Paper currency has become the medium of exchange for today's goods; it has replaced gold and silver in today's financial transactions, and as it is the standard by which goods are valued – since gold and silver are scarcely used – the public treats it as an asset, and it is used to store value in savings, even though it lacks intrinsic value. However, the people's confidence in it and their regard for it as the medium of exchange has bestowed the quality of it being a counter value for any exchange upon it.

The most accurate opinion on the applicability of the rules of *riba* to the purchase and sale of gold and silver is that it is because they are the media of exchange, and this effective cause is also present in paper currency. Based on all the abovementioned reasons, the Council of the Islamic *Fiqh* Academy has decided that paper currency is an independent form of money, and the rules for gold and silver money apply to it; therefore, it is compulsory to pay *zakat* on it. Also, the two types of *riba* (*riba al-fadl* and *riba al-nasi'ah*) can occur in transactions involving paper money, just as they do with gold and silver. This is in consideration of it being a medium of exchange, by analogy, with gold and silver. Therefore, all the rules of money and the obligations imposed by *Shari'ah* on it apply equally to paper currency.

Second: Paper currency is considered an independent form of money, just as gold and silver, as well as other media of exchange are considered independent forms of money.

Moreover, paper currency is a category comprising numerous subcategories. These are as numerous as the entities that issue them in the various countries of the world. That is, Saudi riyals are one subcategory; US dollars are another subcategory, and likewise, the currency of each country is a subcategory of the larger category of media of exchange. As such, the rules of *riba*, in both its forms (*riba al-fadl* and *riba al-nasi'ah*), apply to every one of these currencies, just as they apply to gold, silver and other media of exchange.

All of these have the following legal implications:

1 It is absolutely unlawful to sell one currency for another currency or for gold or silver by delayed delivery.

2 It is prohibited to exchange unequal amounts of a single currency, for instance, ten Saudi riyals for eleven Saudi riyals, whether the transaction is spot or delayed.

3 It is absolutely lawful to sell one currency for an unequal amount of another currency, as long as the transaction is a spot transaction. Therefore, it is lawful to sell Syrian or Lebanese liras for Saudi riyals, whether paper or coin, receiving less or more in exchange. Similarly, one could sell one US dollar for three Saudi riyals, or less or more, as long as the transaction is a spot transaction. This is because they are considered independent subcategories, so one category of money is being sold for another category, and even if the names of the currencies are the same, the ruling is not affected, as long as the two are actually different.

OIC Islamic *Fiqh* Academy

Resolution

(9) D/3/07/86

In the Name of Allah, the Merciful and Beneficent. All praise is for Allah, Lord of the Universe, and may Allah bless and send peace upon our Prophet Muhammad (p.b.u.h.), Seal of the Prophets, and upon his family and companions.

Regarding Paper Money and Change in the Value of a Currency

The Council of the Islamic *Fiqh* Academy [of the OIC], in its third conference, held in Amman, capital of the Hashemite Kingdom of Jordan, from 8 to 13 Safar, 1407 AH (11–16 October, 1986 CE), after having read all the research presented to it on the topic of "The Rules of Paper Money and Change in the Value of a Currency", has decided the following:

First: With regard to the rules that apply to paper currencies:

They are legal tender having the full attributes of media of exchange, and all the *Shari'ah* laws for gold and silver apply to them, e.g., *riba*, *zakat*, *salam*, and all other rules.

Second: With regard to the value of a currency:

Deliberation on this topic shall be delayed until the Academy's fourth session in order for all its aspects to be thoroughly studied.

are very low, or even negligible as in the case of electronic money. In addition, this kind of system brings about the problem of seigniorage, namely the difference between the cost of producing money and the purchasing power it carries thereafter, and who benefits from it. If the cost of printing a US$100 note is only US$1, then everyone would love to print US$100 notes, right? A lucrative business indeed! In actual fact, given that electronic money is the main form of money, the cost of creating, for example a US$1 billion or any other figure is the cost of keying in the figure into the computer, i.e., basically negligible. The seigniorage in this case would be astronomical. No other industry or profession has such a cost-revenue feature. It is precisely for this reason, the prerogative to create modern money lies with the monetary authorities. Any other party who produces money would be guilty of counterfeiting and can be charged for committing crime. This is where the central banks and the entire banking system come in. Banks are the exclusive monopoly producers of money, not because that is the only way money should and can be injected into the economy, but because we have adopted a system in which the production of money requires materials with negligible intrinsic values. However, such exclusivity also means that only banks have access to this lucrative business of creating free purchasing power. Such money that is not backed by gold or anything with intrinsic value is called fiat money (see Exhibit 3.3 for categories of fiat money). Some argue that the usage of fiat money is very unfair when most of the money is produced by privately-owned commercial banks. Accordingly, opening a bank is made very difficult. Huge regulatory frameworks, on top of numerous operational and licencing requirements, make the banking sector the most controlled and regulated sector of all. Simply put, not everyone can own a bank.

Exhibit 3.3 Categories of Fiat Money

Basically, there are two categories of fiat money. One is currency notes and coins. These are issued by the central bank and classified as M0 in money definition. This money is also called **state money** and the seigniorage of it, of course, goes to the central bank or the government. The other form of money is basically created by means of simple double-entry accounting records by the commercial banks when they give out loans. In the case of Islamic banks, the money is used for financing transactions according to *Shari'ah*-compliant contracts like *murabahah*, *ijarah*, *musharakah* and so forth. Therefore, this money is basically **credit money** and also called **bank money**. The seigniorage of bank money goes to commercial banks that create them. The M0 and bank money together form the higher definitions of money. Technically, the M0 is also credit money because it is basically an IOU of the government. A portion of the bank money is demand deposits while others are placed in time deposits and so forth. M0 plus the demand deposits are termed as M1. Adding the time deposits to M1 gives M2.

So, instead of allowing all market players to create a competitive market for the production of money and thereby crush the fiat-monetary system, the solution to the problem of seigniorage is achieved by disallowing banks to utilise money created by them for their own purposes, but to impose a condition that the newly created money can only be lent out to third parties. Hence, every conventional bank lends out the created money, its profits coming not from the seigniorage[4] but from the interest earned on the lent principal amounts. This, however, poses a problem for the Islamic banks, i.e., if the only way for a bank to produce money is by lending it out, then how are Islamic banks supposed to make profits? This is the point in which financing instruments as well as their significance in Islamic banking come in. Given that the actual activity of banks in a fiat monetary system is to create money that they cannot utilise on their own, the Islamic bank operating within the fiat monetary system can finance economic activities of others using equity-based or debt-based instruments but generally it prefers to finance instruments that enable it to act more as a producer and lender of money. The reason is that there is less risk in debt-based instruments and this explains why Islamic banks concentrate on debt-based products instead of equity products preferred by Islamic economists.

Exhibit 3.4 Fiat Money from the Islamic Perspective

Some Muslim scholars opine that fiat money is not *Shari'ah* compliant because it involves the creation of purchasing power out of nothing. In real economics, since one cannot create value out of nothing, indeed whenever fiat money is created in the form of currencies or bank loans, it actually imposes a forced tax on the economy in the form of inflation. They say an Islamic government cannot take wealth from all people, rich and poor alike, by force. Furthermore, newly created fiat money substantially accrues with the richer section of the population and added with interest charges, it causes the income and wealth distribution gap to continuously widen. Thereby, an interest-based fiat money system inherently creates poverty. It particularly causes the price of real estate to rise significantly, bringing about housing problems for the poor. All these significantly cause socioeconomic problems associated with poverty, particularly crime levels. It also has implications for the sovereignty of the economy such that it gradually transfers power from the rulers and politicians to those who create fiat money.

Nonetheless, other scholars are of the opinion that fiat money is compatible with *Shari'ah* since the central bank which is given the sole power to create money is inherently owned by the government lawfully elected by the people. The central bank, using its monetary policy tools, would increase or decrease the money supply in order to achieve its monetary objectives like targeting the inflation rate or exchange rate for example. They argue that fiat money is not only convenient but is acceptable since its use is the custom of the people, i.e., *urf*. It also increases liquidity in the market.

Nonetheless, the former group, while accepting the benefits of fiat money as argued by the latter, point out that fiat money still jeopardises the attainment of *maqasid al-shari'ah.*

4 Seigniorage is a profit to banks when the borrower defaults on the loan. Properties, for example, can be foreclosed and the ownership transferred to the bank or the loan guarantors are made to pay for the default.

Fiat money as a debt certificate

The other scenario is that fiat money, and money in general, is not a commodity at all, but just a debt recording mechanism. In this case, gold or other precious metals are not necessary to produce a currency note, which simply is an attested debt certificate that is transferable. In this scenario, all holders of monetary notes would be in essence creditors, holding certified IOUs. Those who borrowed the money from banks and utilised them in the market for purchasing various goods and services would be debtors. The banks would simply be recording entities while the central banks would play the role of mega clearing houses. If fiat money represents promissory notes, or simply IOUs, then banks are only the intermediaries between creditors and debtors. The terms of credit are of course determined by mutual consent between the parties involved, and no coercion may be applied, especially if it is to be a *Shari'ah*-compliant transaction. However, today's IOUs are being issued without the consent of creditors, i.e., loans are given to debtors without the involvement of creditors. Whenever the banks decide to increase the money supply, they actually decide to increase the credit supply.[5] Such a decision, however, does not happen with the consent of any of the creditors. The central banks do not enquire into the willingness of the society to provide credit. A clear example is the bank bailout approved and imposed by the US government under the leadership of President Barack Obama on the American population as a reaction to the 2007 sub-prime mortgage crisis. Thus, the amount of almost US$1.5 trillion of newly created credit money had been imposed on the American population[6] without their consideration on the terms and conditions of this credit. The distribution of the bailout was discriminating as well since the real economy was not bailed out together. Thus, the American people who together lost more than 1.5 million homes due to bankruptcies were not entitled to bailouts, but the banks with their wealthy shareholders were bailed out, and at very favourable rates, too. Neither collaterals nor personal guarantees were required of them as well.

A good example of a transparent credit institution existing in the current system is the JAK Medlemsbank, translated as JAK Members Bank which operates in Sweden. In this co-operative, member-owned bank, the credit policy is very transparent and equally practised on all the participants without any discrimination or favouritism. Here, the amount of credit which one can receive depends on the number of accumulated saving points which are earned, as the term implies, by means of savings. The amount of saving points can also be transferred to third parties if one does not intend to use them. All the loans are **interest-free**, which is supposedly also the goal of Islamic banking. The bank does not increase the amount of credit in circulation without the corresponding savings, or in other words, the credit expansion takes place only with

5 The central bank can reduce the statutory reserve requirement (SRR), for example, that would increase the maximum amount of credit creation possible.

6 Also on the world population since the dollar is also widely used as an international currency.

the consent of the savers, who are the creditors in the system. This is in total contrast to the general practice of today in which many parties end up as chronic net debtors, a phenomenon which happens due to the absence of the consent of the creditors, leading to a disproportionate allocation of credit, income and wealth.

Exhibit 3.5 Free-Money

The concept of money in the form of credit clearance is sometimes referred to as free-money. In this mechanism, members of a "bank" are given credit allocations according to their eligibility with which they can transact among other members of the bank. Periodically, the balances are netted-off before settlement is done among members. In this way, trade and exchange can be substantially increased with little money or borrowings. The WIR Bank of Switzerland was originally based on this concept and gave out free-money equivalent to billions of dollars to its members.

Local Exchange Trading Schemes (LETS), Bilateral and Multilateral Payment Arrangements and Commercial Barter Exchanges all work in similar ways that involve netting.

The Equation of Exchange

The amount of money that circulates in the economy is very important. While the right amount maximises trade and exchange in the economy, too much of it can cause inflation whereas too little of it can be deflationary and push the economy towards recession. The Equation of Exchange relates this relationship:

$$M\,V = P\,Y$$

Where:

M is the money supply in the economy, normally measured by monetary aggregates like M2

V is the velocity of money circulation

P is the general price level

Y is the real output of goods and services, usually measured using gross domestic output at constant price.

The equation simply relates the monetary sector to the real sector. M is the aggregate money supply in the economy, measured by monetary aggregates like the *M2* (see Exhibit 3.3 for definition). V is the average velocity of money that circulates in the economy. The velocity is relevant here because the same currency or money can be used again and again by the players in the economy when they transact among themselves. P is the general price level while Y is the real output of goods and services, measured by the real gross domestic product (GDP). Basically, the equation says price times quantity constitute what is paid in monetary terms. In macroeconomics, velocity is deemed important since the same money can be used repeatedly.

From the equation, it is obvious that if money supply M grows faster than the real output Y, then price levels would rise to reflect the abundance of money relative to real things. Nonetheless, in the current global fiat monetary system, money supply in most countries does rise faster than the real economy due to three factors, namely fiat money itself, fractional reserve banking that multiplies deposit creation, and interest rates. Hence, most countries have observed inflationary tendencies. In Malaysia for example, if a cup of coffee had cost 10 sen in the early 1970s, it now costs about 1 ringgit, i.e., a 900% price increase within three decades or so. In some Latin American countries for example, the money supply has increased at a whopping rate of more than 200% per annum when their real economy grew at about only 2% per annum. This would surely be hyper-inflationary and can potentially devastate people in the lower income bracket, pushing many into poverty. Thus, it is important that a country monitors the amount of money that circulates in the economy.

The velocity of money in circulation is generally a constant, but can change drastically in certain circumstances. For example, when people lose confidence in a currency, the velocity of its circulation can increase substantially. This is because people would try to quickly spend money that is losing its value. This according to the equation of exchange would substantially increase price levels too. Instances of this include the drastic depreciation of "*duit pokok pisang*" issued by the Japanese during their occupation of Peninsular Malaya in the early 1940s when they lost the war and returned home. Recent examples are the depreciation of the Russian ruble during the fall of the Soviet Union in early 1990s and the recent collapse of the Zimbabwean currency.

From the equation, it is also obvious that price levels can increase if there is a fall in the real output of goods and services, Y. Hence, say there is a shortfall in the supply of grains due to natural disasters like flood, then price levels can be expected to increase. However, most inflation occurs due to monetary reasons as explained above than due to real reasons like a fall in output.

Time Value of Money

The concept of "time value of money" is a basic concept in finance. It says that money today is worth more than money tomorrow. That is to say that a ringgit today has more value than a ringgit in the future. There are at least three main reasons why this is so.

1 ***Money loses its value over time.***

In other words, the purchasing power of money keeps falling particularly due to inflation in the economy. Consider our earlier example where, in Malaysia, a 10 sen coin could buy one a cup of coffee in the 1970s but today the same 10 sen coin cannot buy one a cup of coffee. Hence, the value of the 10 sen fell during those years.

2 ***Money has opportunity costs.***

That is to say that if one were to have money today, one can invest the money in some business ventures and thereby increase one's future amount of money. In conventional analysis, interest income is one of the opportunity costs of money which is however, forbidden in Islam.

3 ***Uncertainty of future cash flows.***

Future cash flows are only expectations, i.e., we expect them to take place but nevertheless due to some circumstances they may not happen. Therefore, future cash flows are uncertain and risky. Hence, people value present cash flows more than future cash flows.

Some Muslim scholars have argued that the time value of money justifies the charging of interest on loans and is therefore not a feature of Islamic finance. However, as pointed out above, interest charge is only one of the opportunity costs that seem to justify time value of money in conventional analysis, i.e., interest charge justifying time value of money and not the other way round. Indeed, Islam encourages one to pay off his or her debt as soon as possible. It recognises particularly, the opportunity cost faced by the lender. Accordingly, many scholars are of the opinion that time value of money is a concept valid in Islamic economics and finance.

Exhibit 3.6 Gold as Money

Some scholars are of the opinion that Islamic contracts are just and contribute to *maqasid al-shari'ah* only when money is real, i.e., when some commodities with characteristics of money are used as measures of value. This conforms to the *hadith*:

> *Abu Said al-Khudri reported Allah's Messenger (p.b.u.h.) as saying: Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates and salt by salt, like for like, payment being made on the spot. If anyone gives more or asks more, he has dealt in riba. The receiver and giver are equally guilty.*
>
> *Sahih Muslim*

Indeed the *Shari'ah* principles of *zakat*, *hudud*, *mahr*, etc., are based on gold and silver as the monetary standards.

> "Islamic monetary laws are based entirely on the bimetallic reference point. The *Shari'ah* laws stipulate that measurements, *zakat*, marriage dowry, *hudud*, compensation payments and other forms of trade were all revealed using gold and silver as the standard. It is an Islamic obligation to use the gold/silver bimetallic system."
>
> *Dr. Yahia Abdul-Rahman*
> Founder, American Finance House – LARIBA

Many scholars are also of the opinion that a return to a monetary numeraire like gold is necessary to solve the current global financial and economic crisis. In accordance with this thinking, in August 2010 the state of Kelantan issued its own gold dinars and silver dirhams that can be used for payments in the state. Kelantan referred to its real money as ***Shari'ah money***. Please see the following references that argue in favour of real money.

1 Meera, A.K. (2009). *Real Money: Money and payment systems from an Islamic perspective*. Kuala Lumpur: IIUM Press.

2 Meera, A.K. (2004). *The Theft of Nations – Returning to Gold*. Kuala Lumpur: Pelanduk Publications.

3 Vadillo, U. I. (1996). *The Return of the Gold Dinar: A Study of Money in Islamic Law*, Madinah Press.

4 Lietaer, B. (2001). *The Future of Money*. Century.

5 Greco, T. H. (2009). *The End of Money and the Future of Civilization*. Vermont: Chelsea Green.

6 Greco, T. H. (2001). *Money – Understanding and Creating Alternatives to Legal Tender*. Vermont: Chelsea Green.

Monetary Policy Instruments

As mentioned in the beginning of the chapter, there are three basic monetary policy tools or instruments available to the central bank in its conduct of monetary policy. These are required reserve ratio, discount rate, and open-market operations. We describe these instruments first and then ponder upon potential Islamic monetary instruments in the existing modern monetary system.

Required Reserve Ratio

Banks play an essential role in intermediating funds in the form of deposits from economic units that have excess funds to those who need funds in the form of lending.

However, banks are required to keep a portion of the deposits as reserves that cannot be lent out, as required by the central bank. The percentage of deposits that must be kept as reserves is the required reserve ratio. Suppose that the total deposit in the banking system is RM2 billion and the required reserve ratio is 10%. The total required reserves would be RM200 million and the remaining, RM1.8 billion is excess reserves. The banks can extend credits to those who need funds up to the availability of excess reserves, which is RM1.8 billion. From this, it is clear that by changing the required reserve ratio, the ability of the banks to extend loans is affected. In the example above, if the required reserve ratio is reduced to 5%, then banks can extend credits up to RM1.9 billion. By contrast, the banks' credit availability will drop if the required reserve ratio increases.

Discount Rate

The central bank not only performs the function of monetary regulation and control but also serves as the bank of financial intermediaries. As the bank to banks, the central bank also extends loans to banks that need funds. The interest rate at which the central bank charges on its loan to banks is termed as discount rate. Normally, the central bank will use the discount rate to signal its monetary intention, whether to expand or contract the stock of monetary supply. By lowering the discount rate, the central bank essentially encourages the banks to borrow funds from it and, consequently, increases the banks' credit availability which they, in turn, can extend as loans to those who need funds.

Open-market Operations

Open-market operations involve the purchases and sales of government securities by the central bank in the open market. The operations are essentially the exchanges of financial assets and monetary assets between the central bank and the public. In the open-market purchases, the central bank buys public securities from, say, commercial banks. This action will reduce public securities held by the commercial banks and their asset portfolios. In exchange, the commercial banks receive payments in terms of increase in reserves. In other words, government securities are withdrawn from public hands and reserves are injected into the banking system. This action increases the credit availability in the banking system. Meanwhile, in open-market sales, the central bank sells government securities to, say, banks. In this case, bank assets in the form of government securities increase. In making payments for the purchase, banks' reserves are reduced. Consequently, this action contracts the credit available in the banking system.

Islamic Monetary Policy Instruments

The aforementioned monetary policy instruments are the main instruments of the conventional banking system. The issue that may be raised at this juncture, in the context of the Islamic monetary system is: do these instruments comply with Islamic principles and thus, can they serve as Islamic monetary policy instruments? Looking at the description of the three instruments, we may reject the discount rate outright as it involves charging an interest rate on the loans provided by the central bank. Open-market operations may also be an issue if the government securities traded have the element of an interest rate. The required reserve ratio may be least objectionable as its use may reflect both monetary control and a prudential measure to safeguard depositors' funds.

Fundamentally, the central bank should not rely solely on the required reserve ratio in its conduct of monetary policy due to its bluntness and lack of flexibility. Namely, the frequent use of a required reserve ratio may result in wide swings in the stock money supply, which may adversely affect prices and financial stability. Moreover, the adoption of the required reserve ratio cannot be simply overturned if it is found to be too contractionary or too expansionary. Based on these disadvantages of the required reserve ratio as a monetary policy instrument, the adoption of other policy tools are viewed as essential. The underlying question is: how should the central bank inject liquidity or reserves in the Islamic banking system?

We are of the opinion that open-market operations may still be used as long as the government securities traded in the transactions are Islamic securities. This, obviously, highlights the need to develop Islamic capital markets such that this instrument can be effectively used. The use of discount window facilities may still be used to increase credit availability in the banking system. However, the discount rate needs to be abolished such that the lending activities are in compliance with Islamic principles.

Based on these, we take as a point of departure to acknowledge the availability of monetary policy instruments within the Islamic monetary system to regulate the level of money supply in the economy.

Money Supply Process

Simple Monetary Supply Process

In a modern financial system, financial intermediaries, particularly banks, play an essential role in extending credits to the private sector and, in the process, this leads to the multiple creation of money. The availability of bank credits, in turn, is affected by the monetary policy instruments described above.

We first use the simple T-account to illustrate the money supply process and how monetary instruments can affect the stock of money supply. We suppose that the money supply is in the form of bank deposits and banks do not keep excess reserves. That is, all excess reserves are extended as loans. Table 3.1 provides the T-account of the banking systems. The required reserve ratio is assumed to be 10%. On the liabilities side, the bank system has a total deposit of RM2 billion. The assets of the banking system consist of RM200 million reserves, RM1.3 billion loans and advances, and RM500 million government securities. Note that the bank has no excess reserves and the stock of money supply in the economy is RM2 billion.

Table 3.1 Banking System Balance Sheet

Assets (RM *m*)		Liabilities (RM *m*)	
Reserves	200	Bank Deposits	2,000
Loans	1,300		
Securities	500		

Suppose that the government purchases government securities from the banking system worth a total of RM200 million. This action reduces the securities held by the banking system to RM300 million. As a payment for the purchase, the central bank increases the banking reserves to RM400 million. This is given in Table 3.2 below:

Table 3.2 Banking System Balance Sheet

Assets (RM *m*)		Liabilities (RM *m*)	
Reserves	400	Bank Deposits	2,000
Loans	1,300		
Securities	300		

At this point, the banking system finds itself having an excess reserve of RM200 million. Since the banking system does not keep the excess reserve, it is lent out to say Mr or Corporation A, who deposits the loans obtained in the banking system. This will increase total deposits to RM2,200 million, the initial deposits of RM2 billion and the new deposits of RM200 million. With the extension of loans, the loans in the banking system increase to RM1.5 billion. Since money is deposited back in the bank, reserves in the banking system remain at RM400 million. The completion of this transaction results in the changes in the banking system balance sheet as shown in Table 3.3.

Table 3.3 Banking System Balance Sheet

Assets (RM *m*)		Liabilities (RM *m*)	
Reserves	200	Bank Deposits	2,200
Loans	1,500		
Securities	500		

A simple fact from Table 3.3 is that, through the lending of RM200 million, money supply increases to RM2,200 million. Simply stated, money supply is created through lending. It should be noted that the creation of money does not stop here since the banking system still has the excess reserves at hand. Further extension of credit is still possible. In other words, there will be multiple creations of money supply. Indeed, it can be easily ascertained that the final balance sheet of the banking system after the completion of multiple creations of money supply will be that shown in Table 3.4:

Table 3.4 Banking System Balance Sheet

Assets (RM *m*)		Liabilities (RM *m*)	
Reserves	400	Bank Deposits	4,000
Loans	3,300		
Securities	300		

At this point, the bank has no excess reserves and thus no further loans can be extended. One essential observation that can be made is: by injecting a reserve of RM200 million, the money supply has increased by RM2 billion. Other monetary instruments will work in the same way by making excess reserves available initially to the banking system and, through the process of lending, the money supply changes.

This simple monetary process that involves multiple deposits or money creation can be expressed by an equation that links the stock of money supply to the monetary base as:

$$M = m \cdot B \tag{1}$$

where M is the stock of money supply, B is the monetary base, and m is the money multiplier. Money supply consists of currency in public hands and bank deposits, and monetary base consists of reserves and currency in circulation. It can be shown that, in the simple money supply process, the multiplier is equal to one divided by the required reserve ratio. Since currency in the public hands or in circulation is assumed to be zero, we can rewrite (1) as:

$$D = \frac{1}{rr} \cdot R \tag{2}$$

where D is deposits, R is reserves and rr is required reserved ratio.

With the required reserve ratio of 10%, the money multiplier will be 10. Thus, in Table 3.1, with a reserve of RM200 million, we have total deposits of RM2,000 million. The changes in deposits will take place with the changes in reserves, the injection of excess reserves in the banking system through the use of monetary policy tools will be:

$$\Delta D = \frac{1}{rr} \cdot \Delta R \tag{3}$$

The open-market purchase example adds RM200 million excess reserve in the banking system and, as indicated by equation 2 with a money multiplier of 10, this leads to the creation of new deposits of RM2,000 million.

Take note that the use of the required reserve ratio will not change the initial reserve of the banking system. However, it frees up the reserve for banks to use as loans. In addition, it changes the money multiplier. A drop of the required reserve ratio from 10% to 5%, for example, results in the increase of money multiplier from 10 to 20, exerting strong impact on the changes in deposits. Based on this, the required reserve ratio is considered a blunt tool in influencing the stock of money supply.

Modified Money Supply Process

Having looked at the simple money supply process, we are in the position to examine how behaviour of economic agents, the banks and the public, influence the money supply process. Thus far, banks are assumed to hold no excess reserve and the public has no preference to hold currency. However, in reality, banks do hold excess reserve to cushion against unexpected withdrawals and as part of risk management. Meanwhile, the public do hold currency due to its liquidity and ease of transactions. Denote the excess reserve ratio as $er = \frac{ER}{D}$ and currency-deposit ratio as $cd = \frac{C}{D}$, where ER is excess reserve, C is currency held by the public and D is total deposits.

From (1), we can express the money multiplier to be the ratio of money supply to monetary base:

$$M = \frac{M}{B} \tag{4}$$

Since money supply consists of deposit (D) and currency (C) and monetary base consists of reserve (required reserve (RR) and excess reserve (ER)) and currency, we can rewrite (4) as:

$$m = \frac{D + C}{ER + RR + C} \tag{5}$$

Divide both numerator and denominator of (5) by D, we obtain:

$$m = \frac{1 + cd}{er + rr + cd} \tag{6}$$

Finally, using this expression in the money supply process, we have:

$$M = \frac{1 + cd}{er + rr + cd} \cdot B \tag{7}$$

The money supply process as represented by (7) differs essentially from (2) in that it allows economic agents to influence the money supply through changes in excess reserve ratio and currency-deposit ratio. As an example, if the currency-deposit ratio (cd) is 0.20, excess reserve to deposit ratio (er) is 0.10 and required reserve to deposit ratio (rr) is 0.05, the money multiplier is:

$$\frac{1 + cd}{er + rr + cd} = \frac{1 + 0.20}{0.10 + 0.05 + 0.20} = 3.43 \tag{8}$$

Thus, the changes in monetary base by one million will lead to the increase in money supply by 3.43 million. However, if the currency to deposit ratio increases to 0.30, the money multiplier will drop to 2.89. A similar analysis can be done for the excess reserve to deposit ratio.

In short, the central bank does not have complete control over the stock of the money supply. Still, in this modified supply process, the central bank can have substantial control over the stock of the money supply. The central bank can still influence the behaviour of the banking system through moral suasion. Meanwhile, the currency-deposit preference of the public can be affected by improvement in the nation's payment system.

Monetary Transmission Mechanism

We have discussed at length in the previous section how the central bank exerts its control over the stock of the money supply in the economy, i.e., through the injection or freeing up of reserves in the banking system and thus allowing banks to extend credits to those who need funds. To the extent that we can accept the current fiat monetary system and fractional reserve banking system, the conduct of monetary policy can be made compatible with Islamic principles as long as the instruments used are free of interest rate elements.

For better understanding on how monetary policy works and whether it is feasible, or even viable for the Islamic banking system and Islamic financial markets to play their roles in the monetary policy process, we need to deal with the process or mechanism by which the use of monetary instruments and subsequent changes in money supply are transmitted to final objectives. That is the so-called monetary transmission mechanism. The traditional monetary transmission mechanism in the conventional banking system is through the changes in interest rate as given below:

Figure 3.1
Traditional Monetary Transmission Mechanism

By increasing credit availability or increasing loan supply, the price of loans or interest rate decreases. This will affect interest-sensitive components of private expenditures, which are mainly private investments and consumption of durable goods. This will alter aggregate demand of the economy and thus influence both real activity and the price level.

This channel of monetary transmission, however, is inoperative in the Islamic financial system as the system is free of interest. However, it can be posited that changes in credit availability may influence profit-and-loss-sharing which, in turn, may affect financing and later real activity. Moreover, within the conventional system, it has been recognised that the interest rate is not the only channel of the monetary transmission mechanism. Other channels that have been noted include the asset price channels and the credit channels. The asset price channels suggest the influence of monetary impulses on such financial asset prices as the price of currency (i.e., exchange rate) and equity prices. Meanwhile, the credit channels work through the banks' loan supply and the firms' balance sheet. Thus, there is room for Islamic monetary policy to work despite the absence of an interest rate. Below, we elaborate on these channels and then conceptually look at how profit-and-loss-sharing can be altered through the conduct of monetary policy.

Asset Price Channel – Exchange Rate Effects

The increase of global market integration and rising international trade have resulted in monetary policy having influences on the economy through changes in the exchange rates. In the conventional setting, the exchange rates are viewed to be determined by capital flows across nations, driven by changes in national interest rates. As we have noted above, changes in money supply lead to changes in the interest rate. With open-market purchase or reduction in discount rate and required reserve ratio, termed as expansionary monetary policy, the interest rate is lowered. This makes domestic financial assets less attractive, leading to an outflow of capital. Consequently, the domestic currency depreciates. According to conventional wisdom, currency depreciation makes domestic goods and services more competitive and foreign goods and services more expensive for domestic residents. As a consequence, net exports are boosted, leading to an increase in real activity.

While the interest rate is at work in the exchange rate channel, it should be noted that the exchange rate may also shift due to expected changes in the price level arising from monetary policy actions. Thus, in the absence of the interest rate, the exchange rate channel may still be operative.

Asset Price Channel – Equity Prices

Monetary policy can also affect real activity through its effect on equity prices. Given money demand, the increase in money supply makes economic agents realise that they have excess money. To bring this excess money to a level consistent with money demand, the economic agents get rid of the excess money by spending part of it in the stock market. The resulting increase in demand for stocks raises stock prices. As stock prices essentially reflect the value of firms, the market prices of the firms increase relative to the replacement cost of the firms, which is known in literature as Tobin's Q. Accordingly, firms are encouraged to issue more stocks to finance investments. In addition, the increase in equity prices raises the financial wealth of consumers which, in turn, stimulates consumer spending as postulated by the life cycle hypothesis of consumption.

Credit Channels

The credit channels stem from the presence of the asymmetric information problem, i.e., two parties in transactions who do not have the same information. There are various transmission channels under the credit view, the main channels of which are the bank-lending channel and the firms' balance sheet channel.

The contraction of bank deposits as a result of monetary policy action may not limit loan supply by banks if there is symmetric information in the market and financial assets are perfectly substitutable. In this case, with a shortage of deposits, banks may be able to raise funds through other sources at the same cost. However, with asymmetric information, there is a wedge between alternative sources of financing. Facing higher cost to raise funds, banks are forced to contract loan supply. On the lending side, firms may also face higher costs by raising funds on their own if bank loans are contracted or limited. These loan supply contractions and the inability of firms to raise funds through other sources limit the firms' investments and, accordingly, real output. Essential conditions for this lending channel to be operative are two: monetary policy actions influence loan supply by banks and there is a substantial number of firms that are dependent on bank loans.

The changes in equity prices due to monetary policy action may also change the extent of adverse selection and moral hazards in the market through its influences on the firms' balance sheet position, more specifically, the firms' net worth. The reduction in the firms' net worth as a result of contractionary monetary policy can amplify the asymmetric information problem, the adverse selection and moral hazard problems. In this situation, banks may be reluctant to extend loans and consequently, curtail private investments.

Table 3.5 Potential Monetary Transmission Mechanisms in the Islamic Financial System

Monetary Policy Actions					
Profit-and-Loss Sharing Channel	**Exchange Rate Channel**	**Equity Price Channel**		**Credit Channels**	
Money Supply	Money Supply	Money Supply	Money Supply	Money Supply	Money Supply
Profit Share of the Firms	Price Expectations	Equity Prices	Equity Prices	Loan Supply	Equity Prices
Investments	Exchange Rate	Tobin's Q	Wealth	Investment	Moral Hazards Adverse Selection
	Net Exports	Investments	Consumption		Investment
Final Objectives (E.g., Real Output and Price Level)					

Profit-and-Loss-Sharing Channel

It would be incomplete not to highlight the potential influences of monetary policy on the profit-and-loss-sharing ratio of Islamic banks. Conceptually, this channel can work in the same way as the conventional interest rate channel. Namely, monetary policy action may alter the profit-and-loss-sharing ratio and, in the process, encourage or discourage firms from seeking financing for their investment activities. Denote R to be an expected return from undertaking investment by a firm. The expected return realised by the firm would thus be sR, where s is the share of profits that goes to the firms. Within the Islamic banking system, monetary policy can have an influence on the profit share of the firms, i.e., s. Suppose that through open-market purchases, bank reserves and accordingly, monetary base increases. All else being equal, banks find their excess reserves to be more than the level targeted, which leads to their willingness to offer financing at a lower sharing ratio going to them. With the reduction in the share going to the bank or the increase in s, even a project that has lower expected return, i.e., lower R, will now be viable to the firm. In this vein, investment by firms will be stimulated.

With these descriptions of monetary transmission mechanisms, we contend that there is plenty of room for monetary policy to work in the Islamic financial system. More specifically, even if the interest rate channel is inoperative in the Islamic financial system, other channels may still be at work to facilitate the Islamic financial system to transmit the intention of monetary policy for the realisation of final objectives. Table 3.5 sums up these monetary transmission channels that are deemed relevant in the Islamic financial system.

Economic Agents in Monetary Policy

Up until this point, we have described the monetary supply process and how an increase in the money supply can influence real activity. We put forth our view that the Islamic banking system can play a role in the monetary policy process and pave the way for the viability of Islamic monetary policy. As far as the economic agents are concerned, there are two aspects of monetary policy that need emphasis. These are the behaviour of economic agents in influencing the money supply process and fairness in monetary policy. The former is essential in designing appropriate monetary policy action in addressing exogenous changes in the behaviour of economic agents that may amplify the influences of money supply action on real activity while the latter is important for pinpointing which channel is the most suitable channel in the Islamic monetary system. In this section, we elaborate on these two aspects of monetary policy first. Then, in the ensuing section, we raise several important issues that need to be tackled to make Islamic monetary policy possible.

Economic Agents and the Money Supply Process

While the monetary authority may have substantial control over the money supply, economic agents also play a role in affecting liquidity in the market. As discussed above, the money supply also depends on the behaviour of banks and individuals in the forms of their excess reserve ratio and currency-deposit ratio respectively. Indeed, the excess reserve and currency-deposit ratios tend to change over the business cycle, which may thwart any policy action. In this context, money supply has the ability to amplify the cycle if not regulated properly. Thus, understanding the contributing role of economic agents in money creation and how it may affect real activity is essential for the well-being of the economy.

In this context, we may take the standard demand and supply of money as a point of departure and we may refer to the noted transmission mechanism as a way of looking at how economic agents' behaviour during phases of economic cycles may influence the final outcome. During recessionary periods, financial markets tend to be riskier. As a result, individuals may have more preference to hold currency. Moreover, as a safeguard measure, banks may not be willing to lend by holding more excess reserves. Due to the increase in both currency-deposit ratio and excess reserve ratio, money supply drops even if the monetary authority is passive. Due to the reduction in money supply, real activity declines as traced by the monetary transmission mechanism.

This feature points to the possibility of the destabilising effect of the fiat system. The preference function of the banking system may deviate so much from that of the central bank in the conventional system to the point that the former may fully frustrate the achievement of the monetary policy objective. This is demonstrated strongly in the behaviour of the US banking system (also at times in the recent past, the Japan banking system) where even with negative or zero interest rates, banks are reluctant to give loans. This is indeed the Achilles heel of conventional monetary policy in which monetary objectives need the cooperation of the banking system to transmit monetary policy intent as formulated by the central bank.

There is a possibility that the present Islamic financial system based on the fiat monetary standard inherits this destabilising feature of the money market. Indeed, this is the core issue raised by proponents of commodity-based money such as gold as being a better payment standard. However, in the present Islamic financial system, monetary policy can still become a powerful tool in influencing banks', firms', and households' portfolio behaviour provided that the channel of monetary policy transmission includes a direct line of influence to households' and firms' portfolio adjustment behaviour through open-market operation that uses equity issues in the central bank's asset portfolio (assuming that such modification in asset acquisition of the central bank is possible) that are traded in the secondary market.

Fairness in Monetary Policy

Economic agents are not only at the contributing end of the monetary supply process. They also are at the receiving end of the process. This is because changes in the transmission variables and subsequently final variables, affect them. The issue of the final outcome of monetary policy action is not nondiscriminatory. More specifically, monetary policy may have sectoral or distributional consequences.

Under the conventional banking system, it is clear that monetary policy will not have the same effect on individuals and firms. Ample evidence has demonstrated the stronger effect of interest rate changes on households than on firms, and on small firms than on large firms. Thus, in the face of monetary contraction, those who really need funds (households and small firms) may be held out from loans. Relationship lending is commonplace between banks and large firms. Moreover, large firms will have easy access to alternative sources of financing when the loan supply from banks contracts. This arises mainly from asymmetric information that tends to be exacerbated during the downturn and tends to alienate households and small firms first.

Essentially, with asymmetric information, one party involved in a transaction does not have the same information as the other party, which seems to be an essential feature of financial markets. For example, a person requesting financing for expanding business operations knows whether he is honest and has better information about how well his business is doing than the banks do. The banks' financing decision is, thus, made difficult. The presence of asymmetric information may lead to an adverse selection problem, in that potential bad and risky borrowers are the ones who actively seek financing and consequently are selected or given financing. Knowing this, banks may concentrate on those with whom they have close relations or are less risky which are normally large firms. Accordingly, small firms are more affected by monetary contraction.

Despite the absence of interest rate, the issue of asymmetric information also prevails in the Islamic financial system. Thus, it is of crucial importance in the Islamic financial system to not only pinpoint the monetary transmission mechanism at work but also to alleviate the discriminatory effect of the mechanism. Distributive justice is basic in the Islamic economic system and it should be the basic objective of the monetary policy as well.

Issues in the Conduct of Islamic Monetary Policy

The preceding sections discussed the monetary policy process from monetary instruments to money supply creation to the monetary transmission mechanism and how it is related to final objectives, such as output, aimed at by the monetary authority. The immediate preceding sections also highlighted some issues related to economic agents, namely, the destabilising effect of the money supply and the distributional consequences of monetary policy. These are the issues that need to be addressed under both financial systems, conventional and Islamic. However, under the Islamic system, the issue becomes even more pressing to ensure just consequences of monetary policy actions.

Apart from these issues, there is a more rudimentary issue that needs to be highlighted for the viability of monetary policy to work in the Islamic financial system. As may be inferred from the preceding discussion, monetary policy works through financial markets to affect the economy. The question is, what are the characteristics of the Islamic financial markets that are prerequisite to the effective use of "Islamic" monetary policy? Relying on the current literature on conventional financial systems, we may acknowledge the importance of the markets at the developed stage characterised by diversified financial instruments, liquidity, transparency, and effective enforcement mechanisms. These characteristics of the markets are essential to make the transmission of monetary policy effective and to alleviate the problem of asymmetric information in the markets.

Despite the rapid growth of Islamic financial markets across the globe, Islamic financial instruments are still subordinate to conventional financial instruments in terms of market share. Moreover, the relatively inactive secondary markets for Islamic financial products make them relatively less liquid and make disclosure of information less than optimal. Moreover, enforcement issues related to Islamic financial contracts still abound. Accordingly, to make monetary policy effective through Islamic financial markets, this relative backwardness of the Islamic financial markets needs to be tackled first. Current emphasis by the monetary authorities of many countries to further develop the Islamic financial markets seem to have put their progress on the right trajectory. However, the steps taken need to be strengthened and enhanced such that "Islamic" monetary policy can be made possible in the near foreseeable future. At the moment, Islamic financial markets only serve a role secondary to the conventional financial markets in the propagation of monetary policy, especially in a dual-banking system such as Malaysia.

The aforementioned characteristics define only half of what is needed. They refer only to formal aspects of the Islamic financial system. In order to build up a complete or truly Islamic financial system, the informal aspect of Islamic financial institutions also needs to be emphasised. This refers to what the institutional economics terms as informal laws and codes of conduct. The Islamic financial system cannot be devoid of values, the Islamic values in governing transactions between two parties. Thus, inculcating Islamic values should go hand-in-hand with the building of Islamic financial structures and formal rules and regulations.

Summary

1 Money can be anything that is widely used and accepted for making payments.

2 However primitive a type of money might have been, money had existed as early as archaeological findings that explored the history of mankind show. The essence was to resolve the exchange-limiting drawbacks of barter exchange.

3 Different types of money emerged and functioned throughout the history of mankind. To claim that only a particular type of money is the true and right one would be a rather baseless argument. What seems to be important is whether or not what is regarded as money at any point in time, is proficient enough to perform the basic functions of money efficiently.

4 Historical evidence revealed that different monetary systems and monies have existed and circulated parallel to each other. The central banking system and the use of fiat money are relatively new in the history of the monetary system. They never constituted the standards of the day about a century ago.

5 The existence of chronic general price level instability across different countries (e.g., Zimbabwe) raises scepticisms on the potency of the present fiat monetary system to function as a *store of value*.

6 Due to the enormous weaknesses attributed to the current banking system under the fiat monetary framework, alternative systems are slowly emerging. Examples include the untraditional bank operated by JAK Medlemsbank in Sweden and the use of the gold dinar in Kelantan, Malaysia, to mention a few.

7 The "time value of money", which constitutes a basic concept in finance, is from many scholars' opinions, valid in Islamic economics and finance.

8 Monetary policy can be made workable through the Islamic financial system but it requires the prerequisites of the availability of active and liquid Islamic financial instruments, and information disclosure and transparency.

9 The building up of the Islamic financial system should not be devoid of Islamic values in those who contribute to the monetary policy process – individuals, banks and the monetary authorities.

10 The inculcation of Islamic values should be an essential part in developing the Islamic financial system and should go hand-in-hand with the development of the Islamic financial infrastructure.

11 There still exists bourgeoning issues on what constitutes an Islamic financial system. These are captured although not exhaustively by the following questions:

(a) Must the payment standard be based on gold or dinar or is the modern fiat system as practised currently acceptable?

(b) Is the present fractional reserve banking system which allows banks to lend in multiples compatible with Islam? Or must it be based on 100% reserve banking system?

(c) What should the pricing of Islamic finance be based on?

(d) Are the present financial instruments really based on or compatible with Islamic principles?

Key Terms and Concepts

Adverse Selection
Asset Channels
Asymmetric Information
Barter Trade
Bimetallism
Bretton Woods
Commodity Money
Credit View
Currency-Deposit Ratio
Discount Rate
Divisible
Double Coincidence of Wants
Durable
Excess Reserve Ratio
Fiat Money
Free-money
Fungible
Gold-Standard
Homogenous
Inflation
Measurable
Medium of Exchange
Mobile
Monetary Policy
Monetary Transmission Channels
Money Multiplier
Money View
Moral Hazards
Open-market operations
Required Reserve Ratio
Stable
Store of Value
Standard of Deferred Payment
Unit of Account

Further Readings

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Review Questions and Problems

1 State and elaborate on the functions money plays in the economy.

2 Differentiate between commodity money and fiat money.

3 What are the characteristics of good money?

4 Can oil make good money? Explain.

5 What is “free-money”? Can the concept be adapted for an Islamic financial system?

6 Discuss the concept of the time value of money. Is it a concept acceptable from the Islamic perspective?

7 Explain how fiat money, fractional reserve banking and interest rates together can increase the money supply and debt in an economy at exponential rates.

8 Explain how the money supply and inflation are related.

9 Which characteristics and functions of money make the possibility for interest rates to exist?

10 “The current dollar crisis is likely to increase the velocity of dollar circulation and thereby is potentially hyper-inflationary.” Do you agree or disagree with the above statement? Explain.

11 Describe the differences between Islamic government securities such as *sukuk* and conventional government securities such as treasury bonds. Can both be used in the conduct of open-market operations?

12 Suppose the consolidated balance sheet of a bank is given as below:

Assets		Liabilities	
Reserves	500	Bank Deposits	5,000
Loans	2,500		
Securities	2,000		

Assume the required reserve ratio to be 10%. Trace the effects of open-market purchases of RM500 on the money supply in the economy.

13 If the interest rate is totally absent from the financial system, would monetary policy be effective? What are possibly the main transmission channels of monetary policy in the absence of the interest rate channel? Discuss.

14 List and discuss the requirements that are needed for the current Islamic financial framework to play an effective part in the monetary policy process.

15 Can the fiat monetary system be made stable? Discuss.

16 Collect the M2 and real GDP data for Malaysia for the period 1990 to 2010. Plot the graphs for both and note the exponential growth of both series. Using regression analysis, estimate the exponential coefficients for both and verify that money supply grows faster than the real GDP.

[Note the M2 and real GDP data are available from Bank Negara Malaysia's website. The real GDP data is given as GDP at constant price. For the regression analysis of an exponential function, you run the following regression: $Y = a + b \ln X + e$, where Y is the M2 and real GDP respectively while X is time, b is the exponential coefficient. If money supply grows faster than the real GDP, then the b for M2 regression should be higher than the b for real GDP regression.]

Chapter 4

Development of an Islamic Financial System

Preview

This chapter examines how Islamic finance has evolved over time. It systematically traces its emergence over the years from the period of Prophet Muhammad (peace be upon him) till the modern day. The chapter also discusses the various models of Islamic finance that have been adopted and implemented in some countries. It is also underscored in this chapter that in order to develop a comprehensive Islamic financial system, there is a need to examine the prerequisites in developing a vibrant system.

In this regard, this chapter discusses among other things, the supervisory, regulatory and legal dimensions to the development of Islamic financial markets. It also uncovers the importance of the development of the financial infrastructure as well as institutional development. This covers discussions on the appropriate regulatory and supervisory framework, corporate governance, transparency and disclosure of information, risk management and the *Shari'ah* framework, just to mention a few. Since the development of interrelated financial markets has an important role in contributing towards stability in the financial system, this chapter elucidates how the development of a comprehensive Islamic financial system could aid the achievement of such a goal.

A picture of Sheikh Zayed Road which hosts a branch of the Dubai Islamic Bank. The bank has the unique distinction of being the world's first commercial Islamic bank.

Learning Outcomes

At the end of this chapter, you should be able to:

- Analyse various ways of classifying the Islamic finance model/structure.
- Explicate the prerequisites in developing an Islamic financial system.
- Comprehend the different approaches in implementing an Islamic financial system in different jurisdictions.
- Explain the functions of key Islamic financial institutions.
- Relate the mechanisms behind the historical emergence of Islamic finance.

Historical Overview of Islamic Finance

The inhabitants of the Middle East and the Arabian peninsula in particular, have for centuries conducted trade and business partnerships which can be traced back to the pre-Islamic period. Communities in the Middle East in pre-Islamic times followed certain customary commercial practices and traditions, some of which did not have any conflict with the principles of Islam. With the introduction of Islam, some of the pre-Islamic commercial practices which were in direct conflict with the teachings of Islam were reevaluated or ratified so as to be consistent with Islamic legal principles. This paved the way for the codification and formalisation of traditional trade and business practices into a formal legal system of standardised contracts which is consistent with the *Shari'ah*.

The development process of Islamic finance can be traced back to the era of Prophet Muhammad (p.b.u.h.). At that time, the doctrine of financial operations was derived directly from the Holy *Qur'an* and the *Sunnah* (traditions) of Prophet Muhammad (p.b.u.h.). The *Shari'ah* specifies, *inter alia*, rules that relate to the allocation of resources, property rights, production and consumption, and the distribution of income and wealth. Since then, *Shari'ah* has coordinated all financial transactions between Muslims and there has been a continuing process of mutual adjustment between *Shari'ah* and the actual financial practices of Muslim societies.

During Prophet Muhammad's lifetime, Islamic methods of finance often drew upon examples from the Prophet's experiences. There are many sayings about the Prophet (p.b.u.h.) buying on credit, taking financing and sometimes giving personal property as a security or lien. It was reported that Prophet Muhammad (p.b.u.h.) used the *mudarabah* contract to trade with Khadijah's capital which involved the Prophet (p.b.u.h.) travelling to Syria. Prophet Muhammad (p.b.u.h.) had acted as an agent in a *mudarabah* contract with an investment from Khadijah. From this evidence, it appears that this form of commercial transaction was practised in pre-Islamic times and continued to be practised throughout the early centuries of the Islamic era. Muslims in Arabia during that period and also in the prehistoric period had widely practised *musharakah* (full partnership) when operating large commercial enterprises under a profit-and-loss-sharing principle. Sayfi bin A'idh became a partner of the Prophet (p.b.u.h.) before his prophethood, to trade in Yemen.

In addition, Prophet Muhammad (p.b.u.h.) made it permissible for people to use sale on credit (*bay' al-salam*). *Bay' al-salam* is a form of financing which provides the producer with funds that can be used for working capital in production including payment of labour and the purchase of raw materials. It was practised in the agricultural sector of

Madinah during the time of the Prophet (p.b.u.h.). Benevolent loans (*qard hasan*), which is another form of financing, were encouraged.

The spread of Islam began shortly after the death of Prophet Muhammad (p.b.u.h.) in 632AD. Within a century after Prophet Muhammad's death, the Muslims brought with them their religion, culture, trade and commerce to other Arabic states and to large parts of the non-Arab world covering Asia, Africa and Europe. As Islam spread to these new geographical regions, new business practices, cultures and customs had to conform to the tenets of Islam. The Islamisation of economic systems during the four centuries following Prophet Muhammad's death reached northern parts of Africa, Spain in Europe and a large part of Asia. The extension of Islamic methods of finance is also indicated by historical records of contracts registered between businessmen at the time, including *mudarabah* and *musharakah*.

Modern Day Islamic Finance

The growth of modern Islamic banking can be attributed to three factors. Firstly, the rise of oil prices after 1974 has seen a number of Arab and Muslim countries experiencing a rise in national income, economic activity, and greater investment. The oil revenues of the 1970s which were often referred to as "petrodollars" offered strong incentives for Muslims, notably high net worth individuals, to find suitable investment avenues which comply with *Shari'ah*. Secondly, devout Muslims would not want to put their money into a financial system that was not based on Islamic principles, and hence they became dissatisfied with the rigid requirements of Western commercial banks and the banks' view of interest-earning activities. Thirdly, in countries that began to gain freedom from years of colonialism and faced rapid industrialisation and urbanisation, the belief grew that the best response, for both individuals and communities, was to rediscover Islamic values and traditions.

The modern experience of Islamic banking can be classified into two categories: Islamic banks coexisting with interest-based banks, and Islamic banks operating under a binding and all-embracing Islamic banking system.

Under the first category, there may be a single Islamic bank operating in a country, such as Al-Hilal Islamic Bank Kazakhstan in Kazakhstan, and many other national Islamic banks or more than one Islamic bank operating in the same country as in Egypt, Qatar, Bahrain and Bangladesh. These banks practise Islamic banking within the framework of the hegemony of the interest-based banking system, as far as their work or integration and the support guaranteed by the credit system are concerned. In addition to these specialised Islamic banks, the practice of conventional banks providing some forms of Islamic financing and investments to their clients has emerged. These conventional banks have opened what are called “Islamic Windows”. This is the case in Malaysia, Qatar, Egypt and Saudi Arabia. It is worth mentioning in this context that some of the banks that are registered and are doing business in non-Islamic countries are also engaged in certain types of Islamic transactions.

Under the second category, there are banks in Sudan and Iran where the conduct of the entire banking system is based on *Shari'ah*. As far as Iran is concerned, all banks have been nationalised since the inception of the Islamic Revolution in 1979 while Sudan has government banks as well as banks owned by the private sector.

Islamic banking was introduced in the early stages by purely private, individual initiatives. As mentioned earlier, the basic practices and principles date back to the early part of the seventh century. The centuries-old practice of finance in Islamic form was largely eclipsed during the period of the European colonial empires, when almost the entire Islamic world came under the rule of Western powers. Most countries adopted Western banking systems and business models and abandoned Islamic commercial practices. Thus, the modern period of Islamic finance traces its beginnings to the independence of Muslim countries after World War II.

The first attempts in Islamic finance can be traced to Malaysia and Egypt in the early 1960s. The first institution that was involved in Islamic finance in Malaysia was the Muslim Pilgrim's Savings Corporation set up in 1963 to help people to save on a regular basis to pay for their pilgrimage to Mecca. In 1969, this corporation evolved into the Pilgrim's Management and Fund Board, or Lembaga Tabung Haji, as it is now popularly known. Lembaga Tabung Haji has been acting as a developmental financial institution that invests the savings of would-be pilgrims in accordance with *Shari'ah*, but its role is rather limited, as it is not a bank. The success of Lembaga Tabung Haji, however, provided the main impetus for establishing Bank Islam Malaysia Berhad (BIMB), which represents a full-fledged Islamic commercial bank in Malaysia.

Islamic banking in Egypt traces its roots back to July 1963 when a bank in the Egyptian town of Mit Ghamr was established as a rural savings bank, based on a German local savings bank. In 1968, according to Kuran (1995), the bank was closed due to the government's hostility towards private initiatives and its being suspicious of religion. No interest was paid on deposits and no interest charged on its loans and all borrowings and lendings were on the basis of profit-and-loss-sharing principles. In 1972, the Mit Ghamr Savings Bank was revived as the Nasser Social Bank, which was considered in financial terms to be a public bank owned and controlled by the government. This small-scale action pushed others towards Islamisation of the financial system. In the 1970s, Islamic banks were established in several countries.

In December 1970, a proposal calling for a study on the establishment of an international Islamic bank for trade and development was presented at the second Islamic conference of foreign ministers held in Karachi, Pakistan. This proposal was linked to the formation of the Islamic Development Bank (IDB). In October 1975, the IDB was established in Jeddah, Saudi Arabia, as a multinational corporation operating at the government level. The IDB serves the financial and investment needs of Islamic countries, especially those which are short of capital and in need of credit for development projects, on the basis of equity participation. More specifically, the purpose of the IDB is to foster economic development and social progress in member countries and Muslim communities in accordance with *Shari'ah* principles. The IDB provides fee-based financial services and profit-sharing financial assistance to member countries. It also helped establish other Islamic banks, as well as research and training institutes in the field of Islamic economics.

Several Islamic financial institutions (IFIs) are at present functioning in various parts of the Muslim world. Most of these institutions were established in the second half of the 1970s and early 1980s in Egypt, Sudan, the Gulf countries, Pakistan, Iran, Malaysia, Bangladesh and Turkey. They fall into two broad categories, being either Islamic commercial banks, or Islamic investment and international holding companies. The first category includes, among others, the Faisal Islamic Bank in Egypt and Sudan, Kuwait Finance House (KFH), Dubai Islamic Bank and Jordan Islamic Bank for Finance and Investment. Dubai Islamic Bank has the unique distinction of being the world's first commercial Islamic bank. The second category, which consists of the Islamic investment holding companies having either a national or an international mandate, includes the Islamic Investment Company of the Gulf, International Investment Bank based in Bahrain and Unicorn Investment Bank.

The objectives of these institutions include the undertaking of all financial operations required by Muslims according to the principles and precepts of *Shari'ah*. This embraces the investment of funds within the Islamic context, the generation of *halal* (lawful/permitted) profits, and the consolidation, promotion and cooperation of Islamic financial operations internationally.

The Islamic banking movement has not been confined to Islamic institutions in Muslim countries. At first, their involvement was primarily in the taking of interbank deposits from Islamic financial institutions that had attracted retail deposits from the Muslim population in the countries in which they operated. The Western banks that received those interbank deposits agreed to use their funds in accordance with Islamic principles.

As Western banks became more comfortable with Islamic finance, they began to establish so-called Islamic windows from which they would offer their own products. Today, western banks are significant players in the Islamic market in their own right. Some of the more active Western participants have been Citibank, Standard Chartered Bank, UBS and HSBC. UBS used the principles of ethical investment to construct a portfolio that would be considered *halal* by Muslim clients. Citibank, a leading Western bank, has been engaging intensively in Islamic financing. This journey of Islamic finance is summarised in Table 4.1.

Table 4.1 Journey of Islamic Finance

1960s	1970s	1980s	1990s	Contemporary
1963 • Mit Ghamr Local Savings Bank, Egypt • Lembaga Tabung Haji, Malaysia	**1971** • Nasser Social Bank, Egypt **1975** • Islamic Development Bank, Jeddah • Dubai Islamic Bank, Dubai **1977** • Faisal Islamic Bank, Sudan **1979** • Bahrain Islamic Bank, Bahrain	**1982** • Al-Baraka **1983** • Bank Islam Malaysia Berhad • Islamic Bank, Bangladesh • Qatar Islamic Bank **1984** • Dar al Maal Islamic Trust, Geneva **1989** • ANZ Global Islamic Finance, UK	**1991** • Accounting & Auditing Organization for Islamic Financial Institutions, Bahrain **1993** • Islamic Bank of Brunei **1994** • Islamic Inter-banks Money Market, Malaysia **1999** • Bank Muamalat Malaysia Berhad	**2002** • International Islamic Financial Market, Bahrain • Islamic Financial Services Board, Kuala Lumpur **2006** • International Centre for Education in Islamic Finance (INCEIF) **2010** • International Islamic Liquidity Management Corporation (IILM)

Source: Adapted from *Islamic Banking: A Practical Perspective* by Khir, Gupta & Shanmugam.

At this juncture, it is worth noting that, the foregoing discussion on the journey of Islamic finance proffers the generic trend. This is not to deny that there exists jurisdiction-specific peculiarities. In this respect, Exhibits 4.1 and 4.2 shed more light on the development of Islamic finance.

Exhibit 4.1 Development of Islamic Finance in Malaysia

The strategy adopted by Malaysia has been to develop a comprehensive Islamic financial system which would have a greater outreach to the various segments of Malaysian society. Malaysia started with the establishment of one Islamic bank in 1983 to spearhead the introduction of Islamic banking products and services. The regulators identified the relevant financial segments that were required to support the expansion of Islamic banking activities. The Islamic financial system in Malaysia operates in parallel with the conventional system.

The initiatives include building the required financial institutions such as the Islamic banking institutions, the *takaful* industry, the non-banking institutions and developing the Islamic money and capital markets. These components have been progressively liberalised to become more integrated internationally. The supporting financial infrastructure includes enabling regulatory and supervisory framework, legal and *Shari'ah* frameworks, the payment and settlement systems and development of the talent pool.

Takaful was introduced in 1984 to complement Islamic banking operations as it provides amongst other things, coverage for Islamic housing mortgages. As Islamic banking and *takaful* progressed, Malaysia expanded its implementation approach by allowing the conventional banking institutions to offer Islamic banking products and services on a window basis. This move created more players in the Islamic financial system and provided the platform for the establishment of an Islamic money market. The Islamic money market served as a platform for the IFIs to manage their short-term portfolio adjustments.

Recognising the importance of the capital market, Malaysia initiated the development of a private Islamic financial securities market. In addition, Malaysia has also initiated the issuance of Islamic financial instruments by the government and central bank, Bank Negara Malaysia (BNM). These instruments are utilised in the conduct of open-market operations by BNM in the Islamic money market to manage liquidity in the domestic financial system.

In order to achieve uniformity of *Shari'ah* decisions and to advise BNM on any *Shari'ah* issues relating to Islamic financial business, the *Shari'ah* Advisory Council (SAC) of BNM was established in May 1997. The role of the SAC was enhanced in 2003 when it was accorded the sole authoritative body on *Shari'ah* matters pertaining to Islamic banking, *takaful* and finance.

Another strategy was adopted to promote greater financial integration with the global financial system. In this regard, the Islamic finance system has been progressively liberalised to allow for foreign entry and participation in the Malaysian financial system.

To enhance the inter-linkages in the global Islamic financial markets, Malaysia launched the Malaysia International Islamic Financial Centre, or MIFC, in 2006. Under the MIFC initiative, several measures and incentives were introduced to promote Malaysia as the premier Islamic financial centre offering Islamic financial products and services.

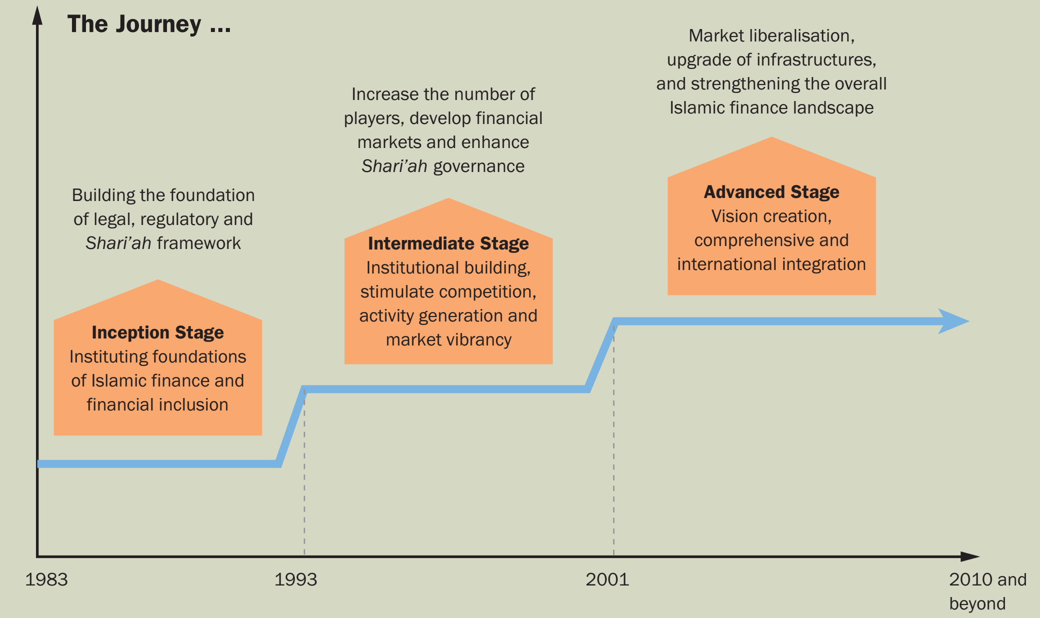
MIFC was launched in 2006 to promote Malaysia as the premier Islamic financial centre.

The Islamic financial system today has emerged as an important component of the overall Malaysian financial system that contributes to the growth and development of the Malaysian economy. Malaysia has now evolved into a comprehensive domestic Islamic financial system that is diversified in terms of its institutions, markets and players.

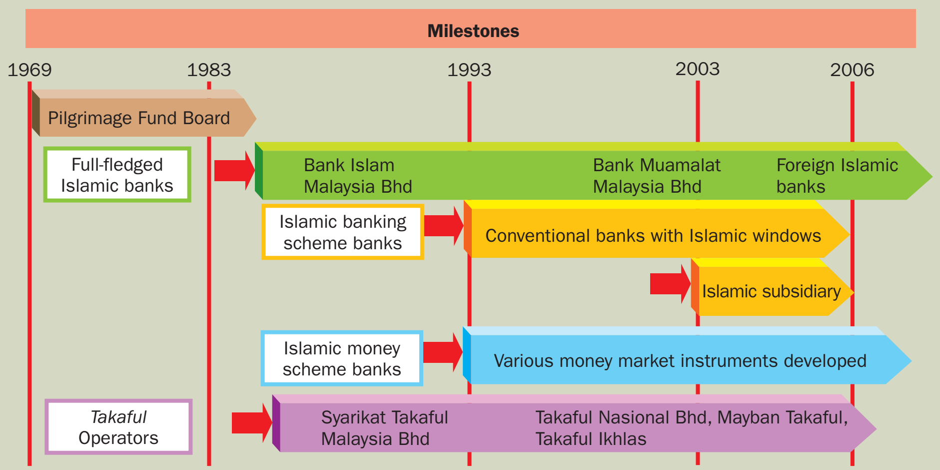
As at December 2009, Islamic banking in Malaysia captured a market share of about 19.6% in terms of total assets. This data is very close to BNM's target of 20% by the end of 2010. Total financing was 21.4% and 20.7% in terms of the total deposits in the industry. There are now 36 financial institutions offering Islamic banking services in Malaysia, including 17 full-fledged Islamic banks.

The asset share of the *takaful* industry grew 19.9% per annum in the last five years, with family and general *takaful* capturing 7.7% and 8.9% respectively, of the overall insurance sector. There are now eight *takaful* operators and four *re-takaful* operators in Malaysia offering *takaful* and *re-takaful* services. In the equity market, *Shari'ah*-compliant equities formed 63.8% of the total market capitalisation in 2009.

Malaysia's pragmatic and gradual development approach in building its Islamic financial system



Stages of Development of Islamic Finance in Malaysia



...achieved significant milestones in building a comprehensive and integrated Islamic financial system with diversity of players...

Source: Bank Negara Malaysia; *Bank Negara Malaysia Annual Reports*, various years.

Malaysia remained the largest global issuer of *sukuk*, accounting for 63% of total global outstanding *sukuk* as at the end of 2009. In 2009, the size of *sukuk* approved by the Securities Commission (SC) was valued at RM34 billion. This value represented 59% of total bonds approved. The amount of *sukuk* issued in 2009, was valued at RM32 billion, representing 53% of the bond market.

Malaysia has also undertaken legal reforms, adopted a self-regulation approach and implemented measures to encourage market-based regulation. Under these arrangements, measures have been introduced to further strengthen the level of governance in banking institutions. This includes reviewing the responsibility and accountability of the board and management as well as requiring the setting up of various board committees. In this respect, the High Court of Malaysia has dedicated high court judges to preside on litigated cases over matters relating to Islamic banking and finance.

Similarly, BNM has also set up a Law Review Committee to review the common law-based domestic legislations to remove any impediments which may hinder the functioning of the Islamic banking and financial system.

Malaysia's securities laws were updated with the passage of the Capital Markets and Services Act 2007 that came into effect in September 2007. This Act reinforces a sound investor protection framework and orderly market development, while promoting international best practices in the capital market and among its participants. The Act also clarifies the legislative framework applicable to Islamic securities and provides for the universal nature of the Islamic banking licence accorded under the Islamic Banking Act 1983. With this legislation, Islamic banks are positioned to take on a more pivotal role in the development of the Islamic capital market.

In view of the importance of Islamic finance, the Malaysian government has codified in law the duality of its financial system in 2009. The new Central Bank of Malaysia Act 2009 explicitly codifies the duality of the Malaysian financial system which shall consist of the Islamic financial system and the conventional financial system. The new Act also provides for an enhanced role of the SAC in Islamic finance to facilitate consistent application of Islamic law in Islamic financial matters.

Exhibit 4.2 Government Policies on Islamic Finance and Legislative Provisions in the Gulf Cooperation Council (GCC) States

The Royal Decree of 1952 establishing the Saudi Arabian Monetary Agency (SAMA) was similar to other central banking laws, the main distinguishing feature being the designation "monetary agency" rather than "central bank". The Saudi Arabian Banking Control Law of 1966, which still governs regulation in the Kingdom, specifically mentions bank lending under Articles 8 and 9, which is not permitted under *Shari'ah*, and Article 10 prohibits banks from engaging in wholesale or retail trade, which could be interpreted as ruling out *murabahah* transactions. Much of the emphasis during the oil boom years of the 1970s was in building a modern banking system to serve the Kingdom's financial needs, but the sensitive issue of *Shari'ah* compliance was not really addressed by SAMA. There was nevertheless support for international Islamic finance initiatives, notably the establishment of the IDB. It opened in Jeddah in 1975, its aim being to serve as a development assistance agency for the Islamic world.

However, Saudis who wished to establish Islamic banks in the Kingdom, notably Prince Mohammed bin Faisal and Sheikh Saleh Kamel, were frustrated in their efforts, and they subsequently turned their attention to promoting Islamic finance overseas.

Kuwait passed legislation on 23 March 1977 to allow the establishment of KFH, which for over two decades, was the only Islamic bank in the GCC states.

The developments might have been expected to influence the attitude of the Saudi authorities to Islamic banking, but they remained surprisingly cautious. Indeed there was a reluctance to provide Al Rajhi Bank, today the world's largest listed Islamic bank, with a banking licence, the concern being that this might highlight the interest-based transactions of the conventional banks in the Kingdom (Wilson, Mediterranean Politics). Al Rajhi Bank was finally given a banking licence in 1987, largely because it already had significant deposits, and it was felt that it would be preferable to have it regulated by SAMA. The danger was that if there was a run on its deposits, this could severely damage confidence in the whole banking system, including the regulated banks.

With the launch of Al Rajhi Bank, five out of the six GCC states had Islamic banks, the exception being Oman, which for political reasons was concerned with limiting the influence of the Ibadi sect, refused to award any Islamic banking licences. It is only recently that Islamic finance has become available in Oman with Sohar Aluminium raising US$260 million for a smelter project through Citi Islamic Investment Bank in Dubai (Alam), but there is still no local Islamic bank.

Other governments have been much more supportive in recent years, notably Kuwait, which in 2004 passed an amendment to the Central Bank Law 32 of 1968 bringing KFH under the regulatory authority of the Central Bank of Kuwait. The new legislative framework was aimed to ensure that competition within the Islamic financial sector was opened up, permitting other banks to apply for Islamic banking licences. As a result, the Kuwait Real Estate Bank converted to being an Islamic bank, changing its name to Kuwait International Bank. A new Islamic financial institution, Boubian Bank, was also awarded an Islamic banking licence. The legislation also contained provisions on Islamic financial governance, especially Articles 86, 87, 93 and 96, including a stipulation that each institution should have a *Shari'ah* board with at least three members. Although Kuwait's legislative provision is only part of its wider banking law, it is more detailed on specific Islamic banking issues than Malaysia's dedicated Islamic banking law that created its dual system.

In summary, the smaller GCC states, apart from Oman, have passed legislation which has facilitated the development of Islamic finance, and Kuwait in particular, has updated and augmented its banking legislation to ensure healthy competition between Islamic banks in its domestic market.

Bahrain's official support for Islamic finance has not been discussed in detail yet, as much of this is at the regulatory rather than the legislative level. Ironically, it is Saudi Arabia that has been the laggard as far as specific laws governing Islamic finance are concerned with no mention of Islamic banking in its banking legislation or even in the Capital Markets Law of 2003, though there have been *sukuk* issuances in the Kingdom and all of the mutual funds governed by the law are *Shari'ah*-compliant. SAMA and the Capital Markets Authority have yet to issue a single document pertaining to Islamic finance, in contrast to BNM and the SC of Malaysia, or even the Financial Services Authority in the UK, which has issued numerous documents and guidelines.

SAMA is involved in the deliberations of the Kuala Lumpur-based Islamic Financial Services Board (IFSB) but this represents a continuation of the policy of being interested in international developments in Islamic finance, but not in domestic matters within the Kingdom.

Source: This is an extract from the working paper entitled *The Development of Islamic Finance in the GCC* which was presented by Rodney Wilson in 2009. The working paper was presented under the Kuwait Programme on Development, Governance and Globalisation in the Gulf States which was hosted at The London School of Economics and Political Science's Interdisciplinary Centre for the Study of Global Governance.

Emerging Interest in Islamic Finance in Other Jurisdictions Today

A survey by *The Banker*, a magazine that covers the top 500 Islamic financial institutions, showed that assets held by fully *Shari'ah*-compliant banks or Islamic banking windows of conventional banks rose by 8.85% to US$895 billion in 2010, from US$822 billion in 2009.[1]

Islamic finance has been registered not only in Muslim countries but also across East Asia, as shown in Figure 4.1, and Western Europe where the growth is driven by commercial and business considerations. Non-Muslim countries such as Hong Kong and the UK have also introduced Islamic finance in their markets. France and Japan have made changes to their laws and regulatory frameworks to facilitate the introduction of Islamic financial products into their markets. The Commonwealth of Independent States (CIS) countries such as Kazakhstan, Kyrgyzstan, and Tajikistan are emerging and proactive in developing Islamic finance in their markets. Kenya, Tanzania and Uganda have reported growing interest in Islamic finance while Australia, Mauritius and Sri Lanka have expressed an interest in developing their countries' Islamic financial markets. This trend is expected to contribute towards greater cross-border flows in terms of increased trade and investment transactions.

"To further consolidate Hong Kong's position as a global financial centre, we should actively leverage on this new trend by developing an Islamic financial platform in Hong Kong."

— Donald Tsang, Hong Kong's Chief Executive, speaking to Hong Kong legislators.

Source: *The China Post*, 11 October 2007.

1 *The Banker*, November 2010.

Source: Adapted from *Islamic Finance and Global Financial Stability Report 2010*, IFSB.

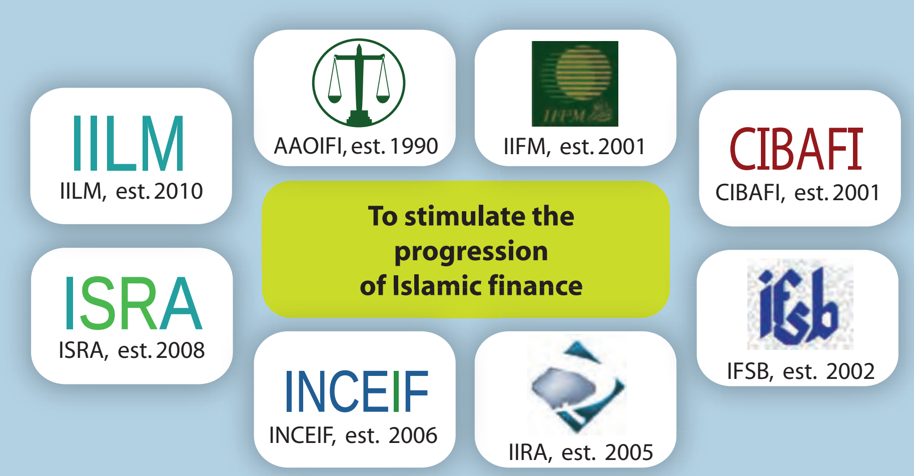
Figure 4.1
Emerging Interest in Islamic Finance

International Infrastructure Institutions

The Islamic financial services industry has seen a number of international Islamic financial infrastructure institutions being established to support its global development, as shown in Figure 4.2. These include the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), International Islamic Financial Market (IIFM), General Council for Islamic Banks and Financial Institutions (CIBAFI), as well as other ancillary institutions such as the International Islamic Rating Agency (IIRA), the Liquidity Management Centre (LMC) and the International Islamic Liquidity Management Corporation (IILM).

Besides cooperating with one another in serving the interests of the Islamic financial services industry, these institutions collaborate with their counterparts from other international organisations in order to help promote and safeguard the well-being of the general global financial system.

1990s – post-2000: Emergence of various global infrastructures to provide an Islamic finance infrastructure to serve global Islamic financial industry needs



Source: Bank Negara Malaysia.

Figure 4.2 International Financial Institutions

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous nonprofit corporate body that prepares accounting, auditing, governance, ethics and *Shari'ah* standards for IFIs and the industry. The existing accounting standards such as the International Accounting Standards or domestic accounting standards were developed for conventional institutions and the conventional accounting practices are insufficient to cater for and report on Islamic financial transactions. The AAOIFI is responsible for examining the specific requirements of Islamic financial transactions and recommending standards to resolve issues of *Shari'ah* compliance and identify gaps in applying conventional financial reporting to IFIs. The AAOIFI has so far issued 26 accounting standards, five auditing standards, seven governance standards, two codes of ethics and 41 *Shari'ah* Standards.

Professional qualification programmes (notably Certified Islamic Professional Accounting (CIPA), the Certified *Shari'ah* Advisor and Auditor (CSAA), and the corporate compliance programme) are offered by AAOIFI in its efforts to enhance the industry's human resource base and governance structures. AAOIFI was established on 26 February 1990 in Algiers and was registered on 27 March 1991 in Bahrain. AAOIFI has gained support for the implementation of its standards, which are now adopted in the Kingdom of Bahrain, Dubai, Jordan, Lebanon, Qatar, Sudan and Syria.

International Islamic Financial Market (IIFM)

The International Islamic Financial Market (IIFM) is the global standardisation body for the Islamic capital and money market segment of the Islamic finance services industry. Its primary focus lies in the standardisation of Islamic products, documentation and related processes. The major objectives of the IIFM are to enhance cooperation among the regulatory authorities of Islamic financial institutions, address the liquidity problem by expanding the maturity structure of instruments, and look into asset-backed securities. The IIFM was founded in 2001 with the collective efforts of the Central Bank of Bahrain, Bank Indonesia, Central Bank of Sudan, Labuan Financial Services Authority (Malaysia), Ministry of Finance (Brunei Darussalam) and IDB. Besides the founding members, the IIFM is supported by its permanent members, namely State Bank of Pakistan and Dubai International Financial Centre Authority, UAE. The IIFM is further supported by a number of regional and international financial institutions as well as other market participants as its members.

The IIFM has worked with the International Swaps and Derivatives Association, Inc. (ISDA) to develop a master (hedging) agreement that is applicable across all jurisdictions where Islamic finance is practised. The agreement, which is called the ISDA/IIFM *Tahawwut* (Hedging) Master Agreement, is the first financial industry framework document, and was launched in March 2010. The development marks the introduction of the first globally standardised documentation for privately negotiated Islamic-hedging products. The IIFM has also issued a Reference Paper on *I'aadat Al Shira'a* which provides a basis in finding a widely acceptable and market-based solution which will play a major role in liquidity management in the primary and secondary markets for *sukuk*.

General Council for Islamic Banks and Financial Institutions (CIBAFI)

The General Council for Islamic Banks and Financial Institutions (CIBAFI) was established in 2001 in Bahrain as an international nonprofit organisation which supports and promotes the Islamic financial services industry through information, media, research and development, consultancy, and human resources development. Since its establishment, CIBAFI has supported the industry with the establishment of the International Islamic Centre for Conciliation and Commercial Arbitration in Dubai in April 2004. The centre aims to settle financial and commercial disputes between concerned parties that have chosen to comply with the *Shari'ah* to settle disputes. CIBAFI also contributed in establishing a department for Islamic banking in the US Treasury Department in 2002, building a database containing historical administrative, financial and statistical information about IFIs, and launching the Quality Certificate Project for Islamic finance products.

Islamic Financial Services Board (IFSB)

IFSB addresses the challenges of the soundness and stability of the Islamic financial services industry.

The Islamic Financial Services Board (IFSB), which is based in Kuala Lumpur, was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. It serves as an international standard-setting body for regulatory and supervisory agencies that have a vested interest in ensuring the soundness and stability of the Islamic financial services industry. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through the introduction of new standards, or adapting existing international standards consistent with *Shari'ah* principles, and recommends them for adoption. To this end, the work of the IFSB complements that of the Basel Committee on Banking Supervision, International Organisation of Securities Commissions and the International Association of Insurance Supervisors. As at end-December 2010, the 195 members of the IFSB comprise 53 regulatory and supervisory authorities, six international intergovernmental organisations and 136 market players, professional firms and industry associations operating in 41 jurisdictions.

The IFSB has issued a whole spectrum of prudential and supervisory standards which constitute the equivalent of Basel II in Islamic finance — covering risk management, capital adequacy, corporate governance, transparency and market discipline. These standards take into account international prudential standards across the banking, investment, securities and insurance markets and simultaneously cater effectively for the specificities of Islamic financial firms, their risks and *Shari'ah* compliance.

Two important projects undertaken by IFSB were, firstly, the preparation of a report describing the role of Islamic finance in contributing to global financial stability and secondly, to formulate an innovative mechanism to enable cross-border liquidity management that would deepen and broaden the global Islamic finance industry.

Islamic International Rating Agency (IIRA)

The Islamic International Rating Agency (IIRA) started operations in July 2005 to facilitate development of the regional and national financial markets by delineating relative investment or credit risk, providing an assessment of the risk profile of entities and instruments. IIRA is the sole rating agency established to provide capital markets and the banking sector in predominantly Islamic countries. While the traditional ratings agencies have a very important role to play in the analysis of conventional institutions and the instruments they issue, the IIRA serves in carrying on the business of rating, evaluating and appraising both institutions and instruments within the Islamic finance space.

IIRA offers sovereign ratings, credit ratings, *Shari'ah* quality ratings and corporate governance ratings. Sovereign and credit ratings assess the likelihood that an entity will repay its debt obligations in a timely manner. *Shari'ah* quality ratings evaluate the level of compliance with the *Shari'ah* principles while the corporate governance ratings consider the practices of an entity to assess the demarcation of stakeholders' rights and responsibilities as well as compliance with the existing decision-making rules and procedures.

IIRA publishes professional analytical research for its multiple constituencies. The research will set a high standard for the market, enhancing the level of understanding of the value of fundamental analysis in assessing default or investment risk. In view of the nature of its activities, the presence of a rating agency should increase transparency in the market through its promotion of disclosure and knowledge of standards in other markets. It will enhance the investment-decision process by educating investors in the use of ratings criteria and methodology utilised elsewhere.

IIRA is structured in a way to preserve its independence. It has a board of directors and a completely independent rating committee. Its *Shari'ah* board comprises experts in the field.

International Islamic Liquidity Management Corporation (IILM)

In order to enhance the ability of IFIs to manage liquidity, an entity was established to address this need. The IILM is an international entity established to issue short-term *Shari'ah*-compliant financial instruments to facilitate more efficient liquidity management for institutions offering Islamic financial services and to support the increasing cross-border transactions between these institutions. Its membership is open to central banks, monetary authorities, financial regulatory authorities, government ministries or agencies that have regulatory oversight on finance or trade and commerce; and multi-lateral organisations which will hold shares of the IILM. The IILM was established on 25 October 2010 with 14 founding shareholders (consisting of 12 central banks or monetary authorities from Indonesia, Iran, Kuwait, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, Saudi Arabia, Sudan, Turkey, and the UAE) and two multi-lateral institutions (the Islamic Development Bank and the Islamic Corporation for the Development of the Private Sector). Its head office is located in Kuala Lumpur.

Models of Islamic Finance

As mentioned above, the development of Islamic finance is a worldwide occurence. But, each jurisdiction adopts varying approaches to develop the Islamic financial system. It would not be fair to determine which approach and model would be effective. However, success of such a model would be contingent on how effectively IFIs are nurtured and supervised.

In some jurisdictions, regulators have allowed dual systems whereby they issue some additional policies and regulations for IFIs in addition to the prudential regulatory framework for conventional banks. Within this category there are variations with regard to the role of regulators in *Shari'ah* compliance. Some countries have declared the entire financial system to be Islamic while in others, no distinction is made between Islamic or conventional financial systems.

Currently, there is greater involvement and buy-in towards the value propositions and business considerations offered by Islamic finance. Countries such as the UK and Singapore have introduced specific regulations to facilitate Islamic finance transactions. Depending on the regulators' adopted policy stance, approaches to the issuance of licencing and role of regulators in *Shari'ah* compliance varies significantly. For instance, some regulators issue a standard form of banking licences (e.g., Saudi Arabia) for both Islamic and conventional institutions, while others issue separate Islamic banking licences (e.g., Malaysia).

Market-Driven versus Government Initiatives

Central banks in emerging market economies have a much broader mandate than their counterparts in the more advanced and mature economies. An additional responsibility is the developmental role the central bank would need to play in that it has to chart

the development of the financial system, institutional development and the overall economic management. This is over and above the responsibilities of achieving monetary and financial stability and ensuring the sound and efficient functioning of the payment system. It is in this respect that some national governments assume an important role in the development of the Islamic financial system. The role of the government among others, is to provide the enabling environment and put in place from the outset, the necessary infrastructure through the formulation of a comprehensive set of legal and regulatory framework for Islamic banking and finance. In addition, this framework needs to be reinforced by a *Shari'ah* framework to ensure that all financial transactions are *Shari'ah*-compliant. The operations should not only be based on best practices, but must also satisfy tenets of the *Shari'ah*.

Full-Fledged versus Dual Banking System

Countries can be divided into three categories on the basis of their approach in the implementation of Islamic banking. The three categories are shown in Table 4.2.

Table 4.2 Countries with specific manifestations of Islamic finance practice

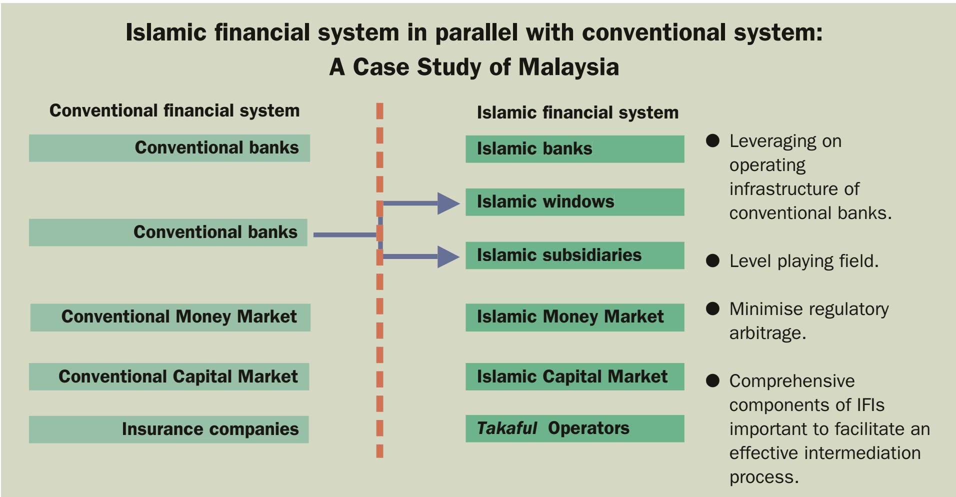
	Category	Countries
1	Islamic banking system only	Iran, Sudan
2	Dual system (Islamic banking system operating in parallel with the conventional system)	Malaysia, Bahrain, Pakistan
3	"Conventional plus" system (The system is basically a conventional system with a few Islamic banking institutions operating on the fringe of the banking system)	UK, Thailand, Bangladesh

The practice of Islamic banking services as they have been developed during the last forty years has three types of governance structures:

1. Full-fledged Islamic banks either newly licensed or converted from conventional banks.
2. Islamic banking windows of conventional banks.

3 Islamic banking subsidiaries of conventional banks either newly established or converted from existing Islamic windows. For Islamic banking windows and subsidiaries, the overriding regulatory concern has been the prevention of any mixing of *Shari'ah*-compliant and non-compliant funds. Hence, such windows and subsidiaries have to comply with firewall requirements, including separate capitals for the two types of banking services.

Most of the countries either choose Category 2 or Category 3 (Table 4.2). In Malaysia, as shown in Table 4.3, the Islamic financial system operates in parallel with the conventional financial system. In such a dual system, it is necessary to avoid the potential for regulatory arbitrage that may result in distortions that undermine the environment of a level playing field between conventional finance and Islamic finance. The development of the legal and regulatory framework for the Islamic financial services industry is therefore grounded on the principle of neutrality in ensuring no worse-off treatment when compared to conventional finance in terms of taxation laws and regulations.



Source: Bank Negara Malaysia.

Figure 4.3
Dual System

Infrastructure for Development

The rapid expansions of the Islamic financial system are actively promoted through deregulation and legal reforms that may give an incentive to foster the development of financial intermediaries and markets. In the following discussion, the attention will be given not only to the supervisory, regulatory and legal dimensions but also to the development of the financial infrastructure and markets as well as to institutional development. The prudential regulatory design has been complemented by concurrent efforts to develop Islamic financial markets, Islamic institutions and Islamic financial instruments.

Appropriate Regulatory and Supervisory Framework

The characteristic of a well-developed financial infrastructure is an effective regulatory and supervisory framework which supports the stability of the financial system. The regulatory and supervisory function is an indispensable and vital component of financial infrastructure. Some examples of this regulation are Islamic bank activities and banking-commerce links, domestic and foreign Islamic bank entries, capital adequacy, deposit insurance design, regulations on easing private sector monitoring of Islamic banks, and government ownership of Islamic banks.

For the Islamic financial system, this framework also needs to be consistent with the requirements of *Shari'ah* principles, including the establishment of a *Shari'ah* committee, which provides assurance that the formulation of policies and the conduct of financial transactions are in compliance with *Shari'ah* principles. This would need to be supported by an efficient court system that can effectively deal with all Islamic banking and finance cases, whose decisions are enforceable over the range of financial issues such as contracts, bankruptcy, collateral and loan recovery, all of which are essential for businesses to operate.

The legal framework should also deal with supervisory issues, including the relevant regulatory agencies involved in the supervision of IFIs that encompass the licencing and conduct of Islamic banking business. The relevant agencies should have clear responsibilities and objectives to ensure effective financial supervision.

While the conventional banking system is guided by the Basel core principles which outline the minimum requirements for the supervisory regime; these principles need to be reviewed from the perspective of Islamic banking, taking into account the unique characteristics and risks involved in Islamic banking and its products and services.

A fundamental issue is the setting of prudent and appropriate minimum capital adequacy requirements for Islamic banks. Such requirements need to reflect the risks that the banks undertake. The framework devised would need to incorporate fundamental Islamic concepts. The principle of *mudarabah*, for example, creates a class of depositors that can also be construed as quasi shareholders. Similarly, risk weights assigned to individual asset components need to reflect the nature of the inherent risks involved. It is not as straightforward as a debtor-creditor relationship in conventional banking but also needs to include other inherent risks arising from the investor-entrepreneur relationship that is inherent in Islamic banking.

The establishment of the Islamic Financial Services Board (IFSB) in 2002 as an international prudential standard-setting body to promulgate the international regulatory and supervisory standards for Islamic financial institutions is aimed towards achieving best practices in parallel with international best practices.

Since its establishment, the IFSB has attracted wide participation. This encouraging development demonstrates the keen interest towards the orderly and sound development of Islamic banking and finance. Another important role to be played by IFSB is in the harmonisation of the different *Shari'ah* interpretations towards a more universally accepted practice. These positive developments are expected to bring about a more robust regulatory and supervisory framework for the Islamic financial institutions to promote financial stability in the system.

In the area of global financial stability, a report that was jointly formed by the IDB and IFSB in 2009 has been released by the Task Force on Islamic Finance and Global Financial Stability. The report examines the conceptual elements inherent in Islamic finance, provides a preliminary assessment on the performance of Islamic finance during the recent international financial crisis, and outlines key recommendations to further strengthen the foundations of the Islamic financial system in a more challenging global environment.

The building blocks identified in the report discussed, among others, the global implementation of the IFSB prudential standards, the development of a systemic liquidity management infrastructure, the establishment of strong financial safety nets, putting in place an effective crisis management and resolution framework, and development of an effective macro-prudential surveillance framework. The report also proposed the setting up of a Financial Stability Forum for regulators to have a frequent dialogue on matters relating to financial stability in Islamic finance.

Recognising the need to mobilise stronger international cooperation in the pursuit of preserving financial stability, the Islamic Financial Stability Forum (IFSF) was conceptualised based on the recommendation of the Task Force of Islamic Finance and Global Financial Stability. The IFSF serves as a strategic platform for regulators to share and facilitate better understanding of emerging issues and challenges in the Islamic financial system in achieving financial stability. This represents yet another milestone in the development of the institutional infrastructure for Islamic finance.

Existence of Strong Corporate Governance

Effective corporate governance practices are essential to achieve and maintain public trust and confidence in the banking system. This is critical for the proper functioning of the financial system and economy as a whole. Poor corporate governance can lead markets to lose confidence in the ability of a bank to properly manage its assets and liabilities including deposits, which could in turn trigger a bank run or liquidity crisis. From a banking industry perspective, corporate governance involves the manner in which the business and affairs of a bank are governed by its board and senior management. For corporate governance to work, good corporate practices need to be instilled and embedded in all aspects of the operations and at all levels within the organisation.

Islam strongly advocates all forms of positive governance and these values have already been built in and are inherent in the community. Islamic corporate governance serves through its underlying principles of the economic well-being of the *ummah*, universal brotherhood, justice, accountability and equitable distribution of income. The virtues of Islam have always advocated good corporate governance and on this basis, Islamic banking institutions should incorporate good corporate governance in all aspects of their operations. For example, the board of an IFI should establish a *Shari'ah* committee and institute comprehensive policies, processes and infrastructure to ensure *Shari'ah* compliance in all aspects of the IFI's operations and activities.

Greater Transparency and Disclosure of Information

The goal of achieving transparency has become more challenging in recent years as banks' activities have become more complex and dynamic. In a rapidly changing environment, transparency is critical for financial institutions to gain public and investor confidence.

Transparency could be defined as public disclosure of reliable and timely information that enables users of that information to make an accurate assessment of a bank's financial condition and performance, business activities, risk profile and risk management practices. This definition recognises that disclosure alone does not necessarily result in transparency. To achieve transparency, a bank must provide timely, accurate, relevant and sufficient disclosures of qualitative and quantitative information that enables users to make a proper assessment of the institution's activities and risk profile. It is also crucial that the information disclosed needs to be complemented with the ability of the market players to analyse, and appropriately interpret the information.

It is in this respect that transparency is crucial for Islamic banks as this would facilitate working partnerships between Islamic banks and their stakeholders in having a better understanding of the performances, competitiveness, and risk management of the Islamic banking institutions.

In promoting transparency, supervisors and regulators need to design effective disclosure standards. To further enhance transparency in the conduct of banking institutions, proper accounting standards need to be in place to reflect the true and fair value of banking operations that would lead to greater accountability and responsibility on the part of the banking institution. Transparency and disclosure is even more crucial in Islamic banking where the concept of *mudarabah* (profit-sharing) requires an investor-entrepreneur relationship and is a significant element in the sourcing of funds. Under the *mudarabah* principle, there is a special need for disclosure by Islamic financial institutions to investors and stakeholders on the manner in which the funds are being managed in ensuring that the underlying business operations, risk profile and risk control mechanisms are in the proper place.

Efforts by AAOIFI and the IFSB have also accelerated the pace of transparency and corporate governance of IFIs in that standards issued by these international institutions are provided with references emphasising the importance of disclosure and its ultimate contribution towards transparency for the Islamic financial industry.

Risk Management Framework

Risk management in a modern financial institution is a complex and constantly evolving task. The identification and assessment of risks and the determination of risk mitigation and management strategies form an essential part of the risk management framework of a financial institution. This framework is not one discrete policy, strategy or document but it comprises the totality of all the structure, policies, strategies and procedures within the financial institution that deal with risk management. It is critical that the risk management framework be adequate for the risks each financial institution faces. With sound risk management practices, this will minimise adverse consequences faced by financial institutions during periods of uncertainty. Robust internal controls are also necessary to provide checks and balances in the overall risk management practices of financial institutions.

The risk management system in IFIs needs to be able to address the unique characteristics associated with Islamic financing operations involving financial contracts and instruments which may give rise to other risks in addition to credit risk. The risk management infrastructure needs to be in place to facilitate the identification, measurement, monitoring and control of all inherent risks present in all the various types of financing. The complexities of the respective risks in Islamic financial instruments therefore need to be fully examined and quantified to provide for their effective assessment and management.

In the area of Islamic banking, the requirement to manage the risks becomes more important because of the unique characteristics in the contracts. Basel II has, to a certain extent, incorporated some aspects in the identification of risks, in particular the credit, market and operational risks that can be assimilated by Islamic banks in terms of its product offering.

The IFSB has issued the Guiding Principles of Risk Management for institutions offering Islamic financial services (IFSB-1). These guidelines set out 15 principles of risk management for IFIs other than the insurance industry. While the Basel Committee on Banking Supervision standards has set out sound practices and principles pertaining to credit, market, liquidity and operational risks of financial institutions, IFSB has provided additional guidance to cater for specificities of IFIs offering Islamic finance services. For example, it includes the requirement to comply with *Shari'ah* rules and principles as the essential feature of the financial institutions' activities and greater fiduciary duty requiring the institutions to apply *Shari'ah*-compliant risk mitigation techniques wherever appropriate.

Effective and Dynamic *Shari'ah* Framework

The *Shari'ah* governance framework is a set of institutional and organisational arrangements to oversee *Shari'ah* compliance aspects of Islamic financial institutions.

The *Shari'ah* framework is a vital pillar in the sustainable development of Islamic finance. *Shari'ah* principles are the foundation of the practice of Islamic finance through the observance of the tenets, conditions and principles espoused by the *Shari'ah*. The *Shari'ah* principles should always be viewed as an enabler of innovation and creativity, rather than a constraint.

The *Shari'ah* framework includes governance structures, processes and arrangements to ensure that all Islamic financial institutions' operations and business activities are in accordance with the *Shari'ah*. The structure and processes include:

1 Rules governing the composition and qualifications of *Shari'ah* committee members of the IFI.

2 Issuance of relevant *Shari'ah* pronouncements/resolutions that govern the whole of its operation.

3 An internal *Shari'ah* compliance review/audit for verifying that *Shari'ah* compliance has been satisfied, during which any incident of noncompliance will be recorded and reported, and as much as possible, addressed and rectified.

4 Dissemination of information on such *Shari'ah* pronouncements/resolutions to the operative personnel of the IFIs.

There is no common approach among countries in developing the *Shari'ah* framework. It is understandable that supervisory authorities may tailor the *Shari'ah* framework adopted by IFIs in their respective jurisdictions to suit market realities, and the stage of development of their Islamic financial services industry. Each model may have its advantages and disadvantages, and supervisory authorities would usually have a clear understanding and justification as to which model would suit their requirements.

Strong and Comprehensive Legal Infrastructure

The legal system that rigorously enforces contracts (including laws protecting creditors and minority shareholders) tends to produce a better-developed financial system. It asserts that law and finance is a set of contracts. These contracts are defined, and made more or less effective, by legal rights and enforcement mechanisms. From this perspective, a well-functioning legal system (and also its origin) facilitates the operation of both markets and intermediaries. It is the overall level and quality of financial services – as determined by the legal system – that improves the efficient allocation of resources and economic growth.

Therefore, another important precondition for continued growth of Islamic banking and finance is a comprehensive legal infrastructure. A legal framework which is aligned with market developments lends certainty and predictability to financial transactions and innovative products and instils public confidence in the financial system. It provides the legislative framework that clearly defines the conduct of IFIs. It also gives due protection to the consumers of Islamic finance, ensures the enforceability of Islamic financial contracts and provides an effective mechanism for legal redress. The legal infrastructure needs to comprise both effective regulatory and substantive laws as well as appropriate adjudicative platforms for parties to resolve disputes relating to Islamic financial transactions.

Development of Vibrant Islamic Financial Markets

In the more developed financial centres, the development of interrelated financial markets has an important role in contributing towards the stability of the financial system. The development of a comprehensive Islamic financial system including the various components of financial markets is important in meeting the requirements of the respective differentiated groups. The development of an Islamic financial system should include key components comprising the Islamic money market and the Islamic equity and debt capital market. These components have strong linkages, interdependence and synergies among them. The Islamic money market acts as a platform to provide a ready source of short-term funding and investment. Financial instruments and interbank investments will allow surplus banks to channel funds to the deficit banks, thereby maintaining the funding mechanism necessary to promote stability in the system. The Islamic money market will also facilitate the conduct of monetary policy.

The Islamic financial system also includes the capital market to provide an alternative source of financing, as well as to create broader and more diverse Islamic financial instruments for investors. The equity and bond markets will contribute towards a more balanced and efficient allocation of financial and economic resources. This would result in a more efficient distribution of risks within the system, thus creating stability in the system. The equity and bond markets would also provide an avenue for raising long-term capital. With a wider spectrum of instruments in the market, fund managers would be able to manage their portfolios better and spread their risks according to their desired level of risk tolerance, thereby contributing towards greater stability.

Complementing these financial markets is the development of non-bank Islamic financial institutions. *Takaful*, or Islamic insurance, provides risk protection to its policyholders and serves as an important mobiliser of long-term funds. In addition, financial institutions, savings institutions and housing credit institutions need to be developed to meet increasingly diversified customer demands. These specialised institutions will meet the different requirements of the economy.

Large Number of Players

Apart from a wide range of products and innovative instruments, an Islamic financial system requires a large number of players in the market. To establish an Islamic money market, it would be essential to have a large number of IFIs. An Islamic money market is integral to the smooth functioning of the Islamic banking system. There are now new players which can provide more product innovation and competition in the Islamic financial services industry. The diversity of the community of players would also result in achieving critical mass for the industry.

Wide Range of Financial Products and Instruments

The Islamic financial services industry has evolved and grown since its inception in the late 1960s, from being mainly a retail banking-focused sector to developing a solid footprint in the commercial and wholesale banking arena. From the 1980s to the 1990s, the activities of IFIs were confined mainly to cost-plus-sale, Islamic trust financing and equity participation. The asset composition of the IFIs remained fairly static and was heavily focused on short-term instruments due to the lack of liquid assets. During this period, there was scarcity of Islamic capital market instruments. This gave rise to the demand for the introduction of new Islamic financial instruments. Over the years, there was significant development of the Islamic capital market with the introduction of a wide range of Islamic capital products that are becoming widely available such as *Shari'ah*-compliant stocks, Islamic funds, *sukuk* and Islamic stockbroking services. The Islamic capital market is also seeing an increase in the offering of more innovative *Shari'ah* products, including exchangeable or convertible *sukuk*, and commodity-linked certificates. Table 4.3 provides a snapshot of the significant developments that have taken place in the Islamic financial services industry.

Table 4.3 Significant Developments in Islamic Finance

Prior to 1970s	1970s	1980s	1990s	Contemporary
Mostly Retail Banking	Commercial Banking	Project Finance and Syndication Islamic insurance (*Takaful*)	Equity Funds Leasing Islamic Securitisation	Advanced treasury services Balance sheet management Innovative asset management

Source: Islamic Finance and Global Financial Stability Report, IFSB.

Tax Neutrality

An appropriate tax framework is one of the basic requirements for establishing sound financial institutions and markets. Like the common law and civil law systems, Islamic jurisprudence offers its own framework for the implementation of commercial and financial contracts and transactions. Nevertheless, commercial, banking, property and company laws appropriate for the enforcement of Islamic banking and financial contracts do not exist in many countries. In most countries, Islamic asset-based financing contracts are treated as purchase and re-sales of the assets, and hence are taxed twice. However, in some countries such as the UK and Singapore, the double stamp duty on some Islamic modes of finance has been abolished, so as to provide tax neutrality. The treatment of *sukuk* as an asset class differs across jurisdictions. There are some common law jurisdictions which tend to put *sukuk* in the same class as conventional bonds, that is, as debt. For example, under the circular issued by the Luxembourg Direct Tax Administration (LDTA) clarifying the tax treatment applicable to *sukuk*, *sukuk* are comparable to conventional finance debt instruments for Luxemborg's direct tax purposes. Therefore, the yield on *sukuk* qualifies as interest and is treated as tax deductible if incurred in the best interest of the issuer. The circular indicates that the yield is not considered as a dividend or hidden dividend distribution for Luxembourg's direct tax purposes and thus is not subject to Luxembourg withholding tax.

Blue Print for Islamic Finance

The formulation of the 10-year master plan for the Islamic financial services industry by the IDB and the IFSB, marks an important step in setting the blueprint for leading the development of Islamic finance in a systematic and coordinated manner across jurisdictions to achieve the common goal of a vibrant and comprehensive Islamic financial services industry.

In February 2011, the Turkish Parliament passed tax neutrality laws for *sukuk ijarah* thus paving the way for corporate *sukuk* issuances.

Source: Menafn.com and Arabian Business.com

In the case of Malaysia, the Malaysian Financial Sector Master Plan represents the blueprint for the development of the financial sector over a ten-year period. The plan, which was launched in 2001, places importance on the development of the Islamic banking and *takaful* sector as an important component in the financial system. To achieve this objective, the Malaysian central bank has emphasised financial infrastructure and institutional development, aimed at enhancing efficiency of the system and building the internal resilience and competitive position of the Islamic banking institutions and *takaful* operators, while meeting the needs of the country.

Indonesia's central bank has introduced a blueprint that aims to bolster the domestic Islamic banking industry by 2015. It will focus on improving the efficiency of Islamic banking, integrating its Islamic financial industry and ensuring it complies with global Islamic banking standards.

Accounting and Auditing Standards for Islamic Financial Institutions

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) plays an important role in supporting the development of the Islamic finance industry, particularly, its contributions in the area of an Islamic accounting framework. AAOIFI has provided measurement approaches for Islamic transactions and improved the overall quality of financial statements for IFIs. Although the Islamic accounting standards issued by AAOIFI have been adopted in several countries such as Bahrain, Sudan, Dubai, Qatar and Jordan, there are still technical issues in Islamic financial reporting that need to be addressed. At the regional level, as in the case of Asia, there has been greater cooperation through the Asian-Oceanian Standard Setters Group (AOSSG) to examine the technical issues in the financial reporting of Islamic finance. The efforts by AAOIFI and AOSSG represent important contributions to current efforts to evolve an accounting framework that is appropriate and further supports the global development of Islamic finance. Standard-setting bodies such as the International Accounting Standards Board (IASB) has been engaged in this process to complement and leverage on the current global efforts to converge international accounting frameworks. Cooperation between the standard-setters would contribute towards the development and adoption of the global financial reporting standards for Islamic finance.

Challenges

Islamic finance faces a number of challenges that need to be addressed to sustain its development in the global financial system. Some of these challenges are explained below.

Adoption of a Robust Domestic Islamic Financial System

The level of development of Islamic finance across jurisdictions varies significantly. While in some Islamic finance is at an advanced stage of development, in others, more meaningful progress is yet to be made. The level of development of Islamic finance needs to reach a certain threshold of development and sophistication. It requires the development of a robust Islamic financial system which encompasses both banking and non-banking Islamic financial intermediaries and Islamic financial markets offering a range of Islamic financial products that is supported by a developed Islamic financial infrastructure.

Efficient and Active International Islamic Financial Markets

There is a need to advance further the development of an efficient and active international Islamic financial market. Well-developed international Islamic financial markets enhance the liquidity of the instruments and risk management capacity of the players. This would promote the efficient functioning of the markets and thus facilitate capital flows and thereby strengthen global integration. Co-ordinated initiatives are therefore essential to foster the development of an efficient and vibrant international Islamic financial market.

Availability of a Wide Range of Instruments

There is a need to have the availability of efficient financial products. Islamic financial institutions urgently need *Shari'ah*-compliant products to meet a number of pressing needs, including:

1. Short-term placement of funds and liquidity, and asset-liability mismatch management.
2. Financial risk management and hedging.
3. Resource mobilisation at a competitive cost.
4. Balance sheet management through securitisation.

Owing to their need to develop new products, Islamic banks have to invest more in their research and development activities as compared to conventional banks.

Human Resource Requirements

Human resource development is of critical importance for Islamic finance. It is important to ensure an adequate supply of a talent pool of experts and high calibre professionals to drive and support the long-term growth and development strategies of IFIs.

The Islamic financial services industry is continually promoting human capital development and expertise to put in place a sufficient pool of experts. This involves attracting and retaining the existing talent, and building highly-skilled individuals for the future. It is also imperative for Islamic financial professionals to have the combined knowledge and understanding of *Shari'ah* with the necessary skills in finance. Currently, talent development and research institutions in Islamic finance have been established in several jurisdictions with several strategic alliances across borders being entered into.

Summary

1 Islamic finance emerged on the international financial scene since the early 1970s. The emergence of Islamic finance could be mainly attributed to the revival or reinvigoration of the principles of Islam and the increasing number of Muslims who want to lead their lives (including, their commercial activities) in accordance with the *Shari'ah*.

2 There is no common approach among countries in developing their respective Islamic financial system. It is understandable that supervisory authorities may tailor the legal, regulatory and *Shari'ah* framework in their respective jurisdictions to suit market realities and the stage of development of their Islamic financial services industry.

3 The level of development of Islamic finance across jurisdictions varies significantly. While in some, Islamic finance is at an advanced stage of development, in others, more meaningful progress is yet to be made. The most important factor at the moment is not the state of development but the establishment of the prerequisites of an Islamic financial system which are a *sine quibus non* for the development and stability of the system.

4 A comprehensive Islamic financial system consists of a set of components comprising the Islamic banking industry, the *takaful* industry, the Islamic capital market and the money market. There is the need for strong linkages, interdependencies and synergies among these components in the system.

5 In a dual banking system, there exists a potential for regulatory arbitrage. If this is allowed, distortions are inherent. Its avoidance is necessary since it undermines a level playing field between conventional finance and Islamic finance. This could be checked through the implementation of legal and regulatory framework based on the principle of neutrality to ensure no worse-off treatment when compared to conventional finance in terms of taxation, laws and regulations.

6 International infrastructure institutions (e.g., IFSB, IIFM, AAOIFI) and ancillary institutions (e.g., IIRA, IILM) cooperate with one another in serving the interests of the Islamic financial services industry. Besides this, they join forces with their counterparts from other international organisations to help promote and safeguard the well-being of the global financial system generally.

7 Islamic finance faces a number of challenges that need to be addressed to sustain its development in the global financial system. These include *inter alia*, below-threshold sophistication in the development of the Islamic financial system in some jurisdictions, the low ebb status of international Islamic financial markets, unavailability of a wide range of instruments and inadequate human resource development.

8 To develop new products, Islamic banks need to invest more in research and development activities as compared to conventional banks to cover important areas of pressing needs. These include short-term placement of funds and liquidity, asset-liability mismatch management, financial risk management and hedging, resource mobilisation at a competitive cost and balance sheet management through securitisation, to mention a few.

Key Terms and Concepts

Market-based Regulation
Banking Supervision
Prudential Standards
Corporate Governance
Islamic Money Market
Comprehensive Legal Infrastructure
Islamic Financial Architecture
Tax Neutrality
Islamic Financial System
Dual Banking System
Islamic Capital Market
Takaful Industry
Islamic Equity Market
Transparency and Disclosure
Risk Management
Shari'ah Framework
IIFM
ISRA
IFSB
AAOIFI

Further Readings

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Review Questions and Problems

1 Describe modern day experiments of Islamic finance.

2 Outline five prerequisites for the development of the Islamic financial system.

3 Describe the models of Islamic finance.

4 Imagine that the central bank of a country is about to embark on developing Islamic finance. What are the essential steps that need to be taken to introduce Islamic finance into the country?

5 What challenges would the Islamic financial industry face in developing a sufficient pool of talent in Islamic finance?

6 Is it necessary for a country which has the intention to introduce Islamic finance to develop a blueprint?

7 Does the law of origin make Islamic finance transactions efficient? Explain.

8 What are the reasons for Saudi Arabia taking a cautious approach as far as regulating Islamic financial institutions is concerned? Discuss.

9 Are the rules and government policy in Kuwait sufficient in the regulation of Islamic finance in the country?

10 Provide an example of one jurisdiction that does not use the term “Islamic finance” in its laws and policy guidelines. Will this restriction impede the development of Islamic finance in that particular country? Discuss.

Part 2

Shari'ah Framework and Principles for the Islamic Financial System

Chapter 5

Shari'ah Framework for Islamic Finance

Preview

This chapter briefly discusses the *Shari'ah* sources and principles which provide the foundation for Islamic financial activities and instruments. It begins with the definitions and classifications of *Shari'ah* sources from the jurists' perspectives. It further elaborates on the sources of *Shari'ah* according to selected classifications which comprise the main textual sources and supporting sources. The discussion on *maqasid* or ultimate objectives of the *Shari'ah* will follow as this is one of the main themes in modern jurisprudence, particularly in finance. In addition, this chapter discusses the main legal maxims governing Islamic commercial law followed by a discussion on the difference of opinion among the jurists, its reasons and effect on the development of modern Islamic banking and finance. The role and functions of *ijtihad* and *mujtahid* in Islamic finance will also be analysed. It will also discuss the prohibited elements in Islamic commercial law like *riba*, *gharar* and *maysir* which could render all transactions null and void and how they might occur in modern transactions. Subsequently, some ethical principles will complement the discussion on the governing principles of Islamic banking and finance. Finally, some key issues, opportunities and challenges will be highlighted. This is concluded by the review of some case studies to further enhance the reader's understanding.

The Holy *Qur'an*, which is one of two primary sources of the principles of *Shari'ah*.

Learning Outcomes

At the end of the chapter, you should be able to:

- Explain the meaning of *Shari'ah* and its sources, and be able to establish its relevance to Islamic banking and finance.
- Describe the salient features and legal position and functions of all *Shari'ah* sources.
- Identify the principles governing Islamic banking and finance.
- Understand the methodology of *ijtihad* in solving the issues pertaining to modern Islamic finance.
- Apply the principles of *Shari'ah* in administrating Islamic banking and finance instruments.

Definition of *Shari'ah*

Shari'ah literally means, "the road to the watering place" or "the straight path to be followed". The *Qur'an* has used the word *Shari'ah* with this meaning in the following verse:

ثُمَّ جَعَلْنَٰكَ عَلَىٰ شَرِيعَةٍ مِّنَ ٱلْأَمْرِ فَٱتَّبِعْهَا وَلَا تَتَّبِعْ أَهْوَآءَ ٱلَّذِينَ لَا يَعْلَمُونَ ١٨

> *"Then We have put you (O Muhammad, (peace be upon him)) on a plain way (شَرِيعَةٍ) of (Our) commandment. So follow you that (Islamic monotheism and its laws), and follow not the desires of those who know not."* (*Al-Qur'an*, 45:18).

As a technical term, however, the word *Shari'ah* was defined by Al-Qurtubi as the canon law of Islam, all the different commandments of Allah (subhanahu wa ta'ala) to mankind. Some scholars defined this word as the injunctions revealed to the Prophets of Allah (s.w.t.) related to law or belief. In addition to the above definition, some scholars confined *Shari'ah* to its linguistic meaning by saying that this word means, "Following strictly the injunctions of Allah (s.w.t.) or the way of Islam (*din*)."

Shari'ah is the sum of the Islamic teachings and system, which was revealed to Prophet Muhammad (p.b.u.h.), recorded in the *Quran* and deduced from the *Sunnah*.

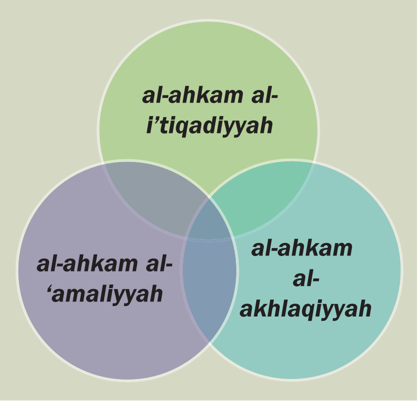
A comprehensive definition of the word *Shari'ah* can be deduced from the different definitions given above as follows: It is the sum of the Islamic teachings and system, which was revealed to Prophet Muhammad (p.b.u.h.), recorded in the *Qur'an* as well as deducible from the Prophet's divinely-guided lifestyle called the *Sunnah*. Some scholars view that all of the different commandments of Allah (s.w.t.) to mankind are part of *Shari'ah*. Each one of these commandments is called a *hukm* (pl. *ahkam*). *Shari'ah* regulates all human actions. This is why it is not "law" in the modern sense as it contains a comprehensive set of dogmas and legal and ethical doctrines. It is basically a doctrine of duties and a code of obligations. For this reason, legal considerations and individual rights have a minor place in it. Above all, the tendency towards a religious evaluation of all the affairs of life is absolute.

In the context of Islamic finance, the word *Shari'ah* is regularly used to denote the compliant aspect of Islamic financial products and services. Of late, there are two key words that are commonly used by the Islamic finance industry, namely "*Shari'ah*-compliant" and "*Shari'ah*-based" products and services. *Shari'ah*-compliant products refer to products which have their origin from the conventional market and are "Islamised" by modifying them to suit *Shari'ah* requirements. This is usually done by inserting certain contracts and peripherals in the structure in order to make it *Shari'ah*-compliant. A classic example of such a structure is in the *ijarah* contract coupled with the option of buying the asset at the end of the contract which is also known as *al-ijarah thumma al-bay'* or *ijarah muntahiyah bittamlik*. This contract is similar to the hire purchase contract in conventional products. On the other hand, *Shari'ah*-based products refer to products which do not originate from conventional practice. Examples of such products are those which utilise the contract of *salam* or *istisna'*.

From the *Shari'ah* point of view, there is no difference between a product which originates from the conventional market or otherwise. The important criteria in determining the acceptability of a particular product from the *Shari'ah* point of view depends on its compliance with the rules and regulations of *Shari'ah*. As long as the product is in compliance with all the requirements of *Shari'ah*, it will be deemed acceptable. This is because in the history of Islamic law, there are rulings which have their origins from pre-Islamic period practices such as the contracts of *mudarabah* and *musharakah*.

Components of *Shari'ah*

The *Shari'ah*, which contains all the different commandments of Allah (s.w.t.) to mankind, can be divided into three fields. The first is *al-ahkam al-i'tiqadiyyah* (the sanctions relating to beliefs) such as the belief in Allah (s.w.t.) and the Day of Judgement. The second is *al-ahkam al-akhlaqiyyah* (the sanctions relating to morals and ethics) such as the injunction to tell the truth, be sincere, be honest, etc. The last category is *al-ahkam al-'amaliyyah* (sanctions relating to the sayings and doings of the individual and his relations with others) which is also called *fiqh*.



Fiqh is the name given to the whole science of jurisprudence because it implies the exercise of intelligence in deciding a point of law in the absence of a binding text (*nass*) from the *Qur'an* or *Sunnah*. *Fiqh* is derived from the root word *faqaha* which literally means comprehension or true understanding. The *Qur'an* has used this word with the above meaning on several occasions. The verse stated below exemplifies, among others, instances of its use in that respect.

> *"And make loose the knot (the defect) from my tongue, that they (yafqahu) understand my speech."* (*Al-Qur'an*, 20: 27–28).

Exhibit 5.1 *Fiqh* (Islamic Law)

Fiqh, or Islamic law, is a component of *Shari'ah* and it has a close relationship with *usul al-fiqh* which comprises the principles of Islamic law. The relationship between *fiqh* and *usul al-fiqh* can be the analogy of the relationship of a particular product and the manufacturer of the product. This is because *fiqh* is the end product of *usul al-fiqh* and without *usul al-fiqh*, there are no rulings of *fiqh*. *Usul al-fiqh* has its own tools in deriving the rulings of *fiqh*. All the sources of *fiqh*, be it primary sources or secondary sources, are tools in deriving the rulings of *fiqh*. For instance, the *Qur'an* says that trading is permitted and usury is forbidden (*Al-Baqarah*, 275). The *usul al-fiqh* experts will study this verse and deduce the rulings of *fiqh* from it. Among the obvious rulings that can be deduced is the permission of trade and the prohibition of usury. Other rulings include the rationale for the prohibition of usury. This might warrant investigating the characteristics of usury such as its element of oppression, unjust possession of others' property, not assuming risk, etc., that is associated with usury. Therefore, the expert of *usul al-fiqh* can conclude that any transaction that resembles the above characteristics is forbidden in Islam. On the other hand, trading is a kind of transaction that could be undertaken by any party without any element of oppression and with risk-taking as an integral part. Therefore, any transaction that possesses the characteristics of trading is permitted in Islam.

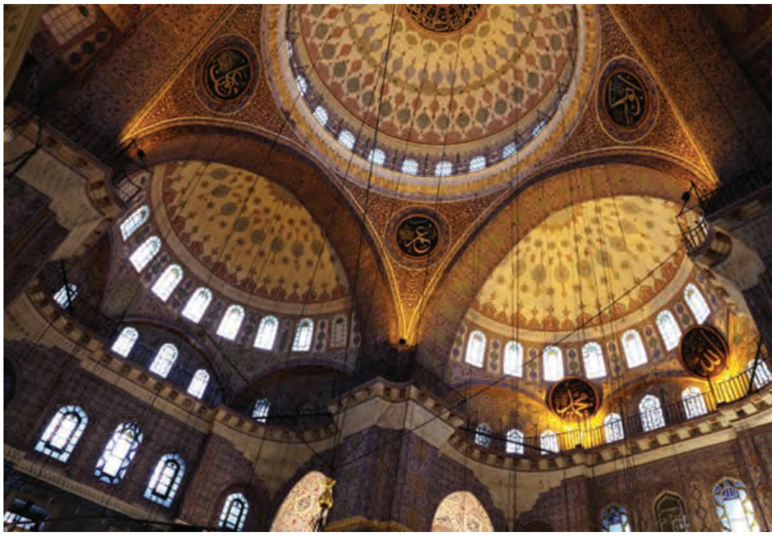
Fiqh is the knowledge of one's rights and obligations derived from its sources.

Before the advent of Islam and during the early days of Islam, the word *fiqh* was used with the above technical meaning. However, the eventual development of the sciences of Islam saw the emergence of its association with various sciences of Islam. As an example, the word *fiqh al-hadith* is used to express the science of *hadith*, which discusses the different subjects and topics related to *hadith* such as the study of the chain of *hadith* (*sanad*) or its text (*matn*). Similarly, the word *fiqh al-Qur'an* is used to state the branches of knowledge related to the *Qur'an*. At present, the word *fiqh al-sirah* is also commonly used to describe the branch of knowledge related to the life of the Prophet (p.b.u.h.). These are general usages of the word *fiqh* in the past and present. The technical usage of the word *fiqh* deals with matters related to Islamic law.

Abu Hanifah, the founder of the Hanafi School of Islamic Law (d. 767CE),[1] defined *fiqh* as "the knowledge of what is for a man's self and what is against a man's self" (*ma'rifat al-nafs ma laha wa ma 'alayha*). This is a general definition of *fiqh* as it includes all the knowledge of Islam. However, Al-Ghazali (d. 505 AH) has confined the word *fiqh* to the science of the rules of law. Al-Amidi has provided a broader definition of *fiqh* by saying that, "*Fiqh* is the science of understanding the legal obligations derived from its sources (i.e., *Qur'an*, *Sunnah* and other sources of Islamic law)." The majority of Islamic authorities, however, define it in terms of its four basic sources and it can, therefore, be defined as follows:

> "*Fiqh*, or the science of Islamic law, is the knowledge of one's rights and obligations derived from the *Qur'an* or *Sunnah* of the Prophet (p.b.u.h.), or

1 C.E. (i.e., Common Era) is used instead of A.D. (Anno Domini, lit. in the year of our Lord) because Muslims do not recognise Jesus the son of Mary as the Lord, but as a Prophet of Allah.



the consensus of opinions among the learned (*ijma'*), or analogical reasoning (*qiyas*)."

This is the classic definition of *fiqh* and is said to be founded on the following famous tradition of Mu'az. The Prophet (p.b.u.h.) was reported to have sent Mu'az b. Jabal, as a governor to Yemen and also appointed him as a judge. Before sending him, the Prophet (p.b.u.h.) asked him: "According to what will you judge if a problem is brought to you?" He replied, "According to the scriptures of Allah (s.w.t.) (*Qur'an*)". "And if you did not find anything in it?" He replied, "According to the *Sunnah* (tradition) of the Messenger of Allah (s.w.t.)." "And if you did not find anything in it?" the Prophet (p.b.u.h.) asked him. "Then I shall strive to interpret with the exertion of my reason," Mu'az replied. And thereupon the Prophet (p.b.u.h.) said: "Praise be to Allah who has favoured the messenger of His Messenger with what His Messenger is willing to approve of." (*Sunan Abu Dawud, hadith* No. 3592). This *hadith* gives expression to what actually must have taken place during the time of the Prophet (p.b.u.h.). It explains the Islamic perception of the methods of deriving legal solutions. It demonstrates that in this process, independent judgement, within certain limits is not only permissible but even praiseworthy.

One of the important points that should be observed about *fiqh* is its flexibility. There are two kinds of *fiqh* rulings according to changeable or fixed rulings as follows:

1 The rulings that were deduced from decisive evidence, i.e., from the *Qur'an* or *Sunnah*. This kind of ruling cannot be changed according to the change of time and place or circumstances. There are only a few rulings of such nature and all the rulings related to '*ibadah* (rituals) fall under this category. Examples of such rulings are rulings related to prayer, fasting, punishment for adulterers, distribution of inheritance and others. However, the implementation of such rulings can be deferred if the situation does not permit for it to be implemented or if the implementation of such rulings might result in defying the objectives of *Shari'ah*. An example of such a deferment has taken place during the reign of Caliph Umar Al-Khattab when he suspended the implementation of the punishment for theft as a result of the drought season in Madinah. The situation had prompted some people to steal food from others in order to survive.

2 The rulings that are deduced by the scholars from their understanding and interpretations of the text of the *Qur'an* or *Sunnah* and from other various sources of Islamic law such as juristic preference (*al-istihsan*), consideration

Two categories of *fiqh* ruling:
1 Fixed rulings:
rulings deduced from the decisive evidences of the *Qur'an* and *Sunnah*.
2 Flexible rulings:
rulings deduced from the understanding and interpretations of scholars of the *Qur'an*, *Sunnah* and other sources of Islamic law.

of public interest (*masalih al-mursalah*), presumption of continuity (*al-istishab*), custom (*urf*) and others. Such rulings depend largely on the ability of the jurists to utilise the power of reasoning in deciding certain *fiqh* issues. In fact, most of the rulings of *fiqh*, particularly the rulings related to *muamalat* fall under this category and they are flexible and might be changed according to the changes of time, place and circumstances.

It is important to note that the *Qur'an*, in most cases, provides general principles and it is dependent on the jurists to utilise these principles to resolve the issues in *fiqh*.

As for the term *usul al-fiqh* or the principles of Islamic law, it explains the indications and methods by which the rules of *fiqh* are deduced from their sources. These indications are found mainly in the *Qur'an* and *Sunnah*, which are the principal sources of Islamic law. The methodology of *usul al-fiqh* refers to *ijtihad* (methods of reasoning) which empowers the usage of the secondary sources which includes *qiyas* (analogy), *istihsan* (juristic preference), *istislah* (public interest), *istishab* (presumption of continuity), *urf* (customary practice), *amal ahl al-madinah* (practice of the people of *Madinah*) and *sadd al-dhara'i'* (blocking the means to an evil). Thus, *fiqh* as such, is the end product of *usul al-fiqh* but the two are separate disciplines. The importance of *usul al-fiqh* is irrefutable as it examines the sources of Islamic law to deduce the rules by a qualified person who is equipped with the relevant knowledge to deduce these laws. Ibn Khaldun emphasised the importance of *usul al-fiqh* when he said: "(It is) one of the greatest sciences of the *Shari'ah*, the most powerful and beneficial sciences for the *mujtahid*."

Sources of Islamic Law

One of the important constituents in Islamic law is the sources that were utilised in order to deduce rulings.

Classification of Sources of Islamic Law

"The other classification is based on the agreement of scholars in utilising the sources. In this regard primary sources include *Qur'an*, *Sunnah*, *ijma'* and *qiyas*, in which no scholars have challenged the authority of these four sources over other subordinate sources. Meanwhile, the secondary sources are the ones that scholars differ in their utilisation as bases in deducing the Islamic legal rulings, where by some consider them as sources while others reject them."

The scholars have classified the sources of Islamic law into various categories. One of these classifications is based on the origin of the sources. This classification views *Qur'an* and *Sunnah* as the primary sources while other sources based on reasoning are called secondary sources. The *Qur'an* and *Sunnah* are considered as the sources that originate from the text of revelation which is called textual sources or *al-nass*. Other sources based on the power of reasoning are called non-textual sources or *al-ra'y*. There are some sources about which scholars of Islamic law are in agreement in their utilisation as valid sources. These include the *Qur'an*, *Sunnah*, *ijma'* and *qiyas*. Indeed, no scholars have challenged the authority of these four sources over other subordinate sources. The other category is the secondary sources of Islamic law about which the scholars differ in their utilisation as relevant sources and as a basis in deducing the rulings of Islamic law. Some scholars consider them sources while others do not. These sources are juristic preference (*istihsan*), presumption of continuity (*istishab*), custom (*urf*), consideration of public interest (*maslahah al-mursalah*), blocking the means (*sadd al-dhara'i'*), and the practice of the people of Madinah (*amal ahl al-Madinah*).

The basis for the sources of Islamic law, which were based on the text and the exercise of opinion in deducing rulings originate from the famous *hadith* of Mu'az discussed under the definition of *fiqh* above.

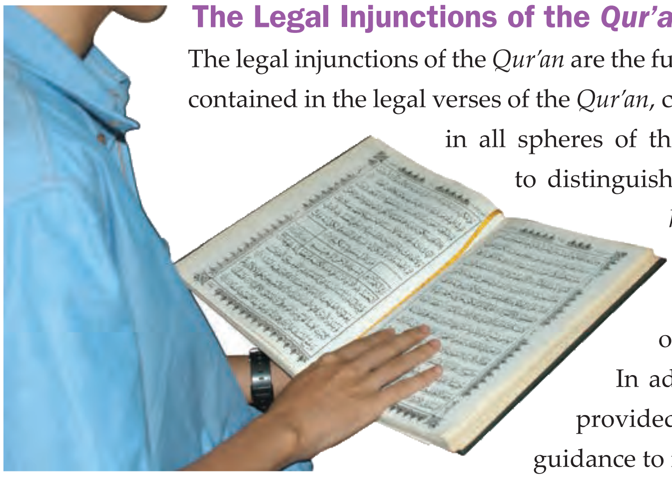
This *hadith* indicates the approval of the Prophet (p.b.u.h.) for using personal opinion provided that it is not against the injunctions of the *Qur'an* and *Sunnah*. In addition, the *hadith* shows the priority in the utilisation of the sources of Islamic law. The first reference must be the *Qur'an*, followed by the *Sunnah* and subsequently, the sources based on opinion and views can be utilised. It is important to note that all the sources of Islamic law, whether textual or non-textual, take their legal origin from the *Qur'an* and the *Sunnah*.

The *Qur'an*

The *Qur'an* is the primary source of the *Shari'ah* upon which all other sources founded their authority. Literally, the word *Qur'an* is derived from the Arabic root word, *qara'a* which means to read or to recite.The *Qur'an* is a verbal noun and hence, it means the act of reading or recitation. Technically, the *Qur'an* has been defined as the speech of Allah (s.w.t.), sent down upon the last Prophet Muhammad (p.b.u.h.), in its precise meaning and precise wording, transmitted to us by numerous persons (*tawatur*), both verbally and in writing. It is inimitable and unique in its style. To sustain these special attributes, it is protected by God from any corruption.

Qur'an is the speech of Allah (s.w.t.), revealed to the Prophet Muhammad (p.b.u.h.) in its precise meaning and wording, and transmitted to us by way of *tawatur*.

The Legal Injunctions of the *Qur'an* (*Ayat Al-Ahkam*)



The legal injunctions of the *Qur'an* are the fundamental sources of the *Shari'ah*. They are contained in the legal verses of the *Qur'an*, considered the code of conduct for Muslims in all spheres of their life. These verses provide the criteria to distinguish true from false, good from bad and the *halal* (lawful) from the *haram* (unlawful) in every aspect of life. The *Qur'an* does not provide detailed rulings on many issues, only selected issues are elaborated in detail. In addition, there are many general principles provided by the *Qur'an*, which can be utilised as guidance to resolve many contemporary issues.

Exhibit 5.2 Example of Legal Verses in the *Qur'an*

Some examples of the legal verses in the *Qur'an* are as follows:

"And do not eat up your property among yourselves for vanities, nor use it as bait for the judges, with intent that ye may eat up wrongfully and knowingly a little of (other) people's property." (*Al-Qur'an,* 2:188).

"O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justice between you. Let not the scribe refuse to write as Allah (s.w.t.) has taught him, so let him write. Let him (the debtor) who incurs the liability dictate, and he must fear Allah (s.w.t.), his Lord, and diminish not anything of what he owes. But if the debtor is of poor understanding, or weak, or is unable himself to dictate, then let his guardian dictate in justice. And get two witnesses out of your own men. And if there are not two men (available), then a man and two women, such as you agree for witnesses, so that if one of them (two women) errs, the other can remind her. And the witnesses should not refuse when they are called on (for evidence). You should not become weary to write it (your contract), whether it be small or big, for its fixed term, that is more just with Allah (s.w.t.); more solid as evidence, and more convenient to prevent doubts among yourselves, save when it is a present trade which you carry out on the spot among yourselves, then there is no sin on you if you do not write it down. But take witnesses whenever you make a commercial contract. Let neither scribe nor witness suffer any harm, but if you do (such harm), it would be wickedness in you. So be afraid of Allah (s.w.t.); and Allah (s.w.t.) teaches you. And Allah (s.w.t.) is the All-Knower of each and everything." (*Al-Qur'an,* 2:282).

The *Sunnah* (Traditions of the Prophet (p.b.u.h.))

Sunnah is what is narrated from the Prophet (p.b.u.h.) including his actions, sayings and tacit approvals.

The second source of *Shari'ah* is the *Sunnah*. All the scholars of Islam are in agreement that the *Sunnah* is the second textual source after the *Qur'an*. The word *Sunnah* literally means clear path or beaten track. It also refers to normative practice or an established course of conduct/behaviour passed on from generation to generation. Technically, the *Sunnah* refers to all that is narrated from the Prophet (p.b.u.h.), including his actions, sayings and whatever he has tacitly approved.

The authority of the *Sunnah* is deduced from the *Qur'an* through several injunctions which command the believers to follow the instructions and injunctions from the Prophet (p.b.u.h.). The *Qur'an* says:

"And whatever the Messenger gives you, take (observe) it and whatever he forbids you, abstain from it" (*Al-Qur'an,* 59:7).

In another verse the *Qur'an* says:

"Obey Allah (s.w.t.) and obey the Messenger and those who are in charge of affairs among you. Should you happen to dispute over some matters, then refer it to Allah (s.w.t.) and to the Messenger" (*Al-Qur'an,* 4:59).

Exhibit 5.3 Classifications of the *Sunnah*

There are numerous classifications of the *Sunnah* and one of the important classifications is based on the level of reliability and authenticity of the *Sunnah*. This classification is based on the strength of the chain of narrators who had narrated the *Sunnah*. In this sense, the *Sunnah* can be divided into three:

1. ***Al-Mutawatir***

   Al-Mutawatir can be defined as a tradition of the Prophet (p.b.u.h.) which is reported by a large number of narrators whose agreement upon a lie is consumable and not plausible. For example:

   "*Whoever tells a lie against me intentionally, then (surely) let him occupy his seat in Hell-fire*." (*Sahih al-Bukhari,* Hadith No. 108)

   According to the majority of '*ulama*, the authority of a *mutawatir hadith* is equivalent to the *Qur'an*. This *hadith* denotes certainty (*yaqin*) which must be relied upon in deriving rulings, as there is no doubt that it actually came from the Prophet. Thus whoever denies this type of *Sunnah* may be considered as a disbeliever or involved in *kufr*.

2. ***Al-Mashhur***

   Al-Mashhur hadith is defined as a *hadith* which is originally reported by one, two or more companions from the Prophet (p.b.u.h.) or from another companion but has later become well-known and transmitted by an indefinite number of people. The agreement upon a lie could be suspected but scholars at large have received it as accepted and have acted upon it. It denotes confidence which means a lessser degree of certainty than *mutawatir*. The *hadith* reported below is an example of this type of *Sunnah*.

   "*The killer shall not inherit.*" (*Sunan Ibn Majah, Hadith* No. 2645)

3. ***Al-Ahad***

   Also known as *Khabar Al-Ahad*, it is a *hadith* which is reported by a single person or by an odd individual from the Prophet (p.b.u.h.). According to *Shafi'i*, *hadith ahad* refers to *khabar al-khassah*, which applies to every report narrated by one, two or more persons from the Prophet (p.b.u.h.) but which fails to fulfil the requirements of either *mutawatir* or *mashhur*.

Functions of the *Sunnah* in Relation to the *Qur'an*

The *Sunnah* as the second primary source of Islamic law further complements the *Qur'an* in three ways. Firstly, the *Sunnah* explains and further elaborates the meanings of the *Qur'an*. It provides explanation to the exact meaning of *Qur'anic* text or gives *tafsir* to the *Qur'an*. For example, the text in the *Qur'an* which mentions the obligation to pray is stated in brief. No detailed explanations were provided as to how many times to pray and how to conduct the prayer. In the case of *zakat*, the *Qur'an* does not mention

Functions of *Sunnah*
1 Explains and elaborates the meanings of the *Qur'an*.
2 Supports the rulings that are stated in the *Qur'an*.
3 Acts as an independent source of Islamic law.

the types of properties about which *zakat* should be paid, and when and to whom it should be paid.

Secondly, the *Sunnah* supports the rulings already stated in the *Qur'an*. For example, the *Qur'an* reads with regard to the sanctity of ownership of properties: "*And do not eat up your property among yourselves by false means/ways.*" (*Al-Qur'an,* 2:188). The *Sunnah* that comes to support the text carries the same meaning: "*The property of a Muslim is prohibited for another Muslim except by his consent.*"

The third function of the *Sunnah* is it acts as an independent source of Islamic law. This means that the Prophet (p.b.u.h.) initiated the rules where the *Qur'an* was silent on certain matters. An example of that is the prohibition for men to wear silk and gold.

Ijma'

The third source of Islamic law is *ijma'*. Unlike the *Qur'an* and the *Sunnah*, *ijma'* does not directly partake in the divine revelation. As a principle and evidence of Islamic law, *ijma'* is rational evidence and binding proof. Literally, *ijma'* is the verbal noun of the Arabic word *ajma'a* which means, "to determine and to agree upon something".

Technically, *ijma'* is defined by *Al-'Amidi* (d. 615AH/1218CE) as the unanimous agreement of the *mujtahidin* of the Muslim community of any period following the demise of Prophet Muhammad (p.b.u.h.) on any matter. This definition includes the agreement on all matters pertaining to Islam whether they are in relation to belief or moral, or legal matters.

The Authority of *Ijma'*

Ijma' is the unanimous agreement of the *mujtahidin* of the Muslim community of any period following the demise of Prophet Muhammad (p.b.u.h.) on any matter.

The scholars of Islamic law have justified the utilisation of *ijma'* on the authority of the *Qur'an*, *Sunnah*, and reason. However, it should be noted that they have on the whole, maintained the view that the textual evidence in support of *ijma'* does not amount to a conclusive and decisive proof but rather, an indication of the utilisation of *ijma'*.

Requirements of *Ijma'*

Scholars have put a standard for the process of *ijma'* by placing certain requirements in order for *ijma'* to be valid. These requirements are:

Exhibit 5.4 *Qur'anic* and *Sunnah* Justification on the Authority of *Ijma'*

The following verses are mentioned in support of *ijma'*:

وَٱعْتَصِمُوا بِحَبْلِ ٱللَّهِ جَمِيعًا وَلَا تَفَرَّقُوا وَٱذْكُرُوا نِعْمَتَ ٱللَّهِ عَلَيْكُمْ إِذْ كُنتُمْ أَعْدَآءً فَأَلَّفَ بَيْنَ قُلُوبِكُمْ فَأَصْبَحْتُم بِنِعْمَتِهِۦٓ إِخْوَٰنًا
وَكُنتُمْ عَلَىٰ شَفَا حُفْرَةٍ مِّنَ ٱلنَّارِ فَأَنقَذَكُم مِّنْهَا كَذَٰلِكَ يُبَيِّنُ ٱللَّهُ لَكُمْ ءَايَٰتِهِۦ لَعَلَّكُمْ تَهْتَدُونَ ﴿١٠٣﴾

And hold fast, all together, by the rope which Allah (stretches out for you), and be not divided among yourselves; and remember with gratitude Allah's favour on you; for ye were enemies and He joined your hearts in love, so that by His Grace, ye became brethren; and ye were on the brink of the pit of Fire, and He saved you from it. Thus doth Allah make His Signs clear to you: That ye may be guided. (*Al-Qur'an*, 3:103)

كُنتُمْ خَيْرَ أُمَّةٍ أُخْرِجَتْ لِلنَّاسِ تَأْمُرُونَ بِٱلْمَعْرُوفِ وَتَنْهَوْنَ عَنِ ٱلْمُنكَرِ وَتُؤْمِنُونَ بِٱللَّهِ وَلَوْ ءَامَنَ أَهْلُ ٱلْكِتَٰبِ
لَكَانَ خَيْرًا لَّهُم مِّنْهُمُ ٱلْمُؤْمِنُونَ وَأَكْثَرُهُمُ ٱلْفَٰسِقُونَ ﴿١١٠﴾

Ye are the best community that hath been raised up for mankind. Ye enjoin right conduct and forbid indecency; and ye believe in Allah (s.w.t.). And if the People of the Scripture had believed it had been better for them. Some of them are believers; but most of them are evil-doers. (*Al-Qur'an*, 3:110)

وَمَن يُشَاقِقِ ٱلرَّسُولَ مِنۢ بَعْدِ مَا تَبَيَّنَ لَهُ ٱلْهُدَىٰ وَيَتَّبِعْ غَيْرَ سَبِيلِ ٱلْمُؤْمِنِينَ نُوَلِّهِۦ مَا تَوَلَّىٰ وَنُصْلِهِۦ جَهَنَّمَ وَسَآءَتْ مَصِيرًا ﴿١١٥﴾

And who so opposeth the messenger after the guidance (of Allah (s.w.t.)) hath been manifested unto him, and followeth other than the believer's way, We appoint for him that unto which he himself hath turned, and expose him unto hell - a hapless journey's end! (*Al-Qur'an*, 4:115)

Ijma' is also supported by the sayings from the Prophet (p.b.u.h.), when he said:

"*My community shall never agree on an error.*" (*Sunan Ibn Majah, Hadith* No. 3950)

1. There are a number of qualified scholars available at the time the issue is encountered.
2. All the scholars, regardless of their locality, race, colour and school of affinity must reach a consensus on a juridical opinion at the time an issue arises.
3. The agreement of the scholars must be demonstrated by their expressed opinion on a particular issue. The expression may be verbal or in writing.

The Possibility of Exercising *Ijma'*

The majority of scholars are in agreement that *ijma'* occurred during the time of the companions particularly during the period of the Rightly Guided *Khulafa'* (*Khulafa' Al-Rashidun*). During their time, most of the scholars among the companions were residing in Madinah therefore making it easy for them to meet and discuss any issues that may arise within the Muslim community. Abu Bakar and 'Umar were reported to have gathered the companions in order to reach an agreement on issues pertaining

to Islam. They also disallowed scholars among the companions to migrate and reside outside Madinah as they needed to discuss with the scholars on matters pertaining to Islam.

After the period of the Companions, with the expansion of the Islamic Empire, a number of scholars chose to settle in other areas such as Kufah in Iraq and Sham. This became an obstacle for them to get together and reach a consensus on issues in Islamic law. Individual *ijtihad* flourished during this time and many scholars established their own methodology of deducing the rulings of *fiqh* which resulted in the formation of different schools of Islamic law (*madhhab*). The tendency to uphold *ijma'* had gradually weakened and according to some scholars, *ijma'* in its exact meaning was not exercised after the Rightly Guided Caliph period.

As for the move to revive and reform *ijma'*, at present, there are no serious attempts to reintroduce *ijma'* in its actual sense. However, the different platforms which exist at present such as the *Majma' Al-Fiqhi Al-'Alami* and the different councils of *fatwa* should study the possibility of introducing an authoritative body which can be recognised to represent the Muslim *ummah*. By virtue of that, such authority could issue legal *fatwas* which can be considered binding upon the Muslim *ummah*.

Qiyas (Analogical Deductions)

Qiyas is the extension of a *Shari'ah* value from the original case (*asl*), to a new case (*far'*) because the latter has the same effective cause (*'illah*) as the former.

The fourth principal source of Islamic law as agreed by scholars to be a rational tool for deducing the rulings of *fiqh* is *qiyas* (analogical reasoning). Literally, *qiyas* means, "measuring or ascertaining the length, weight or quality of something". Technically, it is defined as the extension of a *Shari'ah* value from the original case, or *asl*, to a new case, because the latter has the same effective cause (*'illah*) as the former. The original case is ruled by the text either from *Qur'an* or *Sunnah* and *qiyas* aims to extend the same ruling to the new case based on the shared *'illah*. Being an extension of the existing law, *qiyas* discovers and develops the existing law but does not create a new law. In fact, it widens the application of law contained in the text.

The Pillars of *Qiyas*

There are several pillars (*arkan*) of *qiyas* considered as the essential requirements in exercising *qiyas*. These pillars are:

1 The original case, or *'asl*, is a case about which a ruling is given in the text (i.e., the *Qur'an* or *Sunnah*) and analogy seeks to extend it to a new case.

2 The new case, or *far'*, on which a ruling is needed. *Qiyas* is the extension of the same ruling which is applied in the original case.

3 The effective cause, or *'illah*. Although it is an attribute of the original case, it is found to be commonly shared between the original case and the new case.

4 The rule (*hukm*) governing the original case is to be extended to the new case.

Pillars of *qiyas*:
1 Original case (*asl*)
2 New case (*far'*)
3 Effective cause (*'illah*)
4 Ruling (*hukm*).

Exhibit 5.5 The Authority of *Qiyas*

There are no clear authorities of *qiyas* in the *Qur'an*. However, there are several evidences in the *Sunnah* of the Prophet (p.b.u.h.) which indicate that he resorted to *qiyas* on occasions when he did not receive a revelation on a particular matter. One such occasion happened when a woman came to the Prophet (p.b.u.h.) and said that her father had died without performing the *hajj*. The woman then asked if it would benefit him if she performs the *hajj* on her father's behalf? The Prophet told her: "Supposing your father had a debt to pay and you paid it on his behalf, would this benefit him?" To this, her reply was affirmative and the Prophet (p.b.u.h.) said, "The debt owed to Allah merits even greater consideration." (*Sunan al-Daraqutni*, *Hadith* No. 111).

Exhibit 5.6 Applying *Qiyas* in Islamic Finance

To demonstrate all these requirements in relation to Islamic finance, the *Qur'anic* verses in *Surah Al-Baqarah* that clearly forbids usury can be used as a clear example. Allah (s.w.t.) said:

> *Those who devour usury will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the Fire: They will abide therein (for ever). Allah will deprive usury of all blessing, but will give increase for deeds of charity: For He loveth not creatures ungrateful and wicked.* (*Al-Qur'an*, 2:275–276).

If this prohibition was to be extended by analogy to modern currencies of the same genus, the four pillars of analogy in this example would be:

1 The original case: prohibition of usury in exchange of gold and silver.

2 The new case: modern currencies.

3 The effective cause: medium of exchange.

4 The rule: prohibition of usury in exchange of modern currencies.

There are a number of conditions for each of the four essential requirements of the analogy laid down by the scholars in order to ensure propriety and precision in the application of *qiyas*.

Istihsan

Istihsan is a legal principle which authorises a departure from an established precedent in favour of a different ruling for a reason stronger then the one obtained in that precedent.

The word *istihsan* literally means, "to approve or to deem something preferable, to consider something as good". Technically, as defined by *al-Kharkhi*, *istihsan* is a legal principle which authorises departure from an established precedent in favour of a different ruling for a reason stronger than the one which is obtained in that precedent.

Thus, the essence of *istihsan* is to formulate a decision which sets aside an established analogical reasoning for a reason justifying such a departure and seeks to uphold a higher value in the *Shari'ah*.

The principle of *istihsan* was approved by Hanafi, Maliki and Hanbali scholars but disapproved by Shafi'i scholars as it is regarded as being too independent from the *Qur'an*, *Sunnah* and *ijma'*.

Exhibit 5.7 Examples of *Istihsan*

In the case of *waqf* property, the transfer of the property by *waqf* includes also the transfer of all the ancillary rights of water, passage and flow. According to the usual principle of *qiyas*, by making an analogy of *waqf* to the sale contract, all the rights are not included because in sale, all the subject matters must be clearly identified. If the *waqif* (person who grants the *waqf*) did not mention specifically the rights, they will not be included in *waqf*. However, by *istihsan*, an analogy between *waqf* and contract of lease (*ijarah*) could be made, because both involved a transfer of usufruct (*intifa'*). Therefore, by *istihsan* all the above rights will be included in *waqf* although they are not specified in the contract of *waqf*.

Istishab

Istishab refers to the facts or rules of law, whose existence or nonexistence had been proven in the past, and are presumed to remain due to the lack of evidence to establish any change.

Istishab literally means, "companionship". Technically, *istishab* indicates the facts, or rules of law and reason, whose existence or nonexistence had been proven in the past are presumed to remain so for lack of evidence to establish any change.

Authority for *Istishab*

The principle of *istishab* is supported by the *Qur'an* and *Sunnah*:

1 From the *Qur'an*:

> "*Say: I did not find in the revelation I received anything forbidden (to be eaten) to anyone who wishes to eat, unless it is dead meat, blood poured forth or the flesh of swine.*" (*Al-Qur'an*, 6:145)

In this *Qur'an*ic verse, it could be understood that everything is presumed to be permissible unless prescribed otherwise. This gives support to the principle of *istishab*.

2 From the *Sunnah*:

> *"If any of you feel something in his stomach such that it is unclear to him, whether something has come out or not, then he should certainly not leave the mosque, unless he hears a sound or smells an odour."*
> (*Sahih Muslim*, *Hadith* No. 831)

This *hadith* shows that a person with ablution is presumed to be in the state of ablution until he is certain that the ablution has been invalidated. This supports the principle of *istishab*. One of the examples of *istishab* is when a person is known to be indebted to another, he is presumed such until it is proven that he settled the debt or was acquitted of it.

Maslahah Mursalah (Public Interest)

Maslahah, literally means, "benefit or interest". When it is narrowed to *maslahah mursalah*, it indicates unregulated public interest in the sense of not having been regulated by the Lawmaker as no textual authority can be found on its validity or otherwise. *Al-Ghazali* (d. 505AH/1111CE) defined *maslahah* as the consideration which secures a benefit or prevents harm but is, at the same time, harmonious with the aims and objectives of the *Shari'ah*. These objectives consist of protecting the five essential values, namely religion, life, intellect, lineage and property. According to him, any measure which secures these values falls within the scope of *maslahah* and anything which contravenes them is *mafsadah* (evil) and preventing the latter is also *maslahah*.

Maslahah mursalah is the unregulated public interest, in which no textual authority can be found on its validity or invalidity.

The Authority of Maslahah Mursalah

There are no specific texts of the *Qur'an* or the *Sunnah* which indicate the legality of the usage of *maslahah mursalah*. However, there are many general verses and practices of the Prophet (p.b.u.h.) which can be quoted as the basis of *maslahah*. Among the verses are:

> *"And We have sent you (O Muhammad (p.b.u.h.)) not but as a mercy (rahmatan) for the 'alamin (mankind, jinns and all that exists)."*(21:107)

The general explanation of the word "*rahmatan*" in the above verse will include whatever offer that would benefit mankind, prevent harm and be harmonious with human needs. Consideration of public interest will definitely lead to the benefit of mankind.

Conditions for the Validity of *Maslahah*

Conditions of a valid *Maslahah Mursalah*.
Maslahah must be:
I. Genuine (*haqiqiyyah*)
II. General (*kulliyyah*)
III. In accordance with a principle or value prescribed in the *Qur'an*, *Sunnah* or *ijma'*.

The jurists have also set certain conditions that must be met by the prescribed *maslahah* in order for it to be valid. The following conditions are designed to ensure that *maslahah* does not become an instrument of arbitrary desire or individual bias in legislation:

1 *Maslahah* must be genuine (*haqiqiyyah*), as opposed to imaginary *maslahah* (*maslahah wahmiyyah*), which is not a proper ground for legislation. There must be a sensible probability that the benefits of legislating a rule in the pursuance of *maslahah* outweigh the harms that might accrue from it. An example of an imaginary *maslahah*, according to some scholars is to abolish the husband's right of *talaq* by vesting it entirely in a court of law.

2 *Maslahah* must be general (*kulliyyah*) which means it prevents harm or secures benefit to the people as a whole and not to a particular person or group of persons. This indicates that legislating a rule on the grounds of *maslahah* must consider a benefit to the largest possible number of people. This is because the whole concept of *maslahah* is meant to secure the welfare of the people at large.

3 Finally, *maslahah* must not be in conflict with a principle or value which is upheld by the *Qur'an*, *Sunnah* or *ijma'* (scholar's consensus of opinion).

Sadd al-Dhara'i (Blocking the Means to an Evil)

Sadd al-Dhara'i is defined as blocking the means to an expected evil end which is likely to materialise if such a means is not blocked.

Sadd literally means, "blocking" and the word *dhara'i*, which is the plural of *dhari'ah* (synonymous to *wasilah*) signifies the means of obtaining a certain end. *Sadd al-dhara'i* thus indicates blocking the means to an expected end which is likely to materialise if such a means is not blocked. The means that is to be blocked in this context is the means to evil, i.e., the means to something not good. An example of *sadd al-dhara'i* is the usage of credit cards for those who are certain of not being able to repay the credited amount taken at the due date. This would eventually lead to the accumulation of debt and will normally harm a person in one way or another. Thus, it can be considered forbidden if the harmful effect is certain. The ruling will differ from one individual to another.

The Authority of *Sadd al-Dhara'i*

The authority of *sadd al-dhara'i* can be found in the *Qur'an* in the following verse:

> "*And do not abuse those whom they call upon besides Allah, lest exceeding the limits they should abuse Allah out of ignorance.*" (*Al-Qur'an*, 6:108)[2]

In the above verse, Allah (*s.w.t.*) prevented the Muslims from cursing the object that is worshipped by non believers. The essence is to block the means for them to curse Allah (s.w.t.) which is an act of evil. Therefore, all the steps should be taken to block any kind of evil that might occur.

'Urf (Customary Practice)

'*Urf* literally means, "to know". It can be defined in technical terms as the behaviour of a group of people in their sayings or doings.

'Urf is the behaviour of a group of people in their sayings or doings.

The Authority of 'Urf

The majority of scholars (*jumhur*) recognise '*urf* as a supportive source of the *shari'ah*. They quote several evidences to support their views. The following shows some of the evidences.

1 The verse from the *Qur'an* usually quoted in support of '*urf* is:

"*Keep to forgiveness, enjoin 'Urf and turn away from the ignorant.*" (*Al-Qur'an*, 7:199)

Many exegeses suggested that the meaning of '*urf* in this verse is synonymous to *ma'ruf* which means anything that is good. Mustafa al-Zarqa, in discussing the proof of '*urf*, maintains that the word '*urf* in this verse can be taken as a proof of '*urf* through its literal meaning which is "the good deed which is acceptable."

2 The *hadith* reported by *A'ishah* (r.a). She said: "Hind, the daughter of '*Utbah*, wife of Abu Sufyan, came to Allah's Messenger and said: 'Abu Sufyan is a miserly person. He does not give adequate maintenance for me and my

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2 In the early years of preaching, some of the believers, while arguing with the infidels, did not use discreteness and the skill of spiritual teachers like the Holy Prophet (p.b.u.h.) and in the heat of dispute, resorted to harsh language. When the idolaters of Mecca went to Abu Talib and sought his mediation to stop the show of disrespect to their idols, this verse was revealed. Islam combats against what is wrong and unpardonable (Luqman: 13 and Nisa: 116) through spiritual light so as to dispel darkness and show the right path. Although idolatry has been condemned, yet condemnation of the weakness of the opponents has been discouraged in order that the infidels may not, as a reaction, persist in their self-obsession, and persistently refuse to see the light of guidance. Kind words and show of compassion has brought many an adversary to the fold of Islam. Moreover, Allah (s.w.t.) does not want that through the uncivilised behaviour of the believers, His most glorious name is drawn into mud-slinging.

children, but (I am constrained) to take from his wealth (part of it) without his knowledge. Is there any sin for me?' Thereupon Allah's Messenger said: 'Take from his property what is customary (*ma'ruf*) which may suffice for you and your children.'" (*Sunan Abu Dawud*, *Hadith* No. 3534)

Ibn Hajar al-Asqalani (d. 975AH/1567CE), the famous commentator on the *Sunnah*, comments on this *hadith* by saying that *al-ma'ruf* in this *hadith* means the amount that is known to be enough by *'adah* (custom). He further held that this *hadith*, too, indicates that *'urf* should be relied upon in matters where the *Shari'ah* does not give the exact details.

Conditions of a Valid *'Urf*

Muslim scholars have laid down the conditions that must be fulfilled in a customary practice in order to consider it as a valid *'urf*. Besides being reasonable and acceptable to the people with wise reason and sound behaviour, *'urf* must fulfil certain requirements in order to be authoritative. These are:

Conditions of a valid *'Urf:*
1 Must be a common and recurrent phenomena
2 Must be dominant
3 Must be in existence at the time the transaction is concluded
4 Must not contravene the clear stipulation of an agreement
5 Must not be in conflict with the *Qur'an* or *Sunnah*

1 *'Urf* must represent a common and recurrent phenomena. This means that the *'urf* must be practised by the people frequently in their daily life. The practice of a few individuals or a limited number of people within a large community will not be authoritative. In addition, the practices, which are commonly mentioned in the books of *fiqh*, but not practised by the people, cannot be the basis of a legal decision. An example is that if a sale is concluded in a city where two or three currencies are commonly accepted and the contract in question does not specify the currency that will be used, the one that is the more dominant and common will be deemed applicable.

2 In order for a custom to be authoritative, it must also be dominant in the sense that it is observed in all or most of the cases to which it can apply. If it is observed in some cases but not in others, it is not authoritative. Similarly, if there are two different customary practices on the same matter, the one which is dominant will be upheld. In the event of an incident where a customary practice is performed by some people and not by others, and the amount of both are equal, it cannot form the basis of judicial decisions.

3 The custom must be in existence at the time the transaction is concluded. This means in order for *'urf* to be considered as a basis for judicial decisions, the practice must be prevalent at the time the transaction is concluded and

not an extinct customary practice. This condition is particularly relevant to the interpretation of documents or sayings, which are to be understood in the light of the custom that prevailed at the time they were written or uttered. In this respect, if the customary meaning changes after the transaction has been concluded and if there arises a problem concerning the interpretations and implications of the transaction, it must be referred to the customary meaning related to the time the transaction was concluded and not the eventual customary meaning that occurred later. As an example: if a person said that he intends to make a bequest (*wasiyyah*) of part of his property to an '*alim* (scholar), and the customary meaning of this word at that time refers to those who are experts in religious matter, part of his inheritance must be given to those who are experts in religious matters, albeit, the same word might be used, customarily, for people who are expert in any field and not necessarily to the experts in religious matters. Similarly in *al-'urf al-fi'li*, the customary practice considered is the practice that exists when the transaction was concluded. An example is that the determination of the date of a transaction is considered according to the practice of the place, whether the *Hijri* (Islamic calendar) date or the Christian calendar is used.

4 The custom must not contravene the clear stipulation of an agreement. A custom can only be applied if there is no contractual agreement made in a particular transaction. This is because a custom is only the equivalent of an implied condition. It will not be valid if it is contrary to an explicit condition. The general rule is that contractual agreements prevail over customs. Should a conflict arise between them, it will normally be determined in favour of the former. An example is that the costs of a formal registration in the sale of real property are customarily payable by the purchaser. But if there is a stipulation in the contract that specifically requires the vendor to bear these costs, then the custom would be of no avail and the purchaser would not be required to pay these costs.

5 Finally, the custom must not be in conflict with the *Qur'an* or *Sunnah* (*nass*). The conflict of custom to the *nass* may be absolute or partial. In cases of absolute conflict, the custom will have no effect because texts override customs. Examples of such conflicts are the practices of usury (*riba*). Although

it is widely practised, it has no legal validity, because the presence of usury contradicts with the explicit text. However, if the conflict between the custom and the text is not absolute, where custom opposes only certain aspects of the text, then the custom is allowed to act as a limiting factor on the text.

Maqasid Al-Shari'ah vis-à-vis Islamic Finance

The idea or doctrine of *maqasid al-shari'ah*, or higher objectives of Islamic law, has gradually captured the attention of increasing numbers of modern Muslim scholars for solving contemporary issues. This idea provides a guide and framework for the process of *ijtihad* to solve issues conforming to human interests while complying with the will of the Lawmaker. Ibn Ashur defined *maqasid* as "the deeper meanings and inner aspects of wisdom (*hikam*) considered by the Lawgiver in all or most of the areas and circumstances of legislation". He also explained the importance of the knowledge of *maqasid al-shari'ah* for *mujtahids* not only in understanding and interpreting the texts of *Shari'ah*, but also to find solutions to the new problems facing Muslims and about which those texts are silent.

Maqasid is the deeper meanings and inner aspects of wisdom (*hikam*) considered by the Lawgiver in all or most areas and circumstances of legislation.

Basically, the main objective of *Shari'ah* is to govern human lives and to protect the interests and benefits (*maslahah*) of the people. *Maslahah* in the Islamic context and perspective means what is good and beneficial in the eye of the *Shari'ah*. According to al-Ghazali, the higher objectives of Islamic law consist of two types:

1 **Religious or spiritual (*dini*) objective pertaining to the Hereafter**
This purpose, which revolves around the preservation and promotion of religious faith, is the utmost and ultimate purpose of *Shari'ah*. In its aggressive or positive aspect, the interest of religion is secured by facilitating ritual worship of God and establishing the pillars of Islam, like fasting, prayers, pilgrimage, and paying *zakat*. In its defensive or negative aspect, it entails defending religion, as it prevents the established pillars of Islam from being undermined or destroyed.

2 **Worldly objectives (*dunyawi*) pertaining to mundane affairs of this world**
This includes the worldly interests and encompasses four major objectives. In accordance with their importance and order of priority, these objectives consist

Two types of *maqasid al-shariah* according to al-Ghazali:
1 Religious (*dini*) objective pertaining to the Hereafter, i.e., preservation and promotion of religious faith.
2 Worldly (*dunyawi*) objectives pertaining to mundane affairs of this world. This includes the preservation and promotion of human life (*al-nafs*), intellect (*al-'aql*), progeny and offspring (*al-nasl*), and property (*al-mal*).

Exhibit 5.8 ***Maqasid Al-Shari'ah*** **and Personal Financing**

Maqasid al-shari'ah as defined by Ibn 'Ashur means "the deeper meanings and inner aspects of wisdom (*hikam*) considered by the Lawgiver in all or most of the areas and circumstances of legislation." With reference to wealth and property management, it is the ultimate objective of *Shari'ah* to protect property with proper management and distribution of wealth. Hence, all the rulings relating to property seek to establish the protection of property and to ensure justice in property management in various types of transactions.

Since the early establishment of Islamic banking, equity-based financing on a *musharakah* and *mudarabah* basis had always been promoted as the modes of financing which involve real economic activities and hence are closer to the realisation of *maqasid al-shari'ah* in property protection. Debt-based financing which is based on sale or *ijarah* contracts, particularly for consumption purposes like personal financing through *Shari'ah*-compliant products, as claimed by some scholars is not in line with *maqasid al-shari'ah.* Personal financing is also perceived as a mode of financing which encourages people to incur debt and live beyond their means. Although personal financing is based on sale transactions, it has the element of debt, whereby the customer needs to pay more than the financed amount within a certain period of time, which in turn resembles the features of *riba*. In Malaysia for example, *bay' al-'inah* has been widely used to offer personal financing. The controversy over *bay' al-'inah* adds to the criticisms over personal financing.

One question which might be relevant to ask is, while it is accepted that equity-based financing is more favourable, does it mean it should be to the exclusion of sale or debt-based financing? Or are they both alternatives for *riba,* equally acceptable by *Shari'ah?*

Allah (s.w.t.) has made it clear that while *riba* is prohibited, sale (which is the main contract in debt-based products) is highly recommended. Allah (s.w.t.) put both *riba* and sale as a contradistinction: "Those who devour usury *(riba)* will not stand except as one whom the Evil one by his touch hath driven to madness. That is because they say: 'Trade is like usury,' but Allah (s.w.t.) hath permitted trade and forbidden usury". The pagan Arabs fell into the fallacy when they considered sale and *riba* as equals. For them, if a person can sell cloth, for example, worth 10 dinar for 12 dinar, reasonably there is no distinction with the one who exchanges 10 dinar with 12 dinar. This *Qur'anic* verse had refuted and denied the equality between the two and emphasised that Allah (s.w.t.) only permits sale and prohibited *riba*. Thus, even from the early period when the *Qur'an* denounced *riba,* sale was promoted as its alternative.

The above might be an argument for personal financing based on sale contracts like *'inah* or *tawarruq*. Moreover, in most situations, the customers are in real need of cash for some legitimate purposes. Since both *'inah* and *tawarruq* are allowed in Malaysia, at least, personal financing based on these two contracts is *Shari'ah*-compliant. However, excessive reliance on personal financing in banking products might also hamper the *maqasid al-shari'ah* in the prohibition of *riba* itself.

of the preservation and promotion of human life (*al-nafs*), intellect (*al-´aql*), progeny and offspring (*al-nasl*), and property (*al-mal*).

It is interesting to note that wealth is part of the aspects that the *Shari'ah* seeks to protect. From the aforementioned hierarchy of the worldly objectives, wealth was placed at the bottom of the human needs structure. This, however, does not in any way show that Islam does not put much weight on worldly material gains in the form of properties. It only presents Islamic worldview on wealth as a means or method instead of the ultimate objective. In Islam, property is viewed as an *amanah* from Allah (s.w.t.) to be used as a tool to attain the ultimate objective, to obtain Allah's pleasure.

Legal Maxims Pertinent to Islamic Finance

Legal maxims are general *fiqh* rules and principles which are presented in a simple format.

Legal maxims are general rules which apply to all related particulars. They are a group of questions of jurisprudence under certain general rules, each one of which embraces a large number of questions.

Mustafa Al-Zarqa, one of the most prominent contemporary scholars, defined legal maxims as the general *fiqh* principles which are presented in a simple format consisting of the general rules of *Shari'ah* in a particular field related to it. The function of legal maxims is to facilitate the understanding of how problems and principles could be used to deduce the many rules of *fiqh*. Legal maxims are formulated based on certain evidences from the *Qur'an* or *Sunnah*. For example, the *hadith*:

> *"The burden of proof is on him who claims, and the oath is on him who denies."*
> *(Sunan al-Tirmizi)*

Apart from direct proof from the two textual sources, legal maxims are also constructed upon primary and eternal principles, which are principles of pure justice or the natural law, upon which the interests of human beings are founded. These principles were established as good laws even before the Islamic era. They are eternal and universal principles of justice which do not differ from one society to another and these principles are generally confirmed by the *Shari'ah*.

The jurists in Islamic legal history acknowledged the importance of legal maxims in their writings, and discussed them under the title: the similitude and the like. As early as the era of the companions of the Prophet (p.b.u.h.), these maxims had been observed in their *ijtihad*. Caliph 'Umar, upon sending Abu Musa Al-Ash'ari as his governor commanded: know the semblances and the similitude and collate matters to their likes (in giving judgement).

The jurists throughout history have developed various Islamic legal maxims to solve many issues. Some of the maxims are wide enough to cover almost all issues by their general applications, whereas some others are applicable in certain fields and issues only. Legal maxims which provide for the general rules of *fiqh* indeed have a big role in modern Islamic banking and finance. Modern issues in Islamic finance which have no precedent from the classical texts arise from time to time and these issues need to be addressed according to Islamic rulings. Thus the solution is founded in the application of legal maxims to develop the parameters of Islamic banking and finance and its general principles.

Generally, five major legal maxims are considered as unanimously accepted maxims that cover most issues of *fiqh*. They are briefly explained in the following:

Five major legal maxims:
1 Matters are determined according to intentions.
2 Hardship begets facility.
3 Harm should not be inflicted nor reciprocated.
4 Certainty (*yaqin*) cannot be removed by doubt.
5 Customary practice as a basis of judgements.

1 Matters are determined according to intentions (*Al-'umur bi maqasidiha*)

This maxim originated from a famous *hadith* whereby the Prophet (p.b.u.h.) was reported to have said: "*Deeds are judged by intentions and every person is judged according to his intention*" (Al-Bukhari).

This maxim suggests that an act or words of a person has to be interpreted according to his intention in saying the words or doing the act. Words and acts serve only as manifestation of the intention. According to this maxim, only human acts that originate and stem from the doer's intention are considered. Thus, actions not arising from the doer's intention are not regarded.

Accordingly, all human acts, once done, must be valued in accordance with the intention. In other words, effect to be given to any particular transaction must be in accordance with the intent underlying such a transaction.

The intentions of the parties in a contract or transaction is relevant in determining its legal effect. An example of the application of this maxim in modern Islamic banking is the imposition of *ta'widh*. *Ta'widh* is the compensation paid by the bank's defaulting customers who intentionally or negligently refused to pay their obligations towards the bank. Thus, imposition of *ta'widh* was allowed on the basis of preventing intentional defaults by customers.

2 Hardship begets facility (*Al-mashaqqatu tujlab at-taysir*)

This legal maxim means, difficulty is to be accompanied by easiness. Thus, in times of urgency, laxity must be shown. It becomes necessary to lighten people's burden and to disregard general rules in certain exceptional circumstances if their application were to result in injury and hardship. Another similar maxim: "*Necessity renders prohibited things permissible*" carries the same meaning. An example of the application of this legal maxim is in the case of committing some prohibited act due to compelling needs. For instance, the general rule says a murderer must be killed, but if a person kills in defending himself from being killed, it is necessary to exempt him from the general rule. Whenever adherence to the law may result in injury or injustice, exceptions must be granted in order to avoid the injustice.

The basis for this maxim is founded in both the *Qur'an* and *Sunnah*. In *Surah Al-Hajj*, verse 78, Allah (s.w.t.) said: "*He (Allah) has not laid down upon you in religion any hardship*." In another verse (*Al-Qur'an*, 2:286), He said: "*Allah intends every facility for you, and he does not want to put you in hardship*." Another basis provided in the *hadith* whereby the Prophet (p.b.u.h.) said: "*Religion is facility*."

This legal maxim is found to be of important relevance in modern Islamic finance. An example is the permission to deal with conventional banks for the Muslim minority living in non-Muslim countries. In this case, they might be allowed to temporarily use conventional banking due to the compelling need whereby no Islamic financial facilities are available for products like residential financing. Another example is in compulsory insurance protection whereby no *takaful* product is available to protect against risk. If Muslims are not allowed to take the insurance, they might be subjected to certain hardships. In order to avoid the hardship, they might be allowed to take insurance to cover that particular risk temporarily.

However, it must be emphasised that, although facility is granted in situations of hardship, it is not absolute. Such facility must be limited to a certain extent in order to preserve the original rule. Thus, the permissibility granted due to hardship is limited by another maxim, that is: "*Necessity is estimated by the extent thereof*." Therefore, if permissibility is granted in cases of hardship, it must be granted up to the extent required for meeting that hardship. If a person is allowed to deal with conventional banking products due to necessity, the permission ceases with the availability of Islamic banking products.

3 Harm should not be inflicted nor reciprocated (*La darara wa la dirar*)

Basically, this maxim means injurious or harmful acts must be avoided and prevented in all cases. The maxim was found in a *hadith*: "*La darara wa la dirar*." (*Muwatta' Malik*) The first part of the *hadith* "*La darara*" (no harm should be inflicted) means that it is not permissible to cause or inflict injury or harm another person without a valid reason. The latter part of the *hadith*: "*Wa la dirar*" means it is also not permissible to cause injury in return for an injury caused to you without a proper legal channel. Injury or harm cannot be removed by another similar harm. If a rich person refused to pay *zakat* for example, you should not rob the person to take your right from him. This maxim is also cited as one of the basis for the imposition of *ta'widh* or compensation for late payment as allowed by Bank Negara Malaysia (BNM) as well as the Securities Commission. Based on this principle, the debtor's act of delaying payment which could harm the creditor must be avoided by having a compensation clause.

4 What is certain cannot be removed by doubt (*Al-yaginu la yuzalu bi ash-shakk*)
This legal maxim is pertinent in solving the cases of doubt. The principle states that a rule or situation which has been settled by certainty could not be removed by mere doubt. A settled rule is presumed to exist, until it is changed by a certain evidence to prove otherwise. Mere doubt could never change a rule which was established by certain evidence.

Another maxim closely related to this maxim states that: "*The origin of all things is permissibility*." It means all the things or creatures in this world are permissible for consumption or use by humans, unless Allah says otherwise. The *Qur'an* states in *Surah Al-Baqarah*, verse 29: "*And he has created for you every creation on earth.*" In a *hadith*, the Prophet (p.b.u.h) said: "*What is permitted by Allah in the* Qur'an *is* halal *and what is prohibited is* haram, *what is left unmentioned is permitted so accept the leave given by Allah, verily Allah does not forget anything*." These evidences support that issues not specifically addressed by the *Qur'an* must be referred back to the original rule of permissibility.

With reference to the development of modern Islamic banking and finance, this principle is of crucial importance. This is because it widens and paves the way for the innovation of different financial tools and instruments for financial transactions without necessarily finding the authority for their permissibility.

5 Customary practices as a basis of judgements (*Al-'adatu muhakkamatun*)
This legal maxim rules that customary practices of society in terms of their words and actions are acknowledged and recognised by the *Shari'ah* in the absence of textual injunctions, provided they have fulfilled the following requirements:

1 The custom must not violate a divine text of the *Qur'an* and *Sunnah* or any *Shari'ah* principles.

2 The custom must be consistently applied and prevailing in the society.

3 The custom must have been in effect at the time the activity or transaction was carried out.

4 The two contracting parties must not have agreed to a condition contrary to the customary practice. If they have agreed to the contrary, then the customary practice is not recognised.

The maxim is formulated based on several evidences from the *Sunnah*. Among them is the following *hadith* reported by A'ishah: Hind, the mother of Mu'awiyah, said to the Prophet (p.b.u.h.): "Abu Sufyan (Hind's husband) is a tight-fisted man. Is there anything wrong if I take money from him secretly?" The Prophet (p.b.u.h.) said: "*Take for yourself and your children to suffice your needs according to what is customary.*" (Sahih Al-Bukhari)

In another *hadith*, Ibn Mas'ud narrated that: "*What the Muslims determine to be good is good with Allah (s.w.t.)*" (Musnad Ahmad).

With reference to contemporary Islamic financial transactions, a good example which is deemed to be a valid customary practice by scholars is the acceptance of the definition used in spot trading for cross border transactions. Even though the common understanding for spot trading from the Islamic financial transaction's perspective is on the same day and within the contractual session (*majlis al-aqd*), the delay of two business days (t+2) has now been recognised as a spot transaction due to the prevalent market practice to facilitate the transfer of funds from one country to another.

Differences (*Ikhtilaf*) of Opinion Among Scholars

The differences of opinion among the jurists take place in all stages of the development of Islamic jurisprudence. The nature of textual evidences either from the *Qur'an* or *Sunnah* allows room for differences of opinion. These can be divided into two broad categories: firstly, those texts which are detailed in nature, providing for specified provisions with detailed information. The domain for this type of texts are issues which are not open for changes and development and are not subject to human interpretations, for example, transcendental matters like hell and paradise descriptions, some aspects in marriage like women

within the prohibited degree of marriage and provisions for each heir in inheritance. For these kinds of issues, the *Qur'an* provides detailed and fixed laws because they are not open for changes at different times and places. Therefore, standardisation is favourable in those issues.

On the other hand, the second type of texts are those which provide room for divergence. The texts within this type only provide brief information and general guidelines governing the issues which are subject to changes and developments according to different times and places as well as human experiences. Details and fixed laws are thus not favourable in these issues as they will cause rigidity and restrain development of the laws in the fields which are supposed to be dynamic and ever-changing. Islamic commercial and finance law is one of the best examples of this type of textual sources.

Thus, it is natural that Muslims across the eras and jurisdictions have differences of opinion in economic transactions law, even from the early stage of Islamic laws development in the hands of the early jurists. With regard to modern Islamic banking and finance, the difference across jurisdictions as well as among individual jurists is an acceptable fact. This is due to the fact that modern Islamic finance emerged amidst the complicated conventional system, striving to provide alternatives for Muslims.

The Prophet (p.b.u.h) said in support of *ijtihad* and divergence of opinion: *"If a judge/ jurist made a correct decision through ijtihad he shall be doubly rewarded, but if he errs he shall be rewarded once only"* (Al-Bukhari). This *hadith* is not only an encouragement for the jurists to exercise *ijtihad* but also implies the acceptability of the results of *ijtihad* if exercised within *Shari'ah* parameters and with a high level of professional integrity and diligence. It follows that the different, or even conflicting, outcomes of *ijtihad* by various jurists will be considered as equally true and applicable.

The next section will discuss the main reasons for divergence of opinion among the jurists. Basically, there are four main reasons for conflicting rulings among the jurists. As far as modern Islamic banking and finance is concerned, these reasons contributed to modern jurists' differences of opinion in their rulings on several issues in Islamic finance.

Variation in Understanding the Meaning of a Word in the Texts

The difference in interpreting the meaning of a word in a text leads to a difference of opinion among jurists. Sometimes the words in a text, either from the *Qur'an* or *Sunnah*, have more than one literal meaning. While some of the jurists might prefer certain meanings, others adopt the meanings besides those conceived by the former. This has given rise to differences in rulings.

Reasons for divergence of opinions:

1. Variation in interpreting the meaning of a word in the texts.
2. Differences over the narrations of the *Sunnah*.
3. Conflict in the application of principles.
4. Divergence in the method of *qiyas*.

An example which is relevant to Islamic finance is the meaning of the word gold and silver in a *hadith* relating to *riba* reported by Ubadah bin Samit that the Prophet (p.b.u.h.) said: *"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal and hand to hand, if the commodities differ, then you may sell as you wish provided that the exchange is hand to hand."* The scholars have different opinions whether gold and silver here mean real commodities or currencies as these two metals had been used as currency during the time of the Prophet (p.b.u.h.).

Differences Over the Narrations of the *Sunnah*

The decision over the narrations of the *Sunnah* also constitutes one of the main reasons which leads to the differences of opinion between the jurists. During the era of the great Imams, the *Sunnah* was not yet properly compiled. This manifested in the existence of different sources. Moreover, scholars have different criteria in accepting certain *hadith* as authentic or otherwise. In the field of the application of *hadith*, there also exists variations in interpretations.

To illustrate the above, the example of the different rulings on *bay' al-'inah* could be cited. *Bay' al-'inah* refers to a trading whereby the seller sells his asset to the buyer at an agreed selling price to be paid at a later date and afterwards he immediately buys back the same item from the original buyer at a cash price lower than the agreed selling price. The majority of the jurists rejected the validity of *bay' al-'inah* and considered it as a back door *riba* or using sales which at the end result in *riba*. This is based on some *hadith* whereby the Prophet (p.b.u.h.) condemned those practising this type of trading. For example, Abdullah Ibn 'Umar reported that the Prophet (p.b.u.h.) said: *"When men become frugal with money (gold and silver) and trade on the basis of 'inah and (when they) follow the tails of the cows and leave jihad in the path of Allah (s.w.t.), Allah (s.w.t.) will send down a trial that he would not remove until they revert to their religion."*

On the other hand, the Shafi'is and Zahiris approved the legality of *bay' al-'inah* on the basis of completion of all requirements of sales, irrespective of the intentions of the parties. The aforementioned *hadith* upon which the majority of scholars based their repugnant ruling regarding '*inah* was considered a weak *hadith* for this group of jurists.

Conflict in the Application of Principles

The jurists adopted certain general principles (*usul*) which were rejected by other jurists. This conflict in admissibility of principles, lead to the difference in legal rulings (*furu'*). For example, Imam Abu Hanifah admitted the principle of *istihsan* as one of his sources of *fiqh*. Contrarily, other Imams such as Imam al-Shafi'i rejected the principle, because for him, it is too independent of the *Qur'an*, *Sunnah* and *ijma*'. This gives rise to different results in their *ijtihad*s. On the other hand, Imam Malik regarded the practice of the people of Madinah as a source of *fiqh*. This was not accepted by other Imams.

With reference to the field of Islamic finance, the case of *bay' al-'inah* can also be cited to illustrate how the a difference in the application of principles might lead to a divergence of opinions. In this case, Imam Malik and Imam Abu Hanifah held that *bay' al-'inah* is invalid based on the principle of *sadd al-dhara'i'*. This principle means preventing something which may potentially lead to a prohibited result. Thus, *bay' al-'inah* is prohibited as it could lead to a clear prohibition of *Shari'ah* which is *riba*. On the other hand, Imam al-Shafi'i held that the sale is valid as he did not rely on the principle of *sadd al-dhara'i'*. For him, the validity of the sale must be determined by looking at the requirements of a sale without looking into the possible intent or consequence of the two sales.

Divergence in the Method of *Qiyas*

Generally, *qiyas* was accepted as a secondary source of rulings by all jurists. Nevertheless, they differed in their approach in applying this principle, particularly in determining the '*illah* of the rulings. An example to show the differences in determining the '*illah* is in the case of the prohibition of sale of a few food items in excess or delay as cited in the *hadith*: "*Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal and hand to hand, if the commodities differ, then you may sell as you wish provided that the exchange is hand to hand*." The jurists held different opinions in determining the '*illah* for the food items mentioned in the *hadith* as follows:

1 According to Imam al-Shafi'i, the '*illah* is because they are food, meaning to say all kinds of food are included in the prohibition.

2 According to Imam Malik, the '*illah* is because they are food which could be stored for a long time, therefore perishable food are excluded.

3 According to Imam Abu Hanifah, the '*illah* is because they are foods which are sold by weight, excluding other types of food, or those which are not weighed.

These differences of '*illah* inevitably led to differences of opinion between these jurists as to what are the types of food which are affected in the prohibition of sale in excess or delay.

It should be emphasised here that the jurists' divergence of opinion is restricted to the details or peripheral issues. As to the basic principles like prohibition of *riba* and *gharar*, permissibility of income generating trading or profit-and-loss-sharing and the like are not the subject of differences of opinion. Differences, however, are bound to happen in the detailed application of the general ruling like permissibility of *'inah* sales, *tawarruq* and the like. Apart from the above jurisprudential differences among the jurists, different perceptions of the principles and their extension and implementation in different factual situations also contributed to the divergence of opinions. Thus, the existing legal and regulatory realities of a particular country for example, as well as local socioeconomic environments play an important role in the divergence of opinion in the fast growing Islamic finance industry.

Case Study 1 Offering Credit Cards in Islamic Finance

Credit card usage is common and prevalent in modern days. It grants the user a cash advance to buy goods or pay for certain services. It also eases payment of expenses during personal or business travels in different countries. While its use is convenient in many circumstances, it impacts negatively on one's life. This is manifested by inducing its holder to overspend and incur debt overload. In various countries, credit cards have been identified as the cause of a citizen's overload of debt or bankruptcy.

While there are some contracts identified as valid to the structure of Islamic credit cards, there are two rulings on the offering of credit cards by IFIs. The first rule is that offering a *Shari'ah*-compliant Islamic credit card is permissible. This was decided by looking into the contracts underlying the product as well as their conditions. For instance, the Organisation of the Islamic Conference (OIC) Islamic *Fiqh* Academy ruled that it is permissible to issue and to use a credit or debit card that has an underlying account, i.e., the amount of any purchases is deducted from the cardholder's bank account, on the condition that if there is a delay in settlement, the cardholder will not be charged interest (Resolution No. 139 (15/5) 2004). However, the second ruling of *Shari'ah* scholars restricts offering such a credit card even though it is *Shari'ah*-compliant. This was decided by considering the economic impact of such products which do not comply with *maqasid al-shari'ah*, which requires the Islamic finance industry to assist in the distribution of wealth and achievement of communal prosperity. This shows the differences of opinion among the jurists' *ijtihad* approach and consideration of *maqasid al-shari'ah*.

Role of *Ijtihad* and *Mujtahid* in Islamic Banking and Finance

Ijtihad is an effort made by the *mujtahid* in seeking knowledge of the Islamic legal rulings.

Ijtihad literally means expending of maximum effort in the performance of an act. Technically, it is an effort made by the *mujtahid* in seeking knowledge of the legal rules of *Shari'ah* through interpretation. Thus, *ijtihad* entails the effort made by qualified scholars in order to derive rulings, by using the principles of interpretation of law

known as *usul al-fiqh*. In some complex issues which require examination and investigation from various aspects, *ijtihad* might need to be performed collectively. In these cases, *ijtihad* is exercised collectively by a group of qualified *mujtahid*s. Modern issues like Islamic finance might need collective rather than individual *ijtihad*.

The methods of *ijtihad* by reference to the functions of the *mujtahid*s, are classified as follows:

1. *Ijtihad* to discover the laws directly from the text whether it is explicitly or impliedly mentioned by the text. This involves direct interpretations by the *mujtahid* on the specific meaning of the available texts.
2. *Ijtihad* to extend the law to new cases that might be similar to cases mentioned in the texts by way of *qiyas*. Here, the function of the *mujtahid* in this method is to apply *qiyas* by looking at the *'illah*, or underlying rationale, of both cases and to determine whether *qiyas* is applicable.
3. *Ijtihad* to extend the law to new cases that are not covered by the previous two methods by extending the general principles of law or *maqasid al-shari'ah* as laid down by the texts. In this case, there is neither direct text available on the issue nor similarity in terms of *'illah* with decided issues to enable *qiyas*. Thus, the function of the *mujtahid* is perhaps most complex and challenging in this type of issue as it requires understanding of the issue and related general principles, and *maqasid al-shari'ah* in general. Many issues of modern Islamic finance fall within this type of issue, and hence necessitate the exercise of collective *ijtihad*.

Fundamental Prohibited Elements in Islamic Finance

Prohibition of *Riba*

Riba is an unlawful gain derived from the quantitative inequality of the counter values in any transaction.

Riba literally means excess, expansion, increase, addition or growth. Technically, *riba* could be defined as unlawful gain derived from the quantitative inequality of the counter values in any transaction purporting to affect the exchange of two or more

species which belong to the same genus and are governed by the same efficient cause. Deferred completion of exchange of such species may also amount to *riba* whether or not the deferment is accompanied by an increase in any one of the exchanged counter values.

Hence, *riba* is not restricted to increases in loan transactions due to deferment of time of payment, as it might also occur in any unjustified excess above and beyond the capital, whether in loans (between creditor and debtor) or in trade (with similar commodities).

The main *hadith* with reference to the comprehensive meaning of *riba* is one which was reported by 'Ubadah bin Samit that the Prophet (p.b.u.h.) said: *"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal and hand to hand, if the commodities differ, then you may sell as you wish provided that the exchange is hand to hand"* (Sahih al-Muslim).

This *hadith* indicates two main criteria to constitute *riba*, the first is deferment of the time of exchange and secondly, the difference of counter values in the exchange of two similar *ribawi* (the commodities specified in the *hadith*) items. This means that in the exchange of two similar commodities, two rules apply in order to avoid *riba*:

1 It must be a spot transaction, if one of the commodities are delayed, *riba al-buyu'* occurs.

2 It must be of equal counter value. Meaning to say for example, in a barter transaction, if the parties want to exchange wheat with wheat, it must be an equal exchange, 2 kg of wheat, for instance, with 2 kg of wheat.

It should be submitted that this *hadith* had clearly shown that modern interest is *riba* as it involves the exchange of money and violating both rules because loans are given for an extra repayment to be settled in the future.

Two types of *riba*:
1 *Riba al-duyun* or *riba al-nasi'ah*
2 *Riba al-buyu'* or *riba al-fadl*

Thus, *riba* has been classified generally into two categories according to the transactions which give rise to *riba*. From the above discussions and the texts on *riba*, the following two categories can be observed:

1 *Riba* in loan contract (*riba al-duyun*) – *riba al-nasi'ah* (excess due to delay in payment), also known as *riba al-Qur'an*.

2 *Riba* in exchange contracts (*riba al-buyu'*) – *riba al-fadl*, also known as *riba al-Sunnah*.

Riba al-duyun or *riba al-nasi'ah* occurs in lending and borrowing transactions. Literally, the word *nasiah* comes from the root word *nasa'* which means to postpone, delay, defer, or wait. Technically, it refers to any unjustified increment in borrowing or lending money, whether in kind or cash, over and above the principal amount, as a condition stipulated or agreed between the parties. It is immaterial whether the increment or *riba* is imposed at the beginning and charged proportionately to the time taken for repayment, or imposed at the time of default only.

Riba al-duyun or *riba al-nasi'ah* is any unjustified increment in borrowing or lending money, whether in cash or kind, over and above the principal amount.

Riba al-buyu' occurs from trading or exchange transactions in which a commodity is exchanged for the same commodity from the *ribawi* commodities in an unequal amount

Case Study 2 *Riba* and Late Payment Compensation (*Ta'widh*)

Under the conventional banking system, a debtor who defaulted on a payment obligation may be charged interest. On the other hand, an Islamic financial institution (IFI) may not impose late payment charges as this will infringe the rule of *riba*. The charge, if imposed, will constitute an unjustified increment above the principal amount due to deferment of the payment. However, this situation may trigger a moral hazard issue on the part of the customer, especially in a dual banking system where conventional and Islamic banking systems run side by side. A customer may give priority to settle their obligation with conventional banks, thus putting the Islamic banks at a disadvantage compared to the conventional banks.

The *Shari'ah* Advisory Council of BNM has allowed the bank to impose *ta'widh* on a defaulting customer who fails to meet his obligation to pay the financing. The permissibility to charge the compensation is, however, not absolute as it is subject to some conditions as follows:

1 The amount of *ta'widh* cannot exceed the actual loss suffered by the financier.

2 The determination of compensation is made by a third party, which is BNM.

3 The default or delay of payment is due to negligence on the part of the customer.

The basis of this *fatwa* is to curb the bad intention on the part of the defaulting customer to deliberately delay or not pay their debt as agreed, and to protect the bank from the actual loss incurred due to the customer's negligence. An issue which might arise here is how to determine whether the delay in making the payment is actually due to deliberate negligence or actual financial difficulties on the part of the customer. The essence of the permissibility of *ta'widh* is to deter the tendency by customers who might deliberately decide or intend not to pay their obligations as and when due. However, debtors assessed and confirmed to be in actual difficulties should not be punished. Rather, they should be granted ample time to settle their debts.

Riba al-buyu' occurs when a commodity is exchanged for the same commodity from the *ribawi* commodities in an unequal amount and/or a delay of the delivery of one of the commodities.

and/or delay of the delivery of one of the commodities. It refers to *riba* which results from noncompliance to the two conditions stipulated in the *hadith* mentioned above in transactions involving the six items enumerated. The two conditions are firstly, the object of sale must be of equal amount (equal counter value) and secondly, it must be a spot exchange. However, as mentioned in the *hadith*, if the commodities differ, for example exchange of wheat for dates or vice versa, the amount may differ as long as delivery takes place on the spot.

It should also be noted that the rule of *riba* differs with the different items exchanged, whether they are of the same or different basis. Although the jurists held different opinions on the *'illah* or underlying rationale for the six *ribawi* items mentioned in the *hadith*, basically they had classified them into two bases:

1. Medium of exchange (currency) represented by gold and silver and extended to any items used as currency.
2. Food stuff represented by wheat, barley, dates and salt, but extended to other types of commodities according to different *'illah* by different schools of law.

If the exchange involves the same item, like gold for gold, Malaysia Ringgit for Malaysia Ringgit, or wheat for wheat, both rules of equality and spot delivery must be applied. However, if the items are of different kinds but within the same basis like the exchange of gold for silver or wheat for dates, only the rule of spot delivery is applicable. If they are from different basis like gold and dates, both rules are not applied and the transactions can be of different amount and deferred according to the willing *seller* and willing *buyer* rule. Table 5.1 illustrates the application of the rule of *riba* for different commodities exchanged.

Table 5.1 Summary of the Rules of *Ribawi* Exchange

No	Commodity 1	Commodity 2	Rules Applied	Example of Non-*riba*	Example of *Riba*
1	Currency (A)	Currency (A)	1 Equality 2 Hand to hand	RM100 with RM100 exchanged on the spot.	RM100 with RM150 RM100 with RM100 deferred delivery.
2	Currency (A)	Currency (B)	1 Hand to hand	RM380 with US$100 exchanged on the spot.	RM380 with US$100 on deferred basis.
3	Currency	Food	Nil (Free trading)	RM50 with 10 kg of dates.	-Nil-
4	Food (A)	Food (A)	1 Equality 2 Hand to hand	10 kg of wheat with 10 kg of wheat exchanged on the spot.	10 kg of barley with 15 kg of barley 10 kg of barley with 10 kg of barley deferred delivery.
5	Food (A)	Food (B)	1 Hand to hand	10 kg of dates with 15 kg of wheat on spot exchange.	10 kg of dates with 15 kg of wheat deferred delivery.

Prohibition of *Gharar*

Gharar is another important element which could render a transaction void. Literally, the word *gharar* implies risk, uncertainty and hazard. Technically, Ibn al-Qayyim described *gharar* as a sale in which the vendor is not in a position to hand over the subject matter to the buyer, whether the subject matter is in existence or not. Imam al-Sarakhsi defined *gharar* in a more general term, he defined *gharar* as any bargain in which the result of it is hidden. A contemporary scholar, Sheikh Wahbah al-Zuhaily defined *gharar* in the following term: *"A contract which contains a risk to any one of the parties which could lead to his loss of properties."*

Gharar according to *Wahbah al-Zuhaily* is a contract that contains a risk to anyone of the parties which could lead to his loss of properties.

Unlike the prohibition of *riba*, no verse from the *Qur'an* can be found directly or explicitly prohibiting *gharar*. However, the *Qur'an* had clearly prohibited all forms of business transactions which cause injustice or *zulm* to any of the parties, particularly the party with a weaker economic and bargaining position. For example in *Surah al-Nisa*', verse 29, the *Qur'an* reads: *"O you who believe! Eat not your property among yourselves unjustly by falsehood and deception, except it be a trade amongst you, by mutual consent."* The jurists agree that the word *al-batil* (unjustly) in the above verse includes all categories of illegal and defective elements in commercial contracts, including that of *gharar* as it could result in taking the property of others without a justified basis.

On the other hand, prohibition of *gharar* has been made conclusive in various *hadiths* from the Prophet (p.b.u.h.). The companions related that the Prophet (p.b.u.h.) has forbidden *gharar* in trading. Abu Hurayrah narrated that the Prophet (p.b.u.h.) prohibited all sales on *gharar*. In another *hadith* also by Abu Hurayrah, it was reported that two types of transactions were prohibited by the Prophet (p.b.u.h.), namely *al-mulamasah* and *al-munabadhah*. *Al-Mulamasah* is a sale during the *jahiliyyah* period (pre-Islamic era) whereby a buyer is only allowed to feel a garment but cannot unfold it or examine what is in it. The second prohibited sale, that is, *al-munabadhah*, is a sale concluded when a potential buyer throws his garment to another without making any inspection. In both cases, the sales are prohibited due to *gharar*. Based on the above evidences, the jurists unanimously agreed that *gharar* is prohibited and the existence of *gharar* may render a contract invalid.

The prohibition of *gharar* is founded on the rule of justice and fair dealings. This is because the occurrence of *gharar* in any transaction may result in oppression or injustice and the loss of properties to one or even both of the parties. It may also infringe the rule of mutual consent if a party's consent to the transaction is due to its inadequate knowledge or access to material information. The outcome of the transaction is not clear to the parties due to the lack of information, thus exposing them to unnecessary risk in business transactions. The main reason for the prohibition of *gharar*, consequent to the above, is to avoid future disputes. If the parties involved are not fully aware and clear about any material information of the contracts, they might be engaged in unexpected financial responsibility and commitment. This of course, could lead to disputes among the parties as to the correct and intended consequences of the contracts entered into. It should be noted, however, that, only major *gharar*, or *gharar fahish*, which relates to important and material information to the contract would render the contract void. Minor *gharar*, or *gharar yasir*, or unavoidable *gharar* due to the nature of the subject matter, without causing considerable damage to one of the parties, will not affect the validity of the contract.

From the above discussion on *gharar*, a few main types of *gharar* can be observed, with reference to modern financial transactions, as follows:

Types of *gharar*:
1 *Gharar* due to the non existence of the exchanged counter values (settlement risk or counter-party risk).
2 *Gharar* due to inadequacy or inaccuracy of information (non disclosure of material information on the subject matter).
3 *Gharar* due to the undue complexity of the contract (combining two sales in one interdependent contract).

1 *Gharar* due to the nonexistence of the exchanged counter values or the control of the parties over the subject matter to be exchanged. This is known in the conventional modern term as settlement risk or counter-party risk where the seller, for example, is not in a position to hand over the subject matter to the buyer. Ibn Abbas reported the Prophet (p.b.u.h.) to have said: *"He who buys food grain should not sell it until he has taken possession of it"* (Sahih Al-Bukhari, *Hadith* No. 2136).

2 *Gharar* due to inadequacy or inaccuracy of information. This type of *gharar* might arise due to the non disclosure of material information on the subject matter. This comprises the characteristics of the exchanged counter value, its species, quantities, date of future delivery, etc. The reason for the prohibition of this type of *gharar* is because there exists the possibility of deceit or fraud in such a contract due to the deliberate concealment of valued or relevant information by any of the parties to the contract. The Prophet (p.b.u.h.) had prohibited the act of concealing information to deceive any party. He had once passed by a man who was selling grains and asked him: *"How are you selling it?"* The man then informed him. The Prophet (p.b.u.h.) then put his hand in the heap of the grain and found it was wet inside. At this point the Prophet (p.b.u.h.) said: *"He who deceives other people is not one of us"* (Musnad Ahmad bin Hambal, *Hadith* No. 5113).

3 *Gharar* due to the undue complexity of the contract such as combining two sales in one or two or more interdependent contracts. Example of two sales in one is when a person says to another: "I sell to you this item at RM100 in cash today and RM110 to be paid within a year." The buyer then said: "I accept" without specifying at which price he buys the item. This is why the jurists required that hybrid contract instruments like *al-ijarah thumma al-bay'* or parallel *istisna'* must be independent of each other.

It should be noted here that unlike *riba*, *gharar* is a phenomenal issue which is open for changes based on different circumstances. What constitutes *gharar* in a particular place or time might not be *gharar* in other circumstances due to the development of technology for example.

Prohibition of Gambling (*Maysir*)

Gambling or *maysir*, also known as *qimar*, is defined as any activity which involves betting whereby the winner will take the entire bet and the loser will lose his bet. It means games of pure chance where any party might gain at the expense of the loss of the other party.

Maysir is a game of pure chance where any party might gain at the expense of the loss of the other party.

The *Qur'an* explicitly condemned and prohibited gambling in *Surah al-Ma'idah*, verses 90–91: *"O believers, wine and gambling (maysir), idols and divination by arrows are but abominations devised by Satan; avoid them so that you may prosper. Indeed Satan seeks to stir up enmity and hatred among you by means of wine and gambling and to keep you away from remembrance of Allah (s.w.t.) and from your prayers."* This *Qur'anic* verse also explained the reason for the prohibition of gambling as it invokes enmity in society and distracts believers from worshipping Allah (s.w.t.).

Mutuality of Risk-sharing

As noted above, *gharar* and *maysir* were prohibited due to the element of chance or risk. However, it is very important to differentiate the types and nature of risks as not every risk-taking is prohibited. The *Qur'an* had permitted sale and prohibited *riba* mainly due to fairness in risk and return. As sale assumes risk-taking, for example market risk, the seller deserves the profit from the sale. On the other hand, *riba* is prohibited because it involves profiting without taking or sharing in the related risk.

In relation to the above, risks can be divided into three types, which carry different rulings from the *Shari'ah's* point of view in terms of permissibility or otherwise:

Three types of risk:
1. Enterpreneurial risk; risk that might occur as part of a normal course in economic activities.
2. Risks that occur due to natural disasters and calamities.
3. Unnecessary risks that occur due to games of chance (gambling).

1. Entrepreneurial risk or risk which might occur as part of the normal course of business in every economic activity. The willingness to take this kind of risk is not prohibited but encouraged to enhance the economic activities in

society and to fulfil its needs. It is an unavoidable risk due to the nature of the business and not similar to the avoidable risks in *gharar* transactions.

2 Risks due to the possibility of the occurrence of natural disasters and calamities. People seek to protect themselves from the effect of these calamities by taking insurance. Generally speaking, protection against this type of risk by way of cooperative insurance is allowed in Islam provided that there is no prohibited element involved.

3 Unnecessary risks which are not part of everyday life but arise from games of chance created by people. It is unnecessary in the sense that it does not add any economic value to society like the case of entrepreneurial risk. Moreover, people will not be exposed to such risk if they choose not to participate in these games unlike the former. This is the prohibited risk-taking that underlines the prohibition of gambling or *maysir*.

The first type of risk is associated with the risk in the natural course of business. It is an established principle in Islamic commercial law that risk commensurates with the return. The basis of this principle was established directly in a *hadith*: "الخراج بالضمان" which means that the right to the return is justifiable by assuming the risk of loss. For example, in the contract of *mudarabah*, the capital provider has the right to profit as he is also bearing the risk of loss in the business venture. Likewise, the entrepreneur also has the right to profit as he is also bearing the potential loss of his effort.

Governance and Transparency

Shari'ah governance and transparency is a very critical area in Islamic finance and is no less important than corporate governance to any institution. However, *Shari'ah* governance is particular to Islamic finance, as it is the mechanism which determines the "*Islamicity*" of any particular Islamic business or financial institution as well as the system as a whole. The significance of *Shari'ah* governance transpires via its role of ensuring the confidence of the Islamic finance industry in the eyes of the public. More importantly, *Shari'ah* governance ensures that the industry is at all times in accordance with the wishes and laws of the Almighty by ensuring the legitimacy of the products offered.

Effective *Shari'ah* governance requires the setting up of a clear and comprehensive framework to regulate the Islamic finance industry and guide its development. Fundamental to this process is the definition of its main actors, namely the *Shari'ah* advisors, and their responsibilities as well as the roles that they need to undertake for the well-being of the whole Islamic finance sector. Other aspects of *Shari'ah* governance are supporting initiatives that can assist in enhancing a *Shari'ah* advisor's performance, such as the legitimate mandate, *Shari'ah* secretariat and others.

On the issue of transparency, IFIs must abide and adhere to the same regulatory requirements when it comes to the issue of disclosures. This will ensure the smooth management of IFIs. *Shari'ah* governance as well as corporate governance will be explored further in Chapter 16.

Issues and Challenges

There are several issues and challenges in empowering *Shari'ah* in Islamic finance. Among the issues are:

1 Ensuring the maximum utilisation of the *Shari'ah* principles in developing Islamic financial products. Presently Islamic financial products are developed using the established principles of *Shari'ah* and there is a need to ensure that the scholars explore the rich heritage in the books of *fiqh* to find more instruments and principles so as to give a wider choice of *Shari'ah* principles in product development.

2 Addressing the need for harmonisation of the interpretation of *Shari'ah* across jurisdictions. One of the issues facing the industry is the different interpretation of *Shari'ah* and it is obvious that the nature of *Shari'ah* is that it is subject to different interpretations and views. This, to a certain extent, has hampered the progress of the industry as some products are acceptable to certain jurisdictions and not to others. In order to overcome this impediment, it is important to create an atmosphere of respect and mutual recognition of *Shari'ah* interpretations across jurisdictions. In order to ensure this, it is important for scholars of the *Shari'ah* across the globe to interact more frequently with one another and understand the rationale of a given *Shari'ah* view. In addition, a common platform for scholarly discussion and debate could also be established.

3 Ensuring a high quality and standard of *Shari'ah* services. This is particularly important when the industry is growing in a very encouraging manner. It is essential that those who provide *Shari'ah* advisory services are those who are qualified and have good knowledge of *Shari'ah* and the needs of the market to ensure a high standard of *Shari'ah* advisory services. In order to achieve this goal, the *Shari'ah* services industry should be regulated and a professional body should be established in order to draw the standard, code of conduct and provide continuous professional development programmes to maintain the quality of scholars.

Issues and challenges in Islamic finance:
1 Maximum utilisation of *Shari'ah* principles in developing Islamic financial products.
2 Harmonisation of the *Shari'ah* interpretations across jurisdictions.
3 Ensuring a high quality and standard of *Shari'ah* services.
4 Realisation of *maqasid al-shari'ah* in the product development or the general framework of Islamic finance.

4 Another important challenge is to realise *maqasid al-shari'ah* as described above at the level of the general framework of Islamic finance or at the level of product development and its implementation. The challenge lies in the fact that, Islamic finance has to operate within the conventional interest-based system. Many Islamic financial products as claimed by some critics are mere replication of conventional products. In some cases, the very objectives of Islamic commercial law are jeopardised due to mainstream legal or regulatory requirements. In this relation, the scholars or *mujtahid*s in exercising their function, must open their minds to the current developments and realities, and interpret the whole text in its totality by looking at *maqasid al-shari'ah* in order to realise the ultimate objectives of *Shari'ah* on this particular issue.

Summary

1 The *Qur'an* is the speech of Allah (s.w.t.), sent down upon Prophet Muhammad (p.b.u.h.), in its precise meaning and precise wording, transmitted to us by numerous persons (*tawatur*). In most cases, the *Qur'an* provides general principles and it is dependent on the jurists to utilise these principles to resolve the issues in *fiqh*.

2 The *Sunnah* refers to all that is narrated from the Prophet (p.b.u.h.), including his actions, sayings and whatever he has tacitly approved. Besides acting as an independent source of *fiqh*, the *Sunnah* supports the rulings stated in the *Qur'an* and it explains and further elaborates the meanings of the *Qur'an*.

3 *Fiqh*, or the science of Islamic law, is the knowledge of one's rights and obligations derived from the *Qur'an* or *Sunnah* of the Prophet (p.b.u.h.), or the consensus of opinions among the learned (*ijma'*), or analogical reasoning (*qiyas*).

4 *Shari'ah* is the sum total of the Islamic teachings and system, which was revealed to Prophet Muhammad (p.b.u.h.), recorded in the *Qur'an* as well as deducible from the Prophet's divinely-guided lifestyle called the *Sunnah*.

5 *Shari'ah* does not imply "law" in the modern sense as it contains a comprehensive set of dogmas and legal and ethical doctrines. As such, legal considerations and individual rights have a minor place in it.

6 It does not matter whether a product takes its origin from the conventional market or otherwise. The important factor in determining whether a particular product is acceptable from the *Shari'ah* point of view depends on its compliance with the rules and regulations of the *Shari'ah*. Examples are *mudarabah* and *musharakah*, which took their origin from the pre-Islamic practices.

7 In Islamic finance, *Shari'ah*-compliant products refer to products which have their origin from the conventional market and were "Islamised" by modifying them to suit the *Shari'ah* requirements. Whereas, *Shari'ah*-based products are those products which have no origin from the conventional practices but ensued directly from the Islamic heritage.

8 *Fiqh* rulings are broadly categorised into two: fixed and flexible. Most of the rulings of *fiqh*, particularly the rulings related to *muamalat*, fall under the flexible category which might be amended according to changes in time, place and circumstances.

9 The differences of opinion among the jurists are as old as the development of Islamic jurisprudence. The differences are brought about by the nature of textual evidences from the *Qur'an* or *Sunnah*. Time and juristic peculiarities have also accounted for such divergence of opinions.

10 Jurists' divergence of opinion is restricted to the detailed or peripheral issues. The basic principles like prohibition of *riba* and *gharar*, permissibility of income generating trading or profit-and-loss-sharing and the like are not subject to differences of opinion.

11 Independent judgement, within certain limits, by a qualified jurist is not only permissible but even praiseworthy. This is valid to the extent that it does not contravene any clear principle of *Shari'ah*. With reference to the development of modern Islamic banking and finance, this principle is of crucial importance since it paves the way for the innovation of different financial tools and instruments for financial transactions.

Key Terms and Concepts

Qur'an	*Riba*	Islamic Finance
Legal Maxims	*Shari'ah*-compliant	*Istihsan*
Fiqh	*Ribawi* Exchange	*Ijtihad*
Usul-al-fiqh	*Maslahah*	*Qiyas*
Ta'widh	*Ijma'*	*Sunnah*
'Urf	*Maysir*	Credit Card
Gharar	*Shari'ah*	*Ikhtilaf*
Maqasid Al-Shari'ah	*Shari'ah*-based	*Mujtahid*

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Review Questions and Problems

1 Define *Shari'ah* and *fiqh* and identify the relationship between these two terminologies.

2 Outline the sources and rule-making process of Islamic commercial law.

3 Explain the importance of the principle of transparency in the context of modern financial contracts.

4 Explain how *riba* and *gharar* may occur in modern financial transactions.

5 Discuss *maysir* in the context of speculation in the capital market.

6 The principle of original permissibility provides a legal basis for innovations in modern Islamic commercial transactions. Discuss.

7 Assume you are a *Shari'ah* advisor to a *takaful* company and the company is introducing a product using the *wakalah* contract which permits the charging of fees for the service rendered by the company. Which sources of Islamic law will be used in determining the *wakalah* fee? Does the company have the right to charge different layers of *wakalah* fee for the different tasks undertaken by the company?

8 Continuing from (7) above, assuming the company in question decides to expand its business internationally and would like to operate a nostro account with a conventional bank abroad in order to facilitate its business, advise the company in this matter. Which principles of *fiqh* can be used in such a situation?

Chapter 6

Shari'ah Contracts for Islamic Financial Instruments – Part 1

Preview

This chapter is the first of two chapters dedicated to discussing the various *Shari'ah* contracts underlying Islamic financial transactions. In particular, this chapter focuses on the general framework, characteristics and essential elements of *Shari'ah* contracts which constitute the most fundamental aspect of Islamic financial transactions. It begins with a discussion on the conditions and requirements of each essential element of the contract which needs to be completely satisfied to ensure the validity of the contract instead of the immediate enforceability of its legal effects. It further elaborates on the classification of *Shari'ah* contracts on the basis of various legal considerations to clearly identify the legal effects of each classification of contracts that may differ from one to another.

This chapter focuses on two important types of exchange-based contracts, namely the sale-based and lease-based contracts such as *murabahah*, *salam*, *istisna'*, *bay' al-dayn*, *bay' al-sarf*, and *ijarah*. It delineates numerous aspects of the exchange-based contracts ranging from their legitimacy, basic rules and conditions, salient *Shari'ah* issues and their applications in contemporary Islamic finance.

Learning Outcomes

At the end of the chapter, you should be able to:

- Understand the elements of a *Shari'ah* contract and its essential conditions.
- Explain the classification of *Shari'ah* contracts and the legal consequences of each classification.
- Describe the salient features of each exchange-based contract and their structure flow in contemporary Islamic finance.
- Identify the basic rules and conditions of each exchange-based contract.
- Apply the concept of exchange-based contracts in product development.

Elements of *Shari'ah* Contracts

Literally, the word *'aqd* (contract) is derived from the Arabic word *'aqada* which means to tie, to conclude or to ratify.

A valid *Shari'ah* contract is built upon three essential elements which are the form of the contract, the subject matter of the contract and the contracting parties. These essential elements are to be met completely so as to qualify a contract to be assigned with its prescribed legal effects such as the transfer of ownership and conferment of the right to option.

Exhibit 6.1 Definition of Contract (*'Aqd*)

Literally, the word *'aqd* (contract) is derived from the Arabic verb *'aqada* which means to tie, to conclude or to ratify. *Al-'aqd* as a verbal noun means *al-rabt* which denotes tying or correlating. Muhammad Qadri Basha defines *'aqd* technically as the connection of an offer (*ijab*) emanating from one of the two contracting parties with the acceptance (*qabul*) of the other party in such a way that constitutes an implication on the subject matter. As a result of this connection, both parties fall under obligation to one another. Muhammad Abu Zahrah defines it as a connection between two sayings (of the two contracting parties) from which arises a legal ruling which is applicable to one party or both of them. It can be said that the above two definitions emphasise that *'aqd* is made of a connection between the words of the offeror and the words of the offeree which thereafter creates legal consequences on the subject matter and constitutes contractual obligations binding upon the contracting parties.

Source: Muhammad Qadri Basha. *Murshid al-Hayran 'ila Ma'rifah Ahwal al-Insan*. (1909). Egypt: Nazzarah al-'Umumiyyah, page: 65, Muhammad Abu Zahrah. *Al-Milkiyyah wa Nazariyyah Al-'Aqd Fi Al-Shari'ah Al-Islamiyyah.* (1996). Al-Qahirah: Dar al-Fikr al-'Arabi.

Form of the Contract (*Sighah Al-'Aqd*)

Form of the contract refers to an expression made by the contracting parties to declare their inner will to undertake a contract and thereafter be bound by certain obligations.

The form of the contract refers to an expression made by the contracting parties to declare their inner will to undertake a contract and thereafter be bound by certain obligations. This expression is manifested in an offer (*ijab*) made by the offeror and acceptance (*qabul*) made by the offeree. The offer refers to what originated from a person from whom the ownership (of the transacted subject matter) is transferred, even if it is done after acceptance.

Exhibit 6.2 Definition of Offer and Acceptance

Offer is defined by *Majallah Al-Ahkam Al-'Adliyyah* as the word first spoken for making a disposition of property and the disposition is established by it. Acceptance refers to a second word which comes from a person to whom the ownership (of a transacted subject matter) is transferred even if it is done earlier (than the offer made). The *Majallah* defines it as the word spoken in second place for the making of a disposition of property and the agreement (*'aqd*) becomes complete with it.

Source: Article 101 and 102 of *al-Majallah*, Muhammad 'Ali Basha. *Majallah Al-Ahkam Al'Adliyyah.* (1302H). Beirut: *al-Matba'ah al-Adabiyyah*, page: 34.

It is agreeable among the jurists that the basis of the formation of a contract is its capability of giving a clear reflection of the willingness of both contracting parties to undertake a contract. Hence, the form of the contract should be free from any possibility of indicating other than what is intended by the parties for the contract that they entered into. This rule is also applied in civil law in which an agreement is not considered a contract in the strict sense unless it is made out of the common intention of the contracting parties that it shall be legally enforceable. Although the Contracts Act 1950, Malaysia is silent on the intention to create legal relations as one of the requirements of a valid contract, case law clearly dictates the necessity of this requirement. According to *Shari'ah*, a clear expression of the inner will of the transacting parties may take the form of words or its substitutes, such as conduct, writing and gesture.

It is agreeable among the jurists that the basis of the formation of a contract is its capability of giving a clear reflection of the willingness of both contracting parties to undertake a contract.

Methods of Offer and Acceptance

Generally, offer and acceptance are exercised in words as the will of the contracting parties can be expressly signified in their own words. However, the way by which an offer and acceptance can be made is not only confined to words as it can be exercised also in other methods recognised by *Shari'ah* such as conduct, writing and gesture.

Conditions of Offer and Acceptance

Jurists have prescribed three conditions in order for a contract to be validly concluded (*in'iqad al-'aqd*).[1] They can be summarised as follows:

Clear Indication of Offer and Acceptance

The offer and acceptance must clearly indicate the intended motive of the contracting parties. This is because the internal motive (*iradah batinah*) is hidden and the contract as well as its related particular rulings are not binding and enforceable if the actual contract (*al-'aqd bi 'aynih*) intended by the contacting parties is not known with certainty. This can be realised by using the term that customarily and literally signifies the type of contract intended by both parties. However, there is no prescribed form for a clear indication of the motive because specific form (*shakliyyah*) is not necessary for contracts other than marriage contracts.

The offer and acceptance must clearly indicate the intended motive of the contracting parties.

1 *In'iqad al-'aqd* means its existence and occurrence being recognisable in *Shari'ah* even if it is not free from defects. See 'Ali al-Khafif (1996), *Ahkam Al-Mu'amalat Al-Shari'yyah*, Madinah Nasr: Dar Al-Fikr Al-'Arabi, page: 188.

Exhibit 6.3 Illustration of Actual Conformance and Tacit Conformance

The actual conformance (*muwafaqah haqiqiyyah*) can be illustrated in the following deal.

The seller says: "I sold this book to you for RM30" and the buyer replies to the seller, "I bought it from you for RM30". Tacit conformance (*muwafaqah dimniyyah*) can occur if the buyer replies, "I bought it for RM45". In this case, the contract will not bind except for the amount offered by the party (RM30) whereas the remaining amount is subject to the acceptance of the other party during the session of the contract (*majlis al-'aqd*).

Correspondence of Acceptance to the Offer (*tatabuq al-qabul wa al-ijab*)

The subject (*mawdu'*) accepted in the contract must correspond to what has been offered whereby the acceptance of the subject is to be made in either actual or tacit conformance to what has been offered.

A contract is not validly concluded (*la yan'aqid*) if the subject of acceptance contradicts what has been offered.

A contract is not validly concluded (*la yan'aqid*) if the subject of acceptance contradicts what has been offered such as if the party accepted another subject matter or only half of the offered subject matter. This can be illustrated in the following deal: "I sold my car to you" and the buyer replies, "I bought my friend's car".

Continuity of Offer and Acceptance

The offer and acceptance must be jointly connected in the same session of contract (*majlis al-'aqd*) to indicate the dual declaration of motive if both transacting parties are present at the time of contract or in a session (*majlis*) in which the party may know the offer made to him even if he is not present. Hence, a continuity of offer and acceptance is necessary as it forms the basis for the consistency of the parties' intention and consent by which the offeree knows the offer by listening and understanding it if the contract is done in writing or by seeing if it is done by gesture or conduct.[2] Custom acknowledges that the persistence of the session signifies the persistence of the motive of the party (offerer), and when the session ends, the abovesaid customary acknowledgement is no longer effective.

Consequently, if the contracting parties departed one another before the acceptance is made, the contract is rendered void and not validly concluded.

This is because the offer takes the form of several words and is over upon uttering it, and it is only considered persistent if the session persists. Consequently, if the contracting parties departed one another before the acceptance (*qabul*) is made, the contract is rendered void and not validly concluded. There are three conditions by which the continuity of offer and acceptance can materialise. Firstly, the offer and acceptance must be held in one single session because the offer is not considered a part of the contract by itself unless it is assembled with acceptance. Secondly, there

2 'Ali Al-Khafif (1996), Ahkam Al-Mu'amalat Al-Shari'yyah, Madinah Nasr: Dar Al-Fikr Al-'Arabi, pg: 189.

should be nothing arising from the contracting parties that indicate their objection to the contract. This entails that the conversation should be effected on the subject of the contract, and free from unrelated words that may be pronounced in between the offer and acceptance which is deemed as an indicator (*qarinah*) of an objection to the contract.

Thirdly, the offerer should not retract the offer before being accepted by the offeree. In this regard, the offerer shall persist in his offer to the offeree and if he retracts from it, the contract is invalid. However, the offerer assumes the right to retract his offer before an acceptance is made by the other party after which the offer is deemed void.

Subject Matter of the Contract (*Mahal Al-'Aqd*)

Subject matter of the contract refers to the contracted object upon which the legal rulings and effects of the contracts are manifested. The subject matter may take the form of corporeal property (*'ayn maliyyah*) such as the subject matter of a sale contract (*al-mabi'*) or pledged object (*al-marhun*) in a pledge contract and usufruct in a lease contract. Usufruct in a lease contract may originate from the leased property or rendering of services (*ijarah al-'amal*). The subject matter can also be something of an incorporeal property (*'ayn ghayr maliyyah*) such as a woman in a marriage contract. However, it is worthy to note that not everything is legally or customarily eligible to be contracted as the subject matter since *Shari'ah* has laid down some essential conditions of the subject matter that need to be fulfilled. They can be summarised as follows:

> Subject matter of the contract refers to the contracted object upon which the legal rulings and effects of the contract are manifested.

1. ***The existence of the subject matter at the time of the conclusion of the contract.***

   The contract should not be effected on a nonexistent object or on something whose existence in the future is impossible such as the undertaking of a contract on rendering medical services to a dead person or washing a damaged car.

> The contract should not be effected on a nonexistent object or on something whose existence in the future is impossible.

2. ***Precise determination of the subject matter.***

   The subject matter must be precisely determined and clearly known to the contracting parties to the extent that a later dispute can be avoided. Any form of serious or major ignorance and uncertainty in the subject matter will render the contract void. Civil law also subscribes to this injunction as it provides that an agreement which is uncertain or is not capable of being made certain is void. For example, Ali agrees to sell a car to Ahmad without specifying the type of car. This agreement is considered void on the grounds of uncertainty. According to *Shari'ah*, the precise determination of the subject matter can take place in its actuality through gesture or pointing out (*isharah*)

> Any form of serious or major ignorance and uncertainty in the subject matter will render the contract void.

if it is in existence or through viewing (*ru'yah*) at the time of the contract or prior to it within the duration in which it is not possible for the subject matter to change or through a description that prevents from serious ignorance (*jahalah*) by way of giving a clear description of its type and quantity.

Exhibit 6.4 The Contracted Subject Matter Should be in Existence

According to Hanafi and Shafi'i schools of law, this essential condition applies to both the contracts of exchange and gratuitous contracts (*'uqud al-tabarru'at*) without which the contracts will be deemed void since the Prophet (peace be upon him) forbade the sale of what one does not own. However, they excluded from the *hadith* several types of sale of the nonexistent such as forward sale (*salam*) and manufacturing sale (*istisna'*). This exemption is made on the basis of *istihsan*, consideration of the peoples' needs, their customary practice and the *Shari'ah* acknowledgement of the validity of these contracts. According to Hanbali jurists, this is not an essential condition of the subject matter as they argue that it falls under the *Shari'ah* prohibition of sale contracts due to ambiguity and uncertainty (*gharar*) such as the sale of the foetus of an animal before its birth (*bay' al-haml fi al-batn*). In this regard, Ibn Taymiyyah and Ibn Qayyim argued that *bay' al-ma'dum* is permissible if the nonexistent subject matter is certain in its existence such as selling a house under construction or on the map because *Shari'ah* does not prohibit *bay' al-ma'dum* but it does prohibit *bay' al-gharar* which means the sale of what is not capable of delivery whether it is existent or nonexistent. They opine that the *'illah* of the prohibition of *bay' al-ma'dum* is not the state of nonexistence but the uncertainty in handing over the subject matter to the purchaser which is caused by incapability of delivery. This is in view of the fact that the *Shari'ah* validates certain types of *bay' al-ma'dum* such as the sale of fruit after the appearance of their fruitfulness (*bay' al-thamar ba'da bad' salahih*). Hence, the applicability of this essential condition is clearly associated with the nature (*tabi'ah*) of the contract which renders it legal to be effected on a nonexistent subject matter. If the nature of a particular contract necessitates the existence of the subject matter at the time of the conclusion of the contract, then its existence becomes essentially conditional. In this regard, if a nonexistent subject matter is contracted, the nature and the legality of this contract has been violated as it contravenes the basic tenets of *Shari'ah*. This is because *Shari'ah* has prescribed that this contract can be effected only on existent subject matters to avoid dispute.

Exhibit 6.5 *Jahalah* (Ignorance) in Financial Contracts

Jahalah in financial contracts is divided into three categories which assume different legal rulings. They are *jahalah fahishah* (serious ignorance), *jahalah yasirah* (minor ignorance) and *jahalah mutawassitah* (moderate ignorance). Serious ignorance denotes an occurrence that may lead to dispute among the contracting parties, and hence renders the contract void, e.g., the sale of the foetus of an animal in its mother's womb. Minor ignorance refers to one in which the occurrence does not amount to dispute among the transacting parties, and hence renders the contract valid such as the sale of a house with an unknown basis. Moderate ignorance on the other hand, is the one that jurists are disagreeable whether to categorise it under serious ignorance or minor ignorance. If it falls under serious ignorance, it assumes the same legal ruling as serious ignorance and if it is subsumed into minor ignorance, it assumes the same legal effect as minor ignorance.

It is unanimous among the jurists that this essential condition is only required in financial contracts of exchange such as the contracts of sale and lease. However, they hold different views on the application of this condition to other than financial contracts of exchange. Shafi'i and Hanbali jurists opine that this condition applies to financial contracts of exchange such as sale contracts, non financial contracts of exchange such as marriage contracts and gratuitous contracts (gift (*hibah*), bequest (*wasiyyah*) and trust (*waqf*)). Hanafi jurists on the other hand, stipulate that it is only applicable in financial and non financial contracts and not applicable in gratuitous contracts such as surety (*kafalah*) and bequest (*wasiyyah*) because *jahalah* in this contract will not lead to a later dispute. Maliki jurists seem to be more lenient as they are of the opinion that this condition applies only to financial contracts of exchange and does not apply to non financial contracts of exchange and gratuitous contracts. On this premise, they opine that the contract of *tabarru'* is considered valid even if it is associated with serious ignorance (*jahalah fahishah*) because the objective of this contract is built upon benevolence (*ihsan*) which will not result in any dispute.

Jahalah in financial contracts is divided into three categories: *jahalah fahishah* (serious ignorance), *jahalah yasirah* (minor ignorance) and *jahalah mutawassitah* (moderate ignorance).

3 *Certainty of delivery of the subject matter.*

It is unanimously agreed among the scholars that the delivery of the subject matter must be certain at the time of the conclusion of the contract. Therefore, the contract is not validly concluded if the contracting parties are not capable of delivering the subject matter even though the subject matter exists at the time the contract is concluded and is legally owned by the seller. Jurists are also unanimous that this condition must be fulfilled in financial contracts of exchange as well as in gratuitous contracts. However, Imam Malik opines that it does not apply to gratuitous contracts. Hence, it is not valid to undertake any financial contracts on undeliverable subject matters like the sale of runaway camels, the sale of birds in the air and the sale of fishes in the water.

It is unanimously agreed among the scholars that the delivery of the subject matter must be certain at the time of the conclusion of the contract.

It is not valid to undertake any financial contracts on undeliverable subject matters like the sale of runaway camels, the sale of birds in the air and the sale of fish in the water.

4 *Permissibility of the subject matter.*

Jurists unanimously agree that the subject matter must fulfil the *Shari'a*h rulings (*qabil lihukmih*) which in turn entails that it should be objects of intrinsic value and items of considerable value for Muslims, have some use, legitimately beneficial and can be possessed (*mal mamluk*). This is because certain property may have no economic value for Muslims (*non-mutaqawwim*) but may carry some commercial benefits for non-Muslims such as pork and wine. Thus, various kinds of services, performances of an act, commodities, tangible and intangible assets like intellectual property rights are also included in *mal mutaqawwim* and can be transacted in a financial contract. As the subject matter should also be a thing that can be possessed (*mal mamluk*), the sale of what has been made permissible for general people (*al-mubah li'amat al-naas*), the sale of unacquired (*ghayr muhraz*) things such as fishes in the river, and the sale of public-owned properties such as public hospitals and buildings are not valid. This is because all these are not owned by any particular individual and they do not even allow any individual ownership (*tamalluk shakhsi*). The subject matter must also be things that can be assigned the legal rulings of the contract. For example, one of the legal rulings of a deferred contract of exchange (*bay' mua'jjal*) is that the deferred item should be of fungible property (*mal mithli*) like currency which has its similar counterpart and thus is free from *gharar*. It cannot be heterogeneous property (*mal qimi*) such as a corporeal property like a house or a shirt because these properties may face changes over the course of time which may be tantamount to intolerable *gharar*. Hence, it can be said that non-homogeneous property cannot be assigned the specific legal ruling for a deferred contract of exchange which in this case is permissibility of being delayed. Thus, the property is rendered inappropriate to be the subject matter of a deferred contract of exchange.

Contracting Parties (*Al-'Aqidan*)

A contract can only be established in its actuality if the contracting party has a legal capacity (*ahliyyah*) that renders him competent (*salih*) to offer or accept an offer made in a contract. This implies that a contract can be undertaken only by those who are legally capable and competent to act as a contracting party. People are divided into different categories according to their legal capacity and competency to undertake a contractual obligation. Some may not be legally capable to undertake any contract, some may be legally capable to undertake certain contracts only, while others may be legally competent to undertake all kinds of contracts.

Ahliyyah is the ability to acquire rights and exercise them as well as to accept duties and perform them.

Ahliyyah

Ahliyyah is the ability to acquire rights and exercise them as well as to accept duties and perform them. It comprises two types, namely the capacity for acquisition of rights (*ahliyyah al-wujub*) and the capacity for execution of duties (*ahliyyah al-ada'*).

Ahliyyah al-wujub means the legal competency of a person that establishes rights for himself and imposes obligations on him.

Ahliyyah Al-Wujub

Ahliyyah al-wujub means the legal competency of a person that establishes rights for himself and imposes obligations on him. The underlying basis of this legal capacity is the human's life and his attribute of being a human (*sifah insaniyyah*). Hence, every human being including the foetus in its mother's womb possesses this type of *ahliyyah* which starts with the beginning of an individuality (*shakhsiyyah*) that starts from the creation of a foetus in the womb. This *ahliyyah* stays in company with the individuality, forms the attributes of the individuality and ends with death. However, *ahliyyah al-wujub* does not give any impact to the establishment of a contract (*ibram al-'aqd*) even if it is perfect (*kamilah*).[3] *Ahliyyah al-wujub* is divided into two types: deficient (*ahliyyah al-wujub al-naqisah*) and perfect (*ahliyyah al-wujub al-kamilah*).

1 Ahliyyah Al-Wujub Al-Naqisah.

This type of legal capacity is only confined to a foetus in its mother's womb which renders it capable of accepting only the establishment of the rights that do not require acceptance such as inheritance (*irth*) and bequest (*wasiyyah*). However, no obligation can be incumbent upon it at this stage. This means that every right which requires acceptance such as the rights resulting from the sale contract, and gift (*hibah*) is not established for it because it does not have expressive capability (*'ibarah*). The legal capacity of the foetus is deficient for two considerable reasons, firstly because it constitutes a part of its mother's self and secondly, because it is considered a dependent individual. The former consideration does not make its liability (*dhimmah*) perfect and capable for acquiring both rights and obligations, while the second consideration makes its *dhimmah* deficient and only qualifies it for acquiring rights. As the real existence of the foetus is probable, jurists have stipulated that it should be delivered alive.

2 Ahliyyah Al-Wujub Al-Kamilah.

It refers to the legal capacity of a person to acquire rights and obligations which are established for him since the time he was born alive, and does not dissociate from him in all stages of his life. This legal capacity is established when he or she attains full mental development and acquires the ability to discriminate. However, a minor (*sabi*) whose age is below seven has only a deficient legal capacity (without having a legal capacity for the execution of duties) which qualifies him to acquire only the rights and obligations that his custodian (*wali*) can perform on his behalf such as the obligation of alms-giving (*zakat*). He has absolutely no legal capacity for the execution of duties due to his weakness (*da'fih*) and deficiency in his intellect (*qusur 'aqlih*). On this premise, any rule of law related to financial obligations addressed to him such as the obligation of *zakat* on his property and liability for the damage (*daman al-mutlafat*) is actually borne by his custodian (*wali*) because he is not the actual addressee (*mukhatab*).

3 Al-Zuhayli (2007), *Al-Fiqh Al-Islami wa Adillatuh*, Dimashq: Dar Al-Fikr, v. 4, page: 117.

Ahliyyah Al-Ada': a legal capacity of a person which enables him or her to execute duties in a way that is recognised by *Shari'ah*.

Ahliyyah Al-Ada'

It refers to the legal capacity of a person which enables him to execute duties in a way that is recognised by *Shari'ah*. It is divided into two, namely the deficient and complete capacity for execution of duties.

1 ***Ahliyyah Al-Ada' Al-Naqisah (deficient capacity for the execution of duties).***

This legal capacity is established in a human when he or she is at the stage of discrimination till the stage of puberty. Deficient intellectual and physical capacity constitutes the essence of this legal capacity as it is unanimously agreed that the performance of duties is dependent on one's ability to understand the rules (*khitab*).[4] This also applies to the insane person whose insanity causes weakness of understanding and discrimination but does not reach the level of intellectual dysfunction. This type of legal capacity takes different rulings depending on whether it is related to the rights of Allah (s.w.t.) (*huquq Allah*) or the rights of servants (*huquq al-'ibad*). Fulfilment of *huquq Allah* such as having faith, fidelity, prayers, fasting and pilgrimage by a minor is valid. However, he is not bound to perform the acts of worship (*'ibadat*) except for education (*ta'dib*) and refinement (*tahdhib*) purposes.

2 ***Ahliyyah Al-Ada' Al-Kamilah (complete capacity for the execution of duties).***

Complete intellectual and physical capacity forms the basis for this type of legal capacity which is originally determined by the perfection of one's intellect. However, as intellect is a hidden thing, it is to be determined by puberty which constitutes the origin of intellect and sanity because enforcing execution before the perfection of sanity is a form of "*haraj*" which is to be avoided. A person is considered sane (*'aqil*) based on his reaching puberty (*bulugh*) by which the perfect capacity for execution of duties (*ahliyyah al-ada' al-kamilah*) is established, provided that it is free from the causes of defective legal capacity (*'awarid al-ahliyyah*). Therefore, a human is considered legally capable and responsible for the legal commandment (*takalif shar'iyyah*) when this capacity is perfect in him. He is duty-bound to perform all the legal commandments assigned to him and is considered sinful if he falls in neglect of them. All contracts and conducts emanated from him are valid and their legal consequences will take effect.

4 Kamil Musa (1998), *Ahkam al-Mu'amalat*, Beirut: *Muassasah al-Risalah*, page: 64.

Classification of *Shari'ah* Contracts

Shari'ah contracts are divided into several classifications with regard to the purpose for which certain contracts are entered into. Each category in this regard is different from one to another mainly with regard to the legal purpose intended by the Lawgiver which thereafter causes the difference in the legal effects of the contracts such as transfer of ownership, risk-taking and profit distribution. In fact, the basic conditions and requirements of the contracts are also different from one to the other due to differences in the purpose and nature of the contracts. Hence, these classifications are significant to determine the rules and conditions which need to be met completely so as to make the contracts valid and enforceable, and in turn all the legal effects of the contract will take effect. The classifications are as follows:

Exchange-based Contracts (*'Uqud Al-Mu'awadat*)

Exchange-based contracts are contracts which are entered into by two transacting parties to acquire ownership of an asset or commodity which end up with the transfer of ownership of the exchanged counter values. The exchanged counter values can either be usufruct in a lease contract or a corporeal thing in a currency exchange, forward sale and manufacturing contract. Exchange-based contracts, however, are founded upon the principle of justice in the sense that the rights of both parties are to be fulfilled at a minimum or obligatory level. If the seller earns a profit from a forward sale that he entered into, the buyer also gets the contracted commodity at the stipulated time.

Exchange-based contracts are contracts which are entered into by two transacting parties to acquire ownership of an asset or commodity which end up with the transfer of ownership of the exchanged counter values.

Charity-based Contracts (*'Uqud Al-Tabarru'at*)

Charity-based contracts are the contracts effected by someone on the basis of benevolence (*ihsan*) and cooperation (*ta'awun*), which does not require the exchange of something for another thing. Therefore, an asset ownership in this regard is acquired without any counter value. The examples of charity-based contracts are benevolent loan (*qard*), gift (*hibah*), charity (*sadaqah*), endowment (*waqf*) and asset borrowing (*i'arah*). Usually, any attempt to impose a counter value in the form of an increment or access on the principle loan for instance, may disturb the very purpose of the charity-based contract or its underlying principle. Therefore, an increment on the principle loan is not permissible and is deemed *riba al-nasi'ah* as it violates the very principles of *tabarru'* such as *ihsan* and *ta'awun*.

Waiving Contracts (*'Uqud Al-Isqatat*)

Waiving contracts are contracts which are entered into by someone who has waived the right that has been established in one's liability whether with or without a counter value.

Waiving contracts are contracts which are entered into by someone to waive a right that has been established in one's liability whether with or without a counter value. If it is effected without a counter value such as a rebate (*ibra'*) and the right of pre-emption (*shuf'ah*) is waived, then it is called *isqat mahd* (purely waiving contract) and if otherwise, then it is termed as *isqat al-mu'awadah*.

Partnership Contracts (*'Uqud Al-Ishtirak*)

Partnership contracts refer to contracts which are entered into for the purpose of having a partnership in work and profit.

Partnership contracts refer to contracts which are entered into for the purpose of having a partnership in work and profit. It is founded upon the spirit of cooperation and partnership in the sense that profits are shared together by the partners and losses are borne by both of them. Examples of partnership-based contracts are *musharakah*, *mudarabah*, *muzara'ah* and *musaqah*.

Concept of Exchange-based Contracts

The foregoing discussion on the *Shari'ah* classification of contracts explains that exchange-based contracts can be generally subdivided into two main categories, namely sale-based contracts and lease-based contracts. Therefore, the remaining chapter focuses on both categories of the exchange-based contracts which are widely applied in contemporary Islamic finance, namely *bay' al-murabahah*, *bay' al-salam*, *bay' al-istisna'*, *bay' al-dayn*, *bay' al-sarf*, *bay' al-tawarruq*, *bay' al-'inah* and *ijarah*. The discussion delineates the definitions, legality, basic rules and conditions and salient *Shari'ah* issues arising from contemporary application of the respective contracts.

Bay' Al-Murabahah (Mark up Sale)

Bay' al-murabahah (hereafter *murabahah*) literally means increase in capital or profit trading. Technically, it is defined as a sale in which the mark up is disclosed to the purchaser as per the seller's purchase price for a trust-sale of a certain specified asset, excluding monetary assets such as debt. It may be contracted either on a cash basis or deferred payment basis. The main distinctive feature that distinguishes it from other kinds of sales is that the seller in a *murabahah* contract expressly discloses to the purchaser how much cost he has incurred, and how much profit he is going to earn in addition to the cost.

Bay' al-murabahah: technically, it is defined as a sale in which the mark up is disclosed to the purchaser as per the seller's purchase price for a trust-sale of a certain specified asset, excluding monetary assets such as debt.

Legality of a *Murabahah* Contract

The legality of the *murabahah* can be traced from the *Qu'ran*, the *Sunnah* of the Prophet Muhammad (p.b.u.h.) and the consent of the majority of Muslim jurists. In the *Qur'an*, Allah (s.w.t.) has generally legalised sale contracts, one of which is the *murabahah* sale contract. He says: "And Allah (s.w.t.) has permitted trade and prohibited usury" (2:282). In another verse, Allah (s.w.t.) says: "O you who believe! Eat not up your property among yourselves unjustly except if it is a trade amongst yourselves, by mutual consent" (4:29). In this regard, a *murabahah* contract is a contract concluded on the basis of mutual consent, and hence it falls under the general permission of acquiring wealth in this verse. However, Islamic jurisprudence literature indicates that the legitimacy of *murabahah* is based on the consent of the majority of Muslim jurists.

Conditions of a *Murabahah* Contract

All conditions of a sale contract apply to a *murabahah* contract as it is also a sale contract. However, there are some specific conditions that need to be fulfilled for the *murabahah* contract to be valid. They are as follows:

1 ***The cost price must be disclosed to the contracting parties.***

The cost price must be disclosed to the second buyer because knowing the price is a condition of validity of this type of sale contract. If the original price is not known to the buyer as it is not disclosed to him, then the *murabahah* contract is deemed voidable (*fasid*) until it is disclosed in the session. However, if he is ignorant of the original price until both contracting parties leave each other, the contract is considered void (*batil*). In other words, if the exact cost is unknown, the commodity cannot be sold based on a *murabahah* contract. Instead, it can be sold on the basis of other types of sale contract like the *musawamah* contract, which does not require any reference to the original cost. For example, if a person has purchased two or more things in a single transaction, and he does not know the price of each object separately, he cannot sell the purchased object on a *murabahah* basis.

2 *The mark up (profit) must be disclosed to the contracting parties.*

Since the profit constitutes a part of the selling price, it must be agreed upon between the contracting parties in the contract because the selling price which includes the original price and the mark up is actually a condition for the validity of the sale contract.

3 *The original price should be of fungible things.*

The price in a *murabahah* contract should be of a fungible property such as weighables (*mawzunat*), measurables (*makilat*) and countables (*'adadiyyat*).

The price in a *murabahah* contract should be of a fungible property such as weighables (*mawzunat*), measurables (*makilat*) and countables (*'adadiyyat*). If the price of the goods is not something that can be returned in kind (*mal mithli*) such as non-homogeneous properties (*mal qimi*) or *'urud* (goods other than gold and silver), then it cannot be sold based on a *murabahah* contract.

4 *The* murabahah *contract should not lead to* riba.

If the subject matter in a *murabahah* contract is a *ribawi* item, the validity of the *murabahah* requires that *riba* does not occur in relation to the original price. For instance, if a *ribawi* object measured by weight or volume is initially traded for goods of the same genus in the same amount, then the purchased goods cannot be sold using a *murabahah* contract. In this case, the *murabahah* contract would consist of trading at the initial price plus an increase (*ziyadah*). The increment that arises from a *ribawi* item is considered *riba* rather than profit. Similarly, such goods cannot be sold using the *wadi'ah* contract (sale at below cost). However, they can be sold for the same amount via the *tawliyyah* contract (sale at cost price), where *riba* is not effected.

5 *Validity of initial contract.*

An item that is sold through a *murabahah* contract must be acquired by the seller through a valid contract.

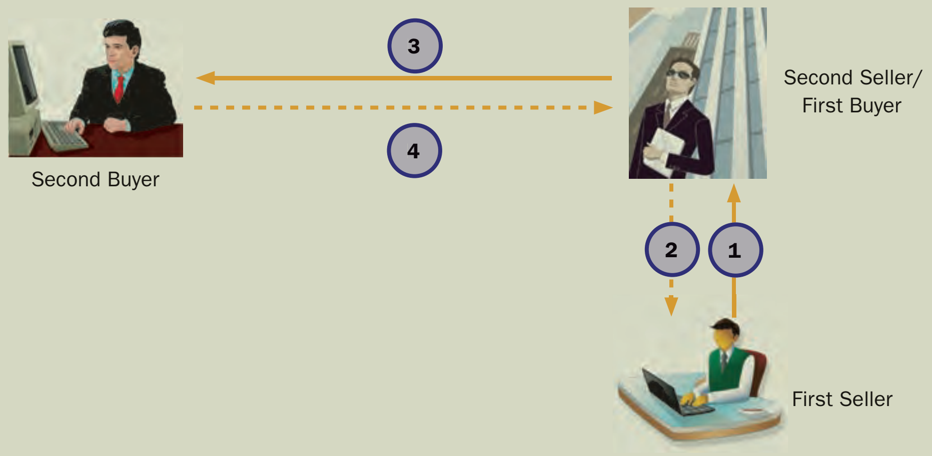
An item that is sold through a *murabahah* contract must be acquired by the seller through a valid contract. Consequently, if the initial contract is irregular or voidable (*fasid*), then the second sale is not permitted to be contracted on the basis of *murabahah* because the *murabahah* contract is actually the resale of a commodity at a similar price with cost plus, and the voidable sale is not allowed to be contracted with the stated price. It is allowed only with the price legally recognised by *Shari'ah* (*qimah al-mabi'*) such as market price. Thus, the naming of the price in a *murabahah* contract is not valid if the initial sale is irregular or voidable.

Types of *Murabahah* Contract

A *murabahah* contract comprises the following two types:

1 *Ordinary* murabahah.

It is a contract in which the seller who is an ordinary trader buys a commodity without relying on any prior promise to purchase or to sell, or without a purchase undertaking or sale undertaking. He then resells it on a *murabahah* basis for a price plus profit to be agreed upon in the contract.



1 The second seller/first buyer buys a commodity from the first seller on a deferred payment basis or spot basis.
2 The second seller/first buyer pays the price of the commodity to the first seller either on a cash basis or on a deferred payment basis. If he pays on a deferred basis through a *murabahah* contract, then he must tell the second buyer that he bought it using a *murabahah* contract.
3 The second seller sells the commodity to the second buyer by disclosing the cost price of the commodity, and whether he bought it from the seller through *murabahah*.
4 The second buyer pays the price either on a cash basis or a deferred basis.

Figure 6.1 Illustration: An Ordinary *Murabahah* Structure Flow

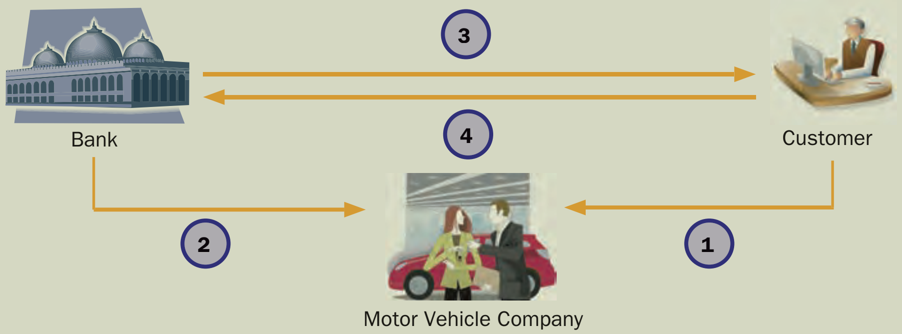
2 Murabahah *to the Purchase Orderer (MPO).*

This type of *murabahah* is widely applied by Islamic financial institutions (IFIs) as one of their financing tools. It involves the sale of a commodity through a *murabahah* contract to the purchase orderer (MPO) for a pre-agreed selling price, which includes a pre-agreed profit mark up over its cost price. This is clearly specified in the customer's promise to purchase the asset. Hence, this transaction includes a prior promise to buy or a request made by a person interested in acquiring the goods on credit from any financial institution. Therefore, it is called "*murabahah* to the purchase orderer". The payment is payable within a fixed future date by lump sum or fixed instalments.

The payment is payable within a fixed future date by lump sum or fixed instalments.

Application of *Murabahah* Contracts in Islamic Finance

Murabahah contracts have been widely used by many Islamic banks and financial institutions as a mode of financing in various financing operations such as home financing, motor vehicle financing, personal financing and trade financing. However, the use of the MPO concept is more prevalent in contemporary Islamic financial products compared to ordinary *murabahah*. Figure 6.2 shows an example of the *murabahah* structure flow for motor vehicle financing:



1 The customer identifies the motor vehicle to be acquired.
2 The bank purchases the identified motor vehicle from the owner on cash basis.
3 The bank sells the motor vehicle to the customer at a cost plus profit on credit basis.
4 The customer pays the bank within the agreed terms of financing.

Figure 6.2 Illustration: A *Murabahah* Structure Flow for Motor Vehicle Financing

Salient *Shari'ah* Issues in a *Murabahah* Contract

> A *murabahah* in its classical form may not give rise to many *Shari'ah* issues as legal rulings related to its application have been laid down clearly and comprehensively by past jurists.

A *murabahah* in its classical form may not give rise to many *Shari'ah* issues as legal rulings related to its application have been laid down clearly and comprehensively by past jurists. However, *murabahah* in its modern structure such as MPO which is a form of combined contracts (*'uqud murakkabah*) may result in many *Shari'ah* issues, especially when it involves undertakings like agency (*wakalah*) and purchase undertaking (*al-wa'd bi al-shira'*).

1 *Rebate in the event of a default.*

Classical jurists argued that the *murabahah* contract is one of the trust-based contracts in which everything should be disclosed including the cost price and the mode of payment of the first sale. For example, if someone bought a commodity through a *murabahah* contract which was concluded on a deferred payment basis, he must disclose to his customer (second buyer) that he has purchased the commodity on a deferred payment basis. If not, he is said to have committed a betrayal (*khiyanah*) because a *murabahah* contract involves the time value of money which must be taken into account as it is recognised by the *Shari'ah*. The time value of money in this regard entails that deferment (*al-ajal*) earns a portion in the price of a *murabahah* contract. Hence,

> Jurists stipulated that an increment in price of a *murabahah* contract is due to assigning monetary value to deferment.

jurists stipulated that an increment in the price of a *murabahah* contract is due to assigning monetary value to deferment. As such, the question that arises from this is whether the bank must give a rebate to the customer in the event of default, and whether to give for early settlement, or not. This is because, in both cases, the deferment which constitutes the basis for increment in a *murabahah* contract is no longer enjoyed by the customer since he has to settle the debt on a spot basis.

2 *Disclosure of cost price.*

The seller is obliged to disclose the actual cost price or purchase price of the asset that is intended to be sold to the customer on the basis of *murabahah*. Therefore, if the exact cost cannot be ascertained or is unknown, it is impossible to have a *murabahah* contract . In this case, the sale must be conducted on the basis of *musawamah* (bargaining).

3 *Use of the interest rate as a benchmark.*

Many institutions do financing by way of *murabahah* to determine their profit or mark up on the basis of the current interest rate, mostly using the LIBOR (Interbank offered rate in London) as the criterion. For example, if the LIBOR is 6%, they would determine their markup on *murabahah* equal to LIBOR or some percentage above the LIBOR. This practice is often criticised on the grounds that profit based on a rate of interest should be prohibited as interest itself.

Bay' Al-Istisna' (Manufacturing Sale)

Literally, the word *istisna'* is derived from the Arabic verb "*istasna'a*" which means to request someone to manufacture an asset. Technically, *bay' al-istisna'* (hereafter *istisna'*) is defined as a contractual agreement with a manufacturer to produce items with specified descriptions at a determined price, and manufactured from his own materials with his own effort. If the materials needed are not provided by the manufacturer as they are from *mustasni'* (the person who requests the construction of an item), the contract is considered a lease contract.

Bay' al-Istisna' is defined as a contractual agreement with a manufacturer to produce items with specified descriptions at a determined price, and is made by the manufacturer's own expertise, using his own material.

Legality of *istisna'*

According to jurists, the legality of an *istisna'* contract is established from different legal sources such as the *Sunnah*, *ijma'*, *qiyas* and *istihsan*. However, *istihsan* seems to represent the first legal basis for this contract, especially in classical Islamic jurisprudence literature. Nafi' reported that Abdullah ibn 'Umar has reported to

him that the Prophet Muhammad (p.b.u.h.) requested the manufacturing of a ring for him.[5] This narration provides a clear basis for the legitimacy of *istisna'* in Islam. According to Hanafi jurists, the *istisna'* contract is legitimate on the basis of the people's customary practice of this contract in all periods of time without any objection, which in turn constitutes a legal consensus (*ijma'*) on the legality of an *istisna'* contract.

Basic Rules and Conditions of an *Istisna'* Contract

1 The object to be manufactured must be precisely determined in its type, kind, quality and quantity. This is because the manufactured object is the subject matter of an *istisna'* contract, which requires a clear determination of its essence considering that an *istisna'* contract is a form of sale of the nonexistent (*bay' al-ma'dum*) which is exempted from its original ruling. Hence, it is always associated with the risk of uncertainty of the deliverability of the subject matter which can be mitigated through the abovementioned mechanism.

The object in an *istisna'* contract must be something that the people are familiar contracting on an *istisna'* basis, i.e., buildings, houses and heavy vehicles.

2 The object in an *istisna'* contract must be something that the people are familiar with to contract it on the basis of an *istisna'* contract, i.e., building houses and heavy vehicles. Therefore, objects such as a book or a shirt is not valid to be the subject matter as the people are not accustomed to contracting them on an *istisna'* basis. The time of delivery of the manufactured object must be clearly specified to avoid uncertainty and ambiguity which may lead to a later dispute among the transacting parties.

(a) The materials should be supplied by the manufacturer. If they are provided by the buyer, the contract is deemed as *ijarah* and not *istisna'*.

(b) The place of delivery should be specified if the commodity needs loading or transportation expenses.

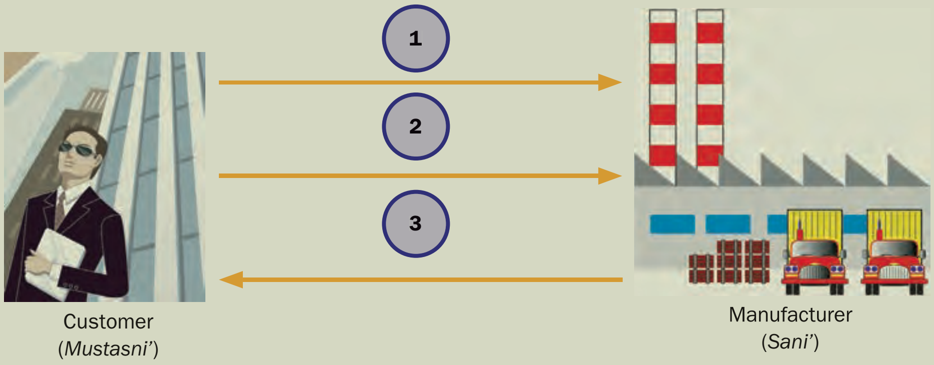
Types of *Istisna'* Contract

The *istisna'* contract is divided into two types, the first of which involves two parties and the other, three parties. They are as follows:

Classical *Istisna'*

A classical *istisna'* contract is one that has been thoroughly discussed by previous scholars in Islamic jurisprudence literature. This type of *istisna'* involves only two contracting parties, namely the buyer as *mustasni'* and the manufacturer as *sani'*.

5 Ahmad b. Hanbal (1998), *Musnad Ahmad*, Musnad Anas Ibn Malik, *Hadith* No. 12012, J. 4. Beirut: '*Alam Al-Kutub*, page 258.



1 The customer requests the manufacturer to construct for him a specified asset for a price agreed upon, payable over a pre-agreed period of time or on a cash basis to be delivered on the stipulated date.
2 The customer pays the agreed price of the asset to the manufacturer either by instalment or spot basis.
3 The manufacturer delivers the completed asset to the customer on the stipulated date.

Figure 6.3
Illustration: Classical ***Istisna'*** Structure Flow

Parallel *Istisna'*

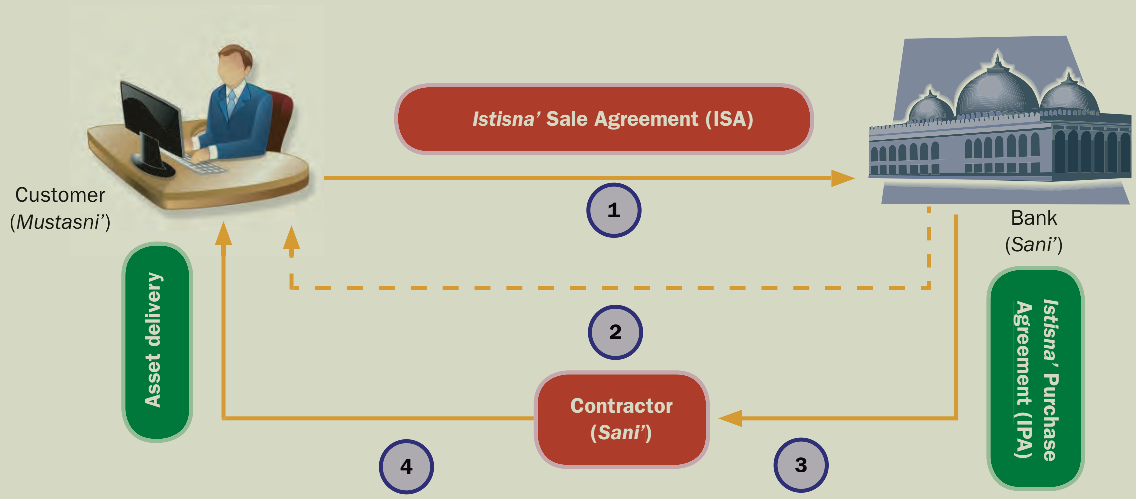
Parallel *istisna'* consists of two series of separate *istisna'* contracts whereby the first *istisna'* contract is between the ultimate purchaser (customer) and the seller (bank), who is responsible for delivering the specified asset to the purchaser.

Application in Contemporary Islamic Finance

In contemporary Islamic finance, an *istisna'* contract is applicable to various industrial productions which can be constructed or manufactured and supervised by specification. For example, an *istisna'* contract can be employed in housing construction and advanced technology industries, equipment such as aircraft, automobile, ship and factory equipment.

Salient *Shari'ah* Issues in Contemporary Application

A *Shari'ah* issue in an *istisna'* contract arises in the event the manufacturer fails to deliver the manufactured asset on the date agreed upon. One way that can be exercised to overcome this issue is by allowing the stipulation of a punitive condition (*al-shart al-jaza'i*) upon the manufacturer in the event of his failure to deliver the purchased asset at the agreed time.



1 A customer requests the bank to construct a specified asset at a pre-agreed price consisting of cost price plus profit margin determined by the bank, payable on a deferred payment basis. Both will sign a sale agreement based on an *istisna'* contract (*Istisna'* Sale Agreement (ISA)) in which the customer acts as a buyer (*mustasni'*) and the bank as a manufacturer (*sani'*).
2 The bank delegates the customer to appoint a contractor on his behalf to construct the asset as specified in the ISA at the price determined by the bank which is payable by instalment.
3 Both bank and contractor sign a purchase agreement based on an *istisna'* contract (*Istisna' Purchase Agreement* (IPA)) whereby the bank is *mustasni'* and the contractor is *sani'*.
4 Upon completion of the asset, the contractor as *sani'* in the IPA will deliver the completed asset to the bank as *mustasni'* and the bank, as in the ISA, will deliver the asset to the customer as *mustasni'* or the contractor with the authority from the bank may deliver the asset directly to the ultimate purchaser (customer).

Figure 6.4 Illustration: Parallel *Istisna'* Structure Flow for House Financing

Bay' Al-Salam (Forward Sale)

Salam literally means giving (*'ita'*), advance (*taslif*) and leaving. Technically, a *bay' al-salam* (hereafter *salam*) contract refers to a sale contract whereby the seller undertakes to sell some specific commodities to the buyer at an agreed future date in exchange for a price fully paid in advance on a spot basis.

Legality of *Salam* Contract

The legitimacy of a *salam* contract can be deduced from the *Qur'an*, the *Sunnah* of the Prophet (p.b.u.h.) and the 'jima'. In the *Qur'an*, Allah (s.w.t.) says: "*O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing, let a scribe write down faithfully as between the parties*" (*Surah al-Baqarah* (2): 282). Ibn 'Abbas said that this verse was revealed regarding the permissibility of a *salam* contract as one of the debt-based contracts.[6] Ibn 'Abbas also related that when the Prophet (p.b.u.h.) migrated to Medina, the people were trading

6 Al-Tabari (2000), *Jami' Al-Bayan fi Ta'wil Al-Qur'an*, Vol. 2, Beirut: *Mua'ssasah Al-Risalah*, page: 48.

fruits for a period of one, two or three years using the *salam* contract. Then he ordained: "Whoever pays money in advance (for fruit to be delivered later) should pay it for a known quality, specified measure and weight (of dates or fruit) and of course, along with the price and time of delivery." Ibn Mundhir transmitted legal consensus of all scholars on the permissibility of the *salam* contract for the purpose of meeting the needs of farmers who needed money for their agricultural productions, and feeding their family up to harvesting time during which the agricultural products can be sold or delivered to the buyer. It is for this reason that the *salam* contract has been exempted from the prohibition of *bay' al-ma'dum* (selling of the nonexistent).

Basic Rules and Conditions of a *Salam* Contract

In a *salam* contract, the buyer is termed as "*rabb al-salam*" or "*musallim*" whereas the seller is called "*musllam ilayh*". The cash price paid in advance by the buyer is called "*ra's al-mal*" and the purchased commodity is termed as "*musallam fih*". The majority of scholars are of the opinion that there are three requirements of a *salam* contract: transacting parties (*musallim* and *musllam ilayh*), subject matter (*ra's mal al-salam* and *musallam fih*) and form (*sighah*) of a *salam* contract (offer and acceptance). A *salam* contract is not valid unless its general and specific conditions are completely met. General conditions refer to the conditions for the valid conclusion of a sale in general whereas specific conditions can be summarised as follows:

The cash price paid in advance by the buyer is called *"ra's al-mal"* and the purchased commodity is termed as *"musallam fih"*.

1 ***Conditions related to the price (ra's al-mal).***

The price must be clearly determined and paid in full by the buyer at the time of undertaking the sale to avoid a later dispute. The seller on the other hand, must take possession of the price in full before departing one another. Otherwise it will be tantamount to the sale of debt for a debt which is prohibited by the Prophet (p.b.u.h.) and against the wisdom and purpose for which it has been made permissible. However, Maliki jurists allowed it to be paid within a few days as long as it is not stipulated as a condition.[7] If the price is a *ribawi* item, it is not allowed to be exchanged for another *ribawi* item based on a *salam* contract to avoid *riba al-fadl* and *riba al-nasi'ah*. Therefore, the exchange of weightable goods like wheat for another weightable goods like barley cannot be done through a *salam* contract.

If the price is a *ribawi* item, it is not allowed to be exchanged for another *ribawi* item based on a *salam* contract to avoid *riba al-fadl* and *riba al-nasi'ah*.

2 ***Conditions related to the purchased commodity (musallam fih).***

A *salam* contract can be effected on the commodities whose quality and quantity can be clearly specified. Therefore, the commodities whose quality or quantity is not determined by specification cannot be sold through a *salam*

7 Kamil Musa (1988), *Ahkam al-Mu'amalat*, Beirut: *Muassasah al-Risalah*, page: 224.

contract. It is unanimously agreed among the scholars that this condition does exist in every commodity which is quantified in weights or through measures. This condition is not fulfilled in anything that cannot be treated as debt such as immovable assets and transport. The commodity must be what is freely available in the market. As for *'urud* (other than gold and silver), the majority of scholars are of the opinion that if its quality and quantity can be normally specified, then it can be sold through a *salam* contract. However, they differ in what can be specified in quantity and quality.

The quantity of the commodity must be agreed upon in unequivocal terms. If the commodity is weighable, its weight must be determined, and if it is measurable, its exact measure should be known. What is normally weighed by the traders cannot be specified in other measures and vice-versa.

3 ***Conditions related to the date and place of delivery.***

The exact date and place of delivery must be specified in the contract. However, scholars differ on the shortest duration of time of delivery. Some of them say that the shortest time is three days, some say that it has to be more than half a day, and some opine that it should be thirty days, while others hold the opinion that it is up to the contracting parties to decide.

In a *salam* contract, the exact date and place of delivery must be specified in the contract.

Types of *Salam* Contract

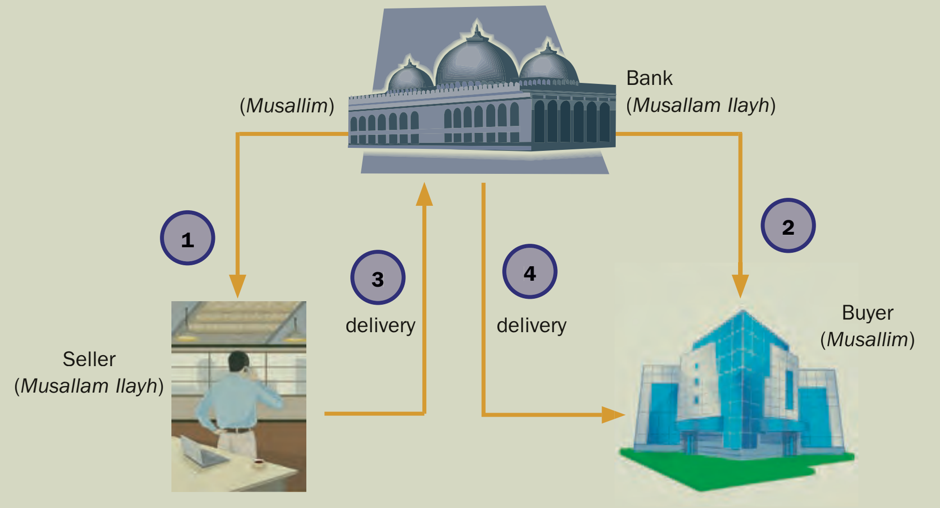
There are two types of *salam* contract. The first is the ordinary *salam* contract and the second one is the parallel *salam* contract.

Ordinary *Salam* Contract

It is a contract of *salam* that has been thoroughly discussed by previous jurists in the classical books of *fiqh*. It involves only two transacting parties: the buyer (*musallim*) and the seller (*musllam ilayh*).

Parallel *Salam* Contract

It is a contractual arrangement that consists of two different and independent contracts; one in which the bank is a buyer and the other in which the bank is a seller. The two contracts cannot be tied up and performance of one contract should not be contingent upon the other.



1 The bank enters a *salam* contract with the seller and pays cash in full for the commodities to be delivered at an agreed time in the future.
2 The bank enters a parallel *salam* contract with the buyer who will purchase the commodities from the bank when they are delivered.
3 The commodities are delivered to the bank.
4 The commodities are delivered to the purchaser who pays the agreed price to the bank.

Figure 6.5
Illustration: Parallel *Salam* Structure Flow

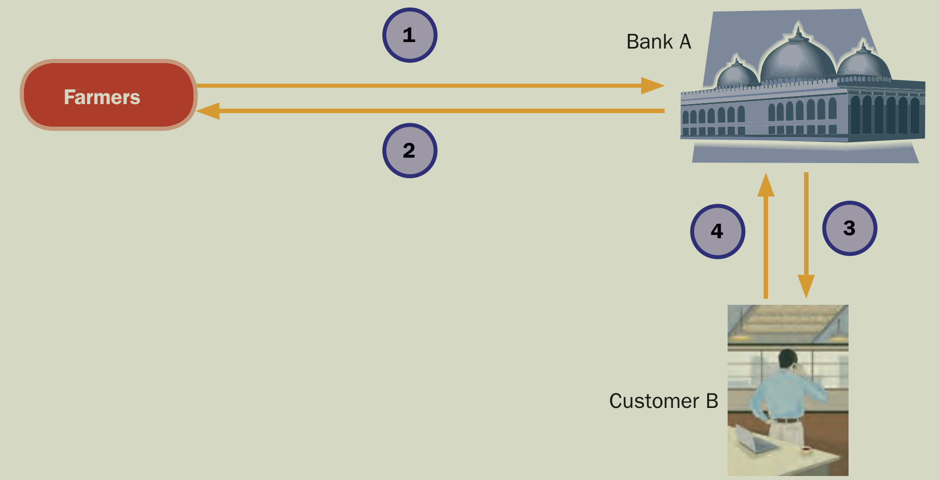
Application of *Salam* Contract in Contemporary Islamic Finance

A *salam* contract is typically used in short-term financing and could also be employed for a longer term of financing. The *salam* and parallel *salam* are among the most effective financing tools available for IFIs, particularly in providing microfinancing services for small and needy farmers. It is an appropriate mode of financing for seasonal agricultural productions in which lies the benefit for both contracting parties: the bank and the farmers (sellers). The banks may benefit from the *salam* contract by entering into a contract in which payment is made on spot basis. Hence, the bank is safe from the deferred contract of exchange like *bay' muajjal* in which the price is to be paid later but at a higher profit rate considering that deferment earns a portion of the price. In this case, the bank can bargain with the farmers for a price less than the market price or the deferred price. The seller on the other hand, will have the funds to enable him to produce the commodities according to the specified quantity and quality.

A *salam* contract is typically used in short-term financing and could also be employed for a longer term of financing.

Salient *Shari'ah* Issues in Contemporary Application

Modern banks are not so much in favour of a *salam* contract as it will result in their receipt of certain commodities from their clients, and will not entitle them to receive money. As banks are accustomed to monetary deals only, it seems irrelevant for them to receive different commodities from different clients, and to resell the commodities in the market since they cannot sell those commodities before they are



1 The farmers execute a *salam* contract to sell a specified amount of wheat in advance for RM10 million to bank A. The wheat is to be delivered on 1 June 2010.
2 Bank A pays RM10 million on a spot basis to the farmers and also stipulates from where to take delivery on 1 June 2010.
3 Bank A enters into a promise with customer B in which customer B undertakes that he will purchase wheat from bank A for RM15 million on 1 June 2010 against of RM5 million.
4 The farmers supply the specified wheat to bank A on 1 June 2010; bank *hamish jiddiyah* A informs customer B to execute the sale and take delivery.

Figure 6.6 Illustration: Application of ***Salam*** Contract in Agricultural Financing

actually handed over to them, because selling a commodity before taking possession is prohibited by the *Shari'ah.*

Bay' Al-Dayn (Sale of Debt)

Bay' al-dayn is the sale of debt which can be either against a debt or other than a debt, to the debtor or other than the debtor, on a cash basis or a deferred payment basis.

Legality of *Bay' Al-Dayn*

Bay' al-dayn is the sale of debt which can be either against a debt or other than a debt, to the debtor or other than the debtor, on a cash basis or a deferred payment basis.

In general, the majority of Islamic jurists are unanimous in the permissibility of the sale of debts to the debtor. They are also agreeable on the prohibition of exchanging one delayed counter value for another delayed counter value (*bay' al-kali' bi al-kali'*). However, they hold different views about the sale of debt to a third party on the grounds that the seller will not be able to deliver the sold debt. Hence, it can be said that the legality of *bay' al-dayn* depends on its types which are determined by the number of parties involved (whether two or three), the party to whom the debt is sold (whether to the debtor or non-debtor) and the modes of delivery (on a spot basis or credit basis).

In general, the majority of Islamic jurists are unanimous in the permissibility of the sale of debts to the debtor.

Types of *Bay' Al-Dayn*

Bay' al-dayn can be contracted on a spot basis at a cash price or on a credit basis at a deferred price. The debt sold on a spot basis may be sold either to the debtor himself or to a non-debtor. Similarly, the debt sold on a credit basis may be sold either to the debtor himself or to the non-debtor. The legal rulings may differ from one type of debt sale to another as follows:

Sale of debt to the debtor on a cash basis

This type of debt sale has been thoroughly discussed by Islamic jurists in classical literatures of jurisprudence. A large majority of Islamic jurists allow this type of debt sale on the premise that what is established in one's liability (*dhimmah*) is considered existent and present in actuality (*hadir*), and the legal ruling for something that is in one's possession is also assigned to what is established in one's liability. Hence, this debt sale is in reality an exchange of an existing counter value for another existing counter value (*bay' hadir bi hadir*) which will not lead to any dispute among the transacting parties, i.e., the creditor and the debtor.

Illustration of the Sale of Debt to the Debtor on a Cash Basis

Ahmad owes Muhammad RM500 and Muhammad sells the debt to Ahmad for a portion of the land owned by Ahmad.

Sale of debt to the non-debtor on a cash basis

Islamic jurists have also discussed this type of debt sale in detail where they hold different views on the legality of this sale contract. The prevalent view of the Shafi'i and Maliki schools of law is that its permissibility is subject to certain conditions. Among the conditions laid down by the Maliki scholars are the following:

Illustration of the Sale of Debt to a Non-Debtor on a Cash Basis

Yusuf owes Ahmad RM5,000. Ahmad then sells the debt (RM5,000) to Zaid for a motorbike on a spot basis.

1 Payment should be made on the spot to avoid the sale of debt against debt which is prohibited, or the occurrence of possession of the price must be instant.

2 The debtor is present at the point of sale.

3 The debtor must confirm the debt so as to avoid any objections from his side that may lead to a dispute.

4 The debtor should have the legal capacity, and hence can be legally bound to the law.

5 Payment is not of the same type as *dayn*, and if it is so, it should be sold at par value to avoid *riba*.

6 If the debt is gold, it cannot be sold for silver to avoid deferred currency exchange contract (*sarf mua'khhar*).

7 The *dayn* should be goods that are tradable before taking possession. This is to ensure that the *dayn* is not of the food type which cannot be traded before the occurrence of *qabd*.

8 There should be no enmity between the debtor and the buyer, which can cause harm to the *madin* (debtor).

Hanafi scholars disallowed this type of debt sale since it is not the same as selling debt to the debtor at a cash price because the seller (creditor) may fail to deliver the payment (debt) to the buyer despite the fact that the debt is established in the liability of the debtor. This will render the contract voidable (*fasid*).

Sale of debt to a debtor for a deferred price

Illustration of the Sale of Debt to a Debtor at a Deferred Price

Yusuf owes Ahmad RM5,000. Ahmad then buys a car from Yusuf and the price is the debt (RM 5,000) itself payable after 10 months.

The majority of Islamic jurists including Hanafi, Maliki and Shafi'i scholars do not allow this type of debt sale because it is a form of selling debt against debt, which is prohibited. It is also a means of committing *riba* because this transaction consists of increment arising from deferment in the terms of payment of the debt by the debtor. However, Ibn Taymiyyah, Ibn al-Qayyim and some contemporary Islamic jurists allow it.

Sale of debt to a non-debtor for a deferred price

Illustration of the Sale of Debt to a Non-Debtor at a Deferred Price

Ahmad owes Ali RM500. Ali then sells the debt (RM500) to Azman for a book payable after 20 days.

Islamic jurists like Ibn Taymiyyah and Ibn al-Qayyim allowed this type of debt sale on the basis of *qiyas* (analogy) upon *hiwalah* contract (transfer of debt). This transaction also secures benefits for the contracting parties. For example, the creditor is in need of certain goods and he has nothing to pay for the goods except the debt he owns, and the debtor may not own the goods that the creditor needs. In this regard, this type of debt sale can be exercised to satisfy the needs of the creditor without causing harm to the debtor. In the meantime, the debtor is obliged to pay the debt either to the original creditor or someone in his place. This opinion is also subscribed by some contemporary scholars. In contrast, the majority of scholars including Hanafi, Maliki, Shafi'i and Hanbali scholars opined that this type of debt sale is impermissible on the grounds that it causes direct harm to the creditor. This is because the debtor may face insolvency (*iflas*), disclaim liability for the debt or travel to evade repayment of the debt. In this regard, the creditor will suffer harm.

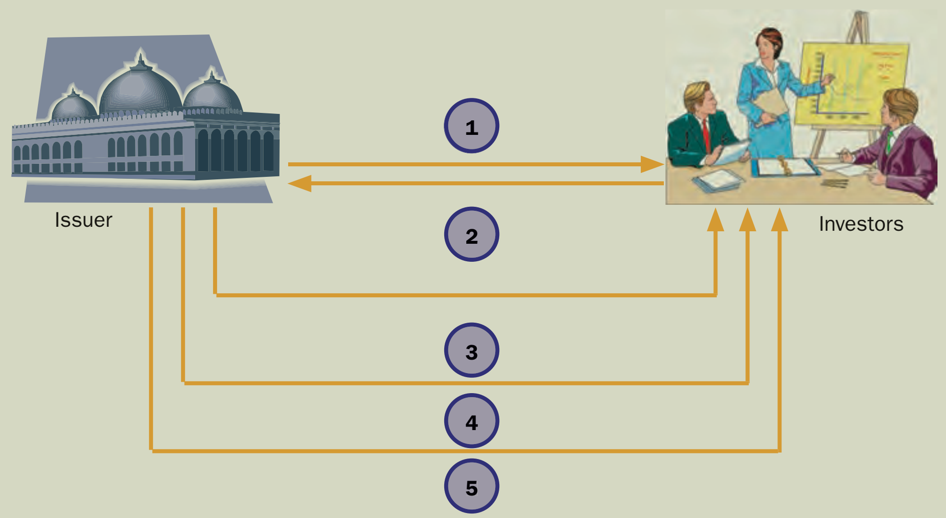
Application of *Bay' Al-Dayn* in Contemporary Islamic Finance

Bay' al-dayn has been mainly used in Malaysia as one of the underlying *Shari'ah* contracts in structuring various Islamic finance facilities including Islamic money market instruments, Islamic treasury bills, Islamic negotiable instruments, Islamic accepted bills and Islamic bonds (refer to Chapter 9 for detailed descriptions).

Salient *Shari'ah* Issues in Contemporary Application

In Islamic securities, *bay' al-dayn* has been widely used for liquidity purposes or capital gains resulting from the tradability of the certificate of debt.

In Islamic securities, *bay' al-dayn* has been widely used for liquidity purposes or capital gains resulting from the tradability of the certificate of debt. As the paper itself is regarded by some Islamic scholars as equal to property (*mal*) since it is supported by some underlying assets via the *'inah* sale, it is allowed to be sold at a discount, and hence produce the same economic effects of conventional bonds. This in turn depicts a bad image of Islamic financial products whereby in this case, they are introduced to



1 The issuer sells an asset worth RM200 million to investors on a cash basis.
2 Subsequently, the investors sell back the underlying asset to the issuer for RM220 million on a credit basis.
3 The issuer makes payment to investors through the issuance of debt certificates (*shahadah al-dayn*).
4 Primary Notes (PNs) are sold to investors at par value redeemable upon maturity to guarantee the repayment of capital. In this case, it represents the amount of RM200 million which will be sold back to the issuer upon maturity for RM200 million on a cash basis.
5 Secondary Notes (SNs) are sold to the investors at par value redeemable at the time agreed upon. In this case, the issuer will pay RM20 million via instalments over a certain period of time.

Figure 6.7 Application of *Bay' Al-Dayn* in Islamic Bonds

satisfy the customers' preferences and also fit the Islamic bank's attitudes of being risk-averse. Instead, Islamic financial products are no longer being imbued with the principle of *al-ghunm bi ghurm* (entitlement to return is related to the liability of risk). If debt is considered money itself, it can only be sold at par value and cannot be traded at a higher price to avoid *riba* or it can be regarded as a real property and not a currency, and hence can be sold at any price, discount, lesser or higher because it is no longer a currency that must be subject to certain rules of currency transaction laid down by the *Shari'ah*. The issue also lies in the legal status of the subject matter (certificate of debt) as to whether it is a commodity or money. Those who argued that it is a commodity based their arguments on the way the debt was primarily created which in the above case is *bay' al-'inah* (buy-back sale). Hence, the debt in this case which includes cost price and profit, did not arise from money-for-money transaction. This renders the debt different from those created out of money-for-money transaction in which the rules related to *riba* must take effect.

Bay' Al-Sarf (Sale of Currency)

Technically, it is a sale of money-for-money such as the sale of gold-for-gold or silver-for-silver. However, Maliki scholars consider money exchange only if the sale is gold-for-gold or silver-for-silver, but gold-for-silver does not belong to such transactions.

Legality of *Bay' Al-Sarf*

The legality of *bay' al-sarf* can be deduced from the prophetic tradition and the legal consensus of Islamic scholars. The Prophet (p.b.u.h.) said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, should be exchanged like for like, equal for equal and hand-to-hand. If the types of exchanged commodities are different, then sell them as you wish, if they are exchanged on the basis of a hand-to-hand transaction".[8] All Islamic scholars unanimously agree on the permissibility of *bay' al-sarf* as it has been practised by people since the time of the Prophet (p.b.u.h.) until now without any objections from anyone.

Basic Rules and Conditions of *Bay' Al-Sarf*

Since trading currency involves *ribawi* items, it is always subject to the Islamic rules enacted to govern such transactions so as to avoid the occurrence of *riba*. In this regard, scholars have come up with certain rules and conditions which can be summarised as follows:

Since trading currency involves *ribawi* items, it is always subject to the Islamic rules enacted to govern such transactions so as to avoid the occurrence of *riba*.

1 *Taking possession before leaving one another.*

Delivery of both currencies must be done at the time of the conclusion of the contract to ensure that taking possession of the currencies exchanged by both transacting parties can be completed in the same session (*majlis*). The Prophet (p.b.u.h.) laid down this rule by saying (on the authority of 'Umar ibn al-Khattab): "Gold for gold (must be) hand-to-hand." This *hadith* stipulates that the delivery of the currencies must take place before the physical departure of the parties. This is because departing with debts on both sides is not permitted as it is regarded as sale of debt against debt (*bay' al-kali' bi al-kali'*) which is banned by the Prophet (p.b.u.h.).

2 *Equal-for-equal transaction.*

If the currency trading involves the exchange of currencies of the same genus (*jins*) such as silver for silver or gold for gold, they must be transacted in like-for-like even if they differ in quality (*sifah*) since consideration is given only to quantity (*qadr*).

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8 *Sahih* Muslim

3 *Freedom from* khiyar al-shart.

The currency trading must be free from *khiyar al-shart* which refers to an option to rescind a sale contract based on certain conditions stipulated earlier in the contract. One of the contracting parties may stipulate certain conditions which, if not met, would grant a legal right to the stipulating party to rescind the contract. This is because *khiyar al-shart* prevents the actual establishment or complete transfer of ownership which makes possession impossible whether actually or constructively.

Currency trading must be free from *khiyar al-shart* which refers to an option to rescind a sale contract based on certain conditions stipulated earlier in the contract.

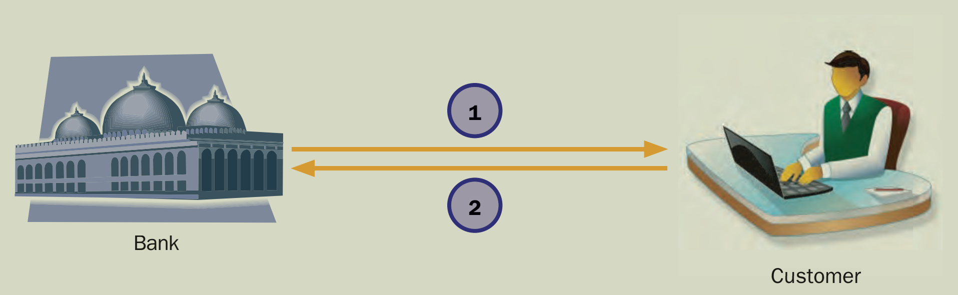
4 Non-deferment.

This condition entails that the delivery of both counter values should not be deferred to a certain point of time in the future. If one of the parties stipulated a deferment in the receipt of one of the currencies, the contract is rendered null and void as it has been prescribed that exchange of goods eligible for *riba* should be on a hand-to-hand basis. This rule is evidenced in the *hadith* narrated by Al-Bukhari and Muslim on the authority of Abu Al-Minhal: "There is no harm in whatever is exchanged hand-to-hand, but any deferment would render it *riba*."

Application in Islamic Finance

Bay' al-sarf is applicable to modern spot forex (foreign exchange) which is based on the spot rate in which the deal settlement is expected to be completed within two business days after the contract has been executed. The permissibility of spot forex is established because it meets all conditions and requirements of *bay' al-sarf* laid down by the Prophet (p.b.u.h.). The majority of scholars opine that different currencies can be exchanged at a different nominal exchange rate considering that currencies of different countries consist of different intrinsic values and purchasing power. The structure of spot forex can be illustrated as follows:

The permissibility of spot forex is established as it meets all conditions and requirements of *bay' al-sarf* laid down by the Prophet (p.b.u.h.).



1 The bank sells US$40 million to the customer on a spot basis.
2 The customer buys RM100 million from the bank on a spot basis.

Figure 6.8 Flow of the Application of *Bay' Al-Sarf* in Spot Forex

Salient *Shari'ah* Issues in Contemporary Islamic Finance

In contemporary Islamic finance, the legal status of widely used currencies in the world remains debatable among *Shari'ah* scholars. Should modern currencies, which have been transformed into paper, fall under *thaman haqiqi* (actual currency) like gold and silver, or should it come under *thaman istilahi* (consensual currency)? The former (*thaman haqiqi*) will make the present currency subject to the rules of *bay' al-sarf* and the latter will render it unrelated to *bay' al-sarf*. However, the OIC *Fiqh* Academy holds the opinion that paper currency, being legal currency, is subject to the dictate of the *Shari'ah* principles applied to gold and silver.[9] There is also a long debate among *Shari'ah* scholars on the legality of forward forex as it is different from spot forex, especially in terms of the delivery of the exchanged currencies. Though it may yield benefits to the contracting parties, particularly when they exercise it for hedging purpose, it does not meet the very basic requirement of *bay' al-sarf*, which entails that the exchanged currencies must be delivered immediately without any delay. Hence, some scholars have made an attempt to find a solution for this issue by resorting to another *Shari'ah* tool called *wa'd* (unilateral promise), *wa'dan* (two unilateral promises) and *muwa'adah* (bilateral promise) which are not an exchange contract in nature except *muwa'adah*, and hence are not subject to the rules of *bay' al-sarf*. However, there are still a number of contentious issues arising from the practice of the abovementioned *Shari'ah* tools that need further deliberation and thorough examination.

Bay' Al-'Inah (Sell and Buyback)

Definition of *'Inah*

Technically, the scholars gave different definitions to *'inah* due to their differing opinions regarding its forms.

Literally, *'inah* is a loan or an advance payment. It is said in Arabic: *I'tana al-rajul* (the man bought on credit). This is usually said when he barters one thing for another on credit or when he buys on credit. This type of sale is named *'inah* (a credit sale) because the buyer of a commodity for a fixed time will take its compensation (from the seller)

9 Resolution no. 21, 3rd session, No. 3, Vol. 3, *Majallah Majma' Al-Fiqh Al-Islami*, page: 1650.

in cash on the spot. Technically, scholars gave different definitions to *'inah* due to their differing opinions regarding its forms, which will be mentioned later. However, the most famous definition given to it by classical scholars was: "A situation whereby a person sells a commodity to another for a specific price with payment delayed until a fixed date, then he buys it back from the other person at a lower price in cash." However, *Al-Mawsu'ah Al-Fiqhiyyah (The Juristic Encyclopedia)* defines it on the basis of the essence of engaging in it: that it is "a loan in the form of a sale in order to make the increase appear lawful."

Forms of *'Inah*

Classical jurists cited different forms of *'inah* in their books. Amongst them are:

1. "A" sells a commodity to "B" for a certain price with payment delayed until a specific date, and then buys it back from him at a lower price in cash.

2. "A" buys a commodity from "B" through an intermediary present at the time of the transaction. The first step is that the intermediary buys it from B. He then sells it to A, the seeker of *'inah*, at a price higher than the price at which the intermediary bought it from B, with payment delayed till a fixed time. Then A sells it to B for cash at a price lower than the price A paid for it. Ibn Taymiyyah commented on this form by saying, "If he buys a commodity from him then sells it to him, and buys it back from him again, or sells it to a third party who is the real owner from whom the loaner bought it in the first instance, it is *riba*."

3. "A" sells a commodity to "B", with payment delayed till a stipulated time. He then buys it back, with payment delayed till a date later than that of the first transaction at a higher price.

Legality of *'Inah*

The legality of *'inah* is closely related to the legality of stratagems (*hiyal*) and the legality of blocking means that may lead to harmful or corrupt objectives *(dhara'i).* Muslim jurists hold different opinions concerning the issue of the formation and substance of a contract. Accordingly, Abu Hanifa, Al-Shafi'i and Ibn Hazm, for instance, are of the view that the validity of a transaction is determined by its expression or the form of the contract. The intention of the contracting parties or one of them are not to be considered unless it is expressed or declared. Therefore, they draw a clear demarcation between the manifestation of corrupted intent (*mala fide*) in the contract and the absence of clear indicators of such intent. When the intent to engage in the unlawful or inflicted harm is apparent, such as the intent to partake in usury, then al-Shafi'i and Ibn Hazm, like other scholars, do not permit it.

Accordingly, Abu Hanifa, Al-Shafi'i and Ibn Hazm for instance, are of the view that the validity of a transaction is determined by its expression or the form of the contract.

Exhibit 6.6 The Polemics of *Bay' Al-'Inah*

There are many misleading views regarding the position of Imam al-Shafi'i representing the Shafi'i school pertaining to *bay' al-'inah*. This view stems from the presumption that Imam al-Shafi'i validates and outrightly endorses *bay' al-'inah*. The following provides some evidences from the classical Islamic jurisprudence texts that refute this view:

Al-Shatibi, commented on this view by saying:

" فلا يَصِحُّ أَنْ يَقُولَ الشَّافِعِيُّ إِنَّهُ يَجُوزُ التَّذَرُّعُ إِلَى الربا بحال، إِلَّا أَنَّهُ لَا يَتَّهِمُ مَنْ لَمْ يَظْهَرْ مِنْهُ قَصْدٌ إِلَى الْمَمْنُوعِ، وَمَالِكٌ يَتَّهِمُ بِسَبَبِ ظُهُوْرِ فِعْلِ اللَّغْوِ (فِي الْبَيْعَةِ المتوسِطَةِ) وَهُوَ دَالٌ على القصْدِ إِلَى المَمْنُوعِ، فَقَدْ ظَهَرَ أَن قَاعِدَةَ الذَّرَائِعِ مُتَّفَقٌ عَلَى اعْتِصَارِهَا فِي الجُمْلَةِ، وَإِنَّمَا الخِلَافُ فِي أَمرِ آخَرَ (المناطُ الذي يَتَحَقَّقُ في التَّذَرُّعِ)."

"It is absolutely incorrect to say that Al-Shafi'i allowed the adoption of means that lead to usury. He does not presume the existence of an intention to do something forbidden unless there is manifest evidence to that effect" (Abu Ishaq al-Shatibi, *al-Muwafaqat fi usul al-Shari'ah*, Volume 4, pages. 435-436).

Al-Shafi'i himself explains his stand by stating that:

أَصْلُ مَا أَذْهَبُ إِلَيْهِ أَنَّ كُلَّ عَقْدٍ كَانَ صَحِيْحًا في الظَّاهِرِ لَمْ أُبْطِلْهُ بِتُهْمَةٍ وَلَا بِعَادَةٍ بَيْنَ الْمُتَبَايِعَيْنِ وَأَجَزْتُهُ بِصِحَّةِ الظَّاهِرِ وَأَكْرهُ (أَيْ أُحْرِمُ) لَهُمَا النِـيَّـةَ) إِذَا كَانَتْ النِـيَّـةُ لَوْ أُظْهِرَتْ كَانَتْ تُفْسِدُ الْبَيْعَ، وَكَمَا أَكْرَهُ لِلرَجُلِ أَنْ يَشْتَرِي السَّيْفَ عَلَى أَنْ يَقْتُلَ بِهِ وَلَا يُحْرَمَ عَلَى بَائِعِهِ أَنْ يَبِيْعَهُ مِمَّنْ يَرَاهُ (بمعنى يَظُنُّهُ) أَنَّهُ يَقْتُلُ بِهِ ظُلْمًا، لِأَنَّهُ قَدْ لَا يَقْتُلُ بِهِ وَلَا أُفْسِدُ عَلَيْهِ هَذَا الْبَيْعَ، وَكَمَا أَكْرَهُ لِلرَجُلِ أَنْ يَبِيْعَ الْعِنَبَ مِمَّنْ يَرَاهُ أَنَّهُ يَعْصِرُهُ خَمْرًا وَلَا أُفْسِدُ الْبَيْعَ إِذَا بَاعَهُ إِيَّاهُ لِأَنَّهُ بَاعَهُ حلَالًا، وَقَدْ يُمْكِنُ أَنْ لَا يَجْعَلَهُ خَمْرًا أَبَدًا، وَفِي صَاحِبِ السَّيْفِ أَنْ لَا يَقْتُلَ بِهِ أَحَدًا أَبَدًا، وَأُفْسِدُ نِكَاحَ الْمُتْعَةِ، وَلَوْ نَكَحَ رَجُلٌ امْرَأَةً عَقْدًا صَحِيْحًا وَهُوَ يَنْوِي أَنْ لَا يُمْسِكَهَا إِلَّا يَوْمًا أَوْ أَقَلَّ أَوْ أَكْثَرَ لَمْ أُفْسِدِ النِّكَاحَ إِنَّمَا أُفْسِدُهُ أَبَدًا بِالْعَقْدِ الْفَاسِدِ (...) فَإِذَا اشْتَرَى الرَّجُلُ مِنَ الرَّجُلِ السِلْعَةَ فَقَبَضَهَا وَكَانَ الثَمَنُ إِلَى أَجَلٍ فَلَا بَأْسَ أَنْ يَبْتَاعَهَا مِنَ الَّذِي اشْتَرَاهَا مِنْهُ وَمِنْ غَيْرِهِ بِنَقْدٍ أَقَلَّ أَوْ أَكْثَرَ مِمَّا اشْتَرَاهَا بِهِ أَوْ بِدَيْنٍ كَذَلِكَ أَوْ عَرَضٍ مِنَ الْعُرُوْضِ سَاوَى الْعَرَضَ مَا شَآءَ أَنْ يُسَاوِي، وَلَيْسَتِ الْبَيْعَةُ الثَّانِيَةُ مِنَ الْبَيْعَةِ الْأُوْلَى بِسَبِيْلٍ"

"The basis for my position is that if a contract fulfils the Shari'ah*'s manifest criteria for its validity, I will not invalidate it on the basis of a presumption or a customary practice between the sellers and buyers. Hence, I will approve it by virtue of its apparent validity, but I prohibit a kind of situation where the two of them nurse an intention that may likely lead to the invalidation of the contract if it is manifested. For instance, I forbid someone buying a sword with the intention to kill with it unjustly, but it is not unlawful for the seller to sell it to someone he suspects will use it to kill unjustly because it is possible that he will not use it to kill unjustly. I, therefore, do not invalidate this kind of business transaction. Likewise, I detest that someone sells grapes to a buyer he thinks will use them to make wine, but I do not invalidate such a sale because he is selling it as something lawful, and it is possible that the buyer will not, however, make wine from the fruit, just as it is possible that the purchaser of a sword may not use it to kill. Likewise I invalidate a temporary marriage, i.e.,* mut'ah*, whereby an expiry date is stipulated in the contract, but if a man marries a woman through a valid contract with the motive to have her as his wife for only a day, or less or more, I would not invalidate such a marriage contract but I would only invalidate the contract when such a kind of intention is made manifest or detected. In another vein, if a man buys a commodity from another person, and the payment is deferred to a stipulated*

Exhibit 6.6 The Polemics of *Bay' Al-'Inah*

> *time, there is nothing wrong if he sells it back to the person he bought it from or to another person for cash at a price lower or higher than the price at which he bought it, or for a debt or barter of a commodity at a value he chooses to assign to it. The reason here is that the second transaction is not linked to the first transaction"* (Al-Shafi'i, *Al-Umm*, Volume 3, page 90).**

This statement of Al-Shafi'i signifies that he does prohibit *'inah* ethically if the party in contract is not able to justify his action and intention before Allah (s.w.t.). This is to say he does not prohibit it on the basis of mere presumption of people's intention in entering into the sales contract. However, if the mal-intention of the person dealing in *'inah* is explicit or apparent through his expression that the commodity is to be resold to the first seller, then he would inevitably prohibit it.

The Zahiri School agreed with Al-Shafi'i, as stated by Ibn Hazm that:

'' وَمَنْ بَاعَ سِلْعَةً بِثَمَنٍ مُسَمًّى حَالَّةً أَوْ إِلَى أَجَلٍ مُسَمًّى قَرِيْبًا أَوْ بَعِيْدًا، فَلَهُ أَنْ يبْتَاعَ تِلْكَ السِّلْعَةَ مِنَ الَّذِي بَاعَهَا مِنْهُ بِثَمَنٍ مِثْلِ الَّذِي بَاعَهَا بِهِ مِنْهُ وبِأَكْثَرِ مِنْهُ وَبِأَقَلِّ حالاًّ وَإِلَى أَجَلٍ مُسَمًّى أَقْرَبَ مِنَ الَّذِي بَاعَهَا مِنْهُ إِلَيْهِ أَوْ أَبْعَدَ وَمِثْلَهُ، كُلُّ ذَلِكَ حَلاَلًا لا كَرَاهِيَةَ فِي شَيءٍ مِنْهُ مالَمْ يَكُنْ ذَلِكَ عَنْ شَرْطٍ مَذْكُوْرٍ فِي نَفْسِ الْعَقْدِ فَإِنْ كَانَ عَنْ شَرْطٍ فَهُوَ حَرَامٌ مَفْسُوخٌ أَبَدًا مَحْكُومٌ فِيهِ بِحُكْمِ الْغَصْبِ وَهُوَ قَوْلُ الشَّافِي''

> *"Whoever sells a commodity for a stipulated price to be paid immediately or for a deferred payment for a short or long term, he has the right to sell that commodity to the one he bought it from at the same price he paid for it, or less or more. Payment can be made instantly, and it may be deferred to a time shorter or longer than the time of the first transaction or for the same time. All these are permissible as long as no condition to that effect is attached to it in the initial contract. If there is such a condition, then it is forbidden and must be nullified without any hesitation, and it should be classified as a kind of coercion as maintained by Al-Shafi'i"* (Ibn Hazm, *Al-Mahalla bi Al-Athar*, Volume 7 page 549).

The *Shari'ah* Advisory Council of Bank Negara Malaysia (BNM) in its meeting held on 12 December 1998 agreed that the objections to *bay al-'inah* are adopted by the majority of *Shari'ah* scholars, but ruled that *bay al-'inah* is acceptable subject to the following two conditions which are:

1 The mechanism practised is acceptable to the Shafi'i school; and,

2 The transacted item is not a *ribawi* item (goods that are not in consonance with *fiqh* rules with respect to cash or items sold by weight and/or measure).

As for the Maliki and Hanbali schools of law, they refute *hiyal* and *dharai'* and uphold the view that matters are to be determined by the intention of the contractors, and therefore any means though permissible, but which are employed in order to achieve a harmful or corrupt motive should be interdicted, such as when a person engages in business with the intention to disguisedly carry out an interest-related transaction because permitting them negates the objectives of the *Shari'ah*.

As for the Maliki and Hanbali schools of law, they refute *hiyal* and *dharai'* and uphold the view that matters are to be determined by the intention of the contractors.

As for the ruling of *'inah*, although Abu Hanifah is of the view that the validity of a transaction is determined by the formula of the contract, he prohibits *'inah* based on the narration of Ibn 'Umar who said: "I heard the Prophet of Allah (p.b.u.h.) say, 'When you enter into the *'inah* transaction, hold the tails of oxen and give up conducting jihad, Allah (s.w.t.) will make disgrace prevail over you, and will not withdraw it until you return to your original religion.'"[10]

Malik and Ahmad Ibn Hanbal on the other hand, prohibit *'inah* based on the above-mentioned narration from the Prophet (p.b.u.h.) and based on the general *Shari'ah* principle of considering the intentions of the contracting parties and blocking the means that lead to harmful or corrupt objectives.

Malaysia and Brunei are the only countries applying *'inah* in their banking system.

Application of *'Inah* in the Banking System

Malaysia and Brunei are the only countries applying *'inah* in their banking system. Their *Shari'ah* scholars agree that the majority of scholars and financial institutions prohibit *'inah*, but consider the issue as a kind of *ijtihad* that allows divergence of opinions.

Exhibit 6.7 Malaysia *Shari'ah* Advisory Council's Resolution on *Bay' Al-'Inah*

The *Shari'ah* Advisory Council of Bank Negara Malaysia in its meeting held on 12 December 1998, resolved that *bay al-'inah* is permissible subject to the following two conditions:

- The transaction of *bay' al-'inah* must strictly follow the mechanism which is accepted by the Shafi'i school.
- The transacted item is not a *ribawi* item (goods that are not in consonance with *fiqh* rules with respect to cash or items sold by weight and/or measure.)

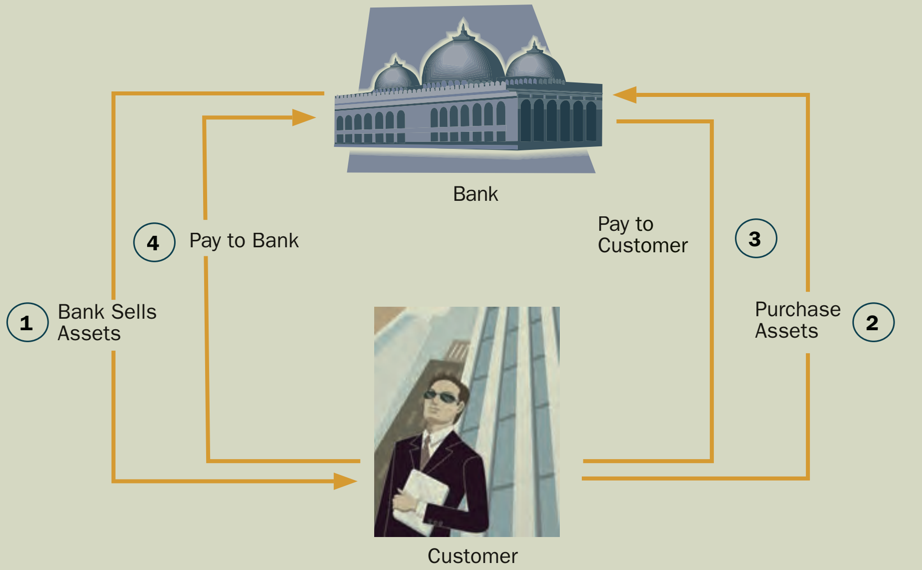
Notwithstanding the above, the Council acknowledges the fact that the issue of *bay' al-'inah* is still a matter of juristic disagreement among *Shari'ah* scholars, backed by their own basis of justifications. Consequently, the Council during the Regional *Shari'ah* Scholars Dialogue on 29 June 2006, resolved that:

- *Bay' al-'inah* concept is still necessary in the context of local Islamic finance development. However, market players are required to strengthen and enhance their operational processes and documentation to comply with the features of *bay' al-'inah* as permitted. Since the *bay' al-'inah* concept is still regarded as a matter of juristic disagreement among *Shari'ah* scholars, it is more desirable for IFIs to limit its use in products.

Source: Bank Negara Malaysia (2007) Shari'ah *Resolutions in Islamic Finance*, 1st Edition, Kuala Lumpur.

10 The *hadith* on *'inah* was authenticated by Ahmad Shakir in *Takhrij al-Musnad*, *Hadith* No: 4825 and 5007. It was also authenticated by Nasir al-Din al-Albani when all of its chains of transmission are considered in totality, whereas, Al-Shafi'i and Ibn Hazm graded the *hadith* as weak. See *Al-Silsilah Al-Sahihah*, Volume 1, page 42, *Hadith* No. 11.

The common mechanism of *'inah* application in the banking system is illustrated in Figure 6.9 below.



1 The bank sells a particular asset to the customer on a deferred payment basis at the real cost plus profit that is equivalent to the maximum amount to be paid by the customer.
2 The customer then resells the same asset to the bank on a cash basis that is equivalent to the limit of the card.
3 The proceeds are then disbursed into a *wadi'ah* savings account designated for the customer. The amount becomes the card limit that may be utilised by the customer when he desires.
4 The customer pays the bank the amount he utilises by instalments or the full amount at once.

Figure 6.9 The Mechanism of *Bay' Al-'Inah* for Charge Card Service

The application of *'inah* in the banking system, is depicted in Table 6.1 below:

Table 6.1 Applications of *'Inah* in the Banking System

Deposit	Commodity *Murabahah*-I
Financing	Personal financing, asset financing, cash line facility, contract financing, education financing, revolving credit facility, working capital financing, home financing
Liquidity Management and Debt Restructuring	Negotiable Islamic Debt Certificate (NIDC), Islamic Private Debt Securities (IPDS), Bank Negara Monetary Notes-I, BNMN-I Sell and Buy-Back Agreement (SBBA)
Government and Corporate *Sukuk* Financing	*Sukuk ijarah, sukuk murabahah*
Risk Management and Hedging Purposes	*Ijarah* rental swaps, Islamic cross-currency swap, Islamic profit-rate swap

Salient *Shari'ah* Issues in *Bay' Al-'Inah*

Stipulation of a condition that contradicts the requirements of a contract

The fact is that in a *bay' al-'inah* agreement, there are two contracts: the first contract is the sale contract executed by the financial institution, and the second is the repurchase contract of the same sold commodity from the customer or a financial institution. It is also known that the second contract is executed instantly, and serves as a condition for the first transaction. The issue raised in this case is that, though al-Shafi'i and Ibn Hazm did not prohibit *'inah*, they did prohibit two sales in one sale, and they also prohibited the specification of additional conditions to a contract. They argued that these prohibitions are based on the *hadith* of the Prophet (p.b.u.h.) that prohibits the carrying out of two sale contracts in one sale contract, as well as that of relating a sale with conditions contravening the requirement of that sale. The question here is: what is the stand of contemporary schools of law with regard to a situation where an opinion is referred to a specific school of law in one legal ruling or a situation where two contradicting views are combined and one of them is rejected by the same school of law or what is called *talfiq?*

It is also known that the second contract in a *bay' al-'inah* agreement is executed instantly, and serves as a condition for the first transaction.

Bay' Al-Tawarruq (Monetisation/Cash Financing/Cash Procurement)

The Definition of *Tawarruq*

Tawarruq is the infinitive (*masdar*) of the verb *tawarraqa* (to eat leaves); it is said as *tawarraqa al-hayawan* (i.e., the animal ate the leaves). As for the word *wariq*, it refers to *dirhams* minted from silver. Some say it refers to both minted and non-minted silver (*al-fidhah al-madhrubah* or *al-fidhah ghayr al-madhrubah*). *Tawarruq* was, therefore, used by earlier generations for the purpose of seeking silver money, while it is used nowadays for seeking paper money, and that is a valid literal usage derived from the same word. Hence, the monetisation beneficiary is called *mutawarriq.* Technically, *tawarruq* is a term commonly used in the books of the Hanbali school of law while other schools mention the form of *tawarruq* under the rubric of *bay' al-ajal* and *bay' al-'inah* (sale and buyback). Hence, the technical meaning varies according to its different types. The *Al-Mawsu'ah al-Fiqhiyyah Al-Kuwaytiyyah* (*Fiqh* Encyclopedia of Kuwait) defined *tawarruq* as "buying a commodity with deferred payment and selling it to a person other than the buyer for a lower price with immediate payment".

The *Al-Mawsu'ah Al-Fiqhiyyah Al-Kuwaytiyyah* (*Fiqh* Encyclopedia of Kuwait) defined *tawarruq* as "buying a commodity with deferred payment and selling it to a person other than the buyer for a lower price with immediate payment".

Types of *Tawarruq*

Generally,there are three types of *tawarruq* and they are as follows:

1 *Al-Tawarruq Al-Fardi (Tawarruq on an Individual Basis)*

The OIC Islamic *Fiqh* Academy defined it as: "The purchase of a commodity possessed and owned by the seller for a delayed payment, whereupon the buyer will resell the commodity for cash to other than the original seller in order to acquire cash (*al-wariq*)."

2 Al-Tawarruq Al-Munazzam (Organised Tawarruq)

This is when the seller handles the process by which cash is acquired for the *mutawarriq* (the seeker of cash). He does so by selling a commodity to him for a delayed payment, he then sells it on his behalf for cash by taking the payment from the buyer and handing it over to the *mutawarriq*.

There are three differences between *tawarruq* on an individual basis and organised *tawarruq*:

> There are three differences between *tawarruq* on an individual basis and organised *tawarruq*.

(i) In an organised *tawarruq*, the original seller acts as an intermediary by selling the commodity for cash on behalf of the *mutawarriq*, whereas the original seller in an individual *tawarruq*, absolutely does not play any role in the resale of the commodity and has no relation with the final buyer.

(ii) In an organised *tawarruq*, the *mutawarriq* (the monetisation beneficiary) receives the cash from the original seller, to whom he owes the delayed price, whereas the cash in an individual *tawarruq* will be taken by the *mutawarriq* directly from the final buyer without the seller being involved.

(iii) In an organised *tawarruq*, the original seller might agree beforehand with the final buyer that he will purchase the commodity. This agreement will occur through the commitment of the final buyer to the purchaser so as to avoid a fluctuation of the price.

3 Al-Tawarruq Al-Masrafi (Banking Tawarruq)

It is a process where the IFI formally organises the sale of a commodity (other than gold or silver) between an international commodity market or other market and the *mutawarriq*, for a delayed payment on a binding condition that may be stipulated in the contract or the custom and norms guiding such a commodity. The IFI, for example, will represent the *mutawarriq* in selling it to another buyer for cash, whereupon the bank will deliver its payment to the *mutawarriq*.

Muslim jurists consider banking *tawarruq* as a form of organised *tawarruq* preceded by *murabahah* (purchase and resale with profit) for the one who orders the purchase. Both of them are structurally the same but different in terms of the entity who administers the procedures of the *tawarruq*.

The Legality of Individual and Banking *Tawarruq*

> The majority of scholars and *fiqh* councils consider individual *tawarruq* as permissible in principle. They, however, laid down some conditions to guarantee its proper application.

The majority of scholars and *fiqh* councils consider individual *tawarruq* as permissible in principle. They, however, laid down some conditions to guarantee its proper application.

As for organised and banking *tawarruq*, scholars disagree on their permissibility. There are those who are of the opinion that banking *tawarruq* is permissible as long as it fulfils some conditions, and there are those who oppose banking *tawarruq* and consider it as a trick to circumvent the prohibition of *riba*.

Evidence of Those Who Support *Tawarruq* in the Banking System

Those who allow *tawarruq* in the banking system do so on the basis of the following arguments:

1 *Tawarruq* falls under the general statement of Allah (s.w.t.) which goes thus: "Allah (s.w.t.) has permitted trade and forbidden *riba*" (2:275). *Tawarruq* is a form of trade, which has, with all its forms, been declared lawful by the comprehensive indication of the abovementioned verse, except when there is specific evidence to prohibit a particular transaction. Therefore, *tawarruq* is one of the forms of trade which Allah (s.w.t.) has permitted in general, and there is no clear-cut evidence that declares it unlawful.

2 It was reported by Abu Sa'id al-Khudri and Abu Hurayrah (r.a.) that the Messenger of Allah (p.b.u.h.) appointed a man as his agent in Khaybar. He brought some *junayb* (good quality) dates to the Prophet (p.b.u.h.), who asked him, "Are all the dates of Khaybar like this?" The man replied, "No, I swear by Allah (s.w.t.), O Messenger of Allah; we exchange a *saa'* of this kind of date for two *saa's* of another (lower in quality), and two *saa's* of this for three *saa's*." Allah's Messenger said, "Do not do that! Sell [your] batch [of dates] for *dirhams* and then pay for the *junayb* dates with the *dirhams*." (Sahih Bukhari). Their angle of reasoning from the *hadith* is that something may be unlawful if its format is not in line with the format endorsed by *Shari'ah*, but if we are able to reshape it to a format approved by the *Shari'ah,* it becomes permissible. *Tawarruq* is an authentic form of trade transaction characterised by its conditions and essential elements, and it is free of any factors that would render it useless or invalid because its aim is to achieve monetary liquidity so that people may not fall into *riba*.

3 The initial assumption for transactions is that they are lawful unless there is proof that prohibits such a particular transaction, whereas there is no known *Shari'ah* proof that forbids this one. Therefore, those who argue that *tawarruq* is lawful are not required to provide evidence. The burden of proof lies on those who prohibit *tawarruq* sales because they are the ones rejecting the initial assumption of permissibility for transactions.

4 The objective of traders from their transactions is to acquire more money in exchange for less money by means of some commodity which serves as an intermediary between the seller and buyer. No one says that when a trader wants to come out of a transaction with more money that the transaction is disliked. The same holds true for *tawarruq* because the aim of the transaction is to acquire money, and the commodity is an intermediate instrument between the two parties. To make a distinction between a seller and a *mutawarriq*, the seller aims at making a profit while the *mutawarriq* sells in order to acquire cash, whether he gains or loses. This is so because the profit itself is a means of acquiring money and the *mutawarriq* does not lose, since the deferment of payment for the commodity has a role in the overall value of the price.

5 Necessity calls for this kind of transaction, for not everyone who wants to borrow money finds someone to lend it to them.

6 *Tawarruq* is to be considered one of the forms of Islamic financing; it helps to cover many needs and to provide sufficient liquidity through lawful means as approved by the *Shari'ah*, and it is extremely effective in realising [the objectives of Islamic] economic philosophy and securing benefits for traders, irrespective of whether they are individuals or organisations. It is also an important instrument by which governments can finance their trade deficits and provide necessary liquidity.

7 The position of the Islamic banking system in Islamic countries with regard to conventional banking requires that not any opportunity should be missed for increasing its profitability and providing its customers with financing instruments.

Evidence of Those Who Repudiate *Tawarruq* in the Banking System

Those who reject *tawarruq* in the banking system rely upon the following arguments:

1 Banking *tawarruq* clashes with the principle that matters are to be evaluated in light of their objectives. The objective of the repeated sales in *tawarruq* is to procure immediate cash in exchange for a deferred payment of a larger amount of cash.

2 *Tawarruq* in the Islamic banking system is a means that leads to *riba*, and blocking of the means is acceptable in Islamic law, as it is reflected in the prohibition of a killer from inheriting the person he has killed. Banking *tawarruq* leads to the same result as *riba*, regardless of the outer form of the contract. This is because *tawarruq* leads to the exchange of immediate cash for deferred payment of a larger amount of cash, and that is the reason why *riba* is prohibited.

Exhibit 6.8 AAOIFI's *Shari'ah* Parameters in the Application of *Tawarruq*

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in its *Shari'ah* Standards No. 30 outlines several parameters to ensure the genuine application of *tawarrruq*. Some salient conditions are as follows:

4/6 The contract for purchasing a commodity on a deferred payment basis and the contract for selling it for a spot price should be linked together in such a way that the client loses his right to receive the commodity. Such a linkage between the two contracts is prohibited whether it is stipulated in the documents or regarded as a normal tradition or incorporated in the procedures.

4/7 The client should not delegate the institution or its agent to sell on his behalf a commodity that he purchased from the same institution and similarly, the institution should not accept such a delegation. If, however, the regulations do not permit the client to sell the commodity except through the same institution, he may delegate the institution to do so after he might have actually or impliedly received the commodity.

4/8 The institution should not arrange a proxy of a third party to sell the commodity on behalf of the client that purchased it from the institution.

4/9 The client should not sell the commodity except by himself or through an agent other than the institution, and should duly observe the other regulations.

4/10 The institution should provide the client with the information that he or his appointed agent may need in order to sell the commodity.

5/1 Monetisation is not a mode of investment or financing. It has only been permitted when there is a need for it and subject to specific terms and conditions. Therefore, the institutions should not use monetisation as a means of mobilising liquidity for their operations, instead, it should exert effort for fund mobilisation through other modes such as *mudarabah*, investment proxy, *sukuk*, investment funds, and the like. The institution should resort to monetisation only when it faces the danger of a liquidity shortage that could interrupt the flow of its operations and cause losses for its clients.

5/2 The institutions should avoid the use of proxy in selling the monetisation commodity, even if the proxy is to be arranged with a third party. In other words, institutions should use their own personnel for selling the monetisation commodity, though using brokers for this purpose is permissible.

Source: AAOIFI *Shari'ah* Standards for Islamic Financial Institutions (2010).

3 Banking *tawarruq* is a form of *'inah*, which is a kind of transaction involving interest. The majority of scholars and *fatwa* councils have prohibited *'inah*. The same *'illah* (effective cause) is also present in banking *tawarruq* and that is the reason why it is prohibited by the Lawgiver. This is blatantly present in the banking *tawarruq* in the contractual agreement between the Islamic

bank and the *mutawarriq* to make an immediate cash payment in exchange for a larger cash payment at a later time. Classifying the organised form of *tawarruq* within the parameters of *'inah* is strengthened by some narrations from the *Salaf*, especially the use of the term *'inah*, for organised *tawarruq*. In the narration of 'Abd al-Razzaq and Ibn Abi Shaybah, Dawud ibn Abi Qasim al-Thaqafi narrated that his sister said to him:

> *"I want to buy a commodity by* 'inah *(credit sale), so order it for me." He told her, "I have some grain in my possession." He further related that: "I sold the grain to her for a price in gold till a fixed time and she took possession of it." She then said: "Find someone who will buy it from me." I told her I would sell it on her behalf, and I did so. Then I had a bad impression about my action which prompted me to consult Sa'id ibn al-Musayyib. He asked me, "Consider [this]; are you not the original owner?" I said: "I am," and he said: "That is absolutely* riba *(interest), so take your capital and return the excess back to her."*[11]

4 Banking *tawarruq* is not a replacement for currency-based financing (i.e., loans on interest); rather it bears a close resemblance to it, for it represents a backward step from the intended course of the Islamic banking system and its dynamic financing instruments which are based upon the principle of promoting an increase in the production and circulation of what is good and useful.

5 The commodity exchanged as part of a banking *tawarruq* may either be a mere document, i.e., certificates sent from one place to another, which are usually in the possession of a broker; or a defective commodity stored in a warehouse which becomes the subject of repeated *murabahah* transactions; or it may be in a warehouse solely for the purpose of being the subject of such *murabahah* transactions.

6 The conditions of a genuine application of *tawarruq* as stipulated by its supporters contravene its actual application in a banking system.

The Application of *Tawarruq*

Tawarruq, or commodity *murabahah*, is one of the popularly used principles to structure various Islamic financial instruments. Table 6.2 provides a list of some common Islamic financial instruments that are structured based on *tawarruq*:

11 *Al-Mudawwanah Al-Kubra li Al-Imam Malik Riwayat SaÍnun ibn Sa'id Al-Tanukhi*, Volume 4, pages 244–248.

Table 6.2 Some Common Islamic Financial Instruments Based on *Tawarruq*

Deposit	Commodity *murabahah* deposit facility and placement.
Financing	Personal financing, asset financing, cash line facility, contract financing, commodity murabahah financing, education financing, revolving credit facility, working capital financing, home financing, project financing facilities.
Liquidity Management and Debt Restructuring	BNM Islamic accepted bills (IABs), islamic private debt securities (IPDSs), interbank commodity *murabahah*, LME commodity *murabahah*, Bursa Malaysia Suq al-Sila'
Government and Corporate *Sukuk* Financing	*Sukuk ijarah, sukuk murabahah*
Risk Management and Hedging Purposes	*Ijarah* rental swaps, Islamic cross-currency swap, Islamic profit-rate swap.

Salient *Shari'ah* Issues in *Tawarruq*

The Agent Performing Deals with Himself

One of the salient issues in a *murabahah* contract is whether the agent is allowed to conduct deals with himself.

One of the salient issues in a *murabahah* contract is whether the agent is allowed to conduct deals with himself. According to the most common opinion of the majority of Muslim jurists including Hanafi, Shafi'i, Maliki and Hanbali scholars, it is absolutely prohibited for the agent to buy for himself. They based their ruling on the conflict of interest between the agent and his client. Some Malikis and Hanbalis view that it is permissible to conduct deals with one's self if the agent does not favour himself or if he offers more than the market price. Contemporary Muslim jurists, too, are also divided in their opinions. AAOIFI in its *Shari'ah* Standard No. 23, item No. 6 stipulates the following:

> 6/1/2: An agent should not conduct deals with himself or with his son or daughter who is still under his guardianship or his partner in the same contract.
>
> 6/1/3: The agent should not act for both parties to the contract.

Ijarah (Lease)

Definition of *Ijarah*

The literal definition of *ijarah* is "the reward given for service rendered". It is derived from the root word *ajara* – to recompense, compensate or to give a consideration or return. ***Ajr* (wage)** when used in the context of *ijarah* means the reward given for work or a service, or a compensation given by the lessee for usufruct in a lease contract. An ***ajir*** (worker) (pl. *ujara'*) is a person whose labour is the usufruct, i.e., the subject matter of a lease contract. He could also be called *musta'jar* (hired) or *mu'ajjir* (lessor), the owner of the leased property. On the other hand, a *musta'jir* (lessee) is the beneficiary of the services of a worker or of the leased property.

Technically, *ijarah* is "a contract for the transfer of ownership of usufruct for compensation". Some scholars say that: "It is a sale of a known usufruct for a known compensation." Thus, the contract of lease is a kind of contract of financial exchange.

Technically, *ijarah* is "a contract for the transfer of ownership of usufruct for compensation".

Related Terms

Ijarah and *Bay'*

The difference between *ijarah* and *bay'* is that *ijarah* is a sale but only of the usufruct, whereas a normal *bay'* (sale) contract is a transfer of the corpus. A lease contract may be carried out immediately or at a future date, whereas a sale contract must be carried out immediately. Consumables may be the subject matter of a sale but not of a lease.

The difference between *ijarah* and *bay'* is that *ijarah* is a sale but only of the usufruct, whereas a normal *bay'* (sale) contract is a transfer of the corpus.

Ijarah and *Kira'*

Malikis use the term *ijarah* exclusively for remuneration for human labour, whereas they use the term *kira'* (rental) for the compensation given to the lease of real estate property such as a land or a house.

Legality of *Ijarah*

The majority of jurists rule that *ijarah* is a permissible and binding contract. The evidence to that effect is drawn from the *Qur'an*, the *Sunnah*, consensus (*ijma'*) and reasoning:

As for the *Qur'an*, the following verses assert its permissibility:

1 "And if they suckle your (offspring), give them their recompense" (65:6).

2 Said one of the (damsels): "O my (dear) father! Engage him on wages: truly the best of men for thee to employ is the (man) who is strong and trusty." He said: "I intended to wed one of my daughters to thee, on condition that thou serve me for eight years; but if thou complete ten years, it will be (grace) from thee" (28:26–27).

3 "Then they proceeded: until, when they came to the inhabitants of a town, they asked them for food, but they refused them hospitality. They found there a wall on the point of falling down, but he set it up straight. (Moses) said: "If thou hadst wished, surely thou couldst have exacted some recompense for it!" (18:77).

With regard to the *Sunnah*, the following narrations of the messenger of Allah (p.b.u.h.) serve as explicit proofs for its permissibility:

1 "He who hires a worker must inform him of his wage." *(Abdu Razzaq, Al-Musannaf*, Volume 8, page 235).

2 "Pay the hired worker his wage before his sweat dries." (*Al-Ba'ihaqi, Al-Sunnan Al-Kubra*, Volume 6, page 121).

3 "Three people I shall be their enemy during doomsday." Then he mentioned: "A man who hired a worker to carry out some work for him, but did not give him his wage"(*Fath Al-Bari Sharh Sahih Al-Bukhari*, Volume 4, page 443).

4 It is also reported that the Prophet (p.b.u.h.) and Abu Bakr had hired a guide from Bani al-Deal. (*Fath Al-Baari Sharh Sahih Al-Bukhari*, Volume 1, page 303).

Consensus is another basic proof for the permissibility of *ijarah* as the *ummah* from the time of the *Sahaba* ("Companions") up to this day agreed upon and conducted *ijarah*.

Consensus is another basic proof for the permissibility of *ijarah* as the *ummah* from the time the *Sahaba* ("Companions") up to this day agreed upon and conducted *ijarah*. Though it was narrated that Abdul Rahaman Ibn Al-Assam has prohibited *ijarah* due to *gharar* as it is a contract on usufructs not yet available, jurists refuted his argument indicating that here, *gharar* shall be ignored because the contract on usufructs is not possible after the existence of usufructs as they perish as time passes. So, a contract for them should be concluded before they become like the *salam* contract on assets.

The evidence from reasoning is that, *ijarah* is a means of facilitating the standard of life by helping people to get the usufructs of assets which they do not own. The need for usufructs is similar to the need for assets, and consideration for the needs of the people is a basic principle in legalising a contract so as to fulfil such needs and requirements.

Types of *Ijarah*

Ijarah is classified on the basis of various considerations:

Ijarah based on subject type

It is divided into two:

The term *'ayn* is generally used as an opposite of *dayn* (debt).

1 **A tangible asset (*'ayn*)**: The term *'ayn* is generally used as an opposite of *dayn* (debt). In the matter of *ijarah*, jurists use it as the opposite of *'amal* (labour); it comprises all tangible assets such as properties, transport facilities and factories, etc.

2 **Labour/Non-tangible asset (*'amal*)**: Labour may be executed by two types of workers: an **employee (*ajir khas*)** and an **independent contractor (*ajir mushtarak*)**. An **employee** is a person or an entity that works only for the

interest of a particular employer. Consequently, he does not have the right to work for any other lessee during the period of the lease contract. The **independent contractor** on the other hand, offers his services to the general public. Examples of independent contractors are tailors, medical doctors or carpenters.

Labour may be executed by two types of workers: an **employee (*ajir khas*)** and an **independent contractor (*ajir mushtarak*)**.

Ijarah based on specification of the subject matter

This is divided into two subcategories as follows:

1 **A particular source of benefit (*ijarah mu'ayyanah*):** It is called so because the lease contract is related to a specific piece of property like a car or a shop.

2 **A liability or a pledge to be fulfilled by a lessor (*ijarah mawsufa fi al-dhimmah*)**: A contract on a particular usufruct that the lessor assumes the liability to provide. It is so termed because the contract is linked to the lessor's liability; for instance, hiring the services of a tailor to sew a garment or hiring the services of a contractor to build a house.

Examples of independent contractors are tailors, medical doctors or carpenters.

Ijarah based on the time the contract becomes effective

This type of *ijarah* is divided into three subcategories:

1 **Instant lease (*ijarah munajjazah*)**: This is a lease contract which comes into effect immediately after the offer is accepted without relation to a future event or a fixed future date.

2 **Lease at a future date (*ijarah mudhafah*)**: This is a lease contract whereby its effect is delayed to a future date. For instance, to lease a shop for a fixed price and period with its occupancy delayed till after three months from the date of the contract.

3 **Lease subjected to fulfilment of certain conditions (*ijarah mu'allaqah*)**: This is a lease contract by which effectiveness is tied to a future event. For example, a lessor says, "When Zayd returns from his journey, I will lease this house to you." According to the majority of jurists, it is invalid because it makes the transfer of ownership contingent upon a void matter because the lease contract is at par with transferring the ownership of usufruct.

How binding is such a contract?

1. **Binding (*lazimah*)**: It is a valid lease devoid of any options of inspection, options of defect or options of stipulation in the sense that the two parties are automatically bound to the contract and neither of them have the right to revoke it without the consent of the other.

Nonbinding (***ghair lazimah***): It is a lease where one of the options mentioned above has been granted to a party, the lease contract becomes a nonbinding one, and the contract shall not be enforced until the end of that option.

2. **Nonbinding (*ghair lazimah*)**: It is a lease where one of the options mentioned above has been granted to a party, the lease contract becomes a nonbinding one, and the contract shall not be enforced until the end of that option.

Ijarah based on the contractual relationship

The contractual relationship is divided into two:

1. **Operating lease (*ijarah tashghiliyyah*):** It is an *ijarah* conducted either by IFIs or business companies. Its main criteria are that it is not tied with a purchasing agreement. It is suitable for costly assets such as ships, aircraft, and heavy-duty industrial and agricultural equipment.

Financing lease (***ijarah tamwiliyyah***): It is an *ijarah* conducted usually by Islamic financial institutions and tied to purchasing or gifting.

2. **Financing lease (*ijarah tamwiliyyah*)**: It is an *ijarah* conducted usually by IFIs and tied to purchasing or gifting. Such transactions are widely used in real estate, machinery and equipment. The contract used in this *ijarah* is termed in Arabic as *al-ijarah thummah al-bay'* (AITAB), *al-ijarah thummah al-iqtina'* or *al-ijarah al-muntahiyah bittamlik.*

Figure 6.10 summarises the types of *ijarah*:

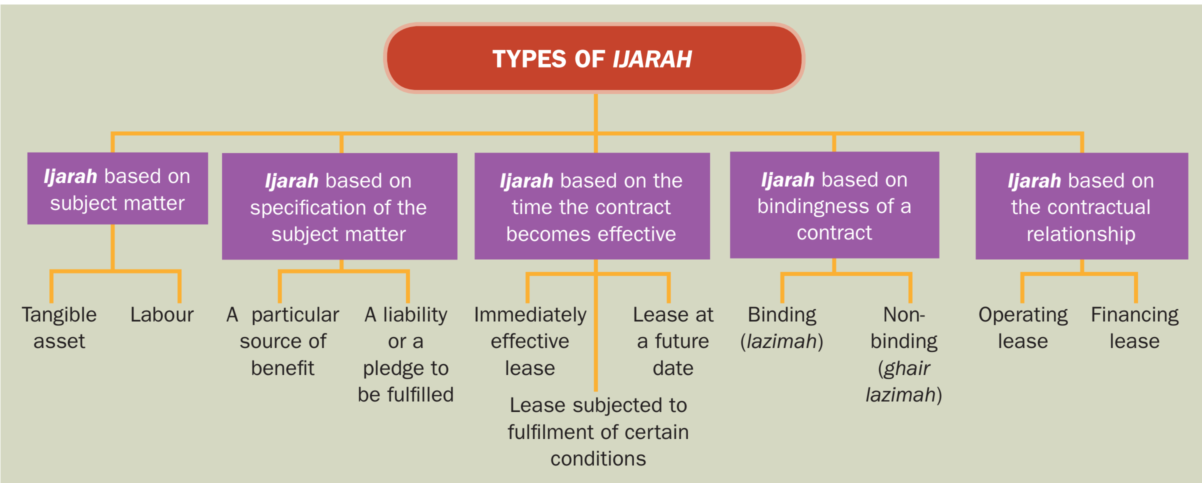


Figure 6.10
Types of *Ijarah*

The Applications of *Ijarah* in the Banking System

The common mechanism of *ijarah* as applicable in Islamic banking contracts is highlighted in Figure 6.11 below:

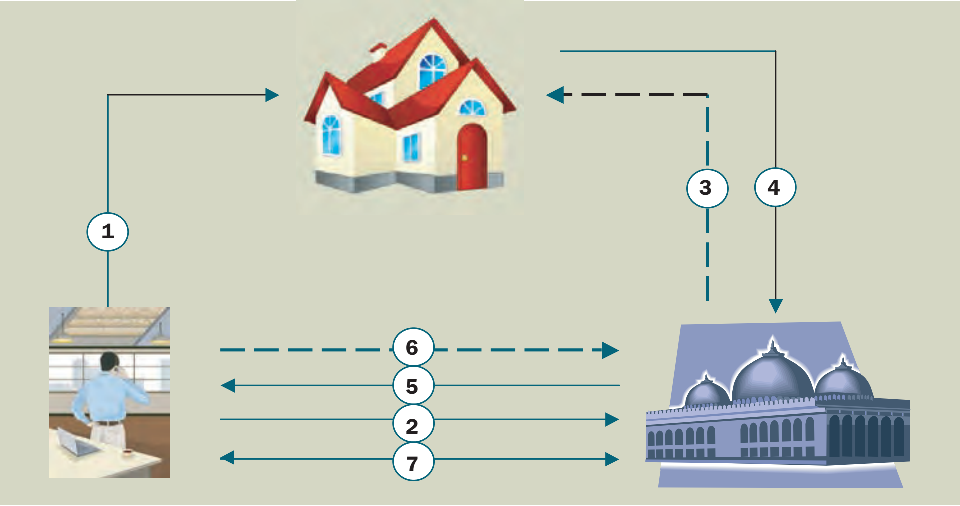


Figure 6.11 Mechanism of *Ijarah* Contract

1 The client identifies and approaches the vendor or supplier of the asset that he or she needs and collects all the relevant information.

2 The client approaches a bank for *ijarah* of the asset and promises to take the asset on lease from the bank upon purchase.

3 The bank makes payment of price to the vendor.

4 The vendor transfers ownership of the asset to the bank.

5 The bank leases the asset, transfers possession and specific right of use to the client.

6 The client pays *ijarah* rentals over future (known) time period(s).

7 The asset reverts to the bank if it is an operating lease or is transferred to the client if it is a financing lease.

Ijarah-based Instruments

Ijarah is incorporated in the Islamic financial system through the following products:

Table 6.3 Islamic Financial Instruments Incorporating *Ijarah*.

Financing	Simple *ijarah*, *al-ijarah thummah al-bay'* (AITAB), *musharakah mutanaqisah*, *ijarah*-based credit card (restricted to leasable items)
Government and Corporate Financing	*Sukuk ijarah*
Risk Management and Hedging Purposes	*Ijarah* rental swaps

Salient *Shari'ah* Issues in the *Ijarah* Contract

Combination of Contracts

Muslim jurists ruled that it is not permissible to tie one transaction with another so as to make the former a precondition for the other.

Muslim jurists ruled that it is not permissible to tie one transaction with another so as to make the former a precondition for the other. However, they allow the combination of more than one contract in one transaction without imposing one contract as a condition in the other, provided that it does not go against the restriction of the *Shari'ah* that prohibits it on an exceptional basis. Therefore, the lessor may enter into a unilateral undertaking to sell the leased asset to the lessee at the end of the lease period. This undertaking shall be binding on the lessor only.

Linked Rentals in Long-term Leases with an Interest Rate Benchmark

Muslim jurists agree that the lessor in a long-term lease may either stipulate a condition that the rent shall be increased with a certain percentage (e.g., 5%) after a specific period. He may also tie the rent amount with other well-defined benchmarks such as linking the increment or decrease in rent to the rate of government taxes or the inflation rate. They, however, disagree on tying the rental with an interest rate benchmark like LIBOR.

There are those who oppose tying *ijarah* rental to an interest rate benchmark.

There are those who oppose tying *ijarah* rental to an interest rate benchmark. They argue that the transaction is rendered akin to interest-based financing. They also argued that since the variations of the rate of interest is unknown, the rental tied to the rate of interest will imply *jahalah* and *gharar,* which is not permissible in the *Shari'ah.* The proponents of the application of such benchmarks argue that the rate of interest is used as a benchmark only and that the basic difference between interest-based financing and a valid lease does not lie in the amount to be paid to the financier or the lessor but in the lessor's bearing of the full risk of the corpus of the leased asset, while in the case of an interest-based financing, the financier is entitled to receive interest, even if the debtor did not at all benefit from the money borrowed. As for *jahalah*, they argued that it has been prohibited because it may lead to a dispute between parties, and there is no dispute in this case because the parties initially agreed with mutual consent. AAOIFI and other scholars agree with applying the interest rate benchmark subject to a limitation on both maximum and minimum levels.

Sale and Lease Back

One of the contemporary common practices in *ijarah,* especially in *sukuk ijarah* is the sale of property executed by the originator to *sukuk* holders through the special purpose vehicle (agent of *sukuk* holders), and subsequently leasing back the asset from the *sukuk* holders and promising to buy back the asset upon the maturity date of the *sukuk*.

This structure raises two *Shari'ah* issues: the first one is the legality of the sale of corpus with the condition to lease it back. Some scholars view this as *'inah* in usufruct. Their argument is that *'inah* is applicable to the sale and buyback of the corpus as well as the sale and buyback of the usufruct; whereas the majority do not consider this as *'inah*. They therefore, allow this transaction.

The second *Shari'ah* issue is related to the repurchasing of the asset or the *sukuk* representing the asset at the maturity date. Most opponents consider this transaction akin to *'inah.* They, therefore, nullify such a transaction, whereas AAOIFI in its *ijarah* standard item No: 8/5 ruled that it is permissible to buy back the leased asset provided that "a (reasonable) period of time between the lease contract and the time of the sale of the asset to the lessee must have expired to avoid the contract of *'inah*". This period is long enough due to the fact that the leased property or its value might have changed.

The second *Shari'ah* issue is related to the repurchasing of the asset or the *sukuk* representing the asset at the maturity date.

Summary

1 The *Shari'ah* contract is an important aspect of Islamic jurisprudence which is evident in the divine commandment that urges people to fulfil their contractual obligations arising from different kinds of contracts that they enter into.

2 There are three elements that make up a perfect *Shari'ah* contract and enable its legal consequences with immediate effect. The elements of a *Shari'ah* contract are the form of the contract, subject matter of the contract, and the contracting parties.

3 The above elements of *Shari'ah* contracts are considered perfectly satisfied and render the contract valid and binding upon the parties if all of its conditions and requirements are completely met.

4 The above elements also serve as the foundation and essence of a *Shari'ah* contract whereas its conditions and requirements constitute the attributes and qualities of a *Shari'ah* contract.

5 It is important to note that a contract is deemed void (*batil*) if its foundation is defective and voidable (*fasid*) if its attributes are illegal, and hence need to be rectified accordingly to make it enforceable. The existence of either of the abovementioned elements in a *Shari'ah* contract or its conditions give rise to several classifications of *Shari'ah* contracts, especially in relation to its legal effect and enforceability.

6 One of the classifications of *Shari'ah* contracts discussed in this chapter are exchange-based contracts which have their specific and peculiar conditions and requirements to be fulfilled in addition to the basic conditions of *Shari'ah* contracts contained in the elements of a *Shari'ah* contract.

7 Some of the specific conditions are not met in the contemporary application of the exchange-based contracts, which in turn give rise to numerous *Shari'ah* issues that need further deliberation.

Key Terms and Concepts

Ahliyyah
Contingent Contracts
Istisna'
Bay' Al-'Inah
Void Contract
Suspended Contracts
Salam
Tawarruq
Voidable Contract
Murabahah
Bay' Al-Dayn
Ijarah

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Review Questions and Problems

1 *C* says to *B*: "I appoint you as my agent to look after my properties, effective on the third day of next month". Explain the legal consequences of the contractual relationship between *C* and *B*.

2 *A* undertakes a sale contract with a child who is six years old and the child does not seek the consent of his custodian for the financial undertaking. What is the status of the abovementioned sale contract?

3 Explain the conditions of offer and acceptance laid down by the jurists with examples from classical jurisprudence.

4 Briefly explain the major differences between contracts effective from a future date (*al-'aqd al-mudaf li al-mustaqbal*) and enforceable contracts (*al-'aqd al-munajjaz*).

5 Explain the differences between voidable and void contracts according to the Hanafi school of law with examples.

Chapter 7

Shari'ah Contracts for Islamic Financial Instruments – Part 2

Preview

This chapter is the second part of the discussion on *Shari'ah* contracts for Islamic financial instruments. In the previous chapter, the emphasis was mainly focused on the basic description, elements, characteristics and various classifications of the *Shari'ah* contract. The chapter has also elaborated on exchange-based contracts, namely the sale-based and lease-based contracts. This chapter shall continue discussing other major types of contracts and principles in the *Shari'ah* that are used to structure Islamic financial instruments. These contracts are divided into several categories based on their nature: partnership contracts which include *mudarabah* and *musharakah*; security contracts such as *kafalah* and *rahn*; charitable contracts like *hibah* and *wadi'ah*; and agency contracts, i.e., *wakalah*. This chapter also highlights some supporting *Shari'ah* principles that are significant in structuring those products, for instance *hiwalah, ibra'*, *muqasah* and *wa'd*. Following the similar structure of our preceding discussion in Chapter 6, the deliberation of these contracts and supporting principles cover different aspects ranging from definition, evidences for legitimacy, pillars and conditions.

In *kafalah*, a guaranteed financial debt must be a valid and binding liability. It must be a valuable asset that can be lawfully owned and sold.

Learning Outcomes

At the end of the chapter, you should be able to:

- Understand the general concept of basic contracts in the *Shari'ah*, which has become the basis for structuring products in Islamic financial institutions.
- Describe the salient features of each partnership contract, security contract, charitable contract, agency contract and some supporting *Shari'ah* principles.
- Discuss important rules and conditions related to each contract. In some issues, the reader will be able to compare different views of Muslim scholars.
- Analyse and relate the contracts under discussion with their modern application in Islamic banking and finance.

Partnership Contracts in Islamic Finance

Musharakah

Definition of *Musharakah*

The Arabic word *musharakah* is a derivative from the root word *sharaka* which literally means sharing and mixing shares of two or more parties to make them interchangeable.

Technically, Hanafi scholars define *musharakah* as "a contract between partners on both capital and profit". The Malikis define it as permission to transact where each of the partners permits the other to transact with the partnership property while at the same time retaining his own right to transact with the same property (Al-Dardir, *Al-Sharh Al-Kabir*, 3/348). Shafi'i scholars define partnership as "a confirmation of the rights of two or more people over a common property" (Al-Sharbini, *Mughni Al-Muhtaj*, 3/221). According to Hanbali scholars, it is the amalgamation of rights or the freedom to use (Ibn Qudamah, *Al-Mughni*, 5/3).

It can be observed from the above definitions that *musharakah* is a term used by some Muslim scholars such as Shafi'i and Hanbali scholars to indicate its broad meaning that includes both *sharikah al-milk* (partnership in ownership) and *sharikah al-'aqd* (contractual partnership). For others, such as Hanafi and Maliki scholars, the definitions given by them incline towards the latter type of *musharakah* (contractual partnership). In the Islamic banking and finance context, these definitions by Hanafi and Maliki scholars are nearer to the modern partnership as a type of contract. In this light, AAOIFI, in its *Shari'ah* Standard No. 12, Clause 2/1 defines *musharakah* as "an agreement between two or more parties to combine their assets, labour or liabilities for the purpose of making a profit."

AAOIFI defines *musharakah* as "an agreement between two or more parties to combine their assets, labour or liabilities for the purpose of making profit".

Legality of *Musharakah*

The legality of *musharakah* is confirmed in the *Qur'an*, *Sunnah* and *Ijma'* (unanimity of scholars). In the *Qur'an*, the concept of *musharakah* is mentioned in the verse related to the distribution of inheritance.

> *"But if more than two, then they shall share in one-third ... (of the inheritance)" (Al-Qur'an*, 4:12).

Even though the verse specifically supports the validity of joint ownership in inheritance, the permissibility of sharing properties can also be extended to the case of contractual partnership.

In another verse, the *Qur'an* acknowledges the concept of partnership and reminds partners on how they shall behave towards each other. Allah the Almighty says in *Surah Sad*, verse 24:

> *"Truly many are partners (in business) who wrong each other, not so do those who believe and work deeds of righteousness and how few are they?" (Al-Qur'an,* 38: 24*).*

The *Qur'an* and *Sunnah* acknowledge the concept of partnership and remind partners on how they should behave towards each other.

In the *Sunnah*, the Prophet (p.b.u.h.) said, "God the Most High says, I am the third [partner] to two partners as long as one of them does not betray the other; if they betray each other, I leave them"(Abu Dawud, *Sunan Abi Dawud*, 3/256). In another *Sunnah*, the Prophet (p.b.u.h.) said: "Allah's Hand is with the two partners so long as one does not betray the other" (Al-Daruqutni, *Sunan Al-Daruqutni*, 3/442).

In addition to the evidences from the *Qur'an* and *Sunnah*, there is a consensus (*ijma'*) among Muslim scholars on the legality of *sharikah* in general (Ibn Qudamah, *al-Mughni*, 5/3). Differences of opinions among them are on some technical matters.

Types of *Musharakah*

The types of *musharakah* are illustrated in Figure 7.1 below.

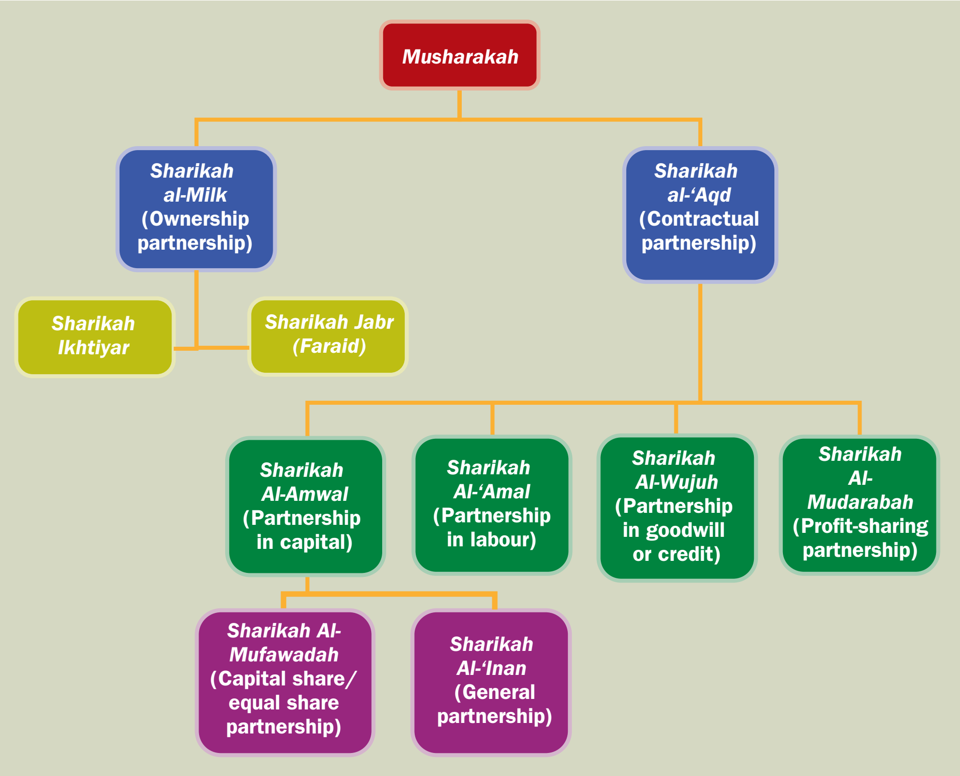


Figure 7.1
Types of *Musharakah*

Elaborations on the types of *sharikahs* are as follows:

1 *Partnership in Holding/Ownership* (Sharikah Al-Milk)

The basic element of *sharikah al-milk* is the mix of ownership, either by choice (*ikhtiyar*) or mandatorily (*jabr*). It occurs when two or more people are joint owners of one thing. There is no formal *sharikah* contract concluded between the parties involved. There are two categories of *sharikah al-milk*:

(a) *Sharikah ikhtiyar*: The ownership is established based on the acts of the partners such as an asset that has been jointly purchased by them or they became new owners of an asset as a result of a will or a gift.

(b) *Sharikah jabr*: The ownership is established mandatorily and not due to the acts of the partners. For example, they became new owners of an asset through inheritance.

The ownership in *sharikah ikhtiyar* is established based on the acts of the partners. However, the ownership in *sharikah jabr* is established mandatorily.

In *sharikah al-milk*, each and every one of the two or more partners is responsible for his share only and he cannot act on behalf of the other partner without his permission.

2 *Partnership by Contract* (Sharikah Al-'Aqd)

AAOIFI in its *Shari'ah* Standard No. 12, Clause 2/1 states *sharikah al-'aqd* is a partnership affected by a mutual contract, which can be translated as a "joint commercial enterprise". It is an agreement between two or more persons to combine their assets, labour or liabilities for the purpose of making a profit. This is considered a proper partnership because the parties concerned willingly entered into a contractual agreement for joint investment and the sharing of profit and risks.

From the perspectives of capital and efforts of the partners, this type of partnership can be further divided into the following categories:

(a) *Sharikah Al-Amwal* (Partnership in capital).
In this type of *sharikah*, all partners contribute capital for the company. It consists of two categories:

- *Sharikah Al-'Inan* (General partnership)
  AAOIFI in its *Shari'ah* Standard No. 12, Clause 3/1 defines *sharikah al-'inan* as a partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on condition that the profit is distributed according to the partnership agreement, and that the losses are borne in accordance with the contribution of each partner to the capital.

Sharikah al-'inan is the most important form of *musharakah* and seems to be nearer to the modern concept of business partnership.

The permissibility of this form of partnership enjoys consensus among all Islamic jurists. It is the most important form and seems to be nearer to the modern concept of a business partnership.

- *Sharikah Al-Mufawadah* (Equal partnership)
  Al-Mufawadah literally means *al-musawah* (equality). According to the Hanafi jurists, *sharikah al-mufawadah* is where two or more persons form a partnership whereby they are equal to each other in respect of capital, profit and freedom of disposal.

  There are differences of opinions among Muslim scholars on the permissibility of this form of partnership. In general, it is allowed by Hanafi and Maliki scholars. While other scholars, based on different reasons, are of the view that this form of partnership is not allowed.

(b) *Sharikah Al-'Amal* (Partnership in services/labour)
This form of partnership is an agreement between two or more parties to provide services pertaining to a profession, vocation or skilled trade, or to render some services or professional advice or to manufacture goods, and to share profits according to an agreed upon ratio. AAOIFI states in its *Shari'ah* Standard No. 12, Clauses 3/3/1 and 3/3/2, that the partnership has no monetary capital. It is also known as *sharikah al-abdan*.

This form of partnership is permissible in the views of Hanafi, Maliki and Hanbali scholars. On the contrary, it is not allowed by Shafi'i scholars.

(c) *Sharikah Al-Wujuh* (Partnership in goodwill)
This is a form of partnership in creditworthiness (partnership of liability). It is a bilateral agreement between two or more parties to conclude a partnership to buy assets on credit on the basis of their reputation for the purpose of making profit, whereby they undertake to fulfil their obligations according to the percentages determined by the parties. The parties should determine for each partner, the percentage of profit-sharing and of liability-sharing. This form of partnership has no monetary capital (AAOIFI, *Shari'ah* Standard No. 12, Clauses 3/2/1 and 3/2/2).

Sharikah al-wujuh is a form of partnership that has no monetary capital.

This form of partnership is permissible in the views of Hanafi and Hanbali scholars. On the other hand, it is not allowed by Maliki and Shafi'i scholars.

(d) *Sharikah Al-Mudarabah*: Technically, *mudarabah* is a partnership in profit whereby one party (*rabbul mal*) provides capital and the other party (*mudarib*) provides labour. Some of the jurists such as Hanafi and Hanbali use the term *mudarabah* while Maliki and Shafi'i use *qirad*. The profit, if any, will be shared between them on a mutually agreed ratio. In the case of losses, it will be borne by the capital provider (*rabbul mal*) and the *mudarib* will lose his efforts.

Basic Rules and Conditions of a *Sharikah Al-'Aqd* (Partnership by Contract)

For each type of *musharakah*, there are certain conditions to be fulfilled. Some of these conditions are agreed upon by the Muslim scholars, while some others are disputed among them. Here, the discussion will concentrate on some common conditions shared by all types of *sharikah al-'aqd* (partnership by contract).

1 Contracting parties: All partners must have the capacity to contract. They must attain the age of capacity and must be a sane person. There is no objection to have a non-Muslim or an institution as partner.

The ratio of profit-sharing between all partners should be determined and mutually agreed at the conclusion of the contract.

2 The ratio of profit-sharing between all the partners should be determined and mutually agreed at the conclusion of the contract which is in the form of an undivided percentage of profit, not a sum of money or a percentage of the capital (AAOIFI, *Shari'ah* Standard No. 12, Clauses 3/1/5/1). This is very important to avoid any element of *gharar* (uncertainty) and the possibility of disputes in the future. The partners may agree to make profit-sharing not proportionate to their contributions to capital, provided the additional percentage of profit over the percentage of contribution to the capital is not in favour of a sleeping partner. As stated in *Shari'ah* Standard No. 12, Clauses 3/1/5/3 and 3/1/5/4 for losses, it is a requirement that the proportion of losses borne by partners commensurate with the proportions of their contributions to the *sharikah* capital.

3 In principle, the capital of *sharikah* should be contributed in the form of monetary assets. Nevertheless, it is permissible, with the agreement of all partners, to provide tangible assets (commodities) as the capital of *sharikah* after the monetary values of these assets are determined and expressed in currency in order to know the share contributed by each partner.

4 The business carried out by partners should be permissible and in compliance from the perspective of the *Shari'ah*. The purpose of the business must also not be illegitimate or prohibited in Islam.

Musharakah Mutanaqisah (Diminishing Partnership)

Diminishing *musharakah* is a form of partnership in which one of the partners promises (*wa'd*) to buy the equity share of the other partner gradually until the title of the equity is completely transferred to him. This transaction starts with the formation of a partnership after which buying and selling of the equity takes place between the two partners. It is, therefore necessary that this buying and selling should not be stipulated in the partnership contract. In other words, the buying partner is allowed to give only the promise (*wa'd*) to buy. This promise should be independent of the partnership contract.

Mudarabah

Definition of *Mudarabah*

Literally, the word *mudarabah* is derived from the phrase "*al-darb fi al-ard*" which means to make a journey. This literal meaning is related to this type of partnership because normally it requires, particularly in the past, travelling to do business.

Technically, *mudarabah* is a partnership in profit whereby one party (*rabbul mal*) provides capital and the other party (*mudarib*) provides labour. Some jurists like Hanafi and Hanbali scholars used the term *mudarabah* while Maliki and Shafi'i' scholars used *qirad.* The profit, if any, will be shared between them at a mutually agreed ratio. In case of a loss, it will be borne by the capital provider (*rabbul mal*) and the *mudarib* will lose his efforts.

Other terms used by classical scholars that carry the same meaning of *mudarabah* are *qirad* and *muqaradah*. Both terms are derived from the word *qarada* which means to cut off (*al-qat'*). This is simply because the capital provider (*rabbul mal*) cuts off some of his money to be utilised by the *mudarib* in business activities. From another angle, it is from the phrase "*al-qard fi al-ard*" (cut off on the earth) which means to make a journey (al-Zamakhshari, *Al-Fa'iq fi Gharib Al-Hadith*, 3/187).

Other terms that carry the same meaning of *mudarabah* are *qirad* and *muqaradah*.

Legitimacy of a *Mudarabah*

Scholars of all known *fiqh* schools are of the view that *mudarabah* is a valid and legal contract. This view is based on evidences from, among others, the *Qu'ran*, *Sunnah*, and *ijma'*.

As for evidences from the *Qur'an*, there are several verses that indicate the legality of *mudarabah* such as the following sayings of Allah the Almighty:

> *"... and others who travel in the land seeking of the bounty of Allah" (Al-Qur'an,* 73: 20*).*

> *"... but when the prayer is ended, they disperse abroad in the land and seek Allah's grace ..." (Al-Qur'an,* 62: 10*).*
>
> *"... there is no blame on you in seeking bounty from your Lord ..." (Al-Qur'an,* 2: 198*).*

Although the above verses do not directly address the legality of *mudarabah*, they have been interpreted to include those who travel for the purpose of trading and seeking permissible income (Al-Kasani, *Bada'i' Al-Sana'i'*, 6/ 79).

The Prophet (p.b.u.h.) used to work as a *mudarib* for Khadijah.

A clearer proof on the legality of *mudarabah* from the *Sunnah* is the act of the Prophet (p.b.u.h.) himself who used to work as a *mudarib* for Khadijah. Another proof from the *Sunnah* is the tacit approval of the Prophet (p.b.u.h.) in the following case:

> Ibn 'Abbas reported that whenever his father Al-'Abbas bin 'Abdal-Mutallib gave money for *mudarabah,* he stipulated some conditions that the *mudarib* will not take his money across the sea, into any valley or buy any animal with a soft belly. If the *mudarib* does any of these things, then he is liable. The Prophet (p.b.u.h.) heard of this practice and permitted it (Al-Bayhaqi, *Al-Sunan Al-Kubra*, 6/184 (no: 11611)).

It was also reported by Ibn Majah that the Prophet (p.b.u.h.) said, "There is blessing in three transactions: credit sales, *mudarabah* and mixing wheat with barley for home consumption, not for trading" (Ibn Majah, *Sunan Ibn Majah*, 2/768).

Another proof on the legitimacy of *mudarabah* is the practice of companions on *mudarabah* that constituted *ijma'* (consensus opinion) among them. It was narrated by Zayd bin Aslam from his father that:

> 'Abdullah and 'Ubaydullah, the two sons of 'Umar, while travelling with the army of Iraq, visited Abu Musa al-Ash'ari, the Governor of Basrah. He welcomed them and offered to help them. His offer was to give them some public money to be delivered to the *bayt al-mal* (treasury), they could trade with it. They could keep the profit and submit the capital (original sum of money) to the Caliph. They did as he suggested. When they reached Madinah and informed the Caliph, he was upset. He asked them if Abu Musa had given similar capital to all other soldiers. As their reply was in the negative, 'Umar got angry and argued that Abu Musa gave them the money simply because they were the sons of the Caliph. 'Ubaydullah argued that the agreement was that, if the money perished, they would have to guarantee it. However, 'Umar insisted that the money (profit) must be surrendered to the *bayt al-mal* and they were not allowed to keep it. When 'Ubaydullah reiterated his argument, one of the companions said: "O Caliph, perhaps you can make it as *qirad*." And 'Umar consented to the arrangement. 'Umar then took the principle and half of the profit (for *bayt al-mal*)

and the other half of the profit was shared between 'Abdullah and 'Ubaydullah (Al-Bayhaqi, *Al-Sunan Al-Kubra*, 6/183).

This practice has been accepted by 'Umar in the presence of the companions of the Prophet (p.b.u.h.). No objection from them was recorded, and therefore constituted the consensus opinion of the companions.

As for *qiyas* (analogy), some Muslim scholars have made an analogy on the validity of *Al-Musaqah.* The *Al-Musaqah* is an agricultural partnership by which the owner of an orchard turns over a specified number of fruit-bearing trees to another who will tend them in exchange for a specified portion of the total yield of the trees (not the yield of certain trees). Therefore, according to some Muslim scholars, both of the contracts, i.e., *mudarabah* and *musaqah* are needed by human beings (Al-Kasani, *Bada'i' Al-Sana'i'*, 6/89).

Pillars and Conditions of *Mudarabah*

There are three pillars of *mudarabah,* namely:

1 From of the contract (*sighah*, i.e., *ijab* and *qabul*)

2 The contracting parties (*rabbul mal* and *mudarib*).

3 The subject matter (capital, work and profit).

It is important to highlight here that the differences of opinions on the number of pillars are merely technical in nature. Even though *sighah* is the only pillar according to Hanafi scholars, it cannot be executed except with the existence of contracting parties and the mentioning of capital, work and profit.

For each of the above pillars, there are some conditions to be fulfilled:

1 Conditions related to *sighah* (*ijab* and *qabul*)
Generally, the condition related to the *sighah* of *mudarabah* is similar to those of other contracts which constitute offer and acceptance. Offer is done by uttering the terms of *mudarabah*, *muqaradah* or any other terms to that effect. An example is when *A* who has money says to *B*:, "Take this money in *mudarabah*, and what God gives in profit will be divided between

us …" (And he specifies a certain profit-sharing ratio). If *B* accepts the offer and takes the money, then the *mudarabah* contract is concluded. The profit that is realised will be divided between them in accordance with the agreed profit-sharing ratio.

The offer and acceptance can be done verbally, in writing or through any means of communication that is acceptable by both contracting parties. However, it would be preferable for all *mudarabah* agreements to be in writing and with proper witnesses, to avoid any future dispute and misunderstanding.

It would be preferable for all *mudarabah* agreements to be in writing and with proper witnesses.

2 Conditions related to the contracting parties: Both *mudarib* and *rabbul mal* must be qualified persons under the law, which means that they must be of sound mind.

3 Conditions related to subject matters:

(a) Some important conditions related to the *mudarabah* capital
The majority of Muslim scholars are of the opinion that the *mudarabah* capital shall be in the form of cash money. Immovable or movable properties cannot serve as the capital of *mudarabah* due to the fact that there is *gharar* (uncertainty) in their value that consequently, will lead to uncertainty in the calculation of profit and loss. This might then lead to a dispute (*al-niza'*) between the contracting parties. While some other scholars such as Ibn Abi Layla and Al-Awza'i are of the opposite opinion (the capital need not be in terms of cash money only); however, the value of the property must be determined and agreed upon on the day the contract is concluded.

(i) The capital must be present during the conclusion of the contract. In other words, debt (even owed by the *mudarib* to the capital provider) or receivables cannot serve as capital for *mudarabah*.

(ii) The capital must be determined in terms of its value and be delivered to the *mudarib*.

(b) Some important conditions related to *mudarabah* profit

(i) It is a requirement that the mechanism for distributing profit must be clearly known in a manner that eliminates uncertainty and any possibility of dispute. The distribution of profit must be on the basis of an agreed percentage of the profit and not on the basis of a lump sum or percentage of capital. The parties should agree on the ratio of profit distribution when the contract is concluded.

It is important to note here that although the ratio of profit must be fixed upfront, it can always be changed or structured on different tiers as long as it is done with the mutual consent of both the *mudarib* and *rabbul mal*. Some illustrations: The contracting parties can agree that 40% of the actual profit shall go to the *mudarib* and 60% to the *rabbul mal* or vice versa. It is also allowed that different proportions are agreed in different situations. For example, the *rabbul mal* may say to the *mudarib,* "If you trade in wheat, you will get 50% of the profit and if you trade in flour, you will have 33% of the profit." Similarly, he can say, "If you do the business in your town, you will be entitled to 30% of the profit, and if you do it in another town, your share will be 50% of the profit." The contracting parties may also agree that if the profit is below *X* amount, then the profit-sharing is, for example 50 : 50, and if the profit is above *X* amount, then the ratio is 60 : 40 respectively.

Although the ratio of profit must be fixed upfront, it can always be changed or structured on different tiers with mutual consent of both *mudarib* and *rabbul mal.*

(ii) AAOIFI states in its *Shari'ah* Standard No. 13, Clause 8/2, apart from the agreed proportion of the profit as determined in the above manner, the *mudarib* cannot claim any periodical salary or a fee or remuneration for the work done by him. However, it is permissible for the two parties to construct a separate agreement independent of the *mudarabah* contract, assigning one party to perform, for a fee, a business activity that is not by custom part of the *mudarabah* operations.

(c) Some important conditions related to the labour of the contract
The *mudarabah* contract can be divided, from the work of the *mudarib* perspective, into two categories:

(i) *Al-Mudarabah Al-Mutlaqah* (Unrestricted *Mudarabah* Contract)
It is a contract in which the capital provider permits the *mudarib* to administer a *mudarabah* fund without restrictions on the type of work that is to be done, the location, the time, method of payment, etc. Under this category of *mudarabah*, the *mudarib* has a wide range of trade or business freedom on the basis of trust and the business expertise he has acquired.

Though the *mudarabah* is of an unrestricted type, there are differences of opinions among Muslim scholars on some acts of the *mudarib* such as loan-taking or lending. Some scholars such as the Shafi'iyyah and the Hanabilah are of the opinion that the *mudarib* can only enter into this kind of act with the permission of the *rabbul mal*.

(ii) *Al-Mudarabah Al-Muqayyadah* (Restricted *Mudarabah* Contract)
Shari'ah Standard No. 13, Clause 5/1A defines a restricted *mudarabah* contract as a contract in which the capital provider restricts the action of the *mudarib* to a particular location or to a particular type of investment, or any other restriction as the capital provider considers appropriate but not in a manner that would unduly constrain the *mudarib* in his operation.

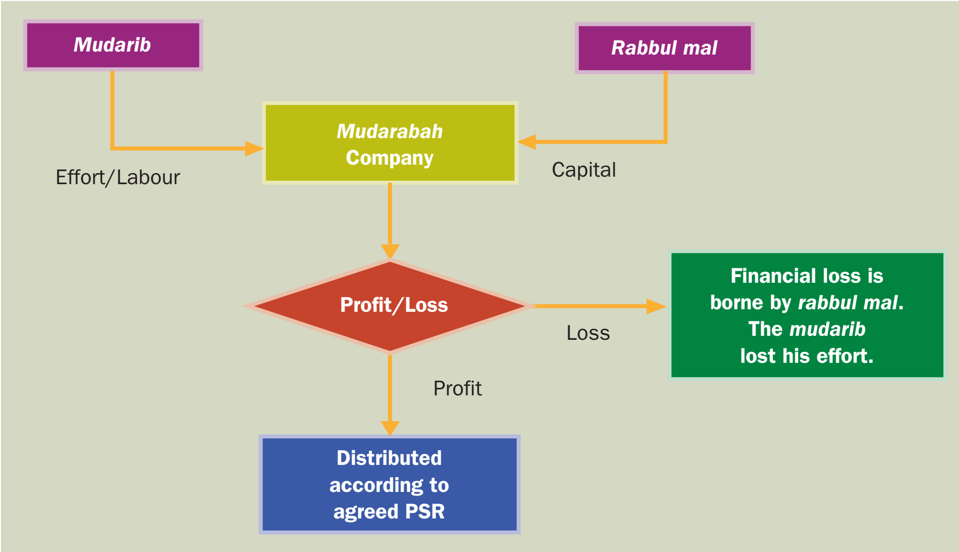


Figure 7.2 Illustration of a *Mudarabah* Contract

Termination of a *Mudarabah* Contract

Before the start of *mudarabah* work, the contract is regarded as *'aqd ghayr lazim* (nonbinding contract), and therefore it can be terminated by either of the two parties by giving a notice to the other party.

However, once the *mudarabah* work has started, Muslim scholars have different views on whether it can be terminated by one party without the consent of the other party. The majority of Muslim scholars are of the opinion that the contract can be terminated based on the fact that it is *'aqd ghayr lazim*. On the other hand, Imam Malik is of the view that it can only be terminated with the mutual consent of the contracting parties.

It may be disastrous to the project if one of the parties terminates the contract once it has started.

In the context of the present circumstances, most commercial enterprises today need time to bring fruits. They also demand constant and complex efforts. Therefore, it may be disastrous to the project, if one of the parties terminates the contract once it has started. In this light, Imam Malik's view may be more practical for application. Another option to avoid future difficulties is for the parties to agree that when entering into the *mudarabah* contract, no party shall terminate it during a specified period, except in specified circumstances. This kind of condition does not violate any principles of *Shari'ah* and it is in line with the famous *hadith*, which says: "All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful" (Al-Tirmidhi, *Sunan Al-Tirmidhi*, 3/626).

Other instances where a *mudarabah* contract can be liquidated as stated by AAOIFI, in *Shari'ah* Standard No. 13, Clause 10/1 are as follows:

1 On the date of maturity if the two parties had earlier agreed to set a time limit.

2 When the funds of the *mudarabah* contract have been exhausted or have suffered losses.

3 The death of the *mudarib* or the liquidation of the institution that acts as *mudarib*.

4 Insanity of any of the parties to the *mudarabah* contract.

If all assets of the *mudarabah* are in cash form at the time of termination, and some profits have been earned, it shall be distributed between the parties according to the agreed ratio. However, if the assets of the *mudarabah* are not in cash form, the *mudarib* shall be given an opportunity to sell or liquidate them, so that the actual profit may be determined.

Security Contracts

Kafalah (Guarantee)

Definition of *Kafalah*

The majority of Muslim scholars view that the terms *daman* and *kafalah* carry the same meaning. However, some scholars confine the definition of *daman* to a "guarantee of property" while the term *kafalah* means guarantee of "*al-nafs*" or oneself. Classical jurists defined *kafalah* as "a conjoining of the guarantor's liability to the liability of the guaranteed" (Al-Sharbini, *Mughni Al-Muhtaj*, 2/198). It may also be defined as a contract which combines one's liability with another person's liability. Legally, in *kafalah*, a third party becomes surety for the payment of debt unpaid by the person originally liable. The degree or scope of suretyship should be known and should not come with preconditions. It is a guarantee given to a creditor that the debtor will pay the debt, fine or any other liabilities.

Kafalah is a guaranteed contract on a certain asset, usufruct and/or service provided by a guarantor to the parties involved.

The *Shari'ah* Advisory Council of Bank Negara Malaysia defines *kafalah* as "a guaranteed contract on a certain asset, usufruct and/or service provided by a guarantor to the parties involved". Generally, *kafalah* means a guarantee or to take on the responsibility for the payment of a debt or for a person's appearance in court.

The guarantee is covered under the term "*kafalah*" in Islamic commercial law. There are two forms of guarantee: *kafalah*, or suretyship, and *rahn*, or pledge/surety. These two pre-Islamic contracts used for guarantee or safe return of loans to their owners were approved by the Prophet (p.b.u.h.) and their elaborated applications were extended by later generations in order to avoid any iniquities to both parties in the contract of loan, especially to the creditor.

Legality of *Kafalah*

The scholars have debated at length on the permissibility of the guarantee contract relying on the sources of *Shari'ah*: *Qu'ran*, *Sunnah*, and *ijma'*. The permissibility of *kafalah* can be derived from the provisions of the *Qu'ran*. For instance, in the following verse Allah (s.w.t.) says: *Some of the ministers reply: "We have missed the royal bowl and for him who produces it is a camel load, I will be bound by it"* (*Al-Qur'an*, 12: 72). Another proof that indicates the permissibility of *kafalah* is the following tradition of the Prophet (p.b.u.h.):

> Narrated from Salamah bin al-Akwa', he says: "Once we were with the Prophet (p.b.u.h.), then a group of people came with a funeral procession and said: 'O Prophet (p.b.u.h.), please conduct the funeral rites for this corpse.' He asked: 'Has he left anything?' They replied: 'Nothing.' Then he asked: 'Has he left any debts?' They replied: 'Yes, three dinar,' then the Prophet (p.b.u.h.) said: 'You should pray for him.' Then Abu Qatadah said: 'O Prophet (p.b.u.h.), please pray for him. I bear the liability of the debt,' then the Prophet (p.b.u.h.) prayed for the corpse (Al-Bukhari, *Al-Jami' Al-Sahih*, 3/94).

The lender can demand some recourse in the event of failure by the borrower to fulfil his obligation.

The lender can demand some security to which he may have recourse in the event of failure by the borrower to fulfill his obligation. The Prophet (p.b.u.h.) himself borrowed from a Jew against the security of an iron breastplate which was with the Jew at the time of his demise (Al-Bukhari, *Al-Jami' Al-Sahih*, 4/41).

Islam has laid down broad principles in this regard as well. In the *Qur'an*, we come across: *"If you are on a journey and cannot find a scribe, a pledge with possession may serve the purpose" (Al-Qur'an,* 2: 283*)*. This is a convincing proof of the fact that a pledge is permissible, it makes no difference whether a person is on a journey or at home, and transactions of this nature can take place even between a Muslim and non-Muslim.

According to AAOIFI *Shari'ah* Standard No. 5, a contract of guarantee is permissible in contracts of exchange, and property. Such a guarantee contract does not affect the validity of the original contract in which it is required. In fact, there is no objection in the *Shari'ah* to include a number of guarantees in one contract, such as incorporating a personal guarantee together with a pledge of security in the same contract.

Types of *Kafalah*

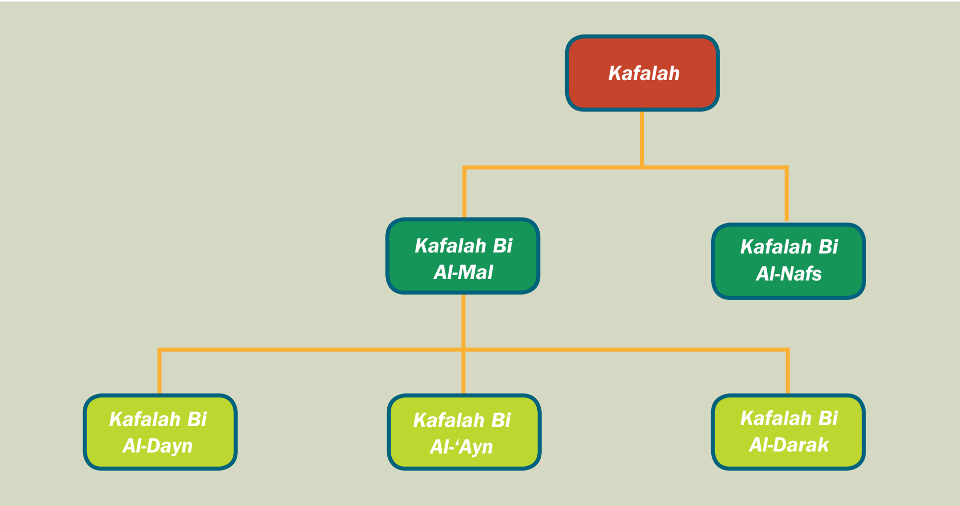


Figure 7.3
Types of *Kafalah*

Generally, *kafalah* may be divided into two types:

1. *Kafalah bi al-mal* is a guarantee to return an asset to its owner.

2. *Kafalah bi al-nafs* is a guarantee to bring someone to a specific authority, such as the judiciary.

   Kafalah bi al-mal may be further divided into three main categories:

   (a) *Kafalah bi al-dayn* is a guarantee for the repayment of another party's loan obligation. It means that when a debtor fails to meet his obligation to repay a loan, then the guarantor will assume this obligation.

   (b) *Kafalah bi al-'ayn* or *kafalah bi al-taslim* is a guarantee of payment for an item or a guarantee of delivery in a transaction. For example, in a sale and purchase contract, the guarantor agrees to guarantee the delivery of the item to be sold to the purchaser. In the event the seller fails to honour his obligation according to the agreement, the guarantor will be responsible for the delivery.

(c) *Kafalah bi al-darak* is a guarantee that an asset is free from any encumbrances. This guarantee is specific for transactions that involve the transfer of titles or rights and ensures that an asset is free from any encumbrances. For example, if A claims and is able to prove that the item bought by B belongs to A, then it will be the guarantor's responsibility to ensure that B gets back the value of his purchase which has been paid to the seller.

Kafalah bi al-dayn is the type of *kafalah* that is applicable in most transactions today. Hence, the discussion here will focus on this type of *kafalah*.

Basic Rules and Conditions of *Kafalah*

1 Guarantor

The guarantor must be a qualified person under the law (having complete legal capacity), which means that he must be of sound mind and is eligible for making voluntary contributions. He must give consent and agree to the contract.

2 Debtor

It is not necessary that the debtor should have legal capacity. He may be a minor, insane or a bankrupt person. According to the majority, it is valid for a guarantor to guarantee the debts of a bankrupt deceased individual. They are also of the opinion that the guarantor must know the debtor whose debts he guarantees. Whereas the stronger view of Shafi'i scholars is that it is not necessary for the guarantor to specify or know the guaranteed debtor (Al-Sharbini, *Mughni al-Muhtaj*, 2/200).

3 Creditor

According to Hanafi scholars, the creditor must be known (Al-Kasani, *Bada'i' Al-Sana'i'*, 6/5). Whereas Maliki and Hanbali scholars permitted guaranteeing debts for unnamed creditors, (Ibn Qudamah, *Al-Mughni*, 5/535), e.g., "I guarantee the debts of Zayd that he owes other people."

4 *Guaranteed object/asset*

According to Hanafi scholars, the object or asset of a guarantee contract must be an established liability (fungible, non-fungible, a person, or an action) (Al-Kasani, *Bada'i' Al-Sana'i'*, 6/5). In AAOIFI *Shari'ah* Standard No. 5, Clause 4/2, the majority of jurists ruled that the object of financial guarantee must be possible to collect from the guarantor; otherwise the contract would not be of any benefit. A guaranteed financial debt must be a valid and binding liability. It must be a valuable asset that can be lawfully owned and sold.

Some Rules Related to Personal Guarantee

1 It is permissible to have more than one guarantor secure the debt.

2 Personal guarantees are divided into two types. One type is a guarantee where the guarantor has a right of recourse to the debtor, and this guarantee is offered at the request or with the consent of the debtor. The other type is a nonrecourse guarantee, which is offered voluntarily by a third party without the debtor's request or consent (voluntary guarantee).

3 It is permissible to fix the duration of a personal guarantee. It is also permissible to set a ceiling on the amount to be guaranteed, and it is permissible that the personal guarantee be restricted by, or be contingent upon, a condition or a future event.

4 It is not permissible to take any remunerations whatsoever for providing a personal guarantee, or to pay commission for obtaining such a guarantee. The guarantor is, however, entitled to claim any expenses actually incurred during the period of a personal guarantee.

Rahn

Definition of *Rahn*

Literally, *rahn* is an Arabic noun derived from the word *rahana* which means either constancy and continuity, or holding and binding. Technically, *rahn*, which is also termed as pawning, mortgage, collateral, charge, lien and pledge, refers to taking a property as a security against a debt, whereby the secured property can be utilised to repay the debt in the case of nonpayment.

Rahn is a charitable contract as it does not require any financial obligation on the part of the *murtahin* (i.e., creditor) when the *rahin* (i.e., debtor) gives him the pawned object. In this case, *rahn* is similar to the other voluntary charitable contracts such as gift (*hibah*), simple loan (*i'arah*), loan (*qard*), and deposit (*wadi'ah*).

Rahn is a charitable contract as it does not require any financial obligation on the part of the *murtahin* (i.e., creditor) when the *rahin* (i.e., debtor) gives him the pawned object.

Legality of *Rahn*

The legality of *rahn* is based on proofs from the *Qur'an*, *Sunnah* and *ijma'*. In the *Qur'an*, Allah (s.w.t.) says: *"If you are on a journey and cannot find a scribe, then use the receipt of pawn objects" (Al-Qur'an*, 2: 283*)*.

This verse clearly indicates the alternative means of documenting the debt in the absence of the scribe, i.e., via pawning. Although it was revealed in the context of travelling, the majority of jurists, except Mujahid and Zahiris, agree that *rahn* is also permissible at home, based on the *Sunnah* of the Prophet (p.b.u.h.) who permitted it without any restriction.

On the other hand, evidences on the permissibility of *rahn* from the *Sunnah* can be observed in the following *hadith*: A'ishah narrated that: "The Prophet (p.b.u.h.) bought some food (on credit) from a Jew and he pawned his iron shield to him." *(Sahih al-Bukhari*, 2/729). In another *hadith* narrated by Abu Hurayrah, the Prophet (p.b.u.h.) said: "Pawned riding animals may be mounted in exchange for their expenses, and the milk of pawned dairy animals in exchange for their expenses; and the one who rides or drinks is thus responsible for the animal's expenses."(*Sahih al-Bukhari*, 2/888). In addition, the Prophet (p.b.u.h.) also mentioned that: "The ownership link between a pawned item and its owner is not severed; he is still responsible for its expenses, and he is entitled to its profit" (Al-Daraqutni, *Sunan Al-Daraqutni*, 3/33 (Kitab al-Buyu', no. 127)). With regards to the *ijma'*, Muslim scholars unanimously agree that *rahn* is permissible.

Basic Rules and Conditions of a *Rahn* Contract

Hanafi scholars regard *sighah,* i.e., offer and acceptance (*ijab* and *qabul*) as the only essential element of *rahn*. Meanwhile, according to the majority of Muslim jurists, *rahn* consists of four elements, mainly: *sighah* (*ijab* and *qabul*)), the contracting parties, i.e., the debtor and the creditor (*rahin* and *murtahin*), the pawned object (*marhun*), and the debt (*marhun bih*).

The difference of opinion among Muslim scholars on the pillars of *rahn* is due to their different approaches in considering the meaning and constituents of essential elements in all contracts, as highlighted in the previous chapter.

The abovementioned elements need to fulfil several conditions in order for the *rahn* contract to be deemed valid, namely:

1 *Conditions related to* sighah (ijab *and* qabul)

According to Hanafis, the *sighah* of *rahn* should not be suspended by a condition or deferred to a future date. The other jurists categorise the conditions for *sighah* of *rahn* into valid (*sahih*) and defective (*fasid*) conditions, whereby the defective conditions may affect the defectiveness of the *rahn* contract, or may render the contract to be valid while the condition itself is defective. In general, valid conditions are the ones that do not contradict the implications of the contract (*muqtada al-'aqd*) and do not lead to a forbidden transaction, such as the creditor must be trustworthy or the creditor can sell the pawned object upon the debt maturity.

Valid conditions are the ones that do not contradict the implications of the contract and do not lead to a forbidden transaction.

Meanwhile, defective conditions that may invalidate the *rahn* contract are ones which are contradictory to the implications of the contract, for example, the pawned item cannot be sold until after one month of the debt maturity, or the pawned object cannot be sold except at a price agreed by the debtor, and etc.

2 *Conditions related to the contracting parties* (rahin *and* murtahin)

Both contracting parties in *rahn* must have legal qualification (*ahliyyah*) to do so. According to the Hanafi and Maliki scholars, they should satisfy the qualifications of the sale contracts discussed in Chapter 6. Hence, whoever is allowed to sell is permitted to pawn. *Rahn* from a discerning child and a mentally incompetent person is valid upon the approval of his *wali* (i.e., father, grandfather, legal guardian or judge).

The Shafi'is and Hanbalis, however, view that the contracting parties in *rahn* need to fulfill the qualifications of both sale and charitable contracts, as *rahn* is regarded as a voluntary action. Therefore, *rahn* is invalid if the person is coerced, not of a legal age (*baligh*), insane, mentally incompetent and bankrupt.

3 *Conditions related to the pawned object* (marhun)

In general, jurists agree that the pawned object must fulfill the conditions of a sale object, so that it can be sold to repay the debt. This is based on the maxim that rules "properties ineligible for sale are ineligible for pawning". These conditions include:

(a) being a valued property.

(b) being a permissible item.

(c) being existent at the time of contract.

(d) being deliverable.

(e) being precisely determined with regards to its essence, quantity and value.

(f) being of sufficient value to cover the debt amount.

(g) being in the possession of the creditor.

(h) being a non-fungible property, not usufruct.

(i) being pawned together if the object is naturally connected. Example: It is not valid to pawn fruits without trees that bear them or crops without the land, as it is impossible to take possession of the fruits or crops without the trees or the land.

4 *Conditions related to the debt/liability* (marhun bih)

Based on the different opinions of Muslim jurists, the conditions related to the underlying debt of *rahn* can be summarised as follows:

(a) The underlying debt must be an established, binding and enforceable one, either through a loan, sale, or damages in the torts against a property. Therefore, *rahn* is invalid if the underlying liability is non-fungible *('ayn)* and held in the possession of a trust such as *wadi'ah*, a leased property in the hand of the lessee, and the capital of a *musharakah* or *mudarabah*.

(b) The underlying debt must be known and defined to both contracting parties. Hence, if one or both parties are uncertain of the debt, for example, the debtor pawns an object for an unspecified debt out of two that he owes the creditor, the pawning is considered invalid.

(c) The underlying debt must be matured/binding or about to be matured. Thus, *rahn* is valid if the debt is based on the price of a binding sale, or during the option period prior to its bindingness as the sale contract is going to be binding after the option expires. However, *rahn* is invalid if the debt is based on *ju'alah* before the completion of the task, as its liability is not binding.

(d) According to the Hanafis and Malikis, the underlying debt must be liable to be paid off. Therefore, *rahn* is invalid if the liability is based on usufruct. For instance, if two individuals lease a property together, and one of them owes the other a portion of the usufruct, that liability cannot be used for pawning. Nevertheless, Shafi'i and Hanbali scholars allow such kind of liability in *rahn*.

5 *Conditions related to the receipt/possession of the pawned object*

As mentioned above, the pawned object should be in the receipt or possession of the creditors. There are several conditions for its validity, mainly:

(a) permission of the debtor.

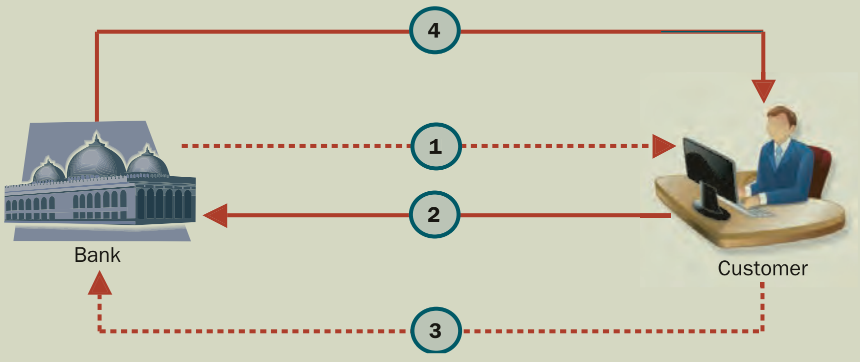
(b) eligibility of the contracting parties.

(c) permanency of possession.[1]

Application of *rahn* in Islamic mortgage and financing

Rahn in the contemporary application may take either the form of papers such as property documents, vehicle papers, *sukuk*, shares, etc., or objects like ornaments, jewelleries and other valuables. In both forms, a basic structure flow of the *rahn* contract will involve two parties, mainly a bank as the creditor and a customer as the debtor, as depicted in Figure 7.4.

Rahn in the contemporary application may take either the form of papers such as property documents, vehicle papers, *sukuk*, shares, etc., or objects like ornaments, jewelleries and other valuables.



1 Bank A provides financing of RM5,000 to customer B.
2 Customer B pawns his valuable item (e.g., jewellery) as collateral for the financed amount.
3 Customer B pays the debt.
4 Bank A returns the jewellery to Customer B.

- - Represents the cash flow.

Figure 7.4 Illustration of a Basic *Rahn* Structure Flow in an Islamic Mortgage or Financing

In the event of default, the asset can be liquidated to settle the debt's outstanding amount. However, the creditor (Bank A) cannot sell off the asset without the consent of the debtor because he is still the owner of the pawned asset. This is in line with the *hadith* of the Prophet (p.b.u.h.) that says: "The ownership link between a pawned item and its owner is not severed; he is still responsible for its expenses, and he is entitled to its profit" (Al-Daraqutni, *Sunan Al-Daraqutni*, 3/33 (*Kitab Al-Buyu'*, No. 127).

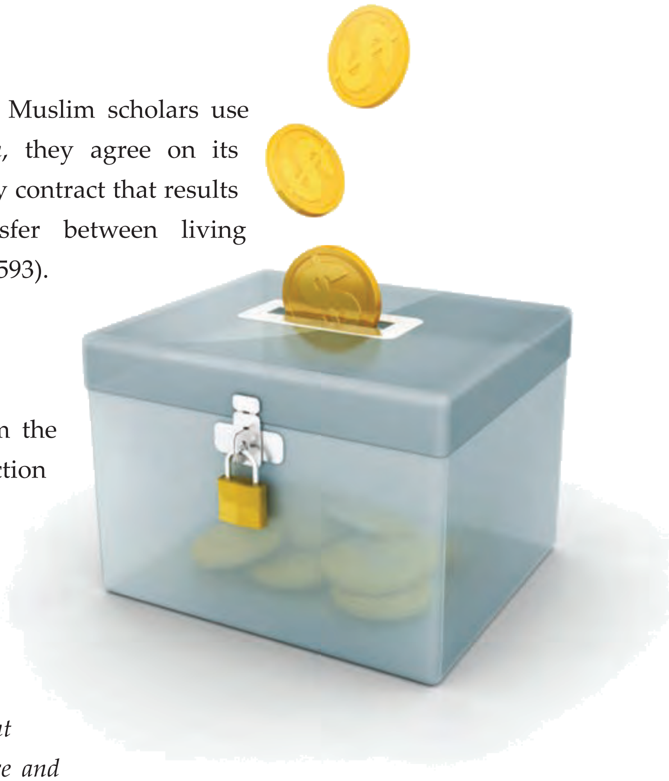
1 Most jurists except the Shafi'is agree that the creditor's possession of the pawned object should be permanent. Thus *rahn* is deemed invalid if the object is returned to or used by the debtor. On the other hand, Shafi'i scholars opine that permanency is not a condition for the possession validity. Hence, they allow the debtor to borrow or use the pawned object for riding, residence, etc. Refer to: Al-Kasani, *Bada'i' Al-Sana'i'*, 13/416, *Al-Dardir, Al-Sharh Al-Kabir*, 3/241–242, *Ibn Qudamah, Al-Mughni*, 4/421, Al-Sharbini, Mughni al-Muhtaj, 7/358.

Charitable Contracts

Hibah

Definition of *Hibah*

It can be observed that even though Muslim scholars use different wordings in defining *hibah*, they agree on its general concept, which is: "A voluntary contract that results in uncompensated ownership transfer between living individuals" (Ibn Qudamah, *Al-Kafi*, 3/593).



Legality of *Hibah*

The principle of *hibah* is derived from the *Qur'an* and *hadith*. The *Qur'anic* injunction of spending in the path of Allah (s.w.t.) encourages Muslims to offer gifts.

> *"And give unto women, their marriage portions in the spirit of a gift; but if they, of their own accord, give up unto you aught thereof, then enjoy it with pleasure and good cheer" (Al-Qur'an,* 4: 4*).*

> *"… and give wealth, in spite of love for it, to relatives, orphans, the needy, the traveller, those who ask [for help], and for freeing slaves …" (Al-Qur'an,* 2: 177*).*

The giving and accepting of gifts is also recommended by the Prophet (p.b.u.h.):

> Narrated by Abu Hurayrah: The Prophet (p.b.u.h.) said, "O Muslim women! None of you should look down upon the gift sent by her she-neighbour even if it were the trotters of the sheep (fleshless part of legs)" (*Sahih al-Bukhari*, 3/153).

Abu Hurayrah also narrated: "Whenever a meal was brought to Allah's apostle, he would ask whether it was a gift or *sadaqah* (something given in charity). If he was told that it was *sadaqah*, he would tell his companions to eat it, but if it was a gift, he would hurry to share it with them" (*Sahih al-Bukhari*, 3/155).

Narrated by 'Aishah: "Allah's apostles used to accept gifts and used to give something in return" (*Sahih Al-Bukhari*, 3/157).

The above verses of the *Qur'an* and traditions of the Prophet (p.b.u.h.) indicate clearly the legitimacy of giving gifts, as well as accepting them.

Pillars and Conditions of a *Hibah* Contract

The pillars of *hibah* according to the majority of jurists except Hanafis are the:

1 Donor

2 Donee

3 *Hibah* object

4 *Sighah* (Al-Sharbini, *Mughni al-Muhtaj*, 2/512).

Hanafi scholars on the other hand, rule that the pillar of *hibah* consists of *sighah* (*ijab* and *qabul*) only.

The conditions for each of the mentioned pillars are as follows:

1 The Donor

Muslim scholars agree that for a donor to be eligible to give his property voluntarily to another, he must be the legal owner of the object of gift, (Ibn Rushd, *Bidayah Al-Mujtahid*, 4/2023) besides being of a legal age (*mukallaf*) and mature (*rashid*). In this regard, the jurists rule that a father may not give away his young child's property as an uncompensated gift because giving away the property is a pure financial loss, and hence it requires the consent of a legally competent owner.

2 The Donee

The recipient of a gift can be any living human being with or without legal capacity. The issue is the gift only becomes binding when the recipient takes possession (*qabd*) of the gift object. Jurists rule that a donee must have legal capacity to take ownership (*qabd*) of the gift given to him by the donor. If the donee is of a legal age and sane, he is entitled to receive the gift by himself, and even if he is not an eligible recipient, the *hibah* is still valid, but the receipt (*qabd*) has to be done by a person who is eligible to receive the gift on the donee's behalf such as his legal guardian.

3 The Gift Object

The gift object is the subject matter of the *hibah*. Generally, the conditions for the gift object can be described by a legal maxim which states that "every object which is legally tradable from the *Shari'ah* perspective is considered legal to be given away as a gift" (Al-Sharbini, *Mughni al-Muhtaj*, 2/515), because the goal of *hibah* is the transfer of ownership of tangible items which is very much similar to a sale and purchase contract (*bay*) (Al-Shayrazi, *Al-Muhadhdhab*, 2/333). The jurists have enumerated several conditions to be met by an item being given as a *hibah*:

"Every object which is legally tradable from the *Shari'ah* perspective is considered legal to be given away as a gift."

(a) The object must be in existence at the time the *hibah* contract is made; otherwise the contract of *hibah* is not valid according to the majority of jurists. The Maliki scholars, however, allow the *hibah* of something which is not in existence as long as it is owned by the donor and transferable. As such, it is allowable according to them to give away the yield of one's orchard for the next 20 years (Ibn Rushd, *Bidayah Al-Mujtahid*, 2/248).

(b) The gift must be a valuable property. A valuable property is a property which is regarded as valuable and permissible by the *Shari*'ah and is to be compensated in case of damage (Wizarah Al-Awqaf, Kuwait, *Al-Mawsu'ahal-Fiqhiyyah*, 42/128). Therefore, a non-valued property such as wine or pork, may not be given as a *hibah* (Nizam and others, *Al-Fatawa Al-Hindiyyah*, 4/417).

(c) The gift object must be separable. There is a *Shari'ah* issue pertaining to the validity of giving a commonly shared property as a *hibah*. There are two different opinions among the jurists.

The Hanafis rule that it is not valid to give a share in a divisible commonly shared property (e.g., an apartment building) as a gift. They consider such a gift contract as defective, because unidentified shares in common property cannot be delivered. Since the goal of *qabd* (delivery) is permitting the owner to have full command of the property, therefore having such a share denies his right to deal in that share on the whole. On the other hand, they rule that it is permissible to give a share in a non-divisible common property (e.g., a car) as a gift (Nizam and others, *Al-Fatawa Al-Hindiyyah*, 4/417).

In contrast, the Malikis, Shafi'is, and Hanbalis rule that giving an unidentified share in a common shared property is permissible, in analogy to the permissibility of selling such a share.

(d) The gift object must be separate. In some way similar with the previous case, the Hanafis ruled that the gift is not valid if its object is physically or actually connected to another thing in an inseparable manner which makes *qabd* in this case impossible (Ibn 'Abidin, *Radd Al-Mukhtar*, 8/493).

(e) The jurists disagree whether *qabd* (taking possession) is a requirement in completing a *hibah* contract. In other words, is a *hibah's* expression of *ijab* and *qabul* (*sighah*) alone sufficient in transferring ownership of the *hibah* object from the donor to the donee, or is it not transferable except through *qabd*?

There are three jurist views pertaining to this issue:

(i) *Qabd* is the condition for a *hibah* contract to be legally binding. The contract is not binding unless a *qabd* is made. According to this view, the *hibah* object before *qabd* is still legally owned by the donor as the ownership transfer is not yet completed. This is the view of the majority of scholars, among them, the Hanafis (Ibn al-Humam, *Takmilah Sharh Fath Al-Qadir,* 9/120) and Shafi'is, Ibrahim Al-Nakha'i, Sufyan Al-Thauri, as it was also reported from Umar al-Khattab (Ibn Al-Mundhir, *Al-Ishraf 'ala Madhahib Al-'Ulama'*, 7/82).

(ii) *Qabd* is neither a condition required to validate a *hibah* contract, nor to make it binding, rather it is a condition for the full effect of the *hibah* contract to be achieved. This means that the ownership of the *hibah* object is transferred from the donor to the donee by a mere *ijab* (offer) and *qabul* (acceptance), hence the contract becomes binding. Therefore, if the donor refuses to deliver the property to the donee, he can be forced to do so. This is the opinion of the Malikis.

(iii) *Qabd* is a validity condition for goods measured by weight and volume. This opinion is favoured by the Hanbalis. The *hibah* objects measurable by weight and volume do not become the donee's property except through *qabd*. As for the objects which are not measurable by weight and volume, there are two opinions in the *madhhab*: the *hibah* is not complete except through *qabd*, but the other opinion states that the *hibah* was deemed concluded even before a *qabd* is made, based on the narration that 'Ali and Ibn Mas'ud said: "A gift contract is permissible if the gift is known, whether or not it is actually received" (Ibn Qudamah, *Al-Kafi*, 3/597–598).

Revocation of a *Hibah* Contract

The *hibah* is a gratuitous contract (*tabarru'at*) in which its general legal effect is the establishment of a donee's ownership of the *hibah* object. However, jurists differed in their opinions regarding the legality of the donor to recall his gift after *qabd* has been made.

The Hanafi scholars rule that the establishment of ownership for the donee is not binding, thus permitting the donor to recall the gift and revoke the contract as long as there is no legal restriction forbidding the revocation. However, this act is considered *makruh*, and the donee has the right to refuse to return the gift. Therefore, returning the gift may only be effected through mutual consent, or by a judge's order.

This ruling is based on a *hadith*: "The donor is more worthy of his gift as long as he received no compensation for it" (*Sunan Ibn Majah*, 2/798). This *hadith* clearly implies that the donor has more right in the gift even after *qabd* has taken place, as long as he received no compensation for it, because according to the custom (*'urf*) the purpose of *hibah* contract is not "to be compensated" (Al-Laknawi, Abd al Hay, *Al-Hidayah Sharh Bidayah Al-Mubtai'*, 6/256).

The Malikis, standing on their view that the ownership of the gift is established by a mere *ijab* and *qabul* (offer and acceptance), and becomes binding through *qabd*, ruled that it is not permissible for the donor to revoke the gift after *qabd* is made, (Al-Qarafi, *Al-Dhakhirah*, 6/260) with exception of the father and the mother (if the father is alive) giving a gift to his son in which he may rescind the gift (Al-Qarafi, *Al-Dhakhirah*, 6/265). Similar to this view of the Malikis, the scholars of the Shafi'i and Hanbali schools also held that the revocation of *hibah* is prohibited, except for a father who is allowed to rescind a gift he previously gave to his son.

This ruling was inferred from the *hadith*: "The one who rescinds his gift is like a dog that eats back its vomit", (Al-Bukhari, *Sahih Al-Bukhari*, 3/157) and from another *hadith*: "Nobody is allowed to give and then rescind it, except for the father's right to rescind a gift given to his child" (*Sunan Abi Dawud*, 3/291).

Stipulating Compensation in *Hibah* Contract

The majority of jurists held that *hibah* is a gratuitous contract (*tabarru'at*) in which its general legal effect is the establishment of the donee's ownership in the *hibah* object, without any compensation to the donor. Therefore, an unconditional *hibah* contract does not require the recipient to compensate the donor for his gift, according to the Hanafis (Al-Kasani, *Bada'i' Al-Sana'i'*, 8/115), a view of the Hanbalis (Al-Maqdasi, *Al-Iqna'*, 3/102) and most of the Shafi'is (Al-Mawardi, *Al-Hawi Al-Kabir*, 7/550). On the other hand, the Malikis ruled that the gift's recipient should compensate the gift if there is any indication that the donor may be expecting compensation (Ibn Rushd, *Bidayah Al-Mujtahid*, 4/2030).

If the gift contract contains a condition requiring the recipient to compensate the donor for his gift, the majority of scholars agree that the *hibah*, is valid and the condition is also valid.

However, if that gift contract contains a condition requiring the recipient to compensate the donor for his gift, the majority of scholars agree that the *hibah* is valid and that the condition is also valid, (Ibn Rushd, *Bidayah Al-Mujtahid*, 4/2030) but they differ in their characterisation of that valid contract whether it is a sale contract from the beginning, or it is a *hibah* contract which is established to be a sale contract.

As far as the *hibah* with compensation is concerned, which is tantamount to a sale contract, the Shafi'i jurists rule that if the compensation is unknown, both the *hibah* and condition are considered as invalid, but if it is known, the more prominent opinion says that they are valid (Al-Mawardi, *Al-Hawi Al-Kabir*, 7/550).

However, in cases when the recipient of a gift voluntarily compensates the donor for his gift, but the compensation was delayed, the majority of jurists are of the opinion that the unconditional *hibah* does not demand compensation and that such delayed compensation is considered a separate and new gift. Therefore, this new *hibah* takes all the conditions of a valid *hibah* as well as the conditions preventing the rescinding of it (*Bada'i' Al-Sana'i'*, 8/129).

Wadi'ah (Deposits)

Definition of *Wadi'ah*

The term *wadi'ah* is derived from the verb *wada'a,* which means to leave, lodge or deposit. Legally, the Hanafi scholars define it as an empowerment to someone for keeping the owner's property explicitly or implicitly. Whereas according to Shafi'i and Maliki scholars, *wadi'ah* is representation in keeping possession of respectable private goods in a specific way. Hanbali scholars add the element of charity when they define *wadi'ah* as representation in keeping (other's property) and it is done (by the keeper) as a charity (Ibn Muflih, *Al-Furu'*, 7/210). In summary, it is clear that *wadi'ah* can be defined as any belongings left by the owner or his representative with somebody to take care of them. The act is done on the basis of charity.

Legality of *Wadi'ah*

Wadi'ah (deposit) is among the permissible contracts and dealings in Islam. Its legality is enshrined in the *Qur'an*, *Hadith* and *ijma'*.

Allah (s.w.t.) says: *"If you trust one another, then let him who is trusted fulfil his trust, and let him be conscious of God, his Sustainer" (Al-Qur'an,* 2:283*).* In another verse, Allah the Almighty says: *"Indeed, Allah commands you to render trust to whom they are due and when you judge between people, to judge with justice" (Al-Qur'an,* 4: 58*).*

The meaning of the above verses has been strengthened by the saying of the Prophet (p.b.u.h.): "And perform the trust (*amanah*) to those who entrusted you and do not betray those who betrayed you" (*Sunan Abi Dawud*, 3/290).

In addition to the evidences from the *Qur'an* and *Sunnah*, all Muslim scholars unanimously agree on the permissibility of *wadi'ah* (Ibn Qudamah, *al-Mughni*, 6/382). This kind of transaction is a necessity and a requisite for protecting mankind and as such should be allowed. The proprietor of the thing is known as the *mudi'* (depositor). The person entrusted with it is known as the *wadi'* or *mustawda'* (custodian) and the deposited asset is the *wadi'ah*. It is encouraged for anyone who has trust in himself to take the *wadi'ah* to help others.

Basic Rules and Conditions of *Wadi'ah*

1 Offer *(ijab)* and acceptance (*qabul)*: The majority of jurists are of the view that there must be a valid offer and acceptance made in the *wadi'ah* contract (Zakariyya Al-Ansari, *Asna Al-Matalib*, 6/179).

2 Contracting parties: The depositor and the custodian must be persons of sound mind (Al-Qarafi, *Al-Dhakhirah,* 7/304). The Hanafi school of thought views that attaining the age of maturity is not compulsory provided consent from parents to do business is obtained (Al-Kasani, *Bada'i' Al-Sana'i'*, 6/326). On the other hand, the majority of Muslim jurists share the common view that the contracting parties must be eligible to be a *wakil* (agent), i.e., they must be persons who are of sound mind, and have attained the age of maturity and intelligence (Al-Qarafi, *Al-Dhakhirah,* 7/304). Jurists also mentioned that whosoever is eligible to be a *wakil*, is allowed to be a trustee and whosoever is eligible to become a principal, is also allowed to be a depositor (Al-Sharqawi, *Hashiyah al-Sharqawi*, 3/208). Furthermore, the custodian must ensure his capability to safe-keep the deposit. He must withdraw himself from taking the deposit if he cannot ensure that he shall return it to the depositor at the stipulated time (Zakariyya Al-Ansari, *Asna Al-Matalib*, 6/178).

3 Deposited property: The deposited property must be owned and deliverable. The item of deposit must also be a form of property that can be possessed physically.

Types of *Wadi'ah*

Wadi'ah can be classified into two types:

1 Wadi'ah Yad Amanah *(Safe custody based on trust)*

As discussed earlier, the *wadi'ah* is based on *amanah* (trust) where it is charitable and divinely rewarded. It is basically a trust to keep. Some important features of this type of *wadi'ah* are as follows:

(a) The custodian shall keep the deposit as if he is keeping and taking care of his own property. He has the duty to protect the property from being lost or damaged according to customary practice.

(b) The custodian is not responsible for any damage to the property so far as it did not result due to his negligence (al-Khurashi, *Hashiyah Al-Khurashi*, 6/ 472).

(c) The custodian is not entitled to any profits gained from the contract (he is at the same time not liable for undertaking the contract). Any benefits accrued from the deposit belong to the owner.

(d) Anything other than a safe-keeping arrangement, such as hiring or lending of the deposited property should be done with the permission of the owner.

(e) The custodian must return the deposited property to the owners at any time upon the request of the depositor (Zakariyya Al-Ansari, *Asna Al-Matalib*, 6/181).

2 Wadi'ah Yad Damanah *(Guaranteed safe custody)*

If the custodian guarantees the refund of the property kept with him, and also ensures to refund the item upon request, we regard the contract as *yad al-daman* (Al-Mawardi, *Al-Hawi Al-Kabir*, 8/357–361). This is the combination of two contracts, namely safe-keeping (*wadi'ah*) and guarantee (*dhaman*).

The jurists mentioned instances whereby the custodian will be regarded as *damin*, for example, if he takes from the trust and returns it back later or utilises it for business, or if he destroys the property deliberately or he mixes it with another property in which it could not be differentiated. In these circumstances, the hand of the trustee will be regarded as *yad damanah.*

This type of *wadi'ah* facilitates wider application in the Islamic banking system, particularly where deposits are the sources of funds for banks. Some important features of this type of *wadi'ah* are as follows:

(a) The custodian is entitled to use the deposited property for trading or any other purposes.

(b) The custodian has a right to any income derived from the utilisation of the deposited item and at the same time he is liable for any damage or loss.

(c) The custodian owns the profit and therefore, it is under his discretion (not an obligation) to give some portion of it as a gift (*hibah*) to the depositor. The gift cannot be in the form of a pre-agreed arrangement. This is simply because this type of *wadi'ah* is similar to a loan and therefore, the pre-agreed benefit will be regarded as *riba*.

(d) The custodian must return the deposited property to the owners at any time upon the request of the depositor.

Agency Contract: *Wakalah*

Definition of *Wakalah*

Literally, the term *wakalah* or *wikalah* is a noun of the word *wakkala* which has several meanings, including performing a task on behalf of others, preservation and delegation of a job to another. In technical terms, a *wakalah* refers to authorising another person to undertake any dealings on one's behalf. According to the AAOIFI *Shari'ah* Standard, Standard No. 23, Clause 2/1, *wakalah* is "the act of one party delegating the other to act on its behalf in what can be a subject matter of delegation".

The *wakalah* is basically a nonbinding contract, whereby the principal or the agent may withdraw at any time by a mutual agreement, unilateral termination, discharging the obligation, destruction of the subject matter and the death or loss of legal capacity of the contracting parties.

Legality of *Wakalah*

Agency contracts are legally approved based on several evidences from the *Qur'an*, *Sunnah* and *ijma'*.

Among the *Qur'anic* verses that allow this contract are as follows:

> *"Now send one of you with this money to the town; let him find out which is the best food and bring some to you" (Al-Qur'an,* 18: 19*).*
>
> *"Commission two arbiters, one (representative) from his family and one (representative) from hers" (Al-Qur'an,* 4: 35*).*
>
> *"Alms are for the poor and the needy and those employed to administer the funds ..." (Al-Qur'an,* 9: 60*).*

In general, these verses specify various types of agencies which include appointing an agent to buy food, an agent to be the arbiter, and an agent to collect the charity (*zakat*).

Regarding the proofs from the *Sunnah*, there are several *hadith* that indicate the legality of the agency contract, among others, the authentic *hadith* reported by al-Bukhari and Muslim that the Prophet (p.b.u.h.) sent agents to collect *zakat*. Al-Hakim narrated that the Prophet (p.b.u.h.) sent 'Amr ibn Umayyah Al-Damri as an agent to ask for the hand of Umm Habibah binti Abu Sufyan in marriage.

A consensus of Muslim scholars agrees on the permissibility of the *wakalah* contract, due to the people's dire need of assistance in accomplishing certain tasks that they are incapable of doing on their own.

Basic Rules and Conditions of a *Wakalah* Contract

For the pillars of the *wakalah* contract, the Hanafi scholars assume the same approach as in other contracts, whereby it consists of offer and acceptance (*sighah*) only. Other jurists, however, are of the opinion that the contract comprises four pillars: offer and acceptance (*sighah*), principal (*muwakkil*), agent (*wakil*), and object of the agency contract (*muwakkal bih*).

Each of these pillars needs to fulfil certain conditions as delineated below:

1. ***Conditions related to the* sighah *(offer and acceptance)***

   Like other contracts, the *sighah* of *wakalah* also requires offer and acceptance. For example, if *A* (the principal) says: "I authorise you to invest this money on my behalf", and *B* (the agent) says: "I accept", then the *wakalah* contract is concluded.

   The jurists agree that the acceptance of *wakalah* is not restricted to verbal indication alone. Rather, it can be established through several other means such as action, writing, sign (gesture), etc. The jurists also rule that the acceptance can either be done immediately or delayed.

2. ***Conditions related to the principal* (muwakkil) *and the agent* (wakil)**

   Among the conditions that both principal and agent need to satisfy are:

   (a) Being eligible to take the actions (*ahliyyah*). The principal should possess a sound mind. Thus, a *wakalah* from an insane, or a child is invalid. The Hanafis, however, view that a *wakalah* from a child in financially beneficial actions such as accepting gifts is permissible, whereas in intermediate cases where the actions may lead to financial gains and losses such as trading and leasing, the permissibility of a *wakalah* from a child depends on whether he is allowed to deal with those actions.

(b) The principal should commission the agency based on his freewill without any coercion from others. In the same manner, the agent should not be forced in conducting the tasks delegated to him.

(c) Muslim scholars agree that the principal should know the agent, either by name or his physical appearance. Likewise, the agent should identify his principal either by name or his characteristics.

3 *Conditions related to the object of agency contract* (muwakkal bih)

Although a general principle in the *wakalah* contract says that "if a person's direct performance of an action is legally recognised, it is valid for him/her to authorise another person to perform it by proxy and to depend upon another party to do it for him", there are some exceptions to this rule, mainly:

(a) The object of an agency contract should belong to the principal. Thus, he should have the right of disposal.

(b) The object of an agency contract should be eligible for legal authorisation, such as financial matters, etc. As such, a *wakalah* is impermissible in pure acts of worship such as prayer and fasting, oath-taking, and testimony. Meanwhile, in acts of worship that have a financial element such as *zakat*, *hajj*, and slaughtering sacrificial animals, the *wakalah* is allowed by most scholars.

(c) The object of an agency contract should not involve activities prohibited in *Shari´ah* or acts of dishonesty such as theft and usurpation of property, trading impermissible commodities or conducting *riba*-based business.

(d) According to the Shafi'is, the object of an agency contract must be known in order to avoid uncertainty (*gharar*). However, minor uncertainty (*gharar yasir*) that does not result in dispute among the contracting parties is allowed.

(e) The Hanafis view that the object of an agency contract cannot be the utilisation of public properties such as the collection of wood from public lands.

Types of *Wakalah* Contract

The *wakalah* contract can be divided into several categories. Table 7.1 highlights the categories based on the various nature of the contract.

Table 7.1 Different Categories of a *Wakalah* Contract

Scope of the agency	Payment to the agent	Bindingness of parties	Duration of the agency contract
• General • Specific	• Paid • Nonpaid	• Binding • Nonbinding	• Continuous • Temporary

Source: Adapted from AAOIFI *Shari'ah* Standards.

1 *Scope of the agency*

It can either be:

(a) general/comprehensive delegation, where the principal says to the agent: "Buy me a house" without specifying any condition; or

(b) specific/restricted, where the principle identifies certain requirements, such as price, feature and mode of payment, etc. For instance, the principal says: "Buy me a bungalow which costs about RM1 million via instalment payments."

The Hanafis and Malikis view that a general or comprehensive *wakalah* is permissible, whereas the Shafi'i and Hanbali scholars rule that it is invalid as a general agency, and may lead to excessive uncertainty (*gharar*). All jurists, however, agree on the permissibility of specific agency.

2 *Payment to the agent*

In an agency contract, the principal can either pay his agent, or not. The basis for the permissibility of paid agency is due to the fact that the agency is useful work for which the agent has the right to ask for remuneration. When the agency is paid, its ruling falls under the rulings of *ijarah*.

The non paid agency is also allowed since it is regarded as a form of charitable act.

3 *Bindingness of parties*

As indicated earlier, an agency contract is nonbinding on both principal and agent since they can revoke the contract at any time. Nevertheless, there are cases where an agency contract can be binding, namely:

(a) When it is a paid agency.

(b) When it involves the rights of others. For instance, the owner of an income-generating asset assigns the collection of his entitlements to an agent.

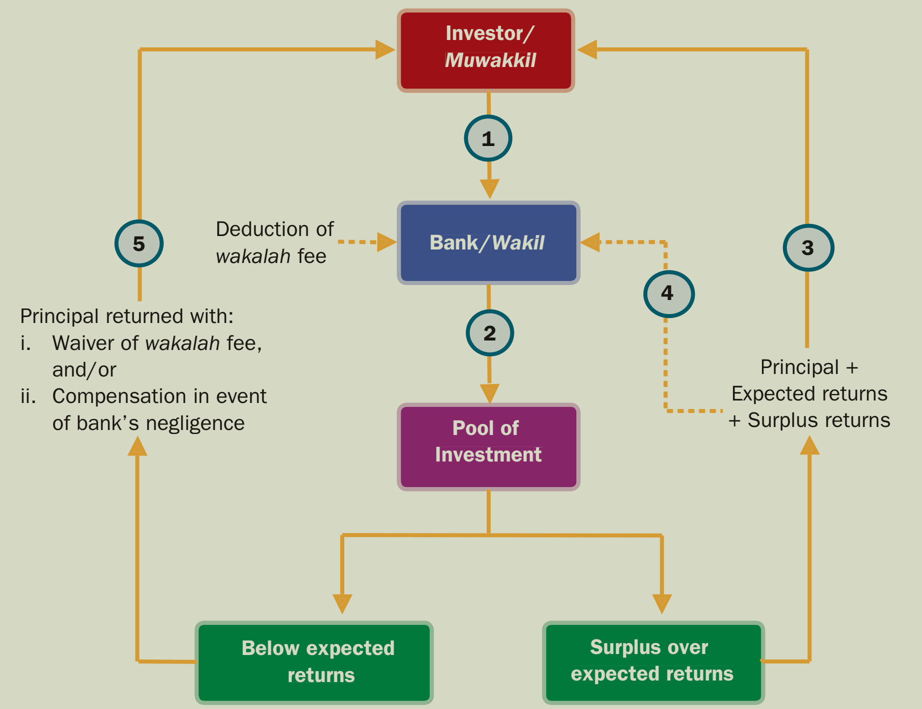
(c) When the agent starts a task that cannot be withdrawn without causing injury to him or the principal.

(d) When the principal or the agent promises not to revoke the contract within a specified period.

4 Duration of the agency contract

In general, there is no time limit for an agency contract to be deemed valid, because of its nonbinding nature. Yet, scholars rule that an agency contract can also be restricted to a certain period based on the agreement of both parties.

Application of *Wakalah* in Islamic Finance



1 The investor appoints the bank to be his agent.
2 The bank will invest the money/business delegated to him.
3 The principal and the expected returns are given back to the investor.
4 The surplus returns are either distributed to the bank as performance incentive or shared by the investor and the bank according to the pre-agreed ratio.
5 The principal is returned to the investor with a waiver of the *wakalah* fee, and/or compensation in the event of the bank's negligence.

Source: Islamic Liquidity Management Workshop, GIFF 2010.

Figure 7.5 Illustration of a Basic Structure Flow of Fee-based *Wakalah Bi Al-Istithmar* Contract

In the contemporary application, a *wakalah* contract is widely used in structuring various Islamic banking capital markets and *takaful* fee-based products.

In the contemporary application, a *wakalah* contract is widely used in structuring various Islamic banking, capital market and *takaful* fee-based products. For example, in Malaysia, the *Shari'ah* Advisory Council of the central bank resolved that the application of *wakalah bi al-istithmar* (agency for investment) contract in a deposit account is permissible. This contract is also used to structure *sukuk*. The agent will normally be entitled to a management fee, as agreed in the agreement. A basic structure flow of a fee-based *wakalah bi al-istithmar* contract is illustrated in Figure 7.5.

Based on the illustration, the bank as a *wakil* needs to give back the principal and returns (if any) to the investor. In the case of a non-profitable investment, only the principal shall be returned to the investor. Hence, it is important to implement a *wakalah* contract prudently in order to avoid the *Shari'ah* issue concerning guarantee of investment returns by the agent.

Supporting Contracts

Hiwalah

Definition of *Hiwalah*

Literally, it is derived from the word *tahwil* which means shifting from one place to another (*intiqal*). It is also correct to pronounce the word *hiwalah* as *hawalah*.

According to AAOIFI, *Shari'ah* Standard No. 7, Clause 2, *hiwalah* is technically of two kinds, namely *hiwalah al-haqq* (transfer of right) and *hiwalah al-dayn* (transfer of debt). *Hiwalah al-haqq* is a replacement of a creditor with another creditor.

As for *hiwalah al-dayn*, Hanafi scholars define it as the transfer of the right to demand (the debt) from the debtor to another liable person. Some other Hanafi scholars are of the opinion that the transfer is not limited to the transfer of the right to demand but also includes the transfer of debt. According to the majority of Muslim scholars, *hiwalah al-dayn* is the transfer of debt from one person (the debtor) to another person. This definition is adopted by AAOIFI in its *Shari'ah* Standard No. 7, Clause 2, where *hiwalah al-dayn* is defined as the transfer of debt from the transferor (*muhil*) to the payer (*muhal 'alayh*).

Hiwalah al-dayn is the transfer of debt from one person (debtor) to another person.

It is important to note that the word *hiwalah*, when it is used as a stand-alone term, is commonly referred to *hiwalah al-dayn*. The discussion here will concentrate only on this type of *hiwalah* (not *hiwalah al-haqq*).

Legality of *Hiwalah*

According to AAOIFI in *Shari'ah* Standard No. 7, Clause 2, *hiwalah* is a legitimate and independent contract made out of courtesy to facilitate payment and recovery. It is not a contract of sale.

The legitimacy of *hiwalah* is based on the tradition of the Prophet (p.b.u.h.) that says:

> "Delinquency of rich debtors is a form of transgression, so if one of you has his debt transferred to a rich person, let him accept the transfer of debt" (*Sahih Muslim*, 3/1197).

In addition to the above evidence from the *Sunnah*, there is a consensus (*ijma'*) among Muslim scholars on its legitimacy (Ibn Qudamah, *Al-Mughni*, 4/394).

Pillars of *Hiwalah*

According to the Hanafi scholars, the pillars of *hiwalah* consist of an offer (*ijab*) from the transferor (*al-muhil*) and an acceptance (*qabul*) from the transferee (*al-muhal*) and the payer (*al-muhal 'alayh*). For the majority of Muslim scholars, the pillars of hiwalah are as follows:

1. The transferor (*al-muhil*).
2. The transferee (*al-muhal*).
3. The payer (*al-muhal 'alayh*).
4. The debt (*al-muhal bih*).
5. The offer and acceptance (*al-sighah*).

Types of *Hiwalah*

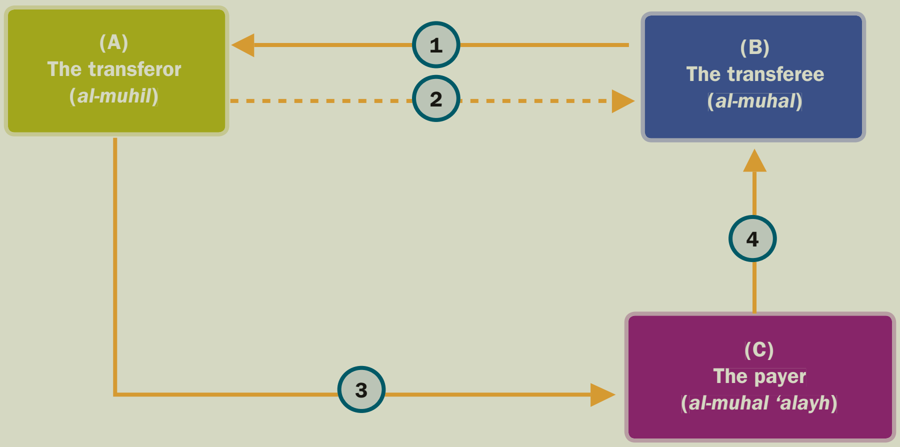
AAOIFI states in *Shari'ah* Standard No. 7, Clause 5, that *hiwalah* can be classified as two types:

1 *Restricted* Hiwalah (Hiwalah Muqayyadah)

It is a transaction where the payer is restricted to settling the amount of the transferred debt from the amount of a financial or tangible asset that belongs to the transferor and is in the possession of the payer.

2 *Unrestricted* Hiwalah (Hiwalah Mutlaqah)

It is a kind of transfer of debt in which the transferor is not the creditor to the payer, and the payer undertakes to pay the amount of the debt owed by the transferor from his own funds, and to have recourse afterwards to the transferor for settlement, provided that the transfer for payment was made on the order of the transferor. (*Shari'ah* Standard No. 7 of AAOIFI 2008, Clause 5/1/2).



Unrestricted *Hiwalah*:
1 *A* owes *B* an amount of RM5,000.
2 *A* is supposed to pay his debt of RM5,000 to *B*.
3 *A* transfers his obligation to pay the debt to *C*.
4 *C* pays the debt (RM5,000) to *B*.

Restricted *Hiwalah*:
The illustration for restricted hiwalah is the same as above with one additional element: *C* was earlier indebted to *A*. In other words, instead of paying his debt to *A*, *C* pays his debt to *B* whom *A* owes for the same amount.

Figure 7.6 Illustration of Unrestricted *Hiwalah*

Basic Rules and Conditions of *Hiwalah* (AAOIFI, *Shari'ah* Standard No. 7, Clause 6)

1 All contracting parties must be legally competent to act independently.

2 All relevant parties (the transferor, the transferee and the payer) shall give their consent on the *hiwalah* arrangement.

3 The transferor must be a debtor to the transferee. As for restricted *hiwalah*, the payer must be the debtor to the transferor.

4 Both the transferred debt and the debt to be used for settlement must be known and transferable.

5 In restricted *hiwalah*, the transferred debt or the transferred portion of the debt must be equal to the debt owed to the transferee in terms of kind, type, quality and amount. However, the transferor may transfer a lesser amount of a debt owed to the transferee, to be settled from a larger amount owed by the transferor, on condition that the transferee be entitled to the equivalent amount of his debt.

Legal Consequences of *Hiwalah*

Some of the major legal consequences of *hiwalah* are as follows (AAOIFI, *Shari'ah* Standard No. 7, Clause 7, 8 and 9):

1. A valid *hiwalah* discharges the transferor from any debt liabilities and any claims in respect of it. In other words, the transferee will have no right of recourse against the transferor for payment. Nevertheless, if the acceptance of the *hiwalah* was based on the condition that the payer must be solvent, then the transferee will have the right of recourse if the payer is not solvent.

2. The transferee is entitled to have a right of recourse against the transferor in the following situations:

   (a) Death of the payer in bankruptcy.

   (b) Liquidation of an institution, that is the payer, in the case of bankruptcy before payment of the debt.

   (c) The payer denies concluding the *hiwalah* contract and has taken a judicial oath to this effect and there is no evidence to prove otherwise.

   (d) The payer is declared bankrupt by a court order.

3. The transferee is entitled to claim the amount of the debt assigned to him through *hiwalah* from the payer.

4. In restricted *hiwalah*, the transferor is no longer entitled to reclaim from the payer (who previously owed to him) an amount transferred to the payer in respect of the debt to be settled.

Termination of a *Hiwalah* Contract

A *hiwalah* contract comes to an end under, among others, the following circumstances:

1. Mutual agreement between contracting parties to terminate the *hiwalah* contract. This will return all of them to the status quo before they entered into the contract. Hence, the transferee is entitled to claim the debt from the transferor and not from the payer.

2. The settlement of the debt by the payer to the transferee.

3. The death of the payer and the transferee inherits his (the payer) property.

4. The debt has been written-off by the transferee.

Muqasah (Set-off)

Definition of *Muqasah*

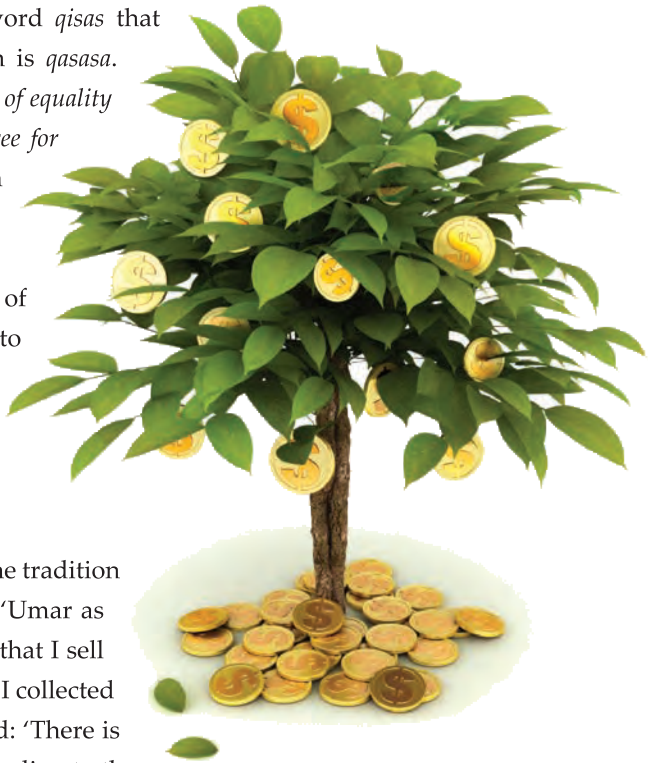
Al-Dardir defines *muqasah* as the setting-off of a debt that is due to the debtor by a creditor who is at the same time indebted to the debtor with certain conditions (Al-Dardir, *Al-Sharh Al-Kabir*, 3/227). Ibn Al-Qayyim defines it as the clearance of the debt which is due, with a debt similar in nature and character (Ibn al-Qayyim, *A'lam Al-Muwaqqi'in*, 1/321).

In other words, *muqasah* means debt settlement by contra-transaction or set-off. It also means the discharge of a debt receivable against a debt payable. In a *muqasah* arrangement, an implicit settlement takes place between the two parties, i.e., debtor and creditor. As a result of the contra-transaction, there is no more debt between the two parties. For example, Ahmad owes Ali RM2,000. Then, Ali owes Ahmad the same amount. This means the two parties are no longer in debt with each other. In this context, *qabad hukmi* (constructive possession) to the amount of the debt has taken place in the form of contra.

Muqasah means debt-settlement by contra-transaction or set-off.

Legality of *Muqasah*

There is no explicit *Qur'anic* verse that indicates the legality of *muqasah*. There are, however, a few verses that use the word *qisas* that is derived from the same root of *muqasah*, which is *qasasa*. Allah the Almighty says: *"O ye who believe! The law of equality is prescribed for you in cases of murder (qisas): the free for free …" (Al-Qur'an,* 2: 178*)* In another verse, Allah (s.w.t.) says: *"In the law of equality (qisas) there is (saving of) life for you …"(Al-Qur'an,* 2:179*).* Some Muslim scholars are of the view that the meaning of the word "*qisas*" mentioned in the verses refers to the arrangement of setting-off by way of payment of the compensation money (*diyyah*) by the murderer. In this context, the *diyyah* is regarded as a kind of debt which is due on the offender.



The legality of *muqasah* can be observed clearly in the tradition of the Prophet (p.b.u.h.) which is narrated by Ibn 'Umar as follows: "I came to the Prophet (p.b.u.h.) and said that I sell camels in Baqi' for a price named in gold coins, but I collected in silver, and vice versa. The Prophet (p.b.u.h.) said: 'There is no harm to do so if the exchange is carried out according to the exchange rates of that day, and as long as you part without any debts between you.'" (*Sunan Al-Nisa'i*, 7/281).

In addition to these evidences, it is logically acceptable (*ma'qul*) to implement such a practice. *Muqasah* is acceptable by modern Muslim scholars as stated in AAOIFI's *Shari'ah* Standard No. 4, Clause 3 that spells out it is permissible for Islamic financial institutions and their customers to exchange bilateral promises that debts which may be created between them in the future will be settled by way of set-off/*muqasah*.

Types of *Muqasah* and their Conditions

Muqasah can be divided into the following types:

1 *Mandatory Set-off* (Al-Muqasah Al-Jabariyyah)

A compulsory set-off is the spontaneous discharge of two debts that is not contingent on the consent of both or either party. The majority of Muslim scholars are of the opinion that this type of *muqasah* is permissible. On the other hand, Maliki scholars opine that *muqasah* shall only be allowed with demand or with mutual agreement (Al-Hattab, *Mawahib Al-Jalil*, 4/549):

Conditions for a compulsory set-off/*muqasah* are as follows:

(a) Each party should be a creditor and debtor simultaneously.

(b) Both debts should be equal in kind, types, description and maturity.

(c) Neither of the two debts should be encumbered by an obligation to a third party (right of pledgee to one of the debts). In other words, the *muqasah* shall not bring any harm to the contracting parties or other related parties.

(d) The *muqasah* should not result in the violation of the *Shari'ah* (involves *riba*/usury).

2 *Mandatory Set-off on Demand* (Al-Muqasah Al-Talabiyyah)

This type of *muqasah* is affected by the demand of one of the parties to discharge the debts by way of set-off. Normally, it is effective upon the request of the superior creditor who has a preference over the other, such as when he has a better quality or higher debt as compared to the debtor, to forego the excess of the amount or privilege owed to him.

Conditions for a *muqasah*/set-off on demand are as follows:

(a) Each party should be a creditor and debtor simultaneously.

(b) The creditor for the superior debt in terms of quality and duration should consent to relinquish his additional right or privilege.

(c) Both debts should be equal in kind and types but not necessarily in quality and date of maturity.

(d) The *muqasah* should not result in the violation of the *Shari'ah* (involves *riba*/usury).

3 *Contractual Set-off* (Al-Muqasah Al-Ittifaqiyyah)

This type of *muqasah* is the discharge of two debts by the consent of the two parties to extinguish their obligations towards each other. In this type, there is no need for the debt to be similar in kind, type, description or maturity.

Conditions for a contractual *muqasah*/set-off:

(a) Each party should be a creditor and a debtor simultaneously.

(b) Both parties must consent to the *muqasah*/set-off.

(c) The *muqasah* should not result in the violation of the *Shari'ah* (involves *riba*/usury).

Ibra'

Definition of *Ibra'*

Literally, *ibra'* means mutual estrangement and removal, as in "*I was absolved of debt when it was removed from me*". It can also be defined as to release, eliminate or purify and to remove. Technically, *ibra'* means "an act of absolving or dropping one's financial rights (to collect payment) from a person who has the obligation to repay the amount borrowed from him".

Ibra' means "an act of absolving or dropping one's financial rights (to collect payment) from a person who has the obligation to repay the amount borrowed from him".

Legality of *Ibra'*

In general, *ibra'* is recommended (*mandub*). Al-Khatib Al-Sharbini of the Shafi'is advocates that *ibra'* is encouraged (*matlub*). As such, its rules are quite flexible compared to guarantee (*dhaman*) since it is generosity and a good deed to waive debt from the debtor even if he is not in difficulty to settle the debt. This is in line with the *Qur'anic* verse:

> *"And if the debtor is in a hard time (has no money), then grant him time till it is easy for him to repay; but if you remit it by way of charity, that is better for you if you did but know" (Al-Qur'an,* 2: 280*).*

Legal Effects of *Ibra'*

Ibra' from a debt which causes the debtor's liability for the debt to be absolved is based on the wording of the offer (Wizarah Al-Waqf Wa Al-Shu'un Al-Islamiyyah Kuwait, *Al-Mawsu'ah al-Fiqhiyyah al-Kuwaitiyyah*, 1/168). Thus, when the liability is withdrawn, the creditor has no rights to demand and his claims relating to *ibra'* are not entertained. The above takes effect if the conditions of *ibra'* are met.

Is *ibra'* an absolution (of rights) or transfer of ownership?

Jurists differ on whether *ibra'* implies absolution or transfer of ownership. The details of their arguments are as follows:

First opinion: According to the opinion of the majority of jurists (*jumhur*); the Hanafis, some Malikis, majority of Shafi'is and the most preferred opinion among the Hanbalis, *ibra'* implies absolution (*isqat*). In this vein, al-Subki asserts: "If what is meant by *ibra'* is a transfer of ownership, then, it would be valid to transfer ownership of *al-a'yan* (tangible asset which is not in the form of debts)." Al-Qadi Zakariyya Al-Ansari of the Shafi'is said: "Even if *ibra'* is a transfer of ownership, what is meant by *ibra'* is absolution."

Second opinion: This is the preferred opinion of Maliki scholars, the other opinion of Shafi'is and Hanbalis. They hold that *ibra'* is a transfer of ownership (*tamlik*). Al-Dasuqi of the Malikis suggests that *ibra'* is a transfer of ownership like *hibah* which requires the recipient's acceptance (Al-Dasuqi, *Hashiyah Al-Dasuqi*, 4/99). Ibn Muflih of the Hanbalis asserts: "If we accept that *ibra'* is absolution, it is as if it is owned, then absolved."

According to the Shafi'is, it is a transfer of ownership from creditor to debtor. As such, what is absolved must be known by both the grantor and the recipient of *ibra'* in the case of a bilateral exchange contract such as the compensation of *khul'* (divorce initiated by a wife by returning the dowry to the husband). Other than a bilateral contract, the knowledge of the grantor is sufficient. An *ibra'* for something unknown is not allowed (Al-Sharbini, *Mughni al-Muhtaj*, 2/202). Ibn Al-Sam'ani of the Shafi'i school asserts that *ibra'* as opposed to *talaq* is a form of transfer of ownership from the *mubarri'* (the one granting *ibra'* or the creditor) and a form of absolution for the *mubarra'* (the one receiving *ibra'*, or the debtor).

To conclude, *ibra'* can be applied for both absolution and transfer of ownership. As for *ibra'* of debt, the two meanings of *ibra'* can be applied. As for *ibra'* of goods, it cannot be imagined except as a transfer of ownership.

Ibra' can be applied for both absolution and transfer of ownership.

Does *ibra'* require acceptance from the recipient?

It is submitted according to the majority of jurists with exception of the Malikis from the above discussion, that there is no requirement of acceptance from the recipient of *ibra'* since *ibra'* itself is dropping one's right just like divorce or giving away a gift (*hibah*). An offer from the grantor is sufficient to establish *ibra'*.

Conditions for a Valid *Ibra'*

There are conditions pertaining to the grantor of *ibra'*, the recipient and the subject matter of *ibra'*.

For the grantor:

1 He must be mature and possess legal capacity.

2 He must have the authority on whether to execute *ibra'* on his own or by assigning an agent.

3 The consent must be obtained willingly and not by coercion.

Most of the jurists hold that an *ibra'* of one who is dying is not valid except if there is consent from the heirs.

As for the recipient, the main condition is that he must be known and identified. This is because *ibra'* contains the meaning of transfer of ownership. In this light, it is argued that a transfer of ownership to an unknown recipient is not valid.

As for the subject matter of *ibra'* (*mahal al-ibra'*):

1 It must be known specifically (be it a debt, right or tangible good). As such, it is not valid to grant *ibra'* for something which is not known.

2 It should not be a tangible asset (*'ayn*). This is because the tangible existing physical asset cannot be treated as debt. What can be absolved is any liability or any debt whether it is in the form of kind or money.

3 Established and confirmed ownership. The party who wants to absolve, must confirm ownership of the rights because ownership in transactions among mankind must be established.

4 Existence of rights, or existence of its causality. *Ibra'* can be executed after a right has been established. However, sometimes *ibra'* is effected before such right is established. Jurists agree that *ibra'* is not valid before the existence

of right or its causality. The ground for this verdict is the *hadith*: "There is no divorce (*talaq*) except for what you own and no freeing a slave except for what you own." (Abu Dawud, *Sunan Abi Dawud*, 2/258).

Conditional *Ibra'*

Ibra' is valid if the preset conditions are real. If it is contingent on death, then, there are additional considerations. If on reasonable conditions, such as the words: "If I have given you debt, on my death you are absolved", this is a valid *ibra'* and a valid condition. Ibn Muflih argues that this view is reasonable and it is chosen by Ibn Taymiyyah (Ibn Muflih, *al-Furu'*, 4/194).

Other than the above, the scholars have several views regarding tying *ibra*' to preset conditions, such as:

1 Not permissible even though the preset condition is known because *ibra'* contains elements of transferring ownership. According to the Hanafi and Shafi'i jurists and narrated from Ahmad, preset conditions are only allowed for absolute absolution of rights and not transferring of ownership (Ibn Muflih, *Al-Furu'*, 4/194).

2 Permissible to stipulate conditions if it is a common practice and not permissible if otherwise. This is the stance of the majority of Hanafi jurists.

3 Permitted absolutely. This is the stance of the majority of Maliki jurists and narrated from Ahmad on the basis that *ibra'* means dropping of rights.

Dha' wa Ta'ajjal (Waiving of Outstanding Debt with a Condition of Expediting Settlement)

There are disputes among the jurists on this issue and they are as follows:

1 It is not permissible. This is the opinion of the majority of jurists. The reason for the prohibition is the resemblance of *riba*.

2 It is permissible. This is the opinion of Ibn Abbas, al-Nakha'i, Abu Thaur and a narrative from Imam Ahmad (Ibn Qudamah, *Al-Mughni*, 7/21). This is because it is an act of extending help to the debtor to relieve him from the liability.

3 The Shafi'is hold that it is not permissible if the grantor of *ibra'* releases the debtor from part of the debt on condition that he expedites on payment of the balance, because of its similarity with usury practised in the day of ignorance. If the payment of the balance is expedited unconditionally whereby the owner takes the payment and releases the debtor from the balance, then it is permissible.

Revocation of *Ibra'*

There are two views among the jurists:

1. The Hanafi and Hanbali jurists, and one opinion of the Shafi'is advocate that the grantor cannot retract his *ibra'*. This is because whatever rights he has had ceased with *ibra'*. Something that has ceased does not return. The debt does not remain his, it is as if he has given it away and it is damaged.
2. The Maliki and Shafi'i jurists, however, hold that the creditor can retract. This is because they emphasise the dominance of ownership in *ibra'* and the condition of acceptance of the offer. There is, thus the possibility of retraction of the offer as long as it has not been accepted by the other party.

Concerning retraction, the Hanafis view that the *ibra'* is effected with the discharge of rights because the *ibra'* is absolution. Absolution is release (*isqat*) of rights and once it is effected, it cannot be retracted based on the maxim "*what has gone cannot return*".

Wa'd

Wa'd is a commitment made by one person to another to undertake a certain actual or verbal disposal beneficial to the second party, or a verbal proposition made by someone to undertake something to the benefit of another person.

Definition of *Wa'd*

Literally, *wa'd* means promise. It is a promise which connotes an expression of willingness of a person or a group of persons on a particular subject matter. In a commercial transaction, a promise has a dual meaning. *Wa'd* has no specific definition of its own. However, it can be explained as a commitment made by one person to another to undertake a certain actual or verbal disposal beneficial to the second party or a verbal proposition made by someone to undertake something to the benefit of another person. Traditionally, *wa'd* is unilateral in nature, and binds the promisor only.

For example, *A* makes a promise to sell his car to *B* for the amount of RM50,000. *B* stays silent. As such, *A*'s promise is unilateral in nature and does not bind *B* to accept the offer. It will only be binding upon both parties after the sale contract (*'aqd al-bay'*) is concluded. A contract is different from a promise in a way that a contract is legally binding upon the contracting parties once it fulfils all the requirements needed. A promise on the other hand, depends on the acceptance of its applicability and to the opinion of jurists, whether they are legally or religiously binding or not.

Legality of *Wa'd*

Islamic jurists have unanimously agreed that when a person promises something without any intention of fulfilling his promise, such an act is not permissible because the promisor will be deemed to be a liar and a pretentious person who is seriously condemned by the religion. What more, if the same promisor takes an oath to convince the promisee to act upon his promise, the promisor in the latter case will not only be subject to Allah's condemnation but also a fine or compensation (*kaffarah*) to relieve him from his false oath.

> *"God will not take you to task for oaths which you may have uttered without thought, but will take you to task [only] for what your hearts have conceived [in earnest]: for God is much-forgiving, forebearing" (Al-Qur'an,* 2: 255*).*

The majority of scholars opine that a promise made by a person to the other is religiously binding (*mulzim diyanatan*) but not legally binding (*mulzim qada'an*).

However, Muslim scholars differ with regards to the extent of liability imposed upon the parties of the promise. The majority, particularly the Hanafi, Shafi'i, Hanbali, and a few from Maliki schools of thoughts opine that a promise made by a person to the other is religiously binding (*mulzim diyanatan*) but not legally binding (*mulzim qada'an*). This is because *wa'd* is part of a voluntary contract (*aqd tabarru'at*). Therefore, the court has no power to enforce the promise because the promisee only has a moral right.

Nevertheless, Imam Malik and some of his followers have dissenting opinions in which they hold that the promise is legally binding though without any commitment from the other side. For instance, if a person says that "*I will travel to such place for such time; therefore do lend me a horse*." Once the horse has been lent to him, he must travel.

When exercising *ijtihad* in permitting the application of *wa'd*, contemporary jurists observed it as a necessity for the interest of the contracting parties. According to them, a *wa'd* should not be rigidly construed in its limited application. Instead, a *wa'd* can be an innovative tool in structuring many forward contracts which require flexibility with full commitment of the parties involved without jeopardising the basic principles and *maqasid al-shari'ah*. It is a unanimously accepted principle that fulfilling a promise is a must for ethical and religious reasons. An absolute promise which is not subject to a particular reason and neither affects to a loss to the other party, is not legally binding.

Basic Rules and Conditions of *Wa'd*

The *Shari'ah* body of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) held that a *wa'd* which is "*mulzim*" in nature by both parties is similar to a contract or *'aqd.* The differences between a promise made by one party and the promise made by two parties are as follows:

The *Shari'ah* body of AAOIFI held that a *wa'd* which is "*mulzim*" in nature by both parties is similar to a contract or *'aqd*.

1 If the promise is made by one party, then the promise will be considered as "*mulzim diyanatan*" upon the promisor. The ruling for such an instance is that the promisor has to carry out his promise if such a promise is related with a specific reason, and there is commitment from the promisee.

2 A promise made by both parties, i.e., "*al-muwa'adah*" is permissible but it is not *mulzimah* in nature upon both parties because if the *muwa'adah* is *mulzimah* in nature, it is synonymous to an *'aqd*.

The latest ruling by OIC Islamic *Fiqh* Academy, in its 17th meeting, stated that:

1 A *mulzim* promise made by both parties is originally *mulzim diyanatan* (religiously binding) and not *mulzim qada'an* (legally binding).

2 A *mulzim* promise by both parties in a contract like the "*'inah*" and "*salaf*" transactions is a trick to circumvent the prohibition of *riba* (interest) and this is prohibited by the *Shari'ah*.

3 In a situation where a sale and purchase transaction cannot be performed because the seller does not possess the object of sale, but there is a public need to ensure that both parties perform the contract in the future based on the provision of law, a binding promise from both parties is allowed whether through the provision of law or by mutual consent of both parties.

4 A promise by both parties as mentioned in paragraph (3) does not consider the future transaction, therefore the ownership of the subject matter will not transfer to the buyer. The sale and purchase will only be executed at the time agreed by both parties after the completion of *ijab* and *qabul*.

5 For the situation mentioned in paragraph (3), if one of the parties breaks the promise, he is legally bound to perform the contract or to remove the hardship which is borne by both parties due to his breach of the contract.

Based on the research, there is no specific opinion from traditional jurists about *wa'd mulzim* from both parties, and similarly, about *'aqd*; it is almost consensual among them. This can be proven by the rulings and writings of modern jurists of *fiqh*. The difference of opinion among jurists regarding plain *wa'd* should not be extrapolated to the *wa'd* that substitutes for the contract, since in this case, the *wa'd* may not be binding under any circumstances. Hence, divergence is inadmissible thereon and must be given up altogether in favour of nonbinding as one consistent position.

Due to the prevalent controversy among modern jurists on unilateral promises (*wa'd)*, the decision of the Islamic *Fiqh* Academy in 1409H reflected the tension of the debate, thus expressing the ebb and flow between the two camps on both sides of the divide. The Academy decided that:

1. A *wa'd* (which is issued unilaterally by either the orderer or the client) is by religion, binding upon the promisor except where otherwise justified. It is also judicially binding if it is made contingent upon a reason and if the *wa'd* entails a cost for the promisee. In such cases, the consequences of the binding character of the *wa'd* are determined by either the fulfilment of the *wa'd* or by reparation for losses actually incurred as a result of the non-fulfilment of the *wa'd* without justification.

2. A bilateral promise (*muwa'adah*) is admissible in *murabahah* upon the condition that the bilateral promise (*muwa'adah*) is optional for both or either parties. If the bilateral promise (*muwa'adah*) offers no choice, then it is inadmissible because a binding bilateral promise (*muwa'adah*) in *murabahah* is comparable to an ordinary sale, where it is required that the seller be in possession of the goods sold, in order not to violate the prohibition by the Prophet (p.b.u.h.) of the sale by a seller of that which is not in his possession.

Summary

1 Islamic financial contracts are structured based on categories of contracts, namely partnership contracts, bilateral supporting contracts and unilateral supporting contracts based on the *Shari'ah*.

2 Contracts which are separated based on their nature, are further divided into several categories: partnership contracts include *mudarabah* and *musharakah*; security contracts such as *kafalah* and *rahn*; charitable contracts like *hibah*, and *wadi'ah*; and the agency contract, i.e., *wakalah*. Other supporting contracts include *hiwalah, ibra'*, *muqasah* and *wa'd*.

3 It is very important that all the relevant key players in the Islamic finance industry, be it the industry people, the users or even the consumers who use Islamic finance products, have the knowledge on how these products are structured and the concept behind its application.

4 The majority of jurists hold the view that *mudarabah* is *aqd' ghayr lazim* and thus can be terminated at anytime by notice even without the consent of the other party (except according to the Maliki school, which requires mutual consent). It is best to adopt the Maliki's view in this context to prevent future disputes and losses in the business as the success of the business may depend on the constant effort and sufficient time in running the business except in certain inevitable circumstances.

5 The scholars have debated at length on the permissibility of the guarantee/*kafalah* contract relying on the sources of *Shari'ah*: the *Qur'an*, *Sunnah*, and *ijma'*. A contract of guarantee is permissible in contracts of exchange and property. In fact, there is no objection in *Shari'ah* to include a number of guarantees in one contract, such as incorporating a personal guarantee together with a pledge of security in the same contract.

6 *Hibah* is a gratuitous contract (*tabarru'at*) in which its general legal effect is the establishment of a donee's ownership in the *hibah* object. However, jurists differ regarding the legality of the donor to recall his gift after *qabd* has been made. The majority of jurists, except for the Hanafi school, do not allow the donor to recall the gift.

7 A contract is different from a promise in a way that a contract is legally binding upon the contracting parties once it fulfils all the requirements needed. A promise/*wa'd* on the other hand, depends on the acceptance of its applicability and to the opinion of jurists whether they are legally or religiously binding.

8 There are differences of views among jurists on the issue of whether *ibra'* is an absolution (of rights) or transfer of ownership. To conclude, *ibra'* can be applied for both absolution and transfer of ownership depending on whether *ibra'* here involves *ibra'* of debt or *ibra'* of goods.

9 *Hiwalah* is divided into two types: restricted *hiwalah* and unrestricted *hiwalah*. Both are different in their form, nature and legal consequences.

10 *Rahn* in the contemporary application may take either the form of paper such as property documents, vehicle papers, and shares, or objects like ornaments, jewelleries and other valuables.

Key Terms and Concepts

Musharakah
Hibah
Muqasah
Debtor
Charitable Contracts
Islamic Financial Products
Mudarabah
Wadi'ah
Ibra'
Creditor
Bilateral Supporting Contracts
Kafalah
Wakalah
Wa'd
Debt
Rahn
Hiwalah
Partnership *Contracts*
Musharakah Mutanaqisah
Unilateral Supporting Contracts

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Review Questions and Problems

1 Outline the classification of contracts in the *Shari'ah* and provide examples of each category.

2 Explain the reasons and justification of the determination of the profit ratio in *musharakah* contracts. Elaborate on how the profit should be distributed.

3 The parties in a *mudarabah* contract are *mudarib* and *rabbul mal*. Discuss the role of both the parties in a *mudarabah* contract and give an example of one Islamic finance product that uses this concept.

4 *Hiwalah* is a contract which may lead to major legal effects and consequences. What are these legal consequences? State also the situations in which the transferee is entitled to have a right of recourse against the transferor.

5 *Rahn* in the contemporary application may take either the form of paper such as property documents, vehicle papers, and shares, or objects like ornaments, jewelleries and other valuables. Illustrate a basic *rahn* structure flow in an Islamic mortgage or financing and give your opinion on how *rahn* can contribute to the development of Islamic mortgage and financing.

6 Ahmad, who is the guardian of an orphan named Aminah, has given out Aminah's jewellery set as *hibah* to someone for charitable purposes with Aminah's consent. Discuss the validity and the effect of this *hibah* contract in the eyes of the *Shari'ah*. Support your answer with relevant provisions or views from Islamic jurists.

7 *Wadi'ah* can be classified into two types which are *wadi'ah yad amanah* (safe custody based on trusts) and *wadi'ah yad dhamanah* (guaranteed safe custody). State the distinct features of both types and the main differences between the two.

8 Discuss the types of *muqasah* and conditions for each type and the views of jurists regarding its validity.

9 There are differences of views among jurists in the issue of whether *ibra'* is an absolution (of rights) or a transfer of ownership. State the views of jurists in this context and whose view you prefer and why.

10 What is the difference between a contract and a mere promise/*wa'd*? Discuss the views from the jurists regarding the effect and the bindingness of a unilateral and bilateral *wa'd.*

Part 3

Islamic Financial Markets

Chapter 8

Islamic Banking Operations and Instruments

Preview

This chapter focuses on Islamic banking as one of the most important components in the Islamic financial system. Indeed, the development of Islamic finance has been widely associated with the rapid growth of Islamic banking worldwide over the past three or more decades. This chapter will discuss the structure, operations and instruments of Islamic banking to enable a better understanding of the functions of an effective and efficient Islamic financial intermediary. This chapter is divided into two main parts that elaborates the business of Islamic banks as reflected in their balance sheet structure. These parts are about the sources of funds in Islamic banks, and how these funds are subsequently channelled for various uses. The first part provides a brief description of Islamic banking deposits and their various underlying *Shari'ah* principles and contracts. The second part, i.e., the asset side of Islamic banking focuses on various forms of retail and corporate businesses that comply with the essence and principles of *Shari'ah*.

In 1963, the Malaysian government established the Muslim Pilgrim's Savings Corporation. This was the first Islamic financial institution in Malaysia; its objective is to help people save on a regular basis for their pilgrimage to Mecca.

Learning Outcomes

At the end of this chapter, you should be able to:

- Distinguish the unique characteristics of Islamic banking operations and instruments.
- Identify the similarities and differences between an Islamic bank and a conventional bank.
- Discuss the characteristics of Islamic deposit instruments and their underlying principles.
- Describe all the salient features and modus operandi of Islamic financing instruments.
- Explain the various types of trade financing instruments and practices.

Introduction

Islamic banking has the same purpose and operations as conventional banking. However, Islamic banking refers to a system of banking activities that operates within the realms of *Shari'ah* teachings. Although Islamic transactional contracts were used throughout the ages, the first experiment with Islamic banks came much later. Many writings have referred to the Mit Ghamr Local Savings Bank, established in Egypt in 1963, as the first Islamic bank. However, the experience lasted for a short while before the bank was taken over by the Egyptian government in 1972 and renamed Nasser Social Bank due to political reasons. Similarly, in 1963, the Malaysian government established the Muslim Pilgrim's Savings Corporation. This was the first Islamic financial institution in Malaysia. Its objective is to help people save on a regular basis for their pilgrimage to Mecca. Later in 1969, it evolved into the Pilgrim's Management and Fund Board, or Lembaga Tabung Haji, as it is now popularly known. Table 8.1 shows a brief historical development of Islamic banking and finance.

Since its inception and especially in the last decade, the Islamic banking industry has evolved into one of the essential and respected components of the international financial system. In brief, Islamic banking has emerged as a result of a revival of interest in Islamic economic thought and the increasing demand from Muslims for services and products that are in line with *Shari'ah* principles.

Today, the Islamic banking industry attracts both Muslim and non-Muslim market participants due to the benefits it offers. The worldwide market for *Shari'ah*-compliant Islamic financial products is estimated to be between US$800 billion and US$1 trillion. According to London-based International Financial Services London (McKenzie, 2010, January), *Shari'ah*-compliant assets grew to US$951 billion by end-2008, an increase of 25% from US$758 billion in 2007, and an increase of 75% from US$549 billion in 2006. Islamic financial institutions (IFIs) are growing at 15% to 20% per annum — a growth rate that far exceeds that of the conventional financial industry. As can be seen over the years, Islamic banking has gained momentum on a global scale. Financial institutions all over the world, including conventional banks, have launched their own Islamic banking units in trying to keep up with the pace of growing demand for *Shari'ah*-compliant products and services.

Table 8.1 Historical Development of Islamic Banking and Finance

Since 2000	• Integration of Islamic financial services in the mainstream financial markets • International Islamic Liquidity Management Corporation (Malaysia) 2010 • International Islamic Centre of Reconciliation & Arbitration 2005 • International Islamic Rating Agency (Bahrain) 2005 • International Islamic Financial Market (Bahrain) 2002 • Islamic Financial Services Board (Malaysia) 2002 • Liquidity Management Centre (Bahrain) 2002	• Advances treasury services • Balance sheet management • Innovation asset management
1990s	• A global phenomenon • Islamic banking & finance in Europe • Emergence of centres of excellence like Bahrain and Malaysia • Bank Muamalat Malaysia Berhad 1999 • The Accounting and Auditing Organization for Islamic Financial Institutions (Bahrain) (AAOIFI) 1994 • Islamic Inter-banks Money Market 1994 • Islamic Bank of Brunei 1993	• Equity funds • Leasing • Islamic securitisation
1980s	• AHZ Global Islamic Finance (UK) 1989 • Turkey Islamic Bank 1986 • Al Rajhi Bank (Saudi Arabia) 1985 • Mauritania Islamic Bank 1985 • Iraq Islamic Bank 1985 • Dar al Mal Islamic Trust (Switzerland) 1984 • Bank Islam (Malaysia) 1983 • Islamic Bank Bangladesh (1983) • Al-Baraka Group (various countries) 1982 onwards • Qatar Islamic Bank 1982 • International Islamic Bank of Investment & Development (Luxemborg) 1980 • Abu Dhabi Islamic Bank 1980	• Property finance and syndication • Islamic Insurance (*Takaful*)
1970s	• Jordan Islamic Bank (Jordan) 1978 • Jordan Financial and Investment Bank 1978 • Islamic Investment Company (UAE) 1978 • Kuwait Finance House 1977 • Faisal Islamic Bank (Sudan) 1977 • Faisal Islamic Bank (Egypt) 1976 • Dubai Islamic Bank (UAE) 1975 • Islamic Development Bank (Saudi Arabia) 1975 • Philippine Amanah Bank (Philippine) 1973 • Nasser Social Bank (Egypt) 1971	• Commercial banking
1960s	• Lembaga Tabung Haji Malaysia 1963 • Mit Ghamr (Egypt) 1963	• Primarily retail banking

Source: Adapted from Venardos (2005), *Islamic Finance and Global Financial Stability* (2010, April) and GIFF 2010 (KFH Research).

Role of Islamic Bank as an Efficient Financial Intermediary

As discussed earlier in Chapter 2, channelling of funds between surplus-fund units (SFUs) and deficit-fund units (DFUs) can be done in two ways: directly through financial markets and indirectly through financial intermediaries. Surplus-fund units involve lower spending than what they presently earn, whereas DFUs involve greater spending than what they presently own. On the whole, however, channelling of the funds is predominantly done through financial intermediaries (i.e., financial institutions such as Islamic banks, Islamic insurance (*takaful*) companies and other finance companies). Among these intermediaries, banks (commercial or investment), however, are the most important since they account for the bulk of financial intermediation. Hence, banks play a major role within the financial system and their soundness is of main concern for the financial stability of the economic system of a country.

Among the primary functions of a bank as a financial intermediary are to transform assets, conduct orderly payments, and transform risks. A more comprehensive set of the various functions of an efficient Islamic financial intermediary is illustrated in Figure 8.1 below.

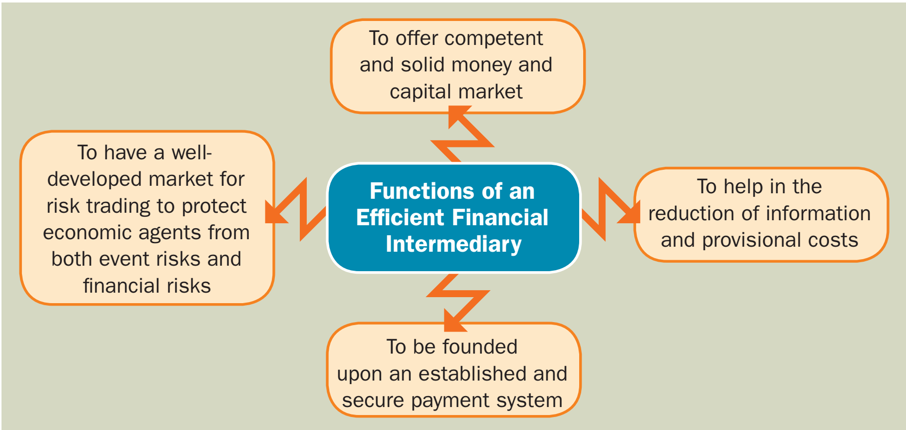


Figure 8.1
Functions of an Efficient Islamic Financial Intermediary

Balance Sheet of an Islamic Bank

An essential role of the conventional banks is to match SFUs and DFUs via intermediation that they provide by collecting deposits from customers, and lending money (deposited funds) out to the borrowers in terms of loans. This collection of deposits by conventional banks is in fact the borrowing of money for which banks pay interest that is relatively low on the liability side of the balance sheet. On the asset side, banks use these deposits to provide financing loans to investors — a service for which commercial banks charge interest as well. However, the interest charged by banks is higher than the interest paid to the depositors. The spread between the interest charged and the interest paid is known as the interest spread and represents the profit to the bank.

An Islamic bank, while performing similar functions, is relatively different from its conventional counterpart due to its unique nature of operations and activities which need to comply with the *Shari'ah* principles and rulings. Islamic banks have at their disposal a number of financial contracts like *wadi'ah yad dhamanah*, *murabahah*, *ijarah*, *istisna'*, etc., that create a unique relationship between depositors and Islamic banks on one side, and Islamic banks and financing customers, on the other.

In the case of Islamic banks, each and every contract has its own features and characteristics that affect the nature of the contractual relationship between the parties involved. This relationship in the case of Islamic banks is inclined towards both equity-based and debt-based financing as opposed to conventional banks which are more inclined towards debt-based financing and lender-borrower relationships. Islamic financial instruments may look like a mirror image of conventional ones, however, their underlying features, contractual relationships, mechanisms and implications are not identical.

Islamic financial instruments may look like a mirror image of conventional ones, however, their underlying features, contractual relationships, mechanisms and implications are not identical.

Table 8.2 below provides a conceptual overview of the general structure, intermediation capabilities and operations of an Islamic bank. This illustration, however, may not represent a balance sheet of each and every Islamic bank, as every Islamic bank may not provide all of these services.

Table 8.2 The Balance Sheet of an Islamic Bank

Assets	Liabilities
Trade Financing	Demand Deposits
Salam *Murabahah*	
Ijarah / Istisna'	Investment Accounts
Mudarabah (Profit / Loss-Sharing Investments)	
Musharakah (Equity Partnership)	Special Investment Accounts
Services (*Ju'alah, Wakalah, Kafalah*)	Capital Equity Reserves

Source: Iqbal & Mirakhor (2007).

Since the charging and paying of interest is prohibited in Islam, Islamic banks use various contracts that are *Shari'ah*-compliant. Consequently, Islamic banks nowadays use equity, as well as debt-based financial instruments for both the mobilisation and use of funds. However, while similar in nature and functions, the Islamic financial products differ significantly when it comes to the underlying contracts and mechanisms used. In fact, it is due to these underlying contracts that the Islamic mode of intermediation is distinguished from the conventional one.

> Unlike deposits placed in conventional commercial banks whose principals and returns are assumed to be guaranteed, Islamic banks are not able to guarantee return of the capital and profit.

On the liability side of an Islamic bank's balance sheet, there are generally demand deposits, investment accounts, special investment accounts, capital, equity and reserves. An Islamic bank can mobilise funds through contracts such as *mudarabah*, *wakalah* and *wadi'ah*. However, unlike deposits placed in conventional commercial banks whose principals and returns are assumed to be guaranteed, Islamic banks are not able to guarantee return of the capital and profit. This is especially true for deposits and investments that are based on *mudarabah* (partnership) and *wakalah bi istithmar* (agency for investment) principles. On the other hand, the principal amount of deposits placed with an Islamic bank is based on the principle of *wadi'ah* (custodianship) or *qard* (loan) and can be guaranteed by the bank but any returns out of the invested amount will solely belong to the banks. It is up to the bank's discretion to share the surplus with the customers.

On the asset side of the Islamic bank's balance sheet, there are a variety of instruments available for the use of the mobilised funds. These include sale-based instruments (like *murabahah*, *salam* and *istisna'*), lease-based instruments (*ijarah*), equity-based instruments (*mudarabah*, *musharakah* and *wakalah bi istithmar*) and other fee/income generating instruments (like *ju'alah*, *rahn*, *wakalah*, *kafalah*, etc.).

The remaining parts of this chapter shall focus on delineating and illustrating the salient instruments used on both sides of an Islamic bank's balance sheet.

Sources of Funds

Islamic banks which consist of their own capital and equity will also rely on two other main sources of funds. The first is transactional deposits which are mainly risk-free and provide no return. The second is the investment deposits which carry the risk of loss in capital for the investments made. There are a total of four main types of deposits.

Savings Deposit

All Islamic banks operate savings deposit accounts, however, the operation of these accounts vary at different banks. Generally, a savings deposit permits customers to deposit and withdraw their money at any time and does not require a minimum balance in the deposit account. It does not have any maturity date, therefore the cash can be withdrawn at any time based on the customer's demand. Generally, Islamic financial institutions structure their savings deposit accounts based on *Shari'ah* principles, either in the form of *qard*, *wadi'ah yad dhamanah* or *mudarabah* savings deposit. Later in the chapter, we will discuss the basic description of each principle used in structuring savings deposits in Islamic banking practice.

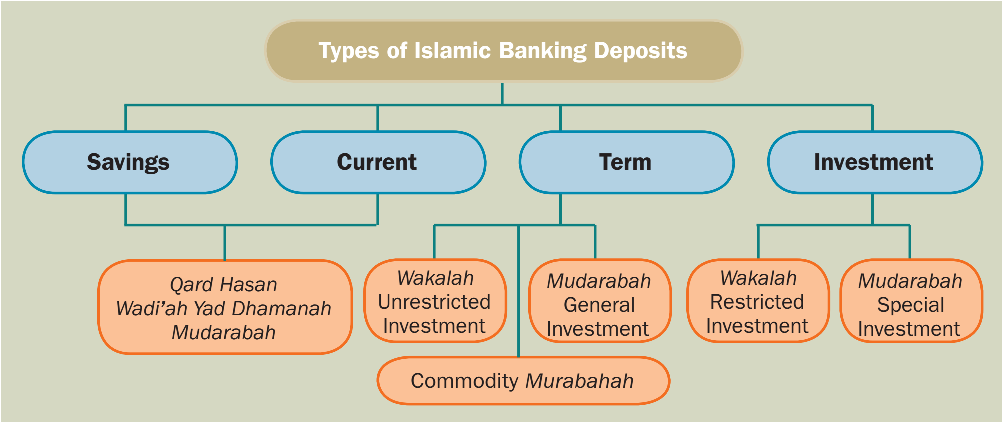


Figure 8.2 Types of Islamic Banking Deposits

Current Deposit

A current deposit account is a form of demand deposit that offers users safe-keeping of their cash deposits, and the choice to be paid in full upon demand. Current account deposit facilities are usually offered to either individuals or companies. It also shares similar features with a savings deposit as it permits for the cash to be withdrawn at any time. The main point of departure between a current deposit and a savings deposit is the presence of a cheque book and a multi-functional card used in the former. If the account holders were to withdraw more than what is sufficient in their balance, there will also be no charges incurred. In the US, current deposit is prominently known as checking account or demand deposits. The three common structures of a current deposit in Islamic financial institutions are: *qard*, *wadi'ah yad dhamanah* and *mudarabah* current deposit. Since both the savings deposit and current deposit share striking similarities, a more detailed discussion on their features will be made in the latter section of this chapter.

The three common structures of a current deposit in Islamic financial institutions are: *qard*, *wadi'ah yad dhamanah* and *mudarabah* current deposit.

Term Deposit

A term deposit is a type of arrangement where the customer's deposits are held at a bank for a fixed term. These deposits will then be deposited to a number of investment pools where it will be invested in business activities which are in accordance to the *Shari'ah*. The money deposited in a term deposit can only be withdrawn at the end of the term as stated in the contract or by giving a predetermined number of days as notice. Usually, term deposits are short-term deposits where the maturities are within a period of one month to a few years. Islamic term deposits are commonly structured based on the commodity *murabahah*, *wakalah* unrestricted investment and *mudarabah* general investment.

Investment Deposit

The main point of departure between the investment deposit and both savings and current deposits is that the former is normally structured based on either the *mudarabah* or *wakalah bi istithmar* principles which do not entail a guarantee of neither principal nor the return of profit.

The investment deposit is usually known as a profit-and-loss sharing (PLS) account or simply, the investment account. The main point of departure between the investment deposit and both savings and current deposits is that the former is normally structured based on either the *mudarabah* or *wakalah bi istithmar* principles which do not entail a guarantee of neither principal nor the return of profit. Nevertheless, the investment account holders have an opportunity to earn more attractive returns although there is also a likelihood of having to bear the risk of capital losses.

Underlying Contracts for Savings and Current Deposit

As indicated earlier, savings or current deposits in Islamic banks can be structured based on *qard*, *wadi'ah* or *mudarabah*. The following sub sections shall briefly illustrate the main features of the different structures respectively.

Qard-based Deposit

As defined by AAOIFI *Shari'ah* Standard No. 19, *qard* is the transfer of ownership in fungible wealth to a person upon whom it is binding to return wealth similar to it. The essence of *qard* is to provide on loan the wealth or property to one who will gain from this act. By giving, the receiving party will employ and consume it in pursuit of his aims and then return back its equivalent value.

The *qard* structure is predominantly used by the Islamic financial institutions in the Middle East and Europe. Essentially, the aim is to provide the depositors with a guaranteed safe-keeping of the amount deposited, and at the same time allow banks to utilise it for their banking and business activities. In a *qard* structure, the depositor is deemed as a lender to the bank who acts as the borrower and the bank guarantees such return even if there is negligence or loss of wealth. Figure 8.3 provides an illustration of a *qard*-based deposit.

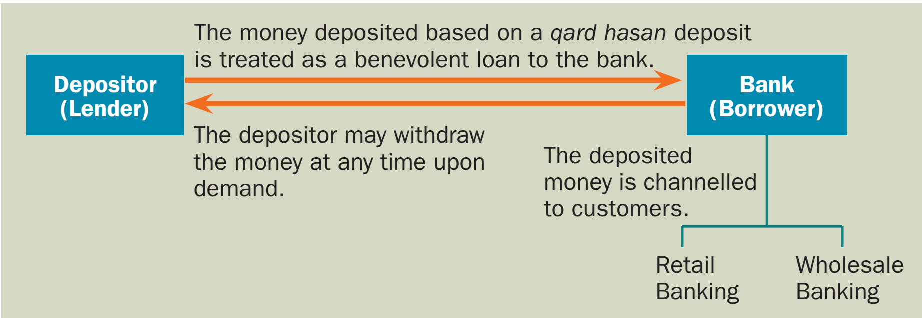


Figure 8.3
A *Qard*-based Deposit

Salient Features of a *Qard*-based Deposit

Among the salient features of a *qard*-based deposit are as follows:

- The money deposited in the bank account by the depositor is treated as a form of benevolent loan to the bank.
- The bank is entitled to use these deposited funds at its own risk without any authorisation from the depositor.
- The bank only owes the principal amount borrowed from the depositor.
- The principal amount is guaranteed by the bank to the depositor even if there is negligence or loss of wealth from the side of the bank.
- No dividends are due in these deposits.

Salient *Shari'ah* Issues

(a) Excess for the Lender

In a loan contract, any excess for the lender whether the excess is in terms of quality, quantity, tangible things, benefits, etc., is deemed prohibited as this may amount to *riba* (usury). Therefore, what is the basis for allowing the account holders (lenders) to utilise the ATM card and the cheque book without any form of compensation? This can be an excess for the lender and may amount to *riba* (usury). According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) *Shari'ah* Standard, this form of utilisation is permissible in the *Shari'ah*. This is because the benefits that arise out of this are common to both parties as both will benefit from this issue. This will then set-off the benefits of both parties against each other and the issue of *riba* will then not arise.

(b) *Hibah* (Gift)

It is not allowed for banks to provide *qard*-based deposit account holders' material gifts, financial inducements or benefits that are not related to the deposits and withdrawals. However, the banks may opt at their own discretion to reward the depositors through *hibah* (gift) as long as it is not pre-agreed and stipulated in the contract.

Wadi'ah Yad Dhamanah Deposit

As mentioned in Chapter 7, the term *wadi'ah* is defined as empowerment to someone for keeping the owner's property explicitly or implicitly. It can be further divided into two types, namely *wadi'ah yad amanah* and *wadi'ah yad dhamanah*. *Wadi'ah yad amanah* is a trust contract where the trustee will be authorised to keep the funds of the depositors in his or her safe custody by explicit or implicit terms. However, there is a paradigm shift from a trust contract to a guaranteed *wadi'ah* contract. The modification of the *wadi'ah*

Wadi'ah yad amanah is a trust contract where the trustee will be authorised to keep the funds of the depositors in its safe custody by explicit/implicit terms.

yad amanah contract is made by attaching the contract of *wadi'ah* with a guaranteed element. The guaranteed element converts the original concept of *wadi'ah,* which is based on trust, to "guaranteed safe custody", also known as *wadi'ah yad dhamanah*. The element of guarantee is deemed necessary since the bank is allowed to utilise the funds at its own risk. However, if the depositors eventually decide to withdraw their money, the bank needs to assure that the money is made available upon demand. The profit gained from the utilisation of the deposited funds belongs exclusively to the bank. However, the bank may voluntarily choose to share the profits obtained with the depositors as a form of discretionary *hibah* (gift). Figure 8.4 provides an illustration on the mechanism of *wadi'ah yad dhamanah* deposit.

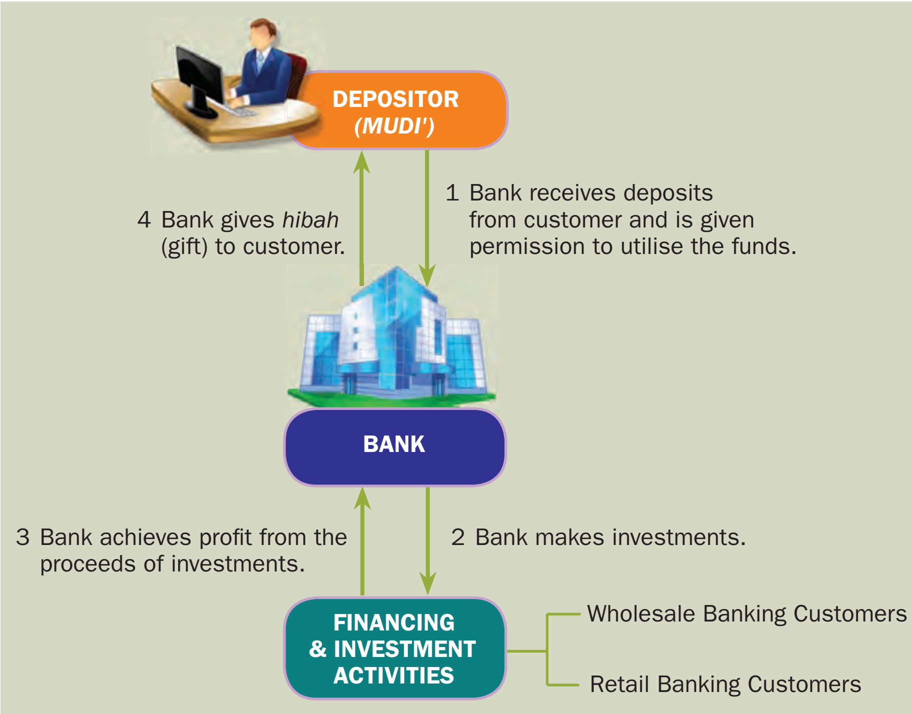


Figure 8.4
A *Wadi'ah Yad Dhamanah* Deposit

Salient *Shari'ah* Issues – *Wadi'ah Yad Dhamanah* Deposit

(a) Similarities of Ruling between *Wadi'ah* and *Qard*

The *Shari'ah* Advisory Council of Bank Negara Malaysia in its fifth meeting held on 30 April 1998/3 Muharram 1419 resolved that *wadi'ah yad dhamanah* is permissible to be used in structuring Islamic banking deposit products. It also reckoned that the legal ruling for *wadi`ah yad dhamanah* shall take the same status as a loan (*qard*) principle. In other words, all rulings and principles of a loan contract in the *Shari'ah* shall be applicable for *wadi'ah*. For example, any benefits derived from a loan contract shall be deemed as *riba*. Therefore, the same ruling applies to *wadi'ah*-based deposits which must not offer any form of benefits such as monetary or non monetary gifts to attract the clients to deposit their money into the bank.

(b) Consistent Giving of *Hibah* (Gift)

Even though the profit gained by the bank from the use of the deposited funds belongs exclusively to the bank and not the account holders, the bank usually chooses to share the profits obtained with the account holders as a form of discretionary *hibah* (gift). The practice of giving *hibah* is deemed controversial by some scholars. Since *wadi'ah yad dhamanah* has a similar legal ruling to a loan contract, any benefits derived from it are deemed to be *riba*. Although banks can justify that the act of giving *hibah* is discretionary and shall not be stipulated in the contract, the practice is still deemed to violate the principle of Islamic jurisprudence which suggests "any act which is known as customary is deemed as conditions of a contract".

Mudarabah Deposit

A *mudarabah* deposit is a form of investment account. Under this principle, the depositor who acts as the *rabbul mal* (wealth/property owner) deposits his money into the bank which acts as a *mudarib* (fund manager) that will subsequently use the money for investment purposes. The distribution of profit between the bank and the depositor is in accordance to a mutually pre-agreed profit-sharing ratio. This must be disclosed and agreed upfront by both parties at the time of the opening of the account. According to the *mudarabah* principle, the capital of the depositor cannot be guaranteed since any financial loss shall be borne entirely by the depositor as the capital provider unless proven negligent or there is a breach of the terms of the *mudarabah* contract on the part of the bank. This is the striking difference between a *mudarabah* deposit and a *wadi'ah yad dhamanah* deposit where the latter entails capital guarantee while the former does not allow banks to guarantee capital or return to the depositor.

> A *mudarabah* deposit is a form of investment account. Under this principle, the depositor who acts as the *rabbul mal* (wealth/property owner) deposits his money into the bank which acts as a *mudarib* (fund manager) that will subsequently use the money for investment purposes.

The *mudarabah* deposit can be divided into two types. It is the restricted *mudarabah* (*mudarabah muqayyadah*) and the unrestricted *mudarabah* (*mudarabah mutlaqa*).

(a) *Mudarabah Muqayyadah* (Restricted *Mudarabah*)

This is a type of *mudarabah* deposit whereby the actions of the *mudarib* (fund manager) are restricted. However, it should not be in a way that would unjustifiably constrain the actions of the *mudarib* (fund manager) in his operations.

(b) *Mudarabah Mutlaqa* (Unrestricted *Mudarabah*)

This is a form of a *mudarabah* deposit whereby the *mudarib* (fund manager) can employ his own good judgement and has complete authority on the management of the capital entrusted to him for any type of investment activities. Figure 8.5 provides an illustration of a *mudarabah* deposit.

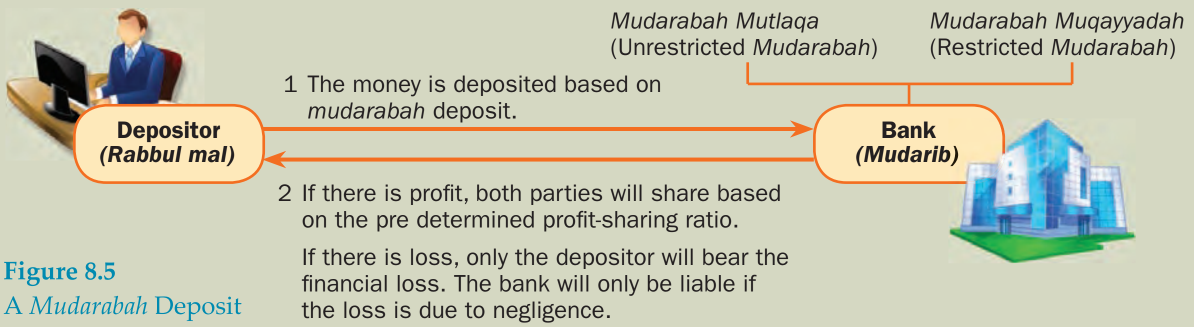


Figure 8.5
A *Mudarabah* Deposit

Case Study 1 *Mudarabah* Savings Deposit Account – Kuwait Finance House (KFH)

Definition:

This is an account for savings and investments based on the concept of *mudarabah*. Any profits derived from the deposit invested by KFH will be shared between the two parties in a mutually agreed profit-sharing ratio.

Product Features:

- An account which accrues profit based on *Shari'ah* principles is credited to the account.
- Ability to transfer the account holder's salary into the account.
- Ability to perform cash and cheque deposit in KFH's branches.
- Ability to transfer money from the account to any other accounts in KFH or outside (applicable if GIRO service is available).
- Ability to buy and sell foreign currencies.
- Ability to send faxes within the country and outside the country.
- Ability to issue payment order to a beneficiary within the country and demand draft to a beneficiary outside the country.
- Ability to purchase Traveller's Cheques.
- Ability to issue a Letter of Guarantee.
- Ability to set up Standing Instructions.
- Sixteen (16) free monthly transactions.
- Fees will be charged for the following services:
    - ✧ Replacement of ATM card.
    - ✧ Early closure of account if it is closed within three months of account opening.
    - ✧ Closure of account after three months will not be charged any fees.

Source: Kuwait Finance House website.

Table 8.3 summarises the main differences between an Islamic deposit and a conventional deposit.

Table 8.3 Islamic Deposit vs. Conventional Deposit

Islamic Savings Deposit	Conventional Savings Deposit
The principal amount is fully guaranteed (except *mudarabah*).	Both the principal and interest are predetermined and guaranteed.
There is no presence of interest. However upon the discretion of the bank, the depositors may be offered *hibah* (gift) which is neither conditional nor promised upfront.	Interest is fixed at a pre determined rate but is subject to revision.
The banks cannot offer any incentives in the form of gifts/promotional items/attractive benefits, etc., to attract new depositors particularly when it is structured based on *qard* or *wadi'ah*.	The banks can offer incentives to attract new depositors.
The deposit is accepted on the condition that the money will be put to work together with the management expertise and skills of the bank.	The deposit is a form of debt given to the bank by the customer.

Term Deposit

There are various structures of Islamic term deposit schemes which have been experimented by Islamic banks to satisfy the needs and requirements of different clientele. Some of these schemes include structures based on commodity *murabahah* term deposit, *wakalah* unrestricted investment deposit and *mudarabah* general investment account. Most of these term deposit schemes are bank-specific, therefore all these various deposits may not be found in all the Islamic banks.

Commodity *Murabahah* Term Deposit

The commodity *murabahah* term deposit is a form of fixed deposit that comprises a series of *murabahah* contracts also known in classical terms as *tawarruq*. A simple illustration and explanation on the deposit taking mechanisms of commodity *murabahah* can be found below.

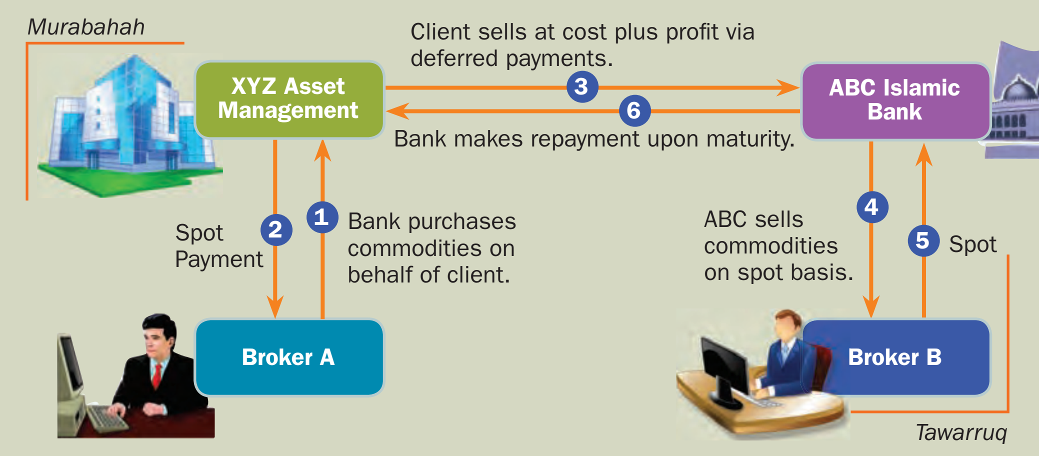


Figure 8.6 Commodity *Murabahah* Term Deposit

Exhibit 8.1 Illustration of Commodity *Murabahah* Term Deposit

XYZ Asset Management placed US$10 million with ABC Islamic Bank for three months. Profit is to be paid upon maturity at a rate of LIBOR plus 25 bps (assuming three months LIBOR is 0.35%, profit rate is 0.60%).

- Value Date: 20 December 2010
- Maturity Date: 19 March 2011
- Repayment Amount: US$10,015,000

1 XYZ Asset Management will appoint ABC Islamic Bank as an agent to purchase on a cash and spot basis US$10 million worth of LME (London Metal Exchange) metal warrants (also known as commodity) from Broker A.

2 Broker A will receive US$10 million.

3 XYZ Asset Management then sells the commodity that has been purchased earlier to the ABC Islamic Bank at US$10 million with an additional profit margin via deferred payment. In this step, the bank will assume the liability (the cost price of the commodity plus profit margin). This additional profit margin along with the principal will be credited to XYZ Asset Management banking account upon maturity.
For example, US$10 million (cost) plus 0.60% profit margin for a duration of three months: US$10 million + (0.60% × 3/12 × US$10 million) = US$11,500,000.

As can be seen from steps (1) to (3), the XYZ Asset Management is practising *murabahah*. It involves purchasing at cost and selling it at a mark-up with the main feature of *murabahah* intact: both cost and profit is disclosed in the contract.

4 After receiving the commodity, ABC Islamic Bank then sells the commodity on spot basis to another broker in the LME (Broker B).

5 ABC Islamic Bank then receives cash of US$10 million on spot from Broker B.

As can be seen from steps (4) to (5), ABC Islamic Bank is practising *tawarruq*. It is a type of sale contract whereby a buyer purchases an asset from a seller with deferred payment and consequently, sells the asset to a third party on cash with a price lower than the deferred price.

Wakalah Unrestricted Investment Deposit

Wakalah unrestricted investment deposit is an agency concept whereby the *muwakkil* (depositor) will appoint the bank as his *wakil* (agent) with respect to the investment of the *muwakkil's* funds in *Shari'ah*-compliant transactions. Based on unrestricted *wakalah*, the *wakil* will use the invested funds for its general corporate purposes; mainly investments in any of the assets on the bank's balance sheet. The investment will be at the full discretion of the *wakil*. The *wakil* will notify the *muwakkil* on the profits expected to be generated upon the placement of funds. However, any profits exceeding the quoted expected profits will be retained as incentives by the *wakil*. This is based on the principle of *tanazul* whereby certain rights of claim will be waived in favour of another party in a contract. The *wakil* will be entitled to draw an agency fee from the incentives obtained. Since *wakalah* is just a form of agency contract, the *muwakkil* as the principal shall bear all risks associated with the transactions except for those risks resulting from the *wakil's* misconduct or negligence.

To attract depositors, banks may sometimes provide explicit guarantee of a minimum return. This should be avoided as it contravenes the principles of *Shari'ah*. Instead, banks should be clear to the *muwakkil* that in occasions where there are losses, the bank will try to fill the gap with its bank reserves, and not guarantee a minimum return. However, this may potentially create legal issues on how to document the payment obligations.

Mudarabah General Investment Account

A *mudarabah* general investment account provides an investment opportunity that operates under the Islamic banking principle of *mudarabah*. As discussed earlier, *mudarabah* is a form of partnership contract whereby a customer known as the *rabbul mal* (wealth/property owner) who is looking for investment opportunities for his or her funds will invest through the bank who acts as the manager of the fund (*mudarib*). Under the "general" investment account, no minimum tenure of investment is required and the investment product will not be unique. The *mudarib* has a broad range of trade or business freedom on the basis of trust and the business expertise he or she has acquired. However, the actions of the *mudarib* must be in accordance to the customs of the *mudarabah* operations and the subject matter of the contract.

The potential *Shari'ah* issue that may arise is when the Islamic banks who are also acting as the *mudarib* of the investments start requesting for administrative fees, etc., for the management of the fund. This is not permissible in the context of *Shari'ah* based on the principle of *mudarabah*. Under this principle, the *mudarib* should manage all the work with regards to the investments without requesting for any additional fees as it comes within the scope of the responsibility of a *mudarib*. However, if the *mudarib* insists on additional fees, this should be taken into consideration while determining the profit-sharing ratio.

Investment Deposit

There are various investment deposits available in Islamic banks. This chapter will explain the two most prominent investment deposits used in Islamic banks: the *wakalah* restricted investment deposit and the *mudarabah* special investment account.

Wakalah Restricted Investment Deposit

As discussed earlier, a *wakalah* is a form of agency contract in which the customer assigns the bank as his *wakil* (agent) to invest the money on his behalf. Therefore, both *wakalah* restricted investment account and *wakalah* unrestricted investment account share the same characteristics except that the former only allows the *wakil* to use the invested funds within the restriction of the fund schemes, for example, the existence of investment parameters, the types of investments to be made by the scheme, etc. The *wakil* must also identify the limitations to the *muwakkil* (depositor).

Mudarabah Special Investment Account

The main features highlighted in the *mudarabah* general investment account will be applicable here. However, the main point of departure is: in a *mudarabah* special investment account, the *rabbul mal* (wealth/property owner) will be advised on where the funds will be invested, what is the minimum amount that they can invest in the projected return and what is the loyalty risks that come with it. Also, the returns on special investment accounts are generally much higher than the *mudarabah* general investment account. In light of this, the *rabbul mal* is usually a government institution or large corporate customer that is involved in specific investments, for example, project financing or repurchase agreements in the Islamic money market.

This chapter will now provide a more comprehensive illustration of a specified investment as presented below.

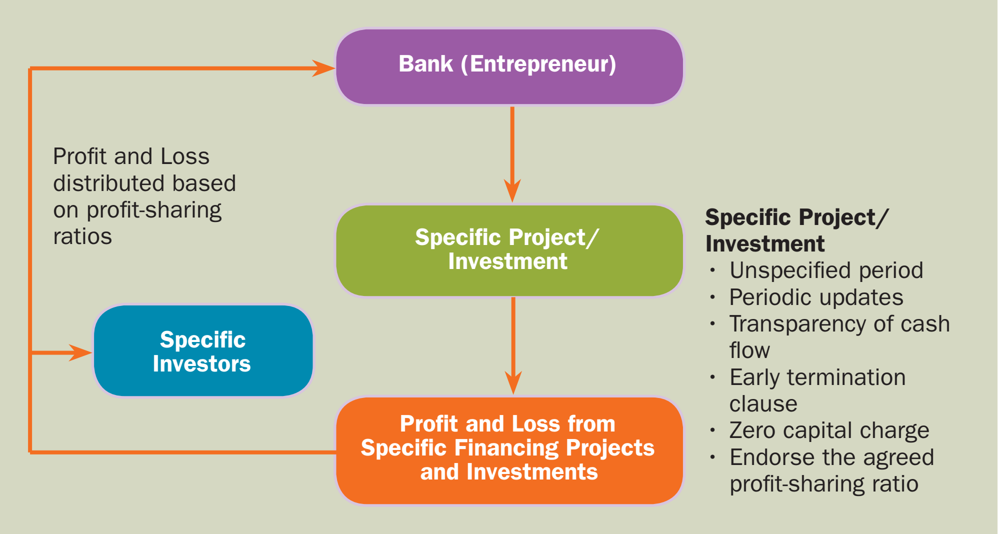


Figure 8.7 Example of a Specified Investment

Mudarabah Special Investment Account – Computation

The following is a case study to explain further the computation of the *mudarabah* special investment account.

Exhibit 8.2 *Mudarabah* Special Investment Account

Case Scenario: Nuha wants to invest $200,000 in a special investment account whereby the funds are invested in the oil industry. The whole investment collected from all the investors in the scheme is estimated to be at $100 million. The weightage assigned by the bank is 0.90 and the weightage assigned to the bank's own fund for the same investment is 1. For example, the amount assigned is $15 million. The total profit made by the bank from the investment is $1,050,000. The profit-sharing ratio agreed between the bank and the customer is 40:60 respectively. The profit earned by Nuha is illustrated in the table below. This illustration will now explain how the calculations are derived and the various terms used.

Exhibit 8.2 *Mudarabah* Special Investment Account (continued)

- Weightage = The weightage assigned is based on the usage of funds. This is because the entire fund cannot be used by the bank for investment. Also, the weightage assigned differs from bank to bank, and it depends on the guidelines of the central bank.
  - Investors = 0.90
  - Bank = 1
- Funds Pooled = This is the balance for all the products and it is used to form a pool of funds by the bank.
  - Investors = $100 million
  - Bank = $15 million
- Weighted Balance = Weightage × Funds Pooled
  - Investors = 0.90 × $100 million = $90 million
  - Bank = 1 × $15 million = $15 million
  - Total Weighted Balance = $90 million + $15 million = $105 million
- Distribution of Income =
  (Weighted Balance for Individual Product ÷ Total Weighted Balance) × Total Income Earned
  - Investors = ($90 million ÷ $105 million) × $1,050,000 = $900,000
  - Bank = ($15 million ÷ $105 million) × $1,050,000 = $150,000
- Profit for each Product = Distribution of Income × Ratio
  - Investors = $900,000 × 40% = $360,000
  - Bank = $150,000 × 60% = $90,000
- Dividend Rate (%) = (Profit for each Product ÷ Funds Pooled) ×
  (Total number of months in a year ÷ No. of profit calculation month) × 100%
  - Total number of months in a year = 12
  - No. of profit calculation month = 1
  - Investors = ($360,000 ÷ $100 million) × (12 ÷ 1) × 100% = 4.32%
  - Bank = ($90,000 ÷ $15 million) × (12 ÷ 1) × 100% = 7.2%
- Computation of Dividend = T × P × DR
  - T = Tenure (1 month)
  - P = Principal amount invested by Nuha (investor)
  - DR = Dividend Rate
  - Investor's = 1 × $200,000 × 4.32 ÷ (12 × 100) = $720

The dividend paid to Nuha is $720.

Type of Product	Weightage	Funds Pooled ($'million)	Weighted Balance ($'million)	Distribution of Income ($'000)	Client Ratio	Profit for each Product ($'000)	Dividend Rate (%)
Mudarabah Special Investment – Investors	0.90	100	90	900	60%	540	6.48%
Mudarabah Special Investment – Bank	1	15	15	150	60%	90	7.2%
Total		**115**	**105**	**1050**		**630**	

Uses of Funds

In the previous section, we discussed about the sources of funds for Islamic banking, and in the remaining parts of this chapter, we will focus on the uses of funds, namely the various characteristics and principles underlying the operations of Islamic financing facilities in Islamic banking. The most common structure of any Islamic commercial bank involves two main sectors, namely the personal or retail sector and the corporate or trade sector. However, not all retail financing involves personal customers exclusively, and likewise not all corporate financing involves customers with corporate business operations. This category is drawn broadly on the basis of the scale of business the customer typically requires. In this section, we will look at two types of uses of funds in Islamic finance, namely retail financing and corporate financing.

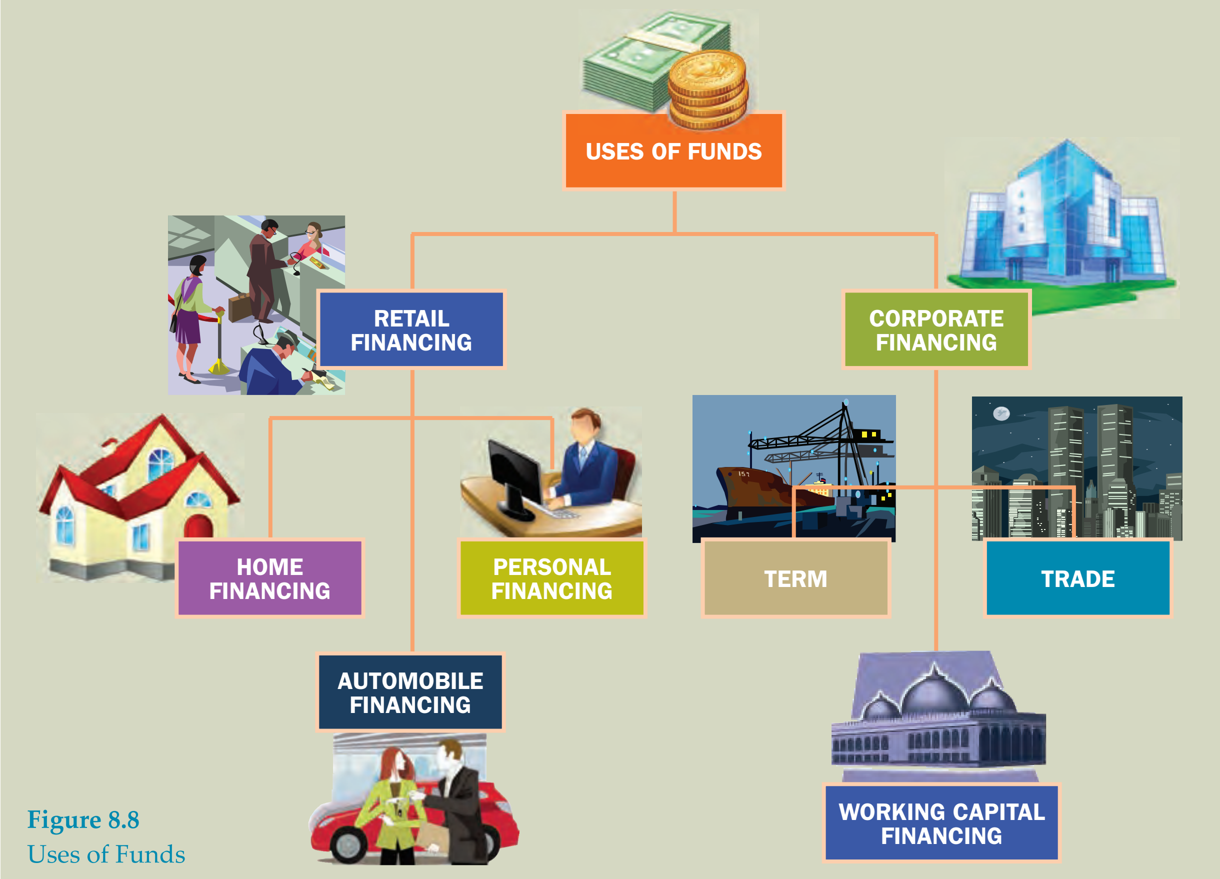


Figure 8.8
Uses of Funds

Islamic Retail Financing

Retail financing can be defined as financing activities where the main emphasis is on service for individuals rather than businesses and corporate entities. It is a business segment which delivers financial services through a network of outlets and service points. The characteristics of retail financing requirements are very narrow and specific to basic individual necessities that can be divided into three broad categories which are home financing, automobile financing and personal financing.

Similarly, Islamic banks offer a wide range of traditional retail financing as offered by their conventional counterparts. In this section, the focus of Islamic retail financing shall be on the three common categories, namely home financing, automobile financing and personal financing. Accordingly, the readers will be introduced to the various underlying *Shari'ah* contracts and principles used and their respective mechanisms.

Home Financing

The most common models and structures in Islamic home financing as offered by many Islamic banks worldwide are either based on *bay' bithaman ajil* (deferred payment sale), *musharakah mutanaqisah* (diminishing partnership), *ijarah* (leasing), or parallel *istisna'* (construction-required sale). Each of these concepts and mechanisms shall be elaborated in the following subsections.

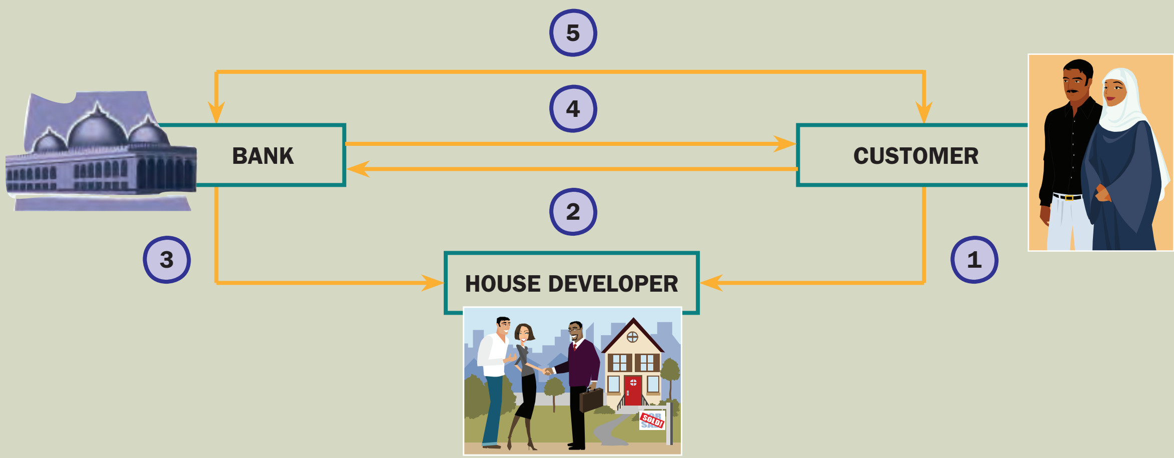
Bay' Bithaman Ajil (BBA) Home Financing

The *bay' bithaman ajil* (BBA) home financing is an Islamic home financing facility, which is based on the *Shari'ah* concept of deferred payment sale. It can be defined as a sale contract in which the payment of the price is deferred and payable at a particular time and period in the future. The term BBA is commonly used in Malaysia and Brunei. In other jurisdictions, the terms that are used to connote the same meaning of a deferred payment sale are known as *bay' muajjal* (which is popularly used in the South Asian region) and *bay' murabahah* (which is a commonly used term in the Middle Eastern countries).

In essence, BBA is a contract that mainly refers to the method of payment in the transaction via a deferred payment basis, it is not a kind of sale. In the current practice, BBA has been referred to as a sale and purchase transaction for the financing of an asset on a deferred and instalment basis with a pre-agreed payment period. The selling price has to be fixed and agreed at the time the contract is made.

Hence, the profit rate for the BBA financing is fixed throughout the period of financing. The monthly instalment will not change according to base lending rate (BLR) because the BBA base lending rate financing scheme is not tagged to the BLR.

Although the BBA financing was structured based on a fixed-rate financing, it is argued that the fixed-rate method may affect the competitiveness and viability of the banks. When the interest rate is high, the customer will shift to a fixed-rate financing but when the interest rate is low, the customer will shift their financing to the conventional bank. Consequently, a variable rate BBA has been introduced with a rebate (*ibra'*) feature. The selling price of the asset sold to the customer on deferred terms would be fixed at a profit-rate known as the ceiling profit-rate. The ceiling rate is set higher than the actual variable rate charged to the client (also known as effective rate). The difference between the ceiling rate and effective variable rate is the amount of *ibra'* (rebate), which is to be returned at the end of each month. The effective rate is normally reflective of the movement of the interest rate in the market. However, if the market interest rate exceeds the contracted ceiling rate, the Islamic banks cannot adjust their effective rate above the ceiling rate. So far, the floating or variable rate of a BBA structure is offered in Malaysia and Brunei.



1 The customer identifies a house he wishes to buy from a house developer. At this stage, the customer normally enters into a sale and purchase agreement with the developer and pays the deposit amount.
2 By paying the deposit, the customer is deemed to have beneficial ownership of the property. Hence, the customer can then approach the bank for financing the remaining balance. This is done by the customer who sells the property to the bank at a price equivalent to the financing amount.
3 The bank purchases the requested house and pays in full. (The amount is normally disbursed direct to the house developer.)
4 The bank then sells the house to the customer at a marked-up price.
5 The customer will pay the sale price on an instalment basis.

The embedded *bay' al-'inah* transactions are reflected through Steps 3 and 4 in the figure above.

Figure 8.9
Bay' Bithaman Ajil Financing

Despite the common understanding of BBA as a deferred payment sale, the practice of this sale contract may differ from one country to another. In the case of Malaysia and Brunei, BBA home financing is normally structured with the embedded concept of *bay' al-'inah* (sale and buyback). The basic modus operandi of a BBA home financing is depicted in Figure. 8.9.

In Malaysia and Brunei, BBA home financing is normally structured with the embedded concept of *bay' al-'inah* (sale and buyback).

Bay' Bithaman Ajil (BBA) – Instalment Financing Computation

The most commonly used BBA financing computation practised by financial institutions is based on the constant rate of return (CRR). There are generally two types of CRR instalment financing computations, namely the BBA with no grace period profit and the BBA with grace period profit. The formula and illustrations of the two types of computations are depicted in the following table and boxes.

Table 8.4 Illustration of CRR method

Element	Computation Formula	Description
Annuity Factor (AF)	$i(1+i)^n \div (1+i)^n - 1$	i = Rate of CRR n = Total number of Periodic Payments
Periodic Repayment	AF × Financing Amount	Financing Amount = Purchase Price
Sale Price	PR × n	PR = Periodic Repayment
Profit Amount	(PR × n) – Financing Amount	Sale Price – Purchase Price

Source: Adapted from Khir et al. (2008).

(a) BBA with No Grace Period Profit

Exhibit 8.3 Example of BBA with No Grace Period Profit

Nazim approaches an Islamic financial institution and applies for financing under the concept of *bay' bithaman ajil* (BBA). Let us say the purchase price of the house is $800,000 and the profit rate is 7%. The financing period is 15 years and Nazim has to repay the selling price in 180 instalments. The computation of the sale price and the monthly instalments based on the CRR method is illustrated below.

Step 1: Annuity Factor (AF)

Formula: $[\ i(1+i)^n\ ] \div [\ (1+i)^n - 1\ ]$

- i = 7% ÷ (100 × 12) = 0.005833
- n = 180 monthly instalments

$[0.005833(1+0.005833)^{180}] \div [(1+0.005833)^{180} - 1]$

= 0.008988

Step 2: Periodic Repayment (PR)

Formula: AF × Financing Amount (Purchase Price)

- Purchase Price = $800,000

0.008988 × $800,000 = $7,190.40

Step 3: Sale Price

Formula: PR × n

$7,190.40 × 180 = $1,294,272

Step 4: Profit

Formula:

Sale Price – Financing Amount (Purchase Price)

$1,294,272 – $800,000 = $494,272

Source: Adapted from Khir et al. (2008).

(b) BBA With Grace Period Profit

Exhibit 8.4 Example of BBA with Grace Period Profit

Adib approaches an Islamic financial institution and applies for financing under the concept of *bay' bithaman ajil* (BBA). Let us say the purchase price of the house is $1,000,000 and the profit rate is 8%. The financing period is twenty years (inclusive of two years as grace period). Adib has to repay the selling price in 240 instalments. The computation of the sale price and the monthly instalments is based on the CRR method with the grace period profit as illustrated below.

Step 1: Annuity Factor (AF)

Formula: $[\ i(1+i)^n\ ] \div [\ (1+i)^n - 1\ ]$

- $i = 8\% \div (100 \times 12) = 0.006667$
- $n = 228$ monthly instalments
    - ✧ 20 years × 12 months = 240 monthly instalments
    - ✧ 2 years grace period × 12 months = 24 monthly instalments
    - ✧ n = 240 – 24 = 228 monthly instalments

$[0.006667(1+0.006667)^{228}] \div (1+0.006667)^{228} - 1 = 0.008545$

Step 2: Periodic Repayment (PR)

Formula: AF × Financing Amount (Purchase Price)

- Purchase Price = $1,000,000

0.008545 × $1,000,000 = $8,545

Step 3: Original Sale Price

Formula: PR × n

$8,545 × 228 = $1,948,260

Step 4: Grace Period Profit

Formula: Sale Price – Financing Amount (Purchase Price)

$1,948,260 – $1,000,000 = $948,260

Step 5: Instalment during Grace Period

Formula: Grace Period Profit ÷ Grace Period

$948,260 ÷ 24 = $39,510.833

Step 6: Sale Price Inclusive of Grace Period Profit

Formula: Original Sale Price + Grace Period Profit

$1,948,260 + $948,260 = $2,896,520

Source: Adapted from Khir et al. (2008).

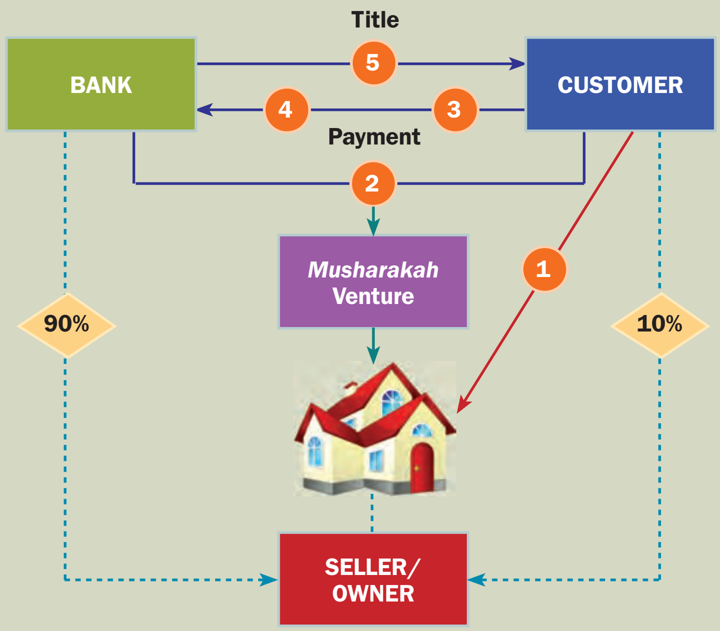
Musharakah Mutanaqisah Home Financing

The *musharakah mutanaqisah* (diminishing *musharakah*) is a hybrid contract which was recently developed by contemporary scholars. Generally, it can be defined as a form of partnership in which one of the partners promise to buy the equity share of the other partner gradually until the title of the equity is completely transferred to him. According to this concept, the transaction generally consists of three steps. First, a bank and a customer form a partnership based on the contract of "*shirkah al-milk*". Second, the customer agrees to rent the bank's undivided share in the property through the contract of *ijarah*. Finally, throughout the financing tenure, the customer will gradually buy the bank's shares through the contract of "*bay'*". In addition, the customer will usually sign the purchase undertaking (*wa'd*) agreement whereby he agrees to gradually buy shares from the bank.

Musharakah mutanaqisah is also known to be an innovative and flexible instrument for Islamic financing. The contract is mostly used in the area of property venture, asset acquisition and business working capital. Many banks that provide home financing adopted the *musharakah mutanaqisah* financing instruments. Some examples are HSBC Amanah (UK), Al Buraq (UK), Islamic Bank of Britain PLC and KFH (Malaysia).

Modus Operandi

There are three main parties involved in this *modus operandi* of *musharakah mutanaqisah*: customer, IFI and the property developer (seller/owner). This is further illustrated in Figure 8.10 below.



1 Customer identifies the property, signs Sales and Purchase (S & P) agreement, pays deposit; and applies for the financing.
2 Once application is approved, Bank enters into a *Musharakah* Arrangement with customer.
3 Customer leases the Bank's share in the house.
4 Customer will pay an amount in addition to the rental to buy the Bank's units in the property.
5 The partnership will be terminated with the customer owning 100% of the house and the title will be transferred to him/her.

Figure 8.10
A *Musharakah Mutanaqisah* Structure

Exhibit 8.5 Default in *Musharakah Mutanaqisah*

In general, a *musharakah mutanaqisah* facility can be terminated in two ways:

1 Without *wa'd* (purchase undertaking); whereby the underlying property will be sold in the market and the proceeds will be shared between the bank and the customer according to the latest ownership share ratio.
2 With *wa'd*; the customer is required to buy all the outstanding shares of the bank at once.

Majority of the banks, however, use *wa'd* in their structures. Hence, here are the highlights of the basic steps in the case of default. The first step would be to issue a notice of termination to the customer declaring that *wa'd* (purchase undertaking) is invoked. At this point in time, the customer is requested to buy all the outstanding shares of the bank; and the transaction documents (where applicable) are immediately enforceable.

The second step involves the liquidation of the asset (property). From the amount realised through the liquidation, the bank will deduct overdue rentals, purchase undertaking on outstanding *musharakah* units, legal costs, and other charges (if any). Finally, the remaining *musharakah* proceeds will be shared between the bank and the customer according to their prevailing ratio in the *musharakah mutanaqisah* facility. However, if there is a surplus, it is usually given to the customer (in cases where *wa'd* is used).

In the case of default, the actual amount claimable is equal to the actual amount disbursed by the bank (i.e., the bank's shares) and actual profit and cost incurred by the bank. The bank will also claim the legal fees incurred by the bank for the liquidation of asset, the penalty (if any), and other fees (if any). The practical implications of the default case with and without *wa'd* are further illustrated in Table 8.5 below.

Table 8.5 *Musharakah Mutanaqisah* in the Event of Default

Issue	Without *Wa'd*		With *Wa'd*	
1	2		3	
Cost of the house	RM100,000		RM100,000	
Customer's share (C)	RM10,000		RM10,000	
Bank's share (B)	RM90,000		RM90,000	
Equity ratio C:B	10:90		10:90	
Default after 3 years				
Customer's share	RM30,000		RM30,000	
Bank's share	RM70,000		RM70,000	
Equity ratio C:B	30:70		30:70	
Creates indebtedness	No		Yes	
Sales proceeds	C-Share	B-Share	C-Share	B-Share
1 Price RM90,000	RM27,000	RM63,000	RM20,000*	RM70,000*
2 Price RM70,000	RM21,000	RM49,000	RM0**	RM70,000**
3 Price RM60,000	RM18,000	RM42,000	-RM10,000***	RM70,000***

Source: Smolo (2010). Managing Default in *Musharakah Mutanaqisah*. *ISRA Bulletin*, Vol. 5, 5-7.

Exhibit 8.5 Default in *Musharakah Mutanaqisah* (continued)

Note: For simplicity of discussion, we will ignore the outstanding rental and legal fees.
* The bank will claim the entire outstanding amount owned by the customer, while any surplus will be given to the customer.
** Banks use *wa'd* to create indebtedness, and the full amount is to be paid by the customer to the bank. Thus, if the proceeds are equal to the amount claimed, the customer will not receive anything, as his or her equity shares will be used to pay off the outstanding amount.
*** If the proceeds are less than the amount claimed, the bank will demand from the customer the remaining balance.

From Table 8.5, we can see the difference in the case of default when *musharakah mutanaqisah* (MM) is implemented without *wa'd* and with *wa'd*. In short, when MM is implemented without *wa'd*, the property will be sold in the market. If there is a surplus, it will be shared between the parties based on the profit-sharing ratio. On the other hand, if there is a loss, it will be shared according to the capital share of each party.

However, in most cases, banks use *wa'd* (purchase undertaking). It obliges the customer to buy all of the bank's outstanding share (in our case, RM70,000). However, as the customer will generally not be able to do so, MM will be terminated and the underlying property will be sold at an auction. The selling price of the house could be higher, lower, or equal to the amount claimed.

If the house is sold for, say, RM90,000, then RM70,000 will be paid to the bank for its share in the house. The additional RM20,000 will be entirely given to the customer. However, if the selling price is equal to the outstanding amount, the customer will receive nothing, as the proceeds will be entirely used to cover the amount claimed by the bank. Finally, if the proceeds are less than the amount claimed, the bank will demand from the customer for the remaining balance (i.e., RM10,000). One thing is for sure, in case default in MM is managed through *wa'd*, the bank is guaranteed of its outstanding amount. Regardless of the selling price, the bank will receive the amount claimed, i.e., RM70,000.

It is worth noting that in the above cases, the proceeds will first be used to cover all costs related to the legal action and property disposal. Overdue rental payments and the bank's outstanding share would be settled next. Finally, in case of purchase undertaking (PU) as practised by KFH, the remaining balance (if any) will be given to the customer. On the other hand, if PU is not used, any remaining balance will be shared between the bank and the customer according to their current ownership ratio.

Source: Smolo, E. (2010). Managing Default in *Musharakah Mutanaqisah*. *ISRA Bulletin*, Vol. 5, 5-7.

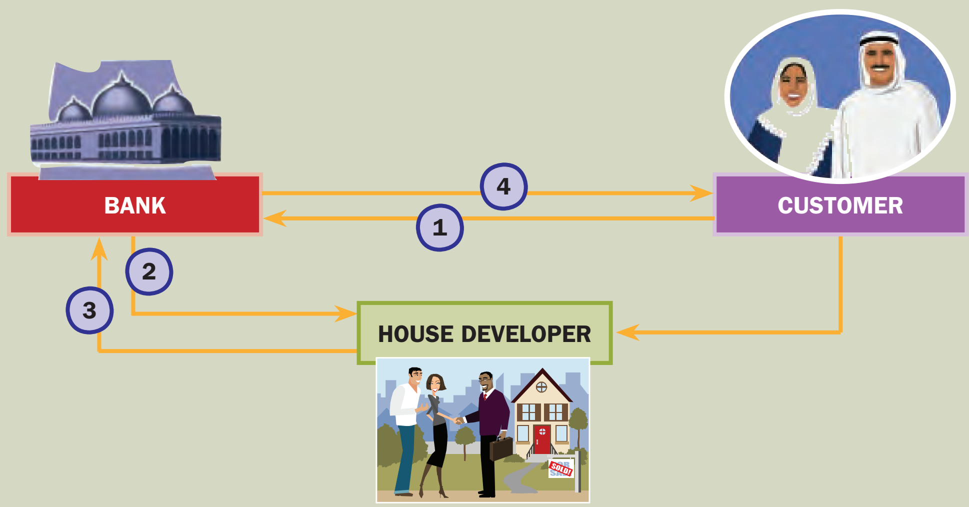
Parallel *Istisna'* Home Financing

In the case of a property under construction, some IFIs adopt the *Shari'ah* concept of *istisna'*. The word *istisna'* literally means a request, invitation or inducement to manufacture or to construct something. *Istisna'* can be defined as a purchase contract of an asset whereby a buyer will place an order to purchase the asset which will be delivered in the future. In other words, the buyer will require a seller or a contractor to deliver or construct the asset that will be completed in the future according to the specifications given in the sale and purchase contract. Both parties of the contract will decide on the sale and purchase prices as they wish and the settlement can be delayed or arranged based on the schedule of the work completed.

Exhibit 8.6 Definition of Parallel *Istisna'*

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines parallel *istisna'* as two forms of separate contracts. The first contract involves the financial institution as a manufacturer, builder or supplier and concludes a contract with the customer, and in the second contract, the financial institution acts as a purchaser and concludes another contract with a builder, supplier, or manufacturer in order to accomplish its contractual obligations towards the customer in the first contract. A profit is then realised through the differences in the price of the two contracts.

The common mechanism of parallel *istisna'* is described in Figure 8.11 below.



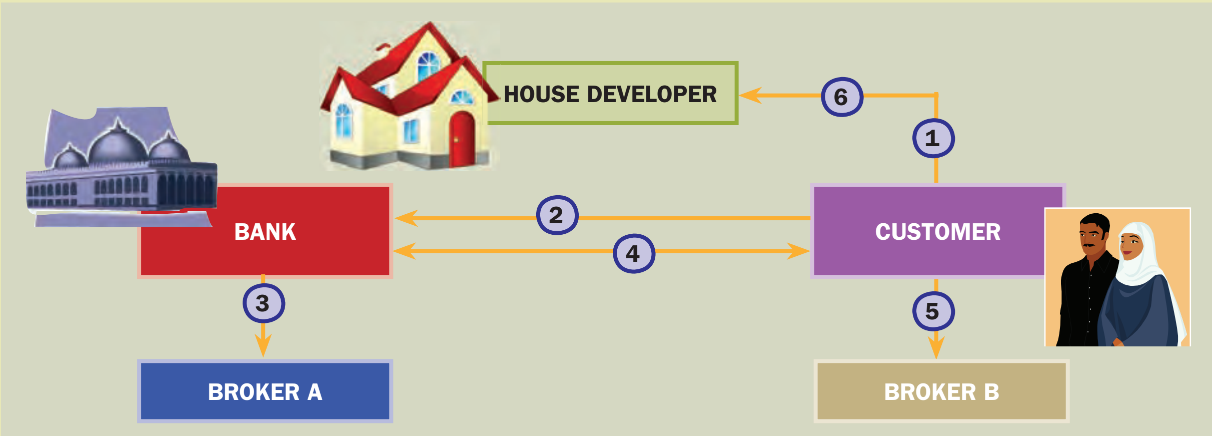
1 The customer appoints the bank (acting as contractor) to undertake a project. To undertake this task, the customer will sign an *istisna'* agreement with the bank (principal + profit margin, e.g., $150,000)
2 The bank shall enter into another parallel *istisna'* contract with a sub-contractor to construct the project (as specified in the first *istisna'* contract between bank and customer) and pays the cost of construction (principal, e.g., $100,000). The two *istisna'* contracts must remain independent. For example, any problems of non-performance of one contract shall not affect the other.
3 The developer will deliver the completed house to the bank.
4 The bank will deliver the house and the customer will pay the instalments.

Figure 8.11
The Parallel *Istisna'* Structure

Tawarruq Home Financing

Tawarruq home financing is another alternative home financing introduced by an Islamic bank in the Middle East. The common mechanism of *tawarruq*-based home financing is illustrated as follows:

Case Study 2 *Al-Rajhi's Tawarruq* Home Financing



1 The customer identifies a house from the developer or house owner and pays 10% down payment.
2 The customer approaches a bank to apply for financing and the bank will assess his credit worthiness.
3 The bank will buy a commodity from broker A, costing say $100,000.
4 The bank sells the commodity to the customer for $140,000. The customer will pay the amount of $140,000 to the bank by instalment throughout the financing period.
5 The customer sells the commodity to broker B and gets cash.
6 The customer pays the remaining 90% balance to the house developer.

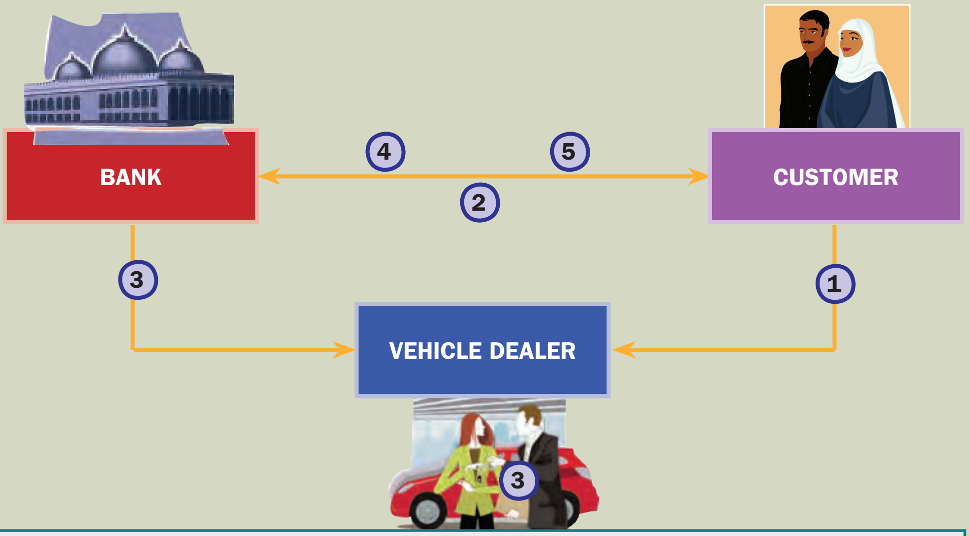
Besides being used as a home financing instrument, *tawarruq* is commonly used by Islamic banks as a mode of financing to facilitate cash transactions such as personal financing, working capital financing and business cash line. Nevertheless, as discussed in Chapter 6, the *tawarruq* concept remains controversial since many *Shari'ah* scholars deem it similar to *bay' al-'inah* which is used to circumvent the *riba* prohibition.

Automobile Financing

In retail banking business, automobile financing is another popular product offered by IFIs. Even though the discussion of the various structures of Islamic home financing above are also relevant and sometimes replicated in automobile financing, the most popular structure used by many IFIs is *al-ijarah thumma al-bay'* (AITAB) or simply known as the Islamic hire purchase. Some jurisdictions use different terms such as *ijarah wa iqtina* or *ijarah muntahiyah bittamlik* which generally implies that the transaction is underlined by a leasing contract (*ijarah*) and ends with the transfer of ownership to the customer upon completion of the financing tenure. The transfer of ownership can be affected either by executing a sale contract (*al-bay'*) with a nominal price or simply executing a gift (*hibah*) with no consideration. The structure shall be discussed in the following subsection.

Al-Ijarah Thumma Al-Bay' (AITAB) Financing

The *al-ijarah thumma al-bay'* (AITAB) vehicle financing is an Islamic vehicle financing facility, which is based on the *Shari'ah* concept of *ijarah* (leasing) and *bay'* (sale). *Al-ijarah thumma al-bay'* can be defined as a contract of lease which is subsequently followed by a sale contract. In order to be a viable tool in Islamic financing, *ijarah* (lease) has been developed to be adapted into a hire purchase contract. The basic *modus operandi* of AITAB financing is as follows:



1 The customer identifies a vehicle he wishes to lease from the vehicle dealer. In some jurisdictions, a deposit is paid by the customer to the dealer. In this case, the deposit shall be deemed as advancement made by the customer on behalf of the bank which shall be set-off against the rental payment later.
2 The customer approaches the bank for the car financing and undertakes to purchase the car once the bank has purchased it from the dealer.
3 The bank buys the vehicle from the dealer and takes ownership of the vehicle.
4 Upon having the ownership of the vehicle, the bank enters into AITAB (Islamic hire-purchase) agreement with the client in which the client shall lease the car from the bank against a specified rental for a certain fixed leasing duration. At the same time, the customer undertakes to buy from the bank at the end of leasing/financing tenure.
5 At the end of leasing period, a sale contract shall be executed with nominal price to effect the transfer of ownership of the vehicle to the customer.

Figure 8.12 *Al-Ijarah Thumma Al-Bay'* (AITAB) Financing

Ijarah Financing Computation

Most of the financial institutions follow a flat rate for the computation of profit. The customer has to either pay rental on a monthly basis or at an agreed period of time. The formula used for the computation is explained in Table 8.6.

Table 8.6 *Ijarah* Financing Computation

Element	Computation Formula	Description
1 Sale Price (SP)	CF + (CF × i × n)	i = Rate of return per year n = Total number of financing periods in years CF = Cost of financing (Purchase price)
2 Total Lease Rental (TLR)	CF + P	CF = Cost of financing (Purchase price) P = Profit
3 Monthly Rental	TLR ÷ n	TLR = Total lease rental n = Number of months

Source: Adapted from Khir et al. (2008).

Exhibit 8.7 *Ijarah* Financing Computation

Nadia approaches an IFI and applies for leasing of a car for a period of two years. The cost of financing the car is $100,000. Nadia is willing to pay the lease in monthly instalments. Let us say the profit rate that the financial institution is requesting is 6%. The computation of the selling price is explained below.

Step 1: Sale Price (SP)
Formula: CF + (CF × i × n)

- i = 6%
- n = 2 years
- CF = Purchase Price

$100,000 + ($100,000 × 6% × 2) = $112,000

Step 2: Profit (P)
Formula: SP – CF
$112,000 – $100,000 = $12,000

Step 3: Total Lease Rental (TLR)
Formula: CF + P = $100,000 + $12,000 = $112,000

Step 4: Monthly Rental Computation
Formula: TLR ÷ n

- n = 2 years × 12 months = 24 months

$112,000 ÷ 24 = $4666.67

Source: Adapted from Khir et al. (2008).

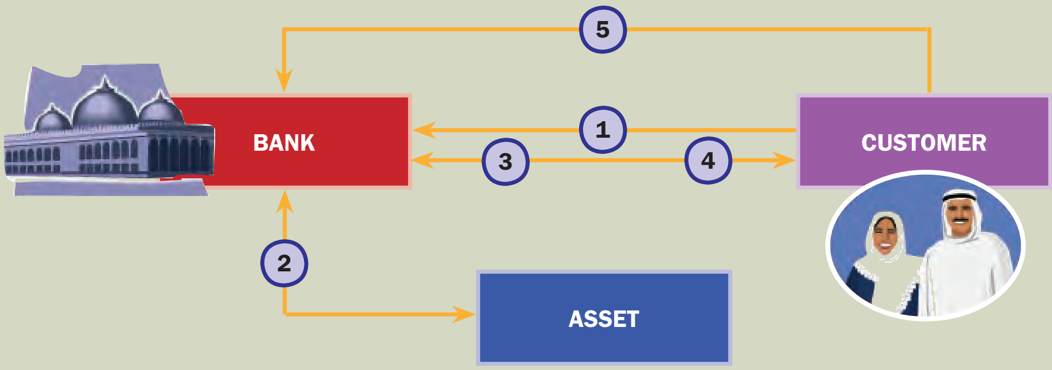
Personal Financing

Unlike other retail financing facilities such as home and automobile as discussed earlier, which involves an asset as the core subject matter, personal financing on the other hand, in most cases does not entail any asset acquisition. Rather, customers require cash or liquidity for various reasons and purposes such as education, medical, performing pilgrimage, marriage, payment of debt and others. To address the diverse clientele needs, expectations, many IFIs are required to introduce personal financing products which are based on controversial principles such as *bay' al-'inah* and *bay al-tawarruq*. The following sub sections shall briefly delineate these mechanisms. The corresponding *Shari'ah* issues related to these structures have already been addressed in Chapter 6.

'Inah Personal Financing

Many IFIs are required to introduce personal financing products which are based on controversial principles such as *bay' al-'inah* and *bay' al-tawarruq*.

As mentioned in Chapter 6, *bay' al-'inah* can be defined as a sale with immediate repurchase. It refers to contracts which involve the sale and buyback transaction of an asset by a seller. A seller will sell the asset to a buyer on a cash basis. The seller will immediately buy back the same asset on a deferred payment basis at a price that is higher than the cash price. *'Inah* can also be applied when a seller sells the asset to a buyer on a deferred basis. The seller will later buy back the same asset on a cash basis at a price which is lower than the deferred price. The basic *modus operandi* of *'inah* personal financing is as follows:



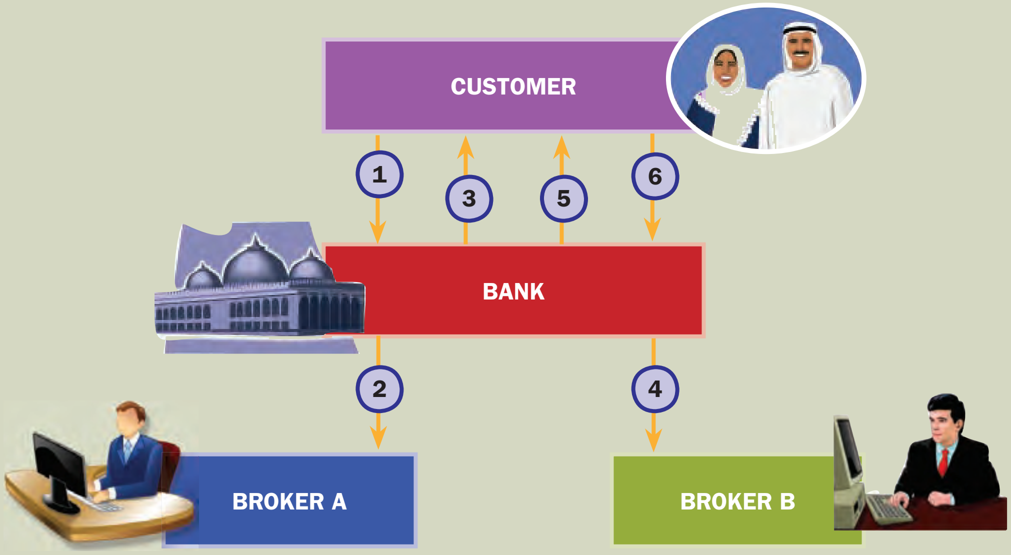
1 The customer approaches the bank for financing.
2 The bank identifies the asset that will be traded under *bay' al-'inah* contract.
3 The bank and customer sign a first sales and purchase contract where the bank sells the asset at a selling price (financing amount + profit margin) on deferred terms and the ownership is transferred to the customer.
4 The bank and the customer sign a second sales and purchase contract where the bank buys back the asset sold to the customer at a cost price and pays on a cash basis.
5 The customer begins to pay his instalments to the bank.

Figure 8.13
'Inah Personal Financing

Tawarruq Personal Financing

Tawarruq is a transaction where one party buys a commodity on credit at a mark up price and sells the same commodity at a lesser price to a third party to gain cash. *Tawarruq* or commodity *murabahah* can be defined as an arrangement that involves the purchase of an asset based on *musawamah* or *murabahah* and the subsequent sale of the same asset to a third party in order to gain cash money.

The basic *modus operandi* of *tawarruq* personal financing is shown in Figure 8.14 below.



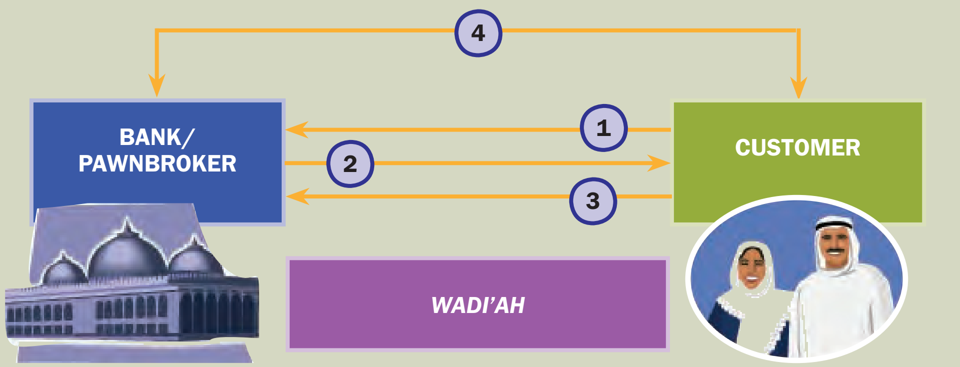
1 The customer and the bank enter into an arrangement where the customer promises to buy a specified commodity or asset from the bank. The customer also appoints the bank as his agent to sell the said commodity.
2 The bank buys a specified commodity from broker A on a spot basis.
3 The bank sells the same commodity to the customer on a deferred basis at cost plus profit.
4 As an agent, the bank sells the same commodity to broker B on a spot basis.
5 The bank pays the customer the sale proceeds in a lump sum.
6 The customer pays the bank the purchase price (cost plus profit) of the commodity on a deferred instalment basis.

Figure 8.14 *Tawarruq* Personal Financing

This transaction results in the customer receiving cash to be used for his or her business or personal requirements.

Rahn Personal Financing

Apart from the controversial contracts such as *'inah* and *tawarruq*, some IFIs have introduced *rahn*-based personal financing. *Rahn* is literally defined as a pledge or collateral. It refers to an arrangement whereby a valuable asset is given as security for a debt. Under *rahn* personal financing, a valuable item is pledged as security by the customer against an interest-free loan (*qard*) to be granted by the bank. The bank shall earn income through a fee (*ujrah*) for safe-keeping services (*wadi'ah*) provided on the valuable item pledged by the customer. If the customer, who is the debtor to the bank, is not able to repay the loan amount, the pawned asset will be sold to settle the outstanding debt and any surplus will be returned to the asset owner who is essentially the customer. Here is the basic *modus operandi* of *rahn* financing.



1 The customer approaches the bank with a valuable item as collateral (e.g., jewellery worth $10,000) for financing.
2 The bank accepts the pledged asset and grants an interest-free loan to the customer (e.g., $8,000).
3 The customer pays a custodian fee for the service rendered in safekeeping the asset.
4 If the debtor is not able to repay the debt, the pawned asset will be sold to settle the outstanding debt and any surplus will be returned back to the customer.

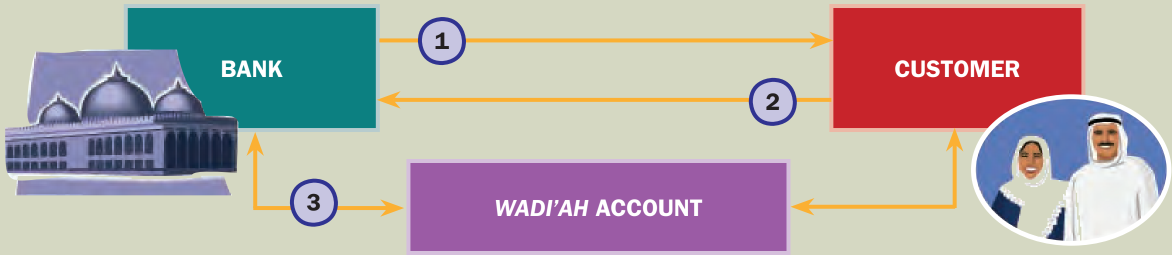
Figure 8.15 *Rahn* Personal Financing

Islamic Credit Cards

Another important and popular segment of Islamic retail financing is the provision of Islamic alternative structures to the credit card facility. The most common structures of Islamic credit cards are *'inah*-based, *tawarruq*-based and *ujrah*-based credit cards.

Islamic Credit Card based on *'Inah*

The basic *modus operandi* of Islamic credit cards based on *'inah* is as follows:

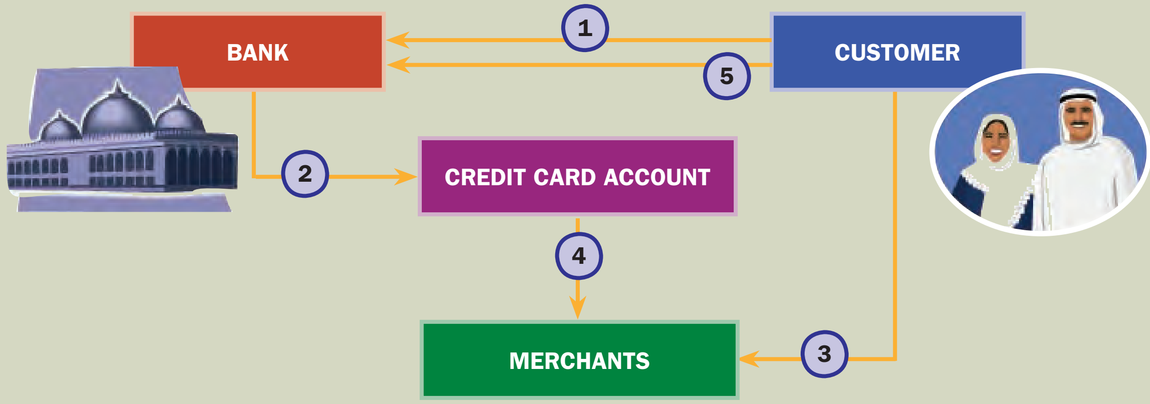


1. The bank sells an asset to the customer on deferred payment to be paid within a certain period of time (which is the credit card's expiry date).
2. The customer subsequently sells the asset back to the bank for a lower amount (equivalent to credit limit) in cash.
3. This amount will be credited into a marginal *wadi'ah* account (also known as the customer's special account) at the bank for the customer's use. Whenever the customer uses the credit card, the amount shall be paid by the bank by deducting it from this account. Once the customer has made a repayment, the amount will then be topped-up.

Figure 8.16 Islamic Credit Card Based on *'Inah*

Islamic Credit Card based on *Ujrah*

The basic *modus operandi* of Islamic credit cards based on *ujrah* is as follows:

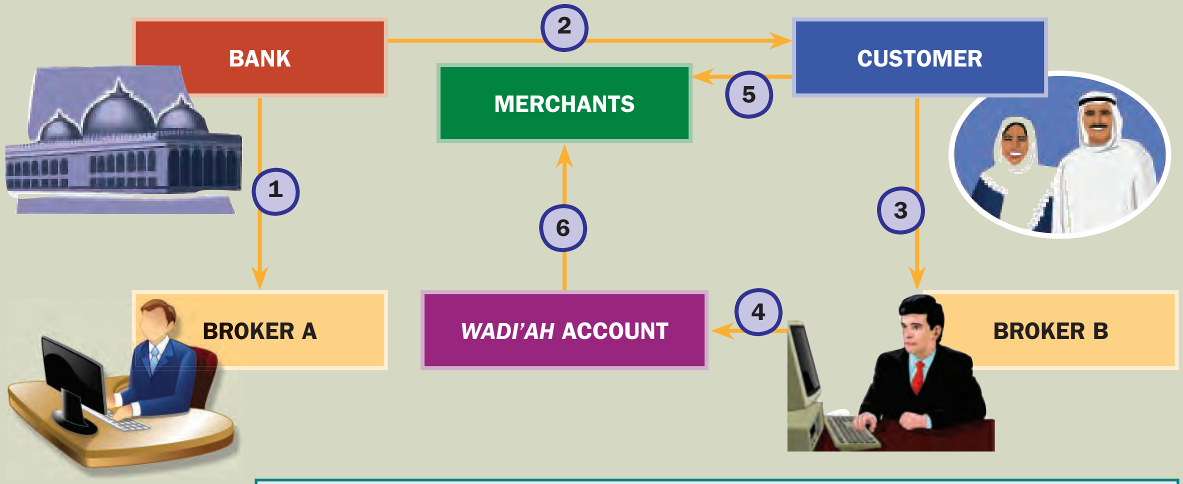


1. The customer applies for a credit card from a bank.
2. The bank provides a credit card account based on the customer's credit worthiness.
3. The customer pays the merchants for the goods from a credit card account.
4. The bank provides *qard* to the customer for the purchased goods.
5. The customer pays the purchase amount and the fee to the bank. The customer will be charged a fixed fee structure or other structures such as monthly service fee which is based on the actual cost of managing the transaction and an annual service fee based on the benefit rendered by the bank. The bank earns profit from the service fee and also commission from the merchants, if any.

Figure 8.17 Islamic Credit Card based on *Ujrah*

Islamic Credit Card based on *Tawarruq*

The basic *modus operandi* of Islamic credit cards based on *tawarruq* is as follows:



1 The bank purchases the commodity from Broker A.
2 The bank sells the commodity to the customer for deferred payment for a price equivalent to the credit limit plus profit.
3 The customer sells the commodity to broker B.
4 Broker B deposits the cash into the customer's *wadi'ah* account.
5 The customer buys the goods from the merchants using the *wadi'ah* account.
6 The purchase price is transferred to the merchants.

Figure 8.18
Islamic Credit Card based on *Tawarruq*

Corporate Financing

Corporate financing caters to the specific needs of the business community which may differ from retail consumers. Like its conventional counterpart, Islamic banking also offers a wide range of corporate or business products ranging from term financing to working capital financing and trade financing.

Exhibit 8.8 Definition of *Murabahah* to the Purchase Orderer

According to AAOIFI, *murabahah* to the purchase orderer involves the selling of an item by the financial institution to a customer (purchase orderer) for a pre-agreed selling price amount, inclusive of the pre-agreed profit mark up over the cost price. This involves the financial institution granting the customer a *murabahah* credit facility. The point of departure between a *murabahah* to the purchase orderer and a normal *murabahah* is that the former is involved with the customer's promise to purchase the item from the financial institution.

Even though deferred payment is not one of the essential conditions of *murabahah* to the purchase orderer, it still plays a role in the transaction. For a *murabahah* to the purchase orderer that involves no deferred payment, the profit mark up for the financial institution will be through a spot sale and not the extra charge it receives from the deferred payment.

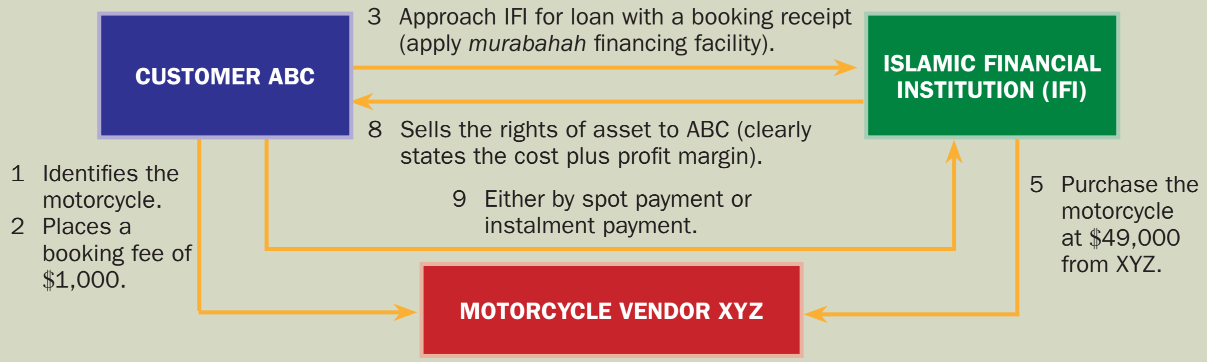
Sale-based

This involves the purchasing of an asset (e.g., machinery) by the IFI and selling it to the customer at a profit. Most of the structures are similar to the asset or property acquisition in retail business as discussed in the preceding sections. The most common structure is *murabahah lil amir bi shira* (*murabahah* to the purchase orderer).

Murabahah to the Purchase Orderer – *Modus Operandi*

Murabahah to the purchase orderer is a straightforward type of sale and it can be applied as a method of financing in an Islamic financial institution by adopting the following steps.

Let us consider this scenario: Customer ABC wants to purchase a motorcycle. He looks around for a viable motorcycle vendor. Customer ABC finds motorcycle vendor XYZ.



1 ABC identifies the motorcycle that he wants to purchase.
2 The price of the motorcycle is estimated to be at $50,000. ABC places a booking fee of $1,000 with vendor XYZ.
3 ABC approaches an Islamic financial institution for a loan. ABC presents the IFI with the booking receipt and applies for *murabahah* financing facility.
4 Once it has been approved, ABC will perform undertaking to purchase the motorcycle from the IFI.
5 The IFI will purchase the motorcycle from vendor XYZ by paying the sale price less the booking fee.
(a) Sale Price = Price of Motorcycle – Booking Fee
= $50,000 – $1,000 = $49,000
6 The IFI will execute an asset purchase agreement with vendor XYZ for the amount of $49,000.
7 The IFI pays vendor XYZ the purchase price of $49,000.
8 The IFI then sells the rights of asset to ABC at an agreed sale price (inclusive of the profit margin). Both the IFI and ABC will sign the Asset Sale Agreement.
9 If the time due for ABC to make payment to the IFI is within one year, ABC can either choose to make payment by spot or instalment as agreed by both parties. For example, if the profit margin is $5,000:

Spot Payment
(a) Purchase Price + Profit Margin = Selling Price
(b) $49,000 + $5,000 = $54,000

Instalment Payment
(a) 1 year = 12 months
(b) Selling Price (as stated above) = $54,000
(c) Monthly instalments = $54,000 ÷ 12 months = $4,500 per month

Figure 8.19 *Murabahah* to the Purchase Orderer

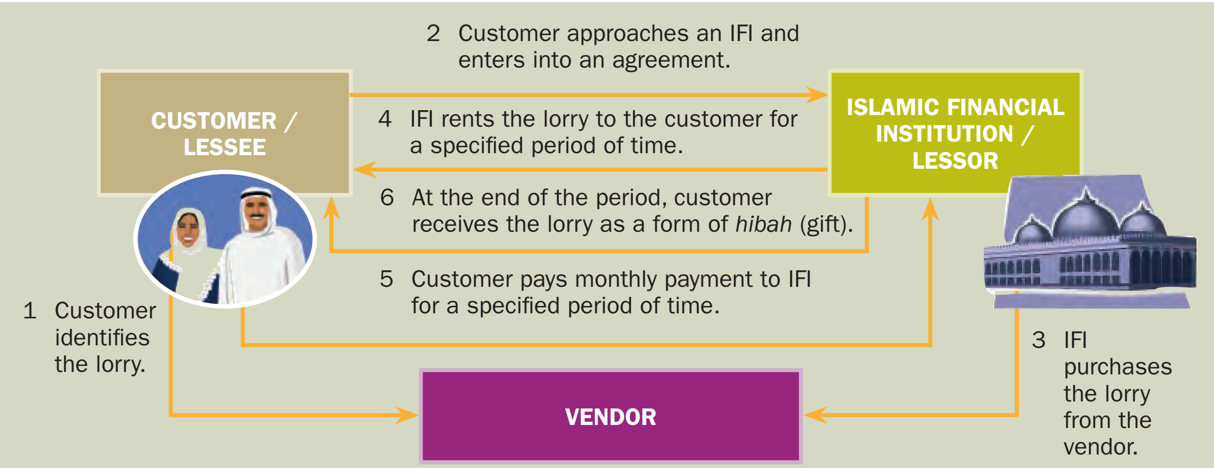
There are various forms of *ijarah* contracts that can be used in structuring Islamic alternative contracts to conventional term financing. The most common structure is *ijarah muntahiyah bittamlik* whereby the leasing involves the element of transfer of ownership at the end of a leasing tenure.

Lease-based

Similar to retail financing, IFIs also adopt the *Shari'ah* principle of leasing in structuring their corporate financing mainly for term financing which involves asset acquisition. As discussed earlier, there are various forms of *ijarah* contracts that can be used in structuring Islamic alternative contracts to conventional term financing. The most common structure is *ijarah muntahiyah bittamlik* whereby the leasing involves the element of transfer of ownership at the end of a leasing tenure. In this type of lease, the lessee will be given the asset as a form of *hibah* (gift) at the end of the leasing period.

Exhibit 8.9 Definition of *Ijarah Muntahiyah Bittamlik*

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) *Shari'ah* Standard further clarifies that in the case of transferring the ownership as a form of *hibah* (gift), it is necessary for a new contract to be drawn up. This is because the ownership of the asset will not be automatically transferred by virtue of the original price document that was drawn up previously.



1. The customer finds a vendor and identifies a lorry that he wishes to lease.
2. The customer approaches the IFI. They both enter into an agreement where the IFI promises to purchase the lorry and the customer promises to lease the lorry from the IFI thereafter.
3. The IFI purchases the lorry from the vendor in accordance to the order of the customer. The ownership is transferred to the IFI.
4. The IFI rents the lorry to the customer for his usage at a rate agreed upon for a specified period of time.
5. The customer pays a monthly lease payment to the IFI for a specified period of time. The customer also agrees to pay for road tax, insurance coverage and maintenance.
6. At the end of the period, the customer receives the lorry as a form of *hibah* (gift). The ownership of the lorry is transferred to the customer in a separate contract.

Figure 8.20 *Ijarah Muntahiyah Bittamlik*

Some IFIs use different names such as *ijarah wa iqtina*. In the context of Malaysia, it is predominantly known as *al-ijarah thumma al-bay'*. In commercial practice, it is abbreviated as AITAB. It shares a similar structure with *ijarah muntahiyah bittamlik*, except the contract of sale, which needs to be executed at the end of the leasing period to effect the transfer of ownership. This was discussed elaborately in the earlier part of this chapter. However, it is important to note that the option to purchase is not an obligation, and hence should not be a precondition in executing the leasing contract as this violates the *Shari'ah* principles. The *modus operandi* of *ijarah muntahiyah bittamlik* as term financing is explained as follows:

Ijarah Muntahiyah Bittamlik – Modus Operandi

There are three main parties involved in this type of Islamic leasing: customer (lessee), IFI (lessor) and vendor. For the sake of illustration, the example used will be motor vehicle financing as shown in Figure 8.20.

Working Capital Financing

Working capital deals with the short-term needs of businesses which are reflected in their balance sheet in both the current assets and the current liabilities. Figure 8.21 depicts the various needs of businesses in managing their balance sheet requirements.

Proper management of working capital is vital as it ensures the company's continuous operations and the availability of sufficient cash flow. This is necessary to pay any upcoming short-term debts and operational expenses. Accordingly, Islamic banking plays a major role by providing various facilities to address the need of businesses to remain competitive, viable and sustainable in the market. The two main products offered by IFIs are Islamic overdraft and revolving credit. They are explained on the next page.

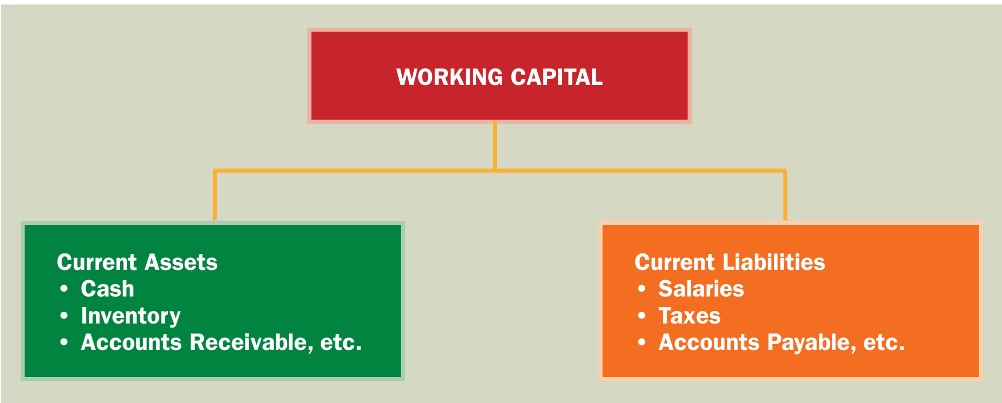


Figure 8.21 Working Capital Required by Businesses

Cash Line Islamic Overdraft/Revolving Credit

Most of the cash line Islamic overdraft facilities are structured based on either *'inah* or *tawarruq*. The financing tenure for such facilities is usually up to a maximum number of five years only. Under the concept of *bay' al-'inah*, the financial institution will first sell to the customer an identified asset belonging to the bank at a deferred price with a profit margin higher than the financing value as per requested by the customer. Subsequently, the customer will sell back the asset to the bank at a price equivalent to the value of the financing amount. The amount which is supposed to be disbursed to the customer as per the second sale execution will then be deposited into a suspense account. From this suspense account, the customer is allowed to overdraw his or her current account. Further illustration on the computation of the sale price and the profit margin can be found below.

Exhibit 8.10 Formula for Cash Line Islamic Overdraft

Sale Price = Amount Financed + Profit Margin

Profit Margin = Fixed Rate / Variable Rate (Flexi) × Financing Period

Exhibit 8.11 Revolving Credit – CIMB Islamic

Definition:
The facility of revolving credit allows the customer to utilise the funds up to a pre-approved credit limit. This is to ensure that the customer's business has that little bit extra during those short-term periods.

Eligibility:
All business entities are eligible to apply — cooperatives, sole proprietorships, partnerships, private/public limited companies.

Concept:
The various concepts used are: *bay' bithaman ajil* (BBA), *bay' al-'inah*, and *murabahah*.

Facility Limit:
This is based on the requirements of the customer and subject to credit evaluation.

Profit Rate:
Formula used – (1) COF + Spread % p.a (2) BFR + Spread % p.a
The profit charged varies as it depends on the customer's credit evaluation.

Availability:
It can be either revolving or for a specific period, subject to periodical review.

Tenure:
The financing period could be either one, three, six or nine months at the option of the customers.

Uniqueness:
There will be no commitment fee on unused portion of the financing amount.

Source: CIMB Islamic website.

The same *bay' al-'inah* principle is adapted in structuring the Islamic version of revolving credit. The principal payment of revolving credit normally commences upon maturity. However, partial instalment or principal payment on a monthly basis can also be requested. The profit earned is through the fixed mark up over the principal amount.

Islamic Trade Financing Instruments and Practices

Trade finance is one of the most important services offered by Islamic banking, especially to address the needs of the business involving cross-border transactions. Trade finance can be categorised into domestic and international. Domestic trade involves the buying and selling of commodities in the country which includes retail trade and wholesale trade. International trade is the external trade of the country, and it encompasses the exchange of commodities between the country and other countries including import and export trade.

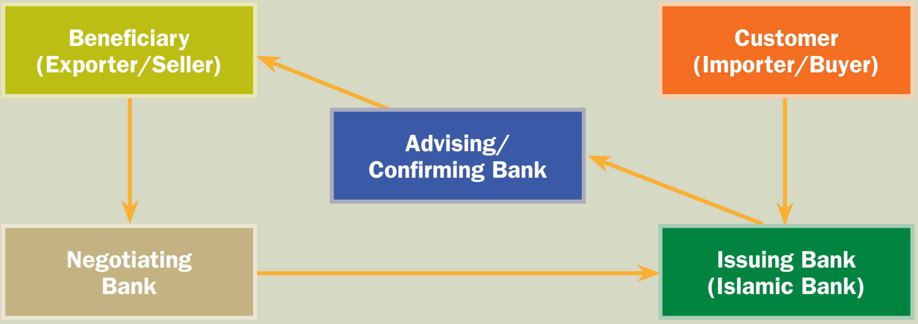
Islamic trade financing facilities include facilities such as Islamic letters of credit, Islamic trust receipt, Islamic accepted bills, Islamic export credit refinancing, Islamic bank guarantee, and Islamic shipping guarantee.

Islamic Letter of Credit

Islamic letter of credit (ILC) is a written undertaking given by the Islamic bank, to the seller (the beneficiary) at the request and on the instructions of the buyer (the applicant), to pay at sight or at a determinable future date, a stated sum of money within a prescribed time limit and against stipulated documents which must comply with terms and conditions. An Islamic bank may offer ILC under several *Shari'ah* contracts, namely *wakalah* (agency), *murabahah* (cost-plus profit) and *musharakah* (partnership).

> Islamic Letter of Credit (ILC) is a written undertaking given by the Islamic bank, to the seller (the beneficiary) at the request and on the instructions of the buyer (the applicant), to pay at sight, or at a determinable future date, a stated sum of money within a prescribed time limit and against stipulated documents which must comply with terms and conditions.

In the case of *wakalah*, the customer must pay in advance the full value of the item in question prior to the issuance of the ILC. In addition, the Islamic bank will receive a commission or service fee upon the service rendered to the customer. Conversely, under the principle of *murabahah*, the Islamic bank would import or purchase goods and subsequently, resell them to customers at a mark up price agreeable to both parties. The title to the goods will be transferred to the customer only on the arrival of the import documents. If the customer does not have deferred payment facilities, he or she must settle in full to the Islamic bank, the resale price and other charges prior to receiving the import documents.



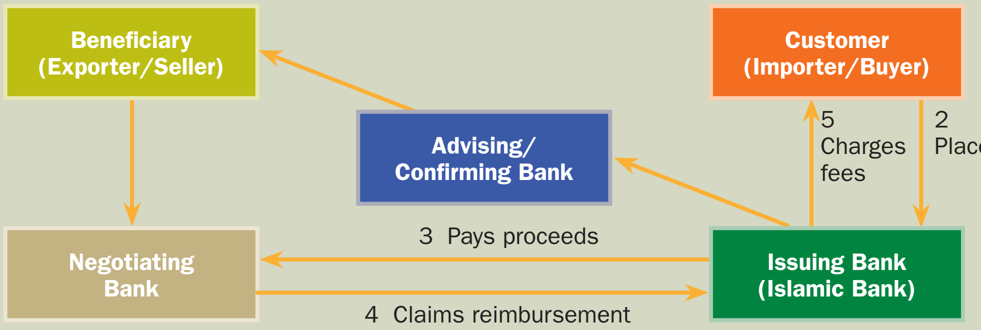
**The Islamic letter of credit is also convertible to a murabahah Islamic trust receipt. It can be liquidated through conversion to an Islamic accepted bill.*

Figure 8.22 *Modus Operandi* for Islamic Letter of Credit*

In certain jurisdictions, the principle of *musharakah* is used in addition to *wakalah* and *murabahah*. In this case, the Islamic bank requires the customer to deposit a certain percentage of money prior to the importation of goods. The Islamic bank will then issue an ILC and make the payment using both the customer's and its own funds. The customer is responsible for selling the goods and returning the bank's portion of capital together with a predetermined portion of the profit. Islamic banks also utilise the services of banks in other countries as their agents or correspondent banks in transactions involving ILC. These agents or correspondent banks are normally institutions where Islamic banks have some kind of normal relationship such as their associate companies or overseas branches of banks based in countries where the Islamic bank is located.

Wakalah Islamic Letter of Credit

Under the principle of *wakalah*, the customer asks the Islamic bank to issue the ILC for a fee. The Islamic bank acts as the agent of the customer. The customer pays the full purchase price to the supplier. Thus, the Islamic bank is an agent and not a purchaser. There are several steps involved in the *modus operandi* of a *wakalah* ILC.

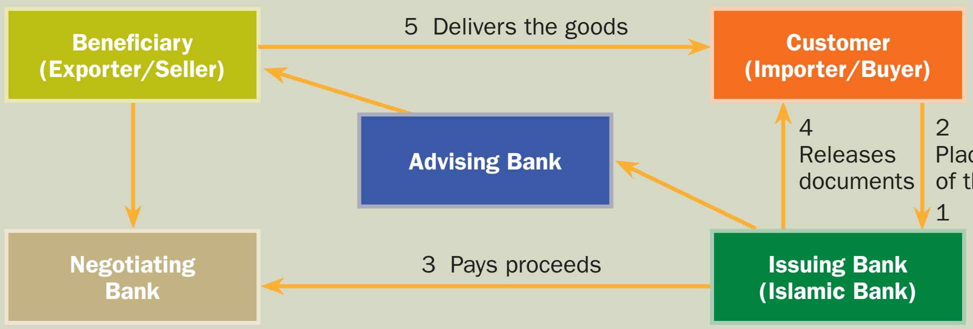


1 The customer informs the Islamic bank of his ILC requirements and requests the Islamic bank to provide the facility.
2 The Islamic bank may require the customer to place a deposit to the full amount of the price of the goods to be purchased or imported, which the Islamic bank accepts under the principle of *wadi'ah yad dhamanah* (guaranteed safe-custody).
3 The Islamic bank establishes the ILC and pays the proceeds to the negotiating bank, utilising the customer's deposit, and subsequently releases the documents to the customer.
4 The negotiating bank claims reimbursement from the Islamic bank as per the reimbursement instruction.
5 The Islamic bank charges the customer fees and commission for its services under the principle of *al-ujr* (fee) based on the *wakalah* principle.

Figure 8.23 *Modus Operandi* for *Wakalah* ILC

Musharakah Islamic Letter of Credit

Under the principle of *musharakah* (partnership), the Islamic bank issues the ILC and both the financier and customer contribute to the purchase price under ILC, and later share the proceeds of sale of the asset based on the pre-agreed profit-sharing ratio. Losses are borne proportionate to the capital contribution. The procedure involved is as follows:

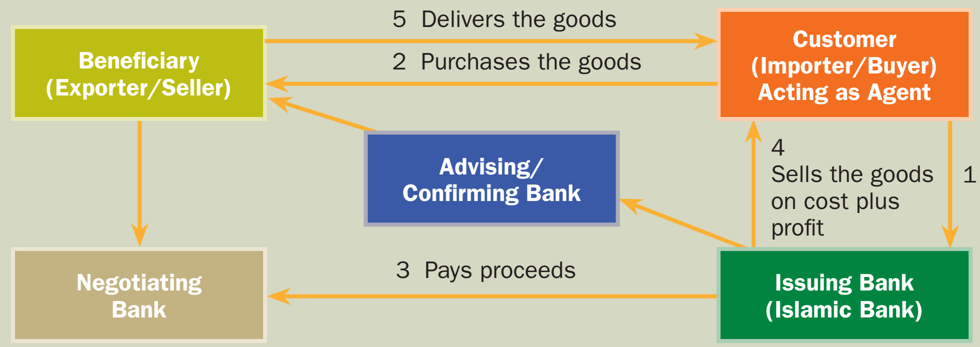


1 The customer informs the Islamic bank of his ILC requirements and negotiates the terms of *musharakah* financing for his requirements.
2 The customer places with the Islamic bank a deposit for his share of the cost of goods to be purchased or imported as per the *musharakah* agreement which the Islamic bank accepts under the principle of *wadi'ah yad dhamanah*.
3 The Islamic bank establishes the ILC and pays the proceeds to the negotiating bank, utilising the customer's deposit as well as its own shares of financing.
4 The Islamic bank releases the documents to the customer.
5 The customer takes possession of the goods and disposes of them in the manner agreed.
6 The Islamic bank and the customer share the profit from the venture as provided for in the agreement.

Figure 8.24 *Modus Operandi* for *Musharakah* ILC

Murabahah Islamic Letter of Credit

Under the principle of *murabahah* (cost plus profit), where the customer is unable to pay the purchase price, the financier issues the ILC and pays the purchase price to the exporter. The financier immediately sells to the customer at a mark up for a deferred payment. There are several stages involved in the *modus operandi* of *Murabahah* ILC.



1 The customer informs the Islamic bank of his ILC requirements and requests the Islamic bank to purchase or import the goods indicating that he would be willing to purchase the goods from the Islamic bank upon negotiation of the ILC on the principle of *murabahah*.
2 The Islamic bank appoints the customer as its agent to purchase the required goods on its behalf.
3 The Islamic bank establishes the ILC and pays the proceeds to the negotiating bank, utilising its own funds.
4 The Islamic bank sells the goods to the customer at a sale price comprising its cost and profit margin under the principle of *murabahah* for settlement on a deferred term.
5 The customer takes possession of the goods and disposes of them in the manner agreed.

Figure 8.25 *Modus Operandi* for *Murabahah* ILC

Table 8.7 Comparison between ILC Advisory and ILC Confirmation

	ILC Advisory	ILC Confirmation
Feature	• A trade service provided by a bank to check the authenticity of LC drawn in favour of its customer (exporter or seller) and to advise them whether to accept or reject the LC.	• A trade service provided by a bank to promise payment to its customer (exporter or seller) in the event there is non-payment by the importer or buyer, or importer's bank or buyer's bank.
Shari'ah Principle	• *Ujr* (Service fee) A payment for a service. It is also applied for salary, wage, pay, fee, charge, enrolment, honorarium, remuneration, reward, etc.	• *Kafalah* (Guarantee) A contract of guarantee where a person underwrites any claims or obligations when a supplier or contractor fails to fulfil his obligation.

Islamic Trust Receipt

Islamic trust receipt (ITR) is a financing facility to finance domestic or international trade documents drawn against ILC or *wakalah* inward bills for collection. Islamic banks issue the ITR facility to the customer based on the *murabahah* principle for financing the purchase of goods. It is a document of trust signed by the customer (importer); the strength on which the Islamic bank allows the customer (importer) to obtain release of the merchandise but makes a lump-sum payment at a later date.

The following are the stages involved in the *modus operandi* of ITR:

1 The customers must first have an approved ITR line. The request for financing must include submission of relevant documentary evidence of the underlying transactions and compliance to the terms of the facility.
2 The customer informs the bank of his letter of credit requirement and requests the bank to purchase the goods.
3 The Islamic bank retains the legal title to the goods but relinquishes physical possession to the buyer or importer.
4 The Islamic bank appoints the customer as its agent to purchase the goods that the customer requires on behalf of the Islamic bank.
5 Upon delivery of the goods, the Islamic bank pays the exporter/supplier for the cost of the goods based on the invoice value.
6 The Islamic bank will resell the goods from the customer at invoice value and resell them to the customer on deferred payment terms at a price inclusive of the Islamic bank's profit margin. If the Islamic bank appoints the customer as its agent, then the Islamic bank cannot purchase from the customer.
7 The deferred payment terms of sale of goods granted to the customer constitutes a creation of debt. This is securitised in the form of a bill of exchange drawn by the Islamic bank and accepted by the customer and payable on maturity.
8 The Islamic bank holds the customer's ITR executed by him. This is to signify his holding of the goods in trust pending the sale of goods.
9 The customer undertakes to settle the Selling Price on the expiry date.

Calculation of ITR

Formula

$$SP = FV\left[\frac{1 + (r \times t)}{36{,}500}\right]$$

Note:

SP = Selling price
FV = Invoice value
r = Mark up rate or annual rate of return
t = Tenure

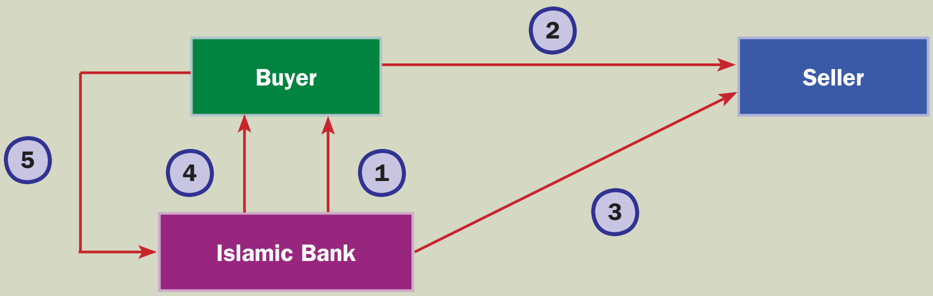
Calculation

Amount paid to negotiating bank: US$100,000 @ 3.8 = RM380,000
Rate: 10% p.a.
Tenure: 90 days

$SP = PP\ [1+ (r \times t/36{,}500)]$

$SP =$ RM380,000 [1+(10 × 90/36,500)]
= RM389,369.86

Figure 8.26 Calculation of Islamic Trust Receipt



1 The Islamic bank appoints the customer (buyer/importer) as the purchasing agent.
2 The customer purchases the required goods from the seller at the invoice price.
3 The Islamic bank pays the invoice price to the seller.
4 The Islamic bank then resells the goods to the customer at a new selling price, i.e., invoice price plus the bank's profit margin.
5 The customer is allowed a deferred payment term of up to 365 days. Upon maturity of the *murabahah* financing, the customer pays the Islamic bank the cost plus profit margin in lump sum.

Figure 8.27 *Modus Operandi* for Islamic Trust Receipt

Islamic Accepted Bills

An Islamic accepted bill (IAB) is a result of the securitisation of a *murabahah* Islamic trust receipt. The IAB is drawn to finance the trading of tangible *halal* goods and formulated based on the Islamic principles of *murabahah* (deferred lump-sum sale or cost-plus) and *bay' al-dayn* (debt-trading). The result of securitising the *murabahah* Islamic trust receipt creates a debt owed to the Islamic bank. For instance, when the customer approaches the Islamic bank to apply for financing for his working capital requirements, the Islamic bank first purchases or appoints the customer as its agent to purchase the required goods on its behalf and settles the purchase price from its own funds. The Islamic bank subsequently sells the goods to the customer at an agreed price, comprising its purchase price and profit margin, and allows the customer to settle this sale price on a deferred term of 30 days, 60 days, 90 days or any other period as the case may be. On the due date, the customer pays the Islamic bank the agreed sale price. In this instance, the Islamic bank draws a bill of exchange to be accepted by the customer. This bill of exchange will be drawn for the full amount of the bank's selling price and payable by the customer to the Islamic bank on maturity date of the financing. The Islamic bank in turn may sell the IAB in the secondary market (Islamic interbank money market) at a discount under the *bay' al-dayn* concept.

There are two types of financing under the IAB facility, namely IAB-IMPORT for imports and local purchases, and IAB-EXPORT for export and local sales.

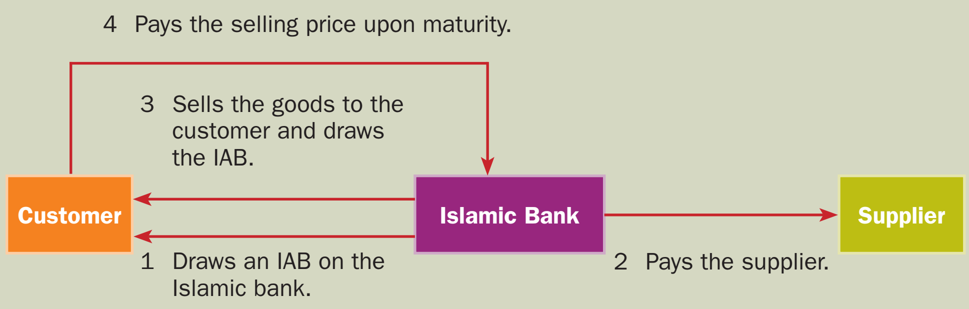
There are two types of financing under the IAB facility, namely IAB-Import for imports and local purchases, and IAB-Export for exports and local sales.

IAB-Import – Imports and local purchases

This financing would fall under the category of *murabahah* working capital financing mechanism. Under this financing mechanism, the Islamic bank appoints the customer as the purchasing agent for the Islamic bank. The customer then purchases the required goods from the seller on behalf of the Islamic bank, which would then pay the seller and resell the goods to the customer at a price, which takes into consideration the profit margin. The customer is allowed a deferred payment term of up to 200 days. Upon maturity of the *murabahah* financing, the customer pays the Islamic bank the cost of goods plus a profit margin.

The sale of goods by the Islamic bank to the customer on deferred payment terms constitutes the creation of debt. This is then securitised in the form of a bill of exchange drawn by the Islamic bank and accepted by the customer for the full amount of the Islamic bank's selling price payable upon maturity. If the Islamic bank decides to sell the IAB to a third party, then the concept of *bay' al-dayn* will be applicable whereby the Islamic bank will sell the IAB at the agreed price.

The following are the stages involved in the operation of imports and local purchases:



1 The customer draws an IAB on the Islamic bank. The Islamic bank appoints the customer as its agent to purchase the required goods from the supplier on behalf of the Islamic bank.
2 The Islamic bank pays the supplier the purchase price.
3 The Islamic bank resells the asset(s) to the customer at an agreed selling price comprising the purchase price and profit margin. The profit margin is computed based on the profit rate comprising the IAB rate for the relevant financing period tenure or such other applicable rates ("benchmark") plus drawing commission. The sale of the goods by the Islamic bank to the customer on deferred terms constitutes the creation of debt. The debt is securitised in the form of bills of exchange drawn by the Islamic bank and accepted by the customer for the full amount of the Islamic bank's selling price payable upon maturity of the IAB.
4 Customer pays the selling price upon maturity.

Figure 8.28
Modus Operandi for Imports and Local Purchases

IAB-Export – Exports and local sales

The bills that have been created will then be traded under the concept of *bay' al-dayn*. An exporter who has been approved for the IAB facility will prepare the export documentation as required under the sale contract or letter of credit. The export documents shall be sent to the importer's Islamic bank. The exporter shall draw upon the commercial Islamic bank a new bill of exchange as a substitution bill and this will be known as the IAB. The Islamic bank shall purchase the IAB at a mutually agreed price using the concept of *bay' al-dayn* and the proceeds will be credited to the exporter's account. Domestic sales will be treated in a similar manner.

In Malaysia, if the export items fall within the list of goods and meet the criteria or guidelines of Bank Negara Malaysia (BNM) under its export-promoting "Export Credit Refinancing" scheme, the Islamic bank will request the customer to draw a similar bill of exchange in lieu of IAB-Export. This bill of exchange will subsequently be sold to BNM at a special rate of refinancing which may be varied from time to time.

The following are the calculation and the stages involved in the operation of exports and local sales:

Calculation for Islamic Accepted Bill

Discounting Formula

$$MP = FV\left[1 - \frac{r \times t}{36{,}500}\right]$$

Where,

MP = Market price or rediscounted proceeds.
FV = Face value or maturity value.
r = Rate of interest charged.
t = Number of days remaining to maturity

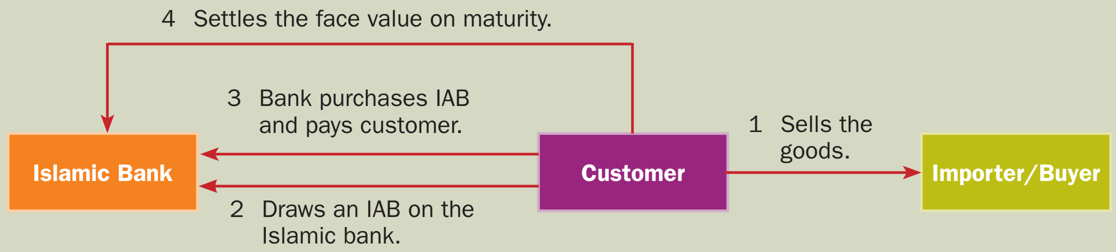
Example:

Principal amount : US$66,394.94 @ RM3.8
Rate of discount : 3.5% p.a.
Acceptance commission : 1% p.a.
Period : 90 days

Eligible amount of financing = RM252,000.00

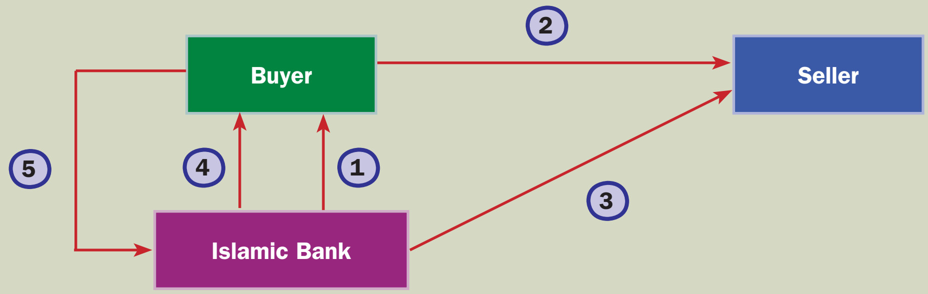
$$MP = \text{RM}252{,}000.00\left[1 - \frac{3.5 \times 90}{36{,}500}\right]$$
$$= \text{RM}249{,}825.21$$

Figure 8.29 Calculation for Islamic Accepted Bill



1 The customer sells the goods on credit and prepares the sale documents as required under the sales contract or letter of credit.
2 The customer draws upon the Islamic bank a new bill of exchange as a substitution bill that represents the IAB.
3 The Islamic bank will purchase the IAB at a mutually agreed price using the concept of *bay' al-dayn* and credit the proceeds to the customer's account.
4 Upon maturity, the customer pays the Islamic bank the face (maturity) value of the IAB.

Figure 8.30 *Modus Operandi* for Exports and Local Sales



1 The Islamic bank appoints the customer (buyer/importer) as the purchasing agent.
2 The customer will purchase the required goods from the seller at the invoice price.
3 The Islamic bank would pay the invoice price to the seller.
4 The Islamic bank would then resell the goods to the customer at a new selling price, i.e., invoice price plus the bank's profit margin.
5 The customer is allowed a deferred payment term of up to 365 days. Upon maturity of the *murabahah* financing, the customer pays the Islamic bank the cost plus profit margin in lump sum.

Figure 8.31 *Modus Operandi* for Islamic Accepted Bills

Islamic Bank Guarantee

A guarantee is a promise by a third party to carry out the obligations owed by one person to another in the event of default. Under the *Shari'ah*, and in accordance with the principle of *kafalah*, an Islamic bank may issue, at the request of the customer, an Islamic bank guarantee (IBG) to a beneficiary named by the customer.

An IBG is an indemnity letter in which the Islamic bank commits itself to pay a certain sum if a third party fails to perform or if any other form of default occurs. It is given by the Islamic bank (guarantor) in writing at the request of the customer (principal) to pay a stated sum of money to the beneficiary upon presentation of written demand. Under the IBG, the financier provides an undertaking in favour of the customer against the third party. The customer pays the fees and the financier pays the third party if the customer fails to honour his obligation and will claim from the customer to reimburse payment made (at par). One of its uses is when an Islamic bank wants a carrier to release a shipment which it has financed but the original bill of lading is not yet available for surrender to the carrier.

The *kafalah* principle used in IBG is a surety given by the first party who agrees to discharge the liability of a third party in case the second party defaults in fulfilling his obligation.

The *kafalah* principle used in IBG is a surety given by the first party who agrees to discharge the liability of a third party in case the second party defaults in fulfilling his obligation. The Islamic bank may require the customer to place a certain amount of deposit for this facility which the Islamic bank accepts under the principle of *wadi'ah* (safe-custody). Thus, the Islamic bank charges the customer a fee for the services it provides. IBG may fall into the following categories:

1 Tender guarantee.
2 Performance guarantee.
3 Guarantee of subcontracts.
4 Guarantee in lieu of security deposits or Special Guarantee.
5 Guarantee for exemption of custom duties.
6 Guarantee for maintaining ledger accounts, for example with governmental agencies such as port authorities or railway authorities.
7 Customs bonds.

The following stages are involved in the operation of an IBG:

1 The customers must first have an approved IBG line. Request for financing must include submission of relevant documentary evidence of the underlying transactions and compliance to the terms of the facility.
2 The customer requests the issue of IBG (type depends on purpose). The IBG may be provided in respect of the performance of a task or the settlement of a commitment.
3 The Islamic bank issues IBG if the *Shari'ah* principles and other requirements are met.
4 The Islamic bank must honour and effect immediate payment in case a claim is made by the beneficiary on first demand, provided the claim meets all the conditions of the guarantee.

Although almost all Islamic banks tend to charge a service fee when issuing letters of guarantee, some *Shari'ah* scholars believe that this practice is against the *Shari'ah*. They argue that this facility is merely an act of guarantee, and therefore no fee should be imposed by the Islamic bank when issuing such a letter. Some Islamic banks, however, do issue letters of guarantees without any service fee. For example, some Islamic banks issue letters of guarantee on behalf of their customers using a hybrid of two concepts, *wakalah bi al-istithmar* (investment agency) and *kafalah* (guarantee), as well as the profit-sharing concept. The Islamic bank is remunerated based on the transaction covered by the guarantee.

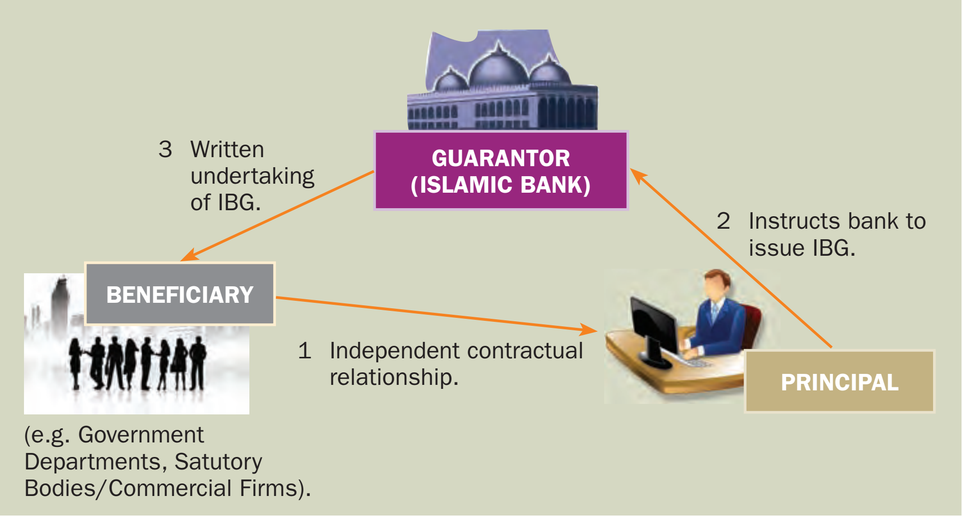


Figure 8.32 *Modus Operandi* for Islamic Bank Guarantee based on the *Kafalah* Principle

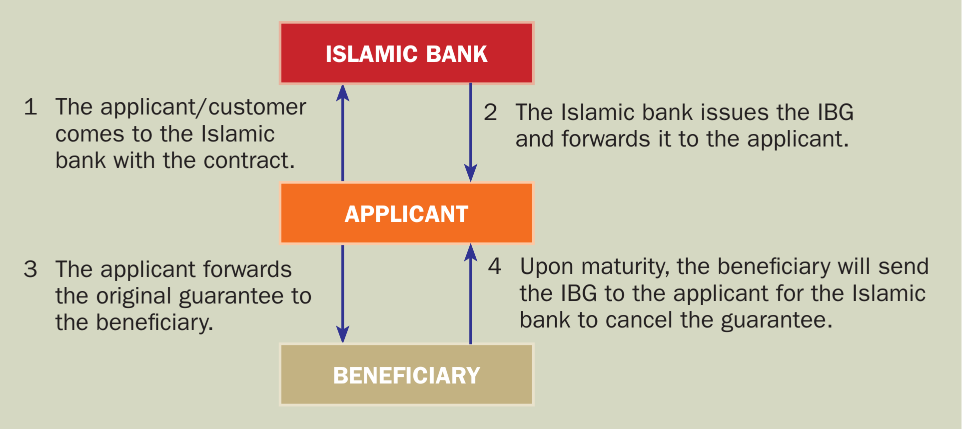
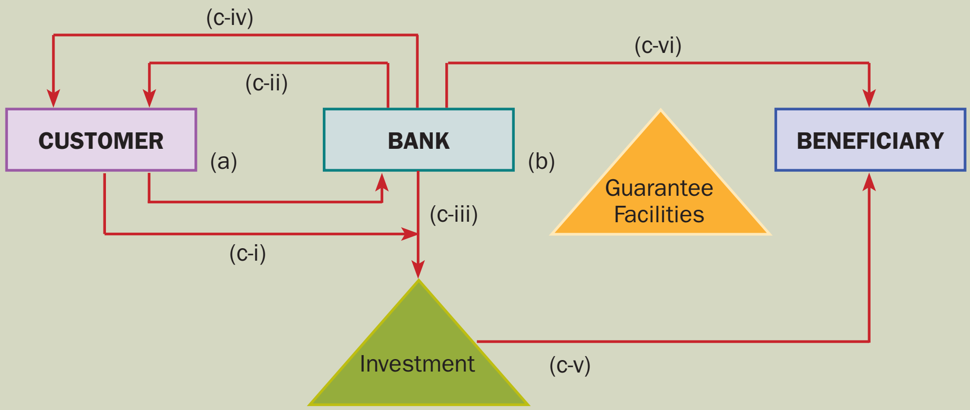


Figure 8.33 Flow of an Islamic Bank Guarantee

Islamic Bank Guarantee using a hybrid of *Wakalah Bi al-Istithmar* (Investment Agency) and *Kafalah* (Guarantee)

Some Islamic banks issue letters of guarantee on behalf of their customers using a hybrid of two concepts, *wakalah bi al-istithmar* (investment agency) and *kafalah* (guarantee) to provide the most *Shari'ah*-compliant and internationally accepted Islamic trade finance alternative to the current practice of charging profit on *kafalah*-based IBGs. The following are the stages involved in the operation of the hybrid of *wakalah bi al-istithmar* and *kafalah*-based IBG:

1 In essence, the Islamic bank will require the customer to place a deposit under *wakalah bi al-istithmar* whereby the Islamic bank will impose/charge an agency fee for managing the funds.
2 In the event of any claims made by the beneficiary, the Islamic bank may uplift the deposit and profits due on the investment to partly cover the amount payable to the Islamic bank.
3 If there are no claims made by the beneficiary, the profit is payable to the customer.
4 Upon claim, procedure and risks are the same as per existing guarantee facilities although the risk is reduced by cash deposited in the form of an investment account held on behalf of the customer by the bank.
5 The difference between the existing guarantee model and proposed structure is that in the present structure, the Islamic bank collects profit through *kafalah* fees upon issuance of the guarantee facility. *Shari'ah* does not permit any profits made on *kafalah*, or guarantee, thus in this structure, charges on the *kafalah* issuance is only on actual incurred costs. Profit is collected from investment fees (as investment agent) on the investment funds deposited with the Islamic bank.



Process flow of transaction:

(a) Customer approaches the Islamic bank to issue the letter of guarantee to a beneficiary, for instance, worth RM1 million.
(b) The Islamic bank issues the required guarantee facilities to a third party (beneficiary, for instance the government who awarded the contract to the customer) based on *kafalah* contract where only actual cost incurred (e.g., RM10 courier, RM5 fax services, RM10 administrative fee, RM10 stamping) by the Islamic bank will be imposed upon the customer.
(c-i) Under a contract of *wakalah bi al-istithmar*, the customer deposits an equivalent to a certain percentage of the guarantee facilities value (for instance 10% of guarantee facilities value = RM100,000) in the form of a deposit to the Islamic bank where the bank acts as an agent to manage the deposit in a selected investment instrument.
(c-ii) The Islamic bank imposes a certain *wakalah* fee (agency fee) on the customer based on the following formula: 10% of the Guarantee facilities value x 4% per annum, so in this case, the *wakalah* fee would be RM100,000 x 4% per annum = RM4,000.
(c-iii) The Islamic bank invests the deposit in certain *halal* investment products or instruments with a certain maturity period which is equivalent to the guarantee facilities i.e., 12 months.
(c-iv) Any profits realised from the investment will be returned to the customer upon maturity or earlier if there is a claim from the beneficiary to the guarantee facilities issued. For instance, if the investment is for a 12-month period, the beneficiary may claim from the bank as the guarantee facilities issuer prior to the completion of the 12-month investment period.
(c-v) In this regard, the Islamic bank will uplift the investment with consent from the customer and pay the investment amount of RM100,000 to partially fulfil the claim by the beneficiary under the guarantee facilities issuance of RM1 million.
(c-vi) The remaining RM900,000 will be paid by the bank itself to make the total payment of RM1 million to the beneficiary.
(d) The Islamic bank will later claim from the customer the RM900,000 paid to the beneficiary under guarantee facilities claim where the amount is treated as a loan given to the customer.
(e) The Islamic bank will impose compensation charges (*ta'widh*) based on prevailing market practice as approved by the National *Shari'ah* Advisory Council (NSAC) of Bank Negara Malaysia upon failure by the customer to pay the claim amount.

Figure 8.34 *Modus Operandi* for Islamic Bank Guarantee based on a Hybrid of *Wakalah Bi Al-Istithmar* and *Kafalah* Concepts in Malaysia

Islamic Shipping Guarantee

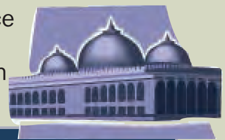
Islamic shipping guarantee (ISG) is primarily a letter of indemnity to the owners and/or agents or master of the vessel for delivery of goods without presentation of the document of title of goods or the original bill of lading. It is a contract where the Islamic bank agrees to discharge the liability of a third party in case of default by the third party.

The ISG is a letter of performance and indemnity issued by the Islamic bank on behalf of the buyer or importer. This letter of performance and indemnity, signed by the buyer or importer and counter-signed by the bank, is addressed to the owner or agent, charter party, or master of the vessel (ship) for the release and delivery of the relative goods to the buyer or importer without production of the bill of lading/document of title of goods. Islamic shipping guarantee is needed by the importer or buyer due to the absence of the bill of lading/document of title of goods from the exporter, whereby the importer or buyer cannot claim the goods from the port. Therefore, the ISG is required to enable the importer or buyer to claim the goods.

Islamic banks use the *kafalah* principle to issue this instrument. The following are the stages involved in the operation of ISG:

1 The customer informs the bank of the ISG requirements and requests the bank to provide the facility.

2 The bank may require the customer to place a deposit to the full amount of the price of the goods to be purchased/imported which the bank accepts under the principle of *al-wadi'ah yad dhamanah*.



CUSTOMER

ISLAMIC BANK

4 The bank charges the customer fees and commission for its services under the principle of *al-ujr* (fee).

3 The bank establishes the ISG and pays the proceeds to the negotiating bank utilising the customer's deposit; and subsequently releases the documents to the customers.

Figure 8.35 *Modus Operandi* for Islamic Shipping Guarantee

1 The buyer or importer applies for an ISG from the Islamic bank. The buyer or importer has to comply with the Islamic bank's necessary procedures and the Islamic bank may require the customer to place a certain amount of deposit for this facility.
2 The Islamic bank issues the ISG signed by the consignee and counter-signed by the Islamic bank to guarantee performance by the consignee.
3 The buyer or importer presents the ISG to the shipping company or agent and takes delivery of the relative good. The consignee is to relinquish the bill of lading duly endorsed upon receipt and to accept the related bill, irrespective of any discrepancies.
4 The exporter's bank delivers the bill of lading together with the other relevant documents to the Islamic bank.
5 The Islamic bank then presents the following documents to the buyer or importer: Bill of lading and advice to the shipping company – (requesting them to return the original ISG for cancellation) and redemption letter.
6 The buyer or importer takes hold of the documents. The buyer or importer then presents the duly endorsed bill of lading to the shipping company.
7 The shipping company or agent returns the ISG or letter of discharge to the buyer or importer or the issuing bank for cancellation.
8 The buyer or importer then presents the ISG or letter of discharge to the Islamic bank for cancellation. The Islamic bank charges the customer a fee for the services provided.

Table 8.8 Comparative Summary of Islamic Trade Financing Facilities based on *Shari'ah* Principles

Trade Financing Facility	***Murabahah***	***Kafalah***
	• Islamic Accepted Bill • Islamic Trust Receipt	• Islamic Shipping Guarantee (ISG) • Islamic Bank Guarantee (IBG)
***Shari'ah* Principle**	• *Murabahah* contract refers to the sale of goods at a price, which includes a profit margin as agreed to by both parties.	• *Kafalah* refers to a contract of guarantee where a person underwrites any claims or obligations when a supplier or contractor fails to fulfil his obligation.
Feature	**Islamic Accepted Bill**	**Islamic Shipping Guarantee**
	• Islamic Accepted Bill (IAB) is a bill of exchange drawn by customer to his order and accepted by the Islamic bank and payable on a specified future date. • IAB is drawn to finance the trading of tangible *halal* goods.	• Islamic Shipping Guarantee (ISG) is a letter of indemnity to the owners and/or agents or master of the vessel for delivery of goods without presentation of the document of title of goods or the original bill of lading, whereby the Islamic bank agrees to discharge the liability of a third party in case of default by the third party. • ISG guarantees compliance by the principal with its obligations or the beneficiary shall be indemnified against the failure of the principal to fulfil its obligation under the contract.
	Islamic Trust Receipt	**Islamic Bank Guarantee**
	• Islamic Trust Receipt (ITR) is a facility extended by the Islamic bank to the customer for the financing of his purchase and imports. • ITR is a document of trust signed by the customer in which the bank allows the customer to obtain release of the merchandise and to make the necessary payment at a later date.	• Islamic Bank Guarantee (IBG) is a trade financing facility whereby the Islamic bank gives a surety to the owner of the shipping vessel to discharge goods to the importer, pending receipt of the original bill of lading. • IBG is an irrevocable unconditional payment undertaking or bond, given by the Islamic bank (guarantor) in writing, at the request of the customer (principal), to pay a stated sum of money to the beneficiary upon presentation of the written demand.

Table 8.9 Comparative Summary between Islamic Letter of Credit, Islamic Bank Guarantee and Islamic Shipping Guarantee

Criteria	Islamic Letter of Credit	Islamic Bank Guarantee	Islamic Shipping Guarantee
Definition	An instrument issued by the Islamic bank on behalf of and for the account of a buyer of merchandise/goods.	A legal instrument executed by the Islamic bank on behalf of its customer favouring the beneficiary, normally a government department, statutory authority or other such third parties in connection with a contract entered into between the customer and the beneficiary.	An instrument issued by the Islamic bank on behalf of and for the account of the importer of merchandise or goods to the shipping company or the forwarding agent.
Feature	With this instrument, the Islamic bank, as the issuing bank, undertakes that the bills of exchange and trade documents of the seller when drawn or presented according to the terms and conditions of the credit instrument will be duly honoured.	Two types of Islamic Bank Guarantee: (a) Financial Guarantee (b) Performance Guarantee	As an indemnity for the shipping company or forwarding agent to release or deliver the shipment to the importer (i.e., the customer) without the surrender of the relevant bills of lading. This will normally happen when the shipment arrives before the transport documents (i.e., bill of lading or airway bill).
***Shari'ah* Principle**	(a) *Wakalah* (agency); and (b) *Murabahah* (cost plus profit sale)	(a) *Kafalah* (guarantee); and (b) *Wakalah Bi Al-Istithmar* (investment agency) & *Kafalah* (guarantee)	(a) *Kafalah* (guarantee) (b) *Wakalah Bi Al-Istithmar* (investment agency) & *Kafalah* (guarantee)
Source of Fund	(a) *Wakalah* Islamic Letter of Credit: fund is from the customer or buyer. (b) *Murabahah* Islamic Letter of Credit: fund is from the Islamic bank via financing.	Does not cause the Islamic bank's funds to be tied-up and its liability is contingent upon the failure of the customer in carrying out his obligations.	It is normally the general policy of the Islamic bank that the ISG can only be used in connection with import transactions under the Islamic letters of credit established by the same Islamic bank.

Table 8.10 Comparison between Conventional and Islamic Trade Finance

Conventional Letter of Credit	*Wakalah* Islamic Letter of Credit
• Agency. • Transit interest. ➢ Upon negotiation – foreign-based interest. ➢ Standard remittance days interest. • Penalty charged for late payment.	• Agency. • No transit interest. • Compensation is claimed for late payment.
Trust Receipt	***Murabahah* Islamic Letter of Credit**
• Based on simple interest basis. • Payment of principal plus interest upon maturity (tail end). • Interest may be varied after issuance of the trust receipt. The customer may end up paying more when the interest rate increases – uncertain profit. • Budget may not be accurate.	• Based on *murabahah* principle. • Mark up deferred payment sales. • Buying and selling. • Payment tail-end. • Profit fixed. • Budget is simpler.
Banker Acceptance	**Islamic Accepted Bill**
• Based on discounting. • The customer pays the interest plus accepts commission upfront either by the bank debiting customer's current account or utilising overdraft facility. • Finances only up to the nearest thousand. The customer has to top up the difference upfront. • The bank is always the acceptor and the customer, the drawer.	Purchase & Import • Based on *murabahah* and *bay' al-dayn* principles for purchase and import. • Mark up deferred payment sales and sales of debt. • Full financing to the exact amount. • Payment at tail-end. • Islamic accepted bill draft drawn on the customer. Islamic bank is the drawer and customer is the acceptor. Sales and Export • Based on *bay' al-dayn* principle or sale of debt. • Payment at tail-end. • The Islamic bank is the acceptor and the customer, the drawer.
Export Credit Financing	**Islamic Export Credit Financing**
• Purchases foreign bill at a discount. • Overhead Finances. • Roll over on CP. • Involves interest.	Islamic Export Credit Refinancing – Pre-Shipment • Based on *murabahah* and *bay' al-dayn* principles. • Finances the customer on a cost plus mark up basis. • Discounts the bill with Exim Bank on *bay' al-dayn* basis or sale of debt. • Does not finance overhead. • No roll-over for CP. Islamic Export Credit Refinancing – Post-Shipment • *Bay' al-dayn* concept or sale of debt. • Discounting basis.
Conventional Letter of Guarantee	**Islamic Bank Guarantee**
• Charges commission.	• Based on *kafalah* (suretyship) or a hybrid concept of *al-wakalah bi al-istithmar* (investment agency) and *kafalah* (suretyship). • Charges commission on a pro-rata basis or charges an agency fee for managing the funds.

Summary

1 The asset side of an Islamic bank tends to carry a more diversified portfolio of assorted asset classes which signify a broader continuum of risk and maturity profile. The liability side generally comprises demand deposits, investment accounts, special investment accounts and capital, equity and reserves.

2 There are all together four main types of deposits, namely savings deposit, current deposit, term deposit and investment deposit. It is noteworthy to know that both savings and current deposit share similar features like the *qard hasan* deposit, *wadi'ah yad dhamanah* deposit and *mudarabah* deposit.

3 Corporate financing deals with the corporate financial decisions of the financial institutions which involve both term finance and working capital finance.

4 Retail financing is a financing activity where the main emphasis is on service for individuals rather than businesses and corporate entities.

5 Islamic banks offer a range of traditional retail financing such as home financing, vehicle financing and personal financing that are also offered by conventional banks.

6 Islamic commercial law has a wide range of principles that can be applied to serve the financial needs of the community.

7 In Islamic banking and finance, trade financing facilities are used to finance domestic or international trade. Domestic trade involves the buying and selling of commodities in a country which includes retail trade and wholesale trade. International trade is the external trade of the country and it encompasses the exchange of commodities between the country and other countries. It includes import trade and export trade.

8 Islamic trade financing facilities include Islamic letters of credit, Islamic trust receipts, Islamic accepted bills, Islamic export credit refinancing, Islamic bank guarantees, and Islamic shipping guarantees.

9 Due to the divergence of *Shari'ah* opinions, there are several Islamic trade financing facilities which are not internationally-accepted but only offered in certain jurisdictions.

Key Terms and Concepts

Rabbul Mal	*Mudarib*	Assets	Liabilities
Mudarabah	*Shari'ah*	Islamic	Conventional
Qard Hasan	*Wadi'ah*	Savings	Current
Term	Investment	*Riba*	AAOIFI
Murabahah	*Tawarruq*	*Wakalah*	Working Capital
Sales	Lease	Equity	Issues
Ijarah	*Modus Operandi*	*Musharakah*	Overdraft

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Review Questions and Problems

1 Compare and contrast Islamic and conventional banks.

2 Discuss the *Shari'ah* issues present in savings and current deposits.

3 Explain the *modus operandi* and risk considerations of the commodity *murabahah* term deposit.

4 Explain the operation and the mechanism of BBA Variable Rate.

5 Explain three contracts applied for an Islamic Credit Card.

6 Compare the differences between BBA and *Musharakah Mutanaqisah*.

7 Explain the Islamic trade financing instruments offered by Islamic banks.

8 Explain the *modus operandi* of each of the Islamic trade financing instruments.

9 Compare and contrast both Islamic and conventional trade financing instruments.

Chapter 9

Islamic Money Market

Preview

This chapter aims to give a broad overview of the Islamic money market as an integral part of the Islamic financial system. Three main functions of the Islamic money market, i.e., liquidity management, platform for secondary trading of money market instruments and an avenue for central banks to conduct monetary policy, are explained. However, most of the discussion is dedicated to explaining the Islamic money market in light of its two main components; namely Islamic interbank market and trading of Islamic money market instruments. Islamic interbank money market is considered the largest component of any Islamic money market, particularly the overnight sub-component. Another aim of this chapter is to build an understanding and an appreciation for the various Islamic money market arrangements such as the *mudarabah* interbank investment, commodity *murabahah* and *wakalah* investment.

The money market can be described as the financial market for transactions in wholesale short-term funds.

Learning Outcomes

At the end of this chapter, you should be able to:

- Understand the many functions performed by the money market.
- Identify the key participants in the money market.
- Understand how banks invest surplus funds and obtain funding for deficits.
- Understand the characteristics of Islamic money market instruments.
- Calculate the price or proceeds of Islamic money market instruments.

Introduction

The money market is an essential and integral component of the financial system. The money market, capital market, derivative market, commodity market and foreign exchange market together constitute a country's financial market. They share a common function by providing an avenue for transactions of financial assets between buyers and sellers, and between lenders and borrowers. The money market can be described as the financial market for transactions in wholesale short-term funds. If one were to think about the banking system and the capital markets as the wheels of a country's financial system, then the money market is the gear that moves both these wheels. The tenure in money market transactions is from overnight to 12 months, although the most common tenure is three months or less. Hence, the money market is often characterised as the market for short-end debts. In many countries, transactions in the primary and secondary money markets take place over-the-counter (OTC) via electronic telecommunication but some are done in an exchange market.

If one were to think about the banking system and the capital markets as the wheels of a country's financial system, then the money market is the gear that moves both these wheels.

Capital market caters for long-term financial transactions with maturities longer than 12 months. The financial instruments in the capital market vary more than the money market and they include *sukuk*, bonds, and equities. Transactions in capital market instruments are either exchange traded or OTC. Derivative markets are markets for financial instruments whose values are derived from underlying instruments such as from those in the money and capital markets. The instruments traded include futures, options, swaps and forward rate agreements. The derivative market caters for future delivery in contrast to other markets where settlements are done on a spot basis. The commodity market offers trading in commodities and precious metals and is used by hedgers and traders. They are traded either in an exchange or OTC. Foreign exchange market is a market for transactions in foreign currencies, both on a spot and forward delivery basis. All transactions in this market are OTC and done in currencies such as US Dollar, British Pound Sterling, Euro, Singapore Dollar, and Japanese Yen.

Money Market Participants

The main participants in the money markets are banks, non-bank financial institutions such as *takaful* and insurance companies, business corporations, the government treasury and the central bank. Banks use the money market for liquidity purposes, especially to adjust the mismatch of assets and liabilities in their balance sheet. They will use the money market to obtain liquidity or to place their surplus funds over a limited period. They could also buy money market instruments such as treasury bills and invest surplus funds, or sell their holdings of these instruments to raise funds.

Business corporations as well as government agencies also use the money market for short-term investments. Likewise, large business corporations by virtue of their high credit rating, source short-term funds by issuing commercial papers. The central bank, as the regulator that promotes market stability, uses the money market to transmit its monetary policy. One such example is the use of open market operations as a means of influencing the liquidity level and short-term interest rates in the domestic financial system. Open market operations refer to the act of buying and selling of government securities by the central bank to influence liquidity and interest rates in the financial system. Changes to the liquidity and short-term interest rates will affect long-term rates in the financial system. The government, another important player in the money market, uses the market as a source of short-term funding via the issuance of securities.

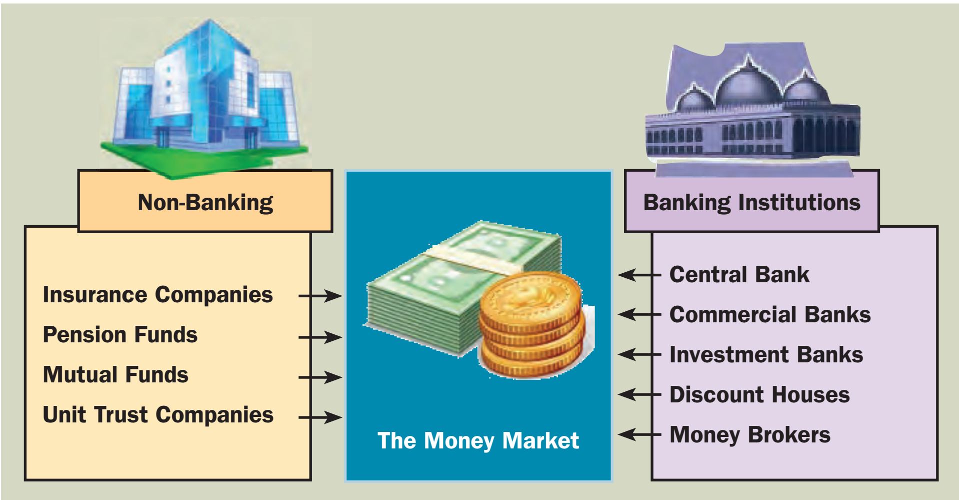

Figure 9.1 Money Market Participants

Money Market Instruments

Treasury Bills

Treasury bills are short-term government securities traded on a yield basis; they represent the short-term debt obligations of a national government. The typical maturities of a treasury bill are three, six and 12 months. The issuing government pays no interest on treasury bills. Since they are traded at a discount from the face value, the investor's yield is derived from the increase in value of the security between the time it was issued and the time it matures. Treasury bills carry virtually no default risk because even if the government finds itself short of money, it could simply issue more money to redeem the bills when they mature. Since treasury bills are short-term instruments, the risk of unexpected changes in inflation is also very low. Furthermore, the market for treasury bills is extremely deep and liquid, hence investors face little risk of not being able to sell their securities when they want to.

Repurchase Agreements (REPOs)

Repurchase Agreements (REPOs) are not a typical instrument but rather a widely used transaction in the money markets. Generally, REPOs represent bilateral transactions encompassing the purchase and resale of securities by agreement; arranged by selling securities to an investor with an agreement to purchase them back from the investor at a fixed price on a fixed date. The party that initially purchases and then resells is effectively the lender of funds. Similarly, the counter-party to the transaction is the borrower. Since the resale price is always higher than the original price, the price difference is the implied interest for the loan. Most REPOs have a very short term, the most common being three to 14 days. The underlying security is typically a treasury security, government bond or some other liquid instrument.

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Negotiable Certificates of Deposit (CDs)

As the name suggests, the Negotiable Certificate of Deposit (CD) is created from a bank deposit and represents a bank-issued security that documents a deposit and specifies the interest rate and maturity date. The purpose of creating this instrument is to enable these deposits to trade on the secondary market. Due to the specified maturity, a CD is a term security. The CD is a bearer instrument which implies that whoever holds the instrument at maturity receives the principal and interest. Negotiable CDs have a maturity of one to four months. Those with a maturity longer than six months suffer from lack of demand. Negotiable CDs, being privately issued, typically provide a higher yield than treasury bills.

Commercial Papers (CPs)

Commercial paper securities are short-term, unsecured (promissory notes) debt instruments issued by corporations that mature in no longer than 270 days. As this instrument is unsecured, it is usually issued by companies with a good credit rating. Yields on commercial papers are typically higher than government securities of similar maturities, reflecting the risk spread. Like treasury bills, most commercial papers are issued on a discount basis. They are very flexible in that the issuers can easily roll over the debt by issuing new papers to redeem outstanding ones.

Yields on commercial papers are typically higher than government securities of similar maturities, reflecting the risk spread.

Banker's Acceptances (BAs)

Banker's acceptances (BAs) are short-term, zero coupon debt papers issued by companies. They are guaranteed by a bank and are therefore known as BAs. The bank guarantee enhances credit rating and makes them transferable, therefore they are suitable for secondary market trading. Bankers acceptances are traded on a discount basis. The purpose of BAs is to facilitate trade by financing goods that have not been transferred from the seller to the buyer. The issuance of a typical BA involves the following steps:

1 The importer requests his bank to send an irrevocable letter of credit to the exporter, i.e., the bank promises to pay the exporter should the importer fail to make the payment by a certain date.

2 The exporter receives the letter, ships the merchandise and is paid by presenting to his bank the letter along with proof that the merchandise was shipped.

3 The exporter's bank creates a time draft based on the letter of credit and sends it along with proof of shipment to the importer's bank.

4 The importer's bank stamps the time draft "accepted" and sends the banker's acceptance back to the exporter's bank so that the exporter's bank can sell it on the secondary market to collect payment.

5 The importer deposits funds at its bank, sufficient to cover the banker's acceptance when it matures.

Banker's acceptances are crucial to international trade. Without them, many transactions would not occur due to counter-party risk. BAs are also favourable for the exporter as he is paid immediately. Furthermore, the exporter is protected from the exchange rate risk because a local bank will pay the exporter in domestic currency. Finally, the exporter does not have to access the credit worthiness of the importer because the importer's bank guarantees the payment.

Since BAs are payable to the bearer, they can be traded until they mature. Interest rates on BAs are very low because the risk of default is barely possible. For example, an investor in BAs has not recorded a loss of principal in more than 60 years.

Functions of a Money Market

The functions of a money market can be divided into three main categories. The first function is liquidity management. Money markets serve as an avenue for financial institutions to source daily funding or short-term investment. Access to money markets enables financial institutions to maintain optimal liquidity, thereby allowing them

Non financial institutions use money markets to manage the fluctuations in their working capital needs either by obtaining short-term funding or placement.

to meet the demand of their customers at any time. This, therefore, allows financial institutions to cope with short-term pressures that may arise, and it also gives them the flexibility to face every liquidity situation that might arise due to different timings of cash inflows and outflows. Non financial institutions use money markets to manage the fluctuations in their working capital needs either by obtaining short-term funding or placement. Consequently, they will be able to enjoy low-cost funding or investment returns with low risk.

Money markets also serve as an avenue for secondary trading of money market instruments. Money market participants, depending on their view of rates of return, will either buy or sell money market instruments in anticipation of obtaining investment returns. The instruments available in the money market provide investors with different levels of risk, returns and maturity.

Finally, money markets are used as a channel for the central bank to conduct its monetary policies. Due to the links that the money market has with both the capital market and banking system, it represents an ideal platform for central banks to conduct monetary operations. Therefore, the initial impact of the open market operations is felt first in the money market. As mentioned in the previous section, the central bank will use the open market operations to purchase and sell eligible securities and provide short-term financing directly to banks which are in a deficit situation. In this way, the central bank is able to manage liquidity and influence benchmark rates in the money market. Changes in the liquidity and benchmark rates in the money market will thereby influence liquidity and rates of return in other markets. As such, the effects of a monetary policy change is firstly reflected in the money market that will ultimately lead to adjustments in other markets such as bond and equity markets and the banking system in general.

The Need for Islamic Money Markets

Just like their conventional counterparts, Islamic banks as a financial intermediary are exposed to liquidity risk emanating from the nature of their asset-liability portfolio. This is particularly true since the balance sheets of Islamic banks are similar to those of conventional banks. Like their conventional counterparts, Islamic banks hold illiquid assets while their liabilities are relatively liquid.

The money market is a key appendage of the banking system. Banks depend on the money market to manage their liquidity. While liquidity management is not the only use of money markets for banks, it is by far the most important. Just like their conventional counterparts, Islamic banks as a financial intermediary are exposed to liquidity risk emanating from the nature of their asset-liability portfolio. This is particularly true since the balance sheets of Islamic banks are similar to those of conventional banks. Like their conventional counterparts, Islamic banks hold illiquid assets while their liabilities are relatively liquid. The nature of the Islamic banking operation that transforms the terms of liabilities into different maturities and characteristics on the asset side of the balance sheet exposes banks to the risk of being unable to match the maturity differences. In fulfilling their role of financial intermediation, Islamic banks face liquidity challenges on a daily basis. Therefore, conventional and Islamic banks alike depend on money markets to manage their liquidity positions.

For example, when existing items on a bank's balance sheet mature or when new items are created, this has implications on the bank's cash flows. Maturing of an asset, for example a loan given out, constitutes a cash inflow to the bank. In other words, the customer has essentially repaid outstanding amounts upon maturity. On the other hand, the maturing item on the liability side would constitute a cash outflow for the bank. For example, when a fixed deposit placed with the bank by a customer matures, the customer redeems the amount, resulting in a cash outflow. Since the maturing items on either side are seldom of equal size, the bank would either have a cash surplus or a deficit. A cash surplus would occur if the maturing assets are larger than the maturing liabilities, and vice-versa. This phenomenon applies to both conventional and Islamic banks.

Consequently, banks can use the money markets to manage these imbalances. A bank with surplus funds can either lend by placing deposits with other banks in the interbank deposit system or lend by purchasing money market instruments. On the other hand, a bank which has experienced a temporary cash deficit can borrow by either accepting deposits in the interbank deposit system or selling money market instruments. Either way, however, the interbank money markets only allow for short-term borrowing or lending.

A bank with surplus funds can either lend by placing deposits with other banks in the interbank deposit system or lend by purchasing money market instruments.

While the money market serves as a suitable avenue for banks to implement proper liquidity management practices, Islamic banks cannot use the instruments offered because they are *Shari'ah* noncompliant. All instruments in the conventional money market are interest bearing and as such, as per the *Shari'ah*, cannot be utilised by Islamic banks. Hence, there is a need for an Islamic money market with instruments that allow Islamic banks to achieve the abovementioned goal of liquidity management, while at the same time comply with the rules and guidelines of the *Shari'ah*. The remainder of this chapter will focus on explaining the Islamic money market and its various *Shari'ah*-compliant instruments that can be used by Islamic banks.

Differences between Islamic and Conventional Money Markets

The Islamic money market enables market players to perform similar functions as those of the conventional market but with the exception that the instruments used to perform these functions are based on *Shari'ah* laws and principles. The Islamic money market provides an avenue for money market players to invest surplus funds or to obtain short-term funding in a *Shari'ah*-compliant way. Similarly, it allows the players to trade *Shari'ah*-compliant money market instruments as well as to carry out *Shari'ah*-compliant hedging facilities.

The Islamic money market enables market players to perform similar functions as those of the conventional market but with the exception that the instruments used to perform these functions are based on *Shari'ah* laws and principles.

Table 9.1 shows that the Islamic money market uses a host of *Shari'ah* contracts, especially for the issuance and trading of Islamic money market instruments whereas the conventional money market uses only one type of contract based on debt. Returns in the *mudarabah* interbank investments as well as *wakalah* investments are also not pre-determined upon placement but rather fixed only upon the maturity of the investment. On the other hand, returns from commodity *murabahah* are fixed and the investor is informed at the onset of the placement of funds.

An interesting feature of the Islamic money market is that it is not only accessible to Islamic financial institutions but also to conventional banks, insurance and other conventional non-bank financial institutions. This is the case especially for the Islamic money market instruments. Conventional financial institutions have unlimited access to invest in Islamic money market instruments as well as bid for Islamic papers in the primary market.

Table 9.1 Comparison between Islamic and Conventional Money Markets

	Islamic	Conventional
Interbank Market	Utilises *Shari'ah*-compliant contracts such as *mudarabah*, *murabahah* and *wakalah*.	Issues debt contract for placement of funds.
Money Market Instruments:		
Issuance Process	Must be *Shari'ah*-compliant and approved by both the Council and *Shari'ah* committee.	Must be approved by the respective financial regulator.
Types of Structure	Structured based on assets, equity and debt-based.	Structured based on debt only.
Investors	Both Islamic and conventional investors.	Conventional investors only.

Source: Adapted from Bank Negara Malaysia

Components of the Islamic Money Market

Typically, the money market will have two key components: an interbank money market and a platform for trading money market instruments. Even though liquidity management is not the sole function of the money market, it is by far, the most important one. Banks are so dependent on the money market that it is often referred to as the **Interbank Money Market**. As the name suggests, the interbank money market is a means by which banks borrow and lend among themselves. The necessity for a bank to borrow and lend in the money market arises from the mismatches in its daily cash flows. These mismatches in the daily cash flows are due to, for example, imbalances between a customer's deposits and withdrawals, and the offset balance of the cheque clearing process. Given this, a bank may face cash shortfalls or surpluses on a daily basis depending on whether withdrawals exceed deposits and vice-versa. Since banks have little influence on the causes of cash imbalances, managing these temporary shortfalls is of crucial importance, and this is where the money market comes in handy. Their ability to borrow and lend among themselves allows banks to manage their liquidity.

As previously mentioned, trading of money market instruments is the second key component of the money market. Just like the interbank money market that enables banks to borrow or lend directly among themselves, money market instruments achieve the same objective through the issuance/purchase of debt instruments. By using debt instruments, banks are able to transfer debt easily through secondary market trading. In other words, a money market instrument purchased by the bank today can be sold within the next few days. Hence, the bank would recoup its money without having to wait until the maturity date of the instrument. Therefore, a liquid secondary market for money instruments is an essential element which enables debt to be traded before its maturity.

Likewise, the Islamic money market essentially comprises two components: the Islamic interbank market and trading of Islamic money market instruments.

Islamic Interbank Market

Generally, the Islamic interbank market is considered the largest component of any Islamic money market and in particular, the overnight sub-component. An active interbank market is essential in providing signals to central banks to determine the volume of open market operations. Table 9.2 provides an example of Malaysia's Islamic interbank money market's monthly volume.

Table 9.2 Islamic Interbank Money Market Monthly Volume by Tenure for the Year 2009

MYR Million					
Month	**Overnight**	**1 Week**	**1 Month**	**3 Months**	**Others**
Jan	13,329	421	370	20	695
Feb	10,535	475	0	70	1,570
Mar	14,630	340	425	150	1,984
Apr	14,407	633	100	0	1,748
May	12,779	682	160	0	1,515
Jun	7,489	455	180	0	650
Jul	9,298	571	770	140	630
Aug	10,673	546	830	50	1,563
Sep	13,920	535	610	0	1,330
Oct	11,608	476	270	0	1,075
Nov	7,105	1,076	110	0	1,935
Dec	11,516	486	180	100	2,091
Total	137,289	6,696	4,005	530	16,786

Source: Bank Negara Malaysia

The overnight market is where the IFIs trade among themselves their reserve balances to meet their day-to-day liquidity requirements. For instance, banks with surplus liquidity can place their excess funds with other banks overnight. The overnight rate adjusts to balance the supply of and demand for bank reserves. A short-term market rate, in particular the interbank overnight rate, may be used to serve as an operational guide for monetary operations of central banks. Table 9.2 shows that the overnight market comprises 83% of the total interbank market while the other tenure remains an insignificant percentage. The *Shari'ah* contracts currently used in the Malaysian Islamic interbank market are *mudarabah*, *murabahah* and *wakalah*.

Mudarabah Interbank Investment (MII)

In this arrangement, a surplus bank as *rabbul mal*, or the funds provider, will place its excess funds for a limited period with a deficit bank which is a *mudarib* (or the manager of the funds) at a pre-agreed profit-sharing ratio. In line with the *mudarabah* principles, losses, if any, will be borne by the surplus bank. This is illustrated in Figure 9.2.

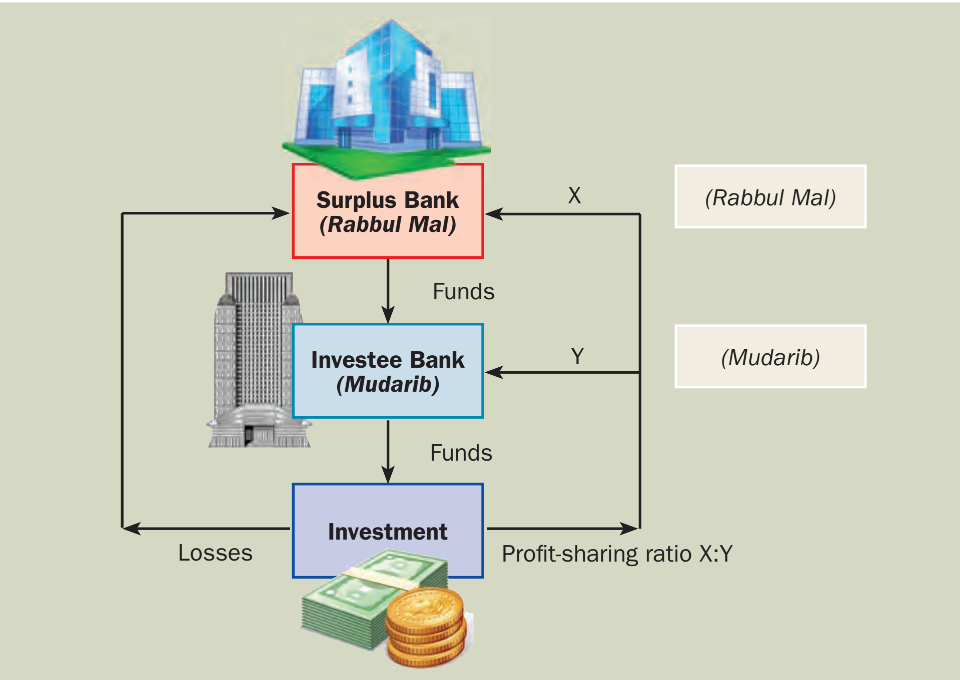


Figure 9.2 *Mudarabah* Interbank Investment

In the case of Malaysia, the rules stipulated by the Central Bank (also known as Bank Negara Malaysia or BNM) require that *Mudarabah* Interbank Investment (MII) maintains a minimum investment amount of RM50,000, while the tenure can be from overnight to 12 months. In the beginning, when MII was first introduced, the rate of return paid by the deficit bank was based on its gross profit rate on a one-year investment. However, this method was not transparent as some banks under-declared their returns through the exclusion of certain types of income. Following this, in 1995, BNM came up with a new rule by introducing a benchmark rate that is equivalent to the prevailing rate of the Government Investment Issue (GII) plus a spread of 0.5%. Hence, the minimum rate of return payable to the surplus bank is the prevailing rate of return from the GII plus 0.5%. This rate of return computation methodology was used until 2004 when BNM replaced it with a more comprehensive framework where it sets out the calculation of distributable profits and the derivation of the rates of return to the depositors.

The framework consists of two components: the calculation table and the distribution table. The calculation table specifies the income and expense items that must be reported and establishes the standard calculation in arriving at the net distributable income. It also introduced the Profit Equalisation Reserve (PER) as a tool to mitigate the fluctuation of rates of return and to ensure the rates remain competitive and stable.

Exhibit 9.1 Techniques Commonly Used by IIFS for Smoothing and Compensating Losses in Investment Returns: PROFIT EQUALISATION RESERVE (PER)

Institutions offering Islamic Financial Services (IIFS) are exposed to the rate of return risk in the context of their overall balance sheet exposures. An increase in benchmark rates may result in Investment Account Holders' (IAHs') having expectations of a higher rate of return. Rate of return risk differs from interest rate risk in that IIFS are concerned with the result of their investment activities at the end of the investment-holding period. Such results cannot be pre-determined exactly.

A consequence of the rate of return risk may be a **displaced commercial risk**. IIFS may be under market pressure to pay a return that exceeds the rate earned on assets financed by IAH when the return on assets is under-performing as compared with the competitors' rates. IIFS may decide to waive their rights to part or the entire *mudarib* share of their profits in order to satisfy and retain their fund providers and dissuade them from withdrawing their funds. Displaced commercial risk derives from competitive pressures on IIFS to attract and retain investors (fund providers). The decision of IIFS to waive their rights to part or all of their *mudarib* share in profits in favour of IAH is a commercial decision, the basis of which needs to be subject to clear and well-defined policies and procedures approved by the IIFS's Board of Directors.

A **Profit Equalisation Reserve** (PER) is the amount appropriated by IIFS out of their gross income before allocating the *mudarib* share, in order to maintain a certain level of return on investment for IAH and to increase owners' equity. The basis for computing the amounts to be appropriated should be pre-defined and applied in accordance with the contractual conditions accepted by the IAH and after formal review and approval by the IIFS's board of directors. In certain jurisdictions, the supervisory authority lays down requirements relating to the maintenance of the PER.

The distribution table then prescribes the allocation of the net distributable income among demand, savings and general investment deposits according to their structures (*mudarabah* or non-*mudarabah*), maturities and the pre-agreed profit-sharing ratios. BNM further requires Islamic banks to calculate their rates of return on a monthly basis, and to declare their monthly rates of return on a specified date, usually the 15th of each month. The declared rate of return will remain effective until the following announcement date.

Profit Calculation for *Mudarabah* Interbank Investment

The profit payable to the investing bank in the *mudarabah* interbank investment is determined by two factors: the agreed profit-sharing ratio (PSR) and the declared gross profit rate of the receiving bank on one-year investments. The first one is agreed upon at the onset of the investment while the second one is known only at the maturity of the investment. However, an investing bank knows that the profit payable due can be predicted based on the declared rate of return if the tenure of investment falls before the next announcement date. If, on the other hand, the tenure of investment crosses the next announcement date, the profit payable will be based on the newly declared gross profit rate.

The formula to calculate the profit payable to the investing bank is as follows:

$$X = \frac{Prt(K)}{36{,}500}$$

Where:

X = Amount of profit (in Ringgit) to be paid to investing bank
P = Face value or principal amount of investment
r = Gross profit rate before distribution declared by receiving bank on one year investments
t = Tenure in days of investment
K = Profit-sharing ratio

The number 36,500 in the denominator is 365 days × 100. Thus, in the numerator, the percent "r" will be entered as a whole number and not as a decimal.

The total amount payable to the investing bank upon maturity will comprise principal invested plus X, the profit earned based on the agreed profit-sharing ratio.

Suppose Kuwait Finance House (KFH) has RM5 million surplus funds and wishes to place it out for 30 days. Similarly, assume that Bank Islam Malaysia Berhad is in need of a similar amount for the same tenure. Further, assume both banks agreed that the profit-sharing ratio for this investment is 70:30 where 70% is in favour of KFH.

Let us assume that Bank Islam declared a gross profit rate of 5.8% per annum before distribution. KFH will therefore receive a net profit of RM16,684.93 or a return of 4.06% per annum for the 30-day investment.

The profit payable to KFH is calculated as follows:

$$X = \frac{5{,}000{,}000 \times 5.8 \times 30 \times 0.7}{36{,}500}$$

$$= \text{RM}16{,}684.93\text{, i.e., a return of } 4.06\% \text{ p.a.}$$

Therefore, on Day 30, Bank Islam is liable to pay RM5,016,684.93 to KFH (i.e., the principal plus profit due).

Figure 9.3 *Mudarabah* Interbank Investment (MII)

Commodity *Murabahah*

Commodity *Murabahah* is a popular term used in the market to imply a contract of *bay al-tawarruq*, or simply *tawarruq*. The term *tawarruq*, as discussed in Chapter 6, generally implies a sale contract whereby a buyer buys an asset from a seller with deferred payment, and subsequently sells the asset to the third party on cash with a price less than the deferred price, for the purpose of obtaining cash. This transaction is called *tawarruq* mainly because when the buyer purchases the asset on deferred terms, it is not the buyer's interest to utilise or benefit from the purchased asset, rather it is to facilitate him to attain liquidity.

Tawarruq generally implies a sale contract whereby a buyer buys an asset from a seller with deferred payment, and subsequently sells the asset to the third party on cash with a price lesser than the deferred price.

Hence, commodity *murabahah* is the instrument most commonly used by Islamic financial institutions to provide short-term interbank liquidity.

Commodity *murabahah* is a liquidity management programme originally introduced as an avenue for Islamic banks to invest their excess funds with the central bank. Now, it is used as an interbank investment by Islamic money market participants.

Commodity *murabahah* represents one of the most widely utilised techniques for short-term liquidity management in the Gulf region (especially Saudi Arabia and United Arab Emirates). The transaction is based on commodities traded on the London Metal Exchange (LME).

Case Study 1 London Metal Exchange (LME)

About the LME

London Metal Exchange is the world's premier non-ferrous metals market with a 130-year-long history. LME offers a range of futures and options contracts for non-ferrous and minor metals, steel and plastics.

The Exchange serves as a platform for all trading activity, and consequently it facilitates the price discovery process, i.e., it helps to "discover" what the price of a material will be months and years ahead. This assists the physical industry to plan forward to navigate the future which is often characterised by severe and rapid price movements. Since LME's liquidity is ample, the prices which are "discovered" at the Exchange are recognised and relied upon by the industry throughout the world.

The LME is a highly liquid market, and in 2009, it achieved trading volume equivalent to $7.41 trillion annually and $29 billion on an average business day. LME is a global market with an international membership and with more than 95% of its business coming from overseas. Being a principal-to-principal market, the only organisations able to trade are its member firms, of which there are various categories. LME members provide the physical industry with access to the market, risk management tools and delivery mechanisms.

LME contracts

The Exchange offers forward contracts to producers, fabricators, merchants and consumers which allow them to insure against price risk. Lots rather than tonnes is a measure used in conducting trade with each lot of aluminium, copper, lead and zinc amounting to 25 tonnes. Nickel is traded in 6-tonne lots, tin in 5-tonne and aluminium alloy in 20-tonne lots. Cobalt is traded in 1-tonne lots while molybdenum is traded in 6-tonne lots of Roasted Molybdenum Concentrates (RMC) and steel billet is traded in 65-tonne lots.

Prices in the exchange are quoted in US Dollars, but the LME also permits contracts in Sterling, Japanese Yen, and Euros and provides official exchange rates from US Dollars for each of them. The contract for each metal is standardised and certain specifications have to be adhered to, i.e., shapes, weights and methods of strapping (metals). The contract specifications are for the quality and shape most widely traded and demanded by the industry.

Price Discovery Function of the Exchange

Price discovery is one of the most important functions of the Exchange. Each day the LME announces a set of official prices, which are determined from trading on the Exchange. These prices are used worldwide as the basis for contracts in the physical material. The most reliable prices in any market are derived from those where the greatest concentration of trading takes place. The greatest concentration of trading for each contract occurs during the five-minute open outcry "ring sessions". However, due to LME's flexibility, trading can take place at any time.

Source: London Metal Exchange, http://www.lme.com/

In Malaysia, however, the Bursa *Suq Al-Sila'* was established to provide a platform for commodity *murabahah* transactions. The underlying asset used in this exchange is Crude Palm Oil (CPO). Under this arrangement, an investing bank purchases an underlying asset, say CPO from a broker and sells it to the investee bank at cost-plus with an agreement that it pays the investing bank on a deferred payment basis. The investee bank may then appoint the investing bank as its agent to sell the commodity to another broker on spot basis or sell the commodity on its own to another broker. The reverse of this transaction also known as reverse *tawarruq*, can be done if a bank is in need of short-term funds. The commodity *murabahah* arrangement is illustrated in Figure 9.4.

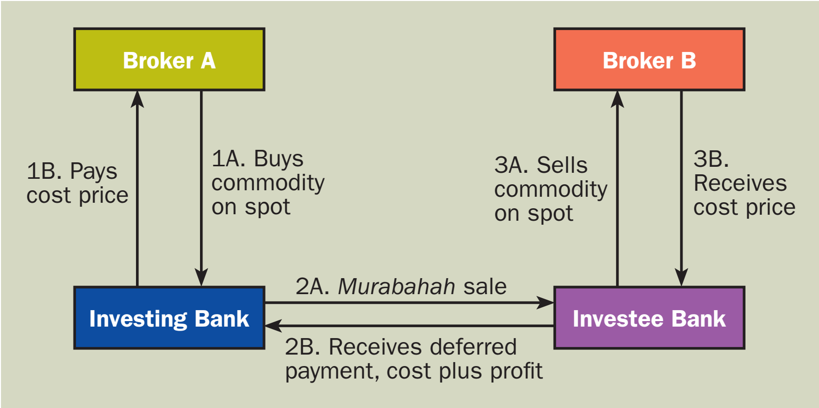


Figure 9.4
Commodity *Murabahah*

In contrast to MII where the rate of return is determined upon the maturity of the investment, the rate of return for commodity *murabahah* is determined upfront and is made known to the investing bank. The formula to calculate the profit payable to the investing bank is as follows:

$$X = \frac{Prt}{36{,}500}$$

Where:

X = Amount of profit (in Ringgit) to be paid to investing bank

P = Face value or principal amount of investment

r = Annual profit rate

t = Tenure in days of investment

Similar to MII, the total amount payable to the investing bank upon maturity will be comprised of the principal invested plus X, the profit earned based on *murabahah*.

Case Study 2 Bursa Malaysia *Suq Al-Sila'* (BSAS)

Bursa Malaysia *Suq Al-Sila'* is a commodity-trading platform for the Islamic financial and capital market designed as a multi-commodity and multi-currency platform. The underlying commodity is Crude Palm Oil (CPO), and plastic resin along with other types of commodities that will also be available soon.

At present, Bursa *Suq Al-Sila'* has 33 registered members comprising financial institutions, commodity suppliers and financial brokers. Bursa *Suq Al-Sila'* was established with the primary objective of addressing one of the biggest challenges faced by Islamic banks today, i.e., managing liquidity, and is the first initiative of its kind in the world. The element of *Shari'ah* governance is embedded in the trading rules that members must adhere to. This provides supervisory and audit powers to the exchange with regard to *Shari'ah* compliance matters.

The platform was established with the added objective of enhancing trading efficiency, encouraging market transparency, mitigating counter party risks associated with over-the-counter bilateral trades and contributing to the development and evolution of the industry.

The BSAS is developed with an end-to-end adherence to *Shari'ah*. BSAS provides a market of physical commodity and enables physical delivery to buyers at their option. Similarly, the rules of BSAS also ensure that, in such a market, a seller owns the commodity before selling the same to a buyer. This is in line with the *Shari'ah* principle which prohibits one from selling something he does not own.

Besides enabling physical delivery, BSAS is able to facilitate financing, *sukuk* or interbank transactions which use the *Shari'ah* contracts of *murabahah* or *musawamah*. The mechanics of BSAS, for such a purpose, are best explained in the illustration below.

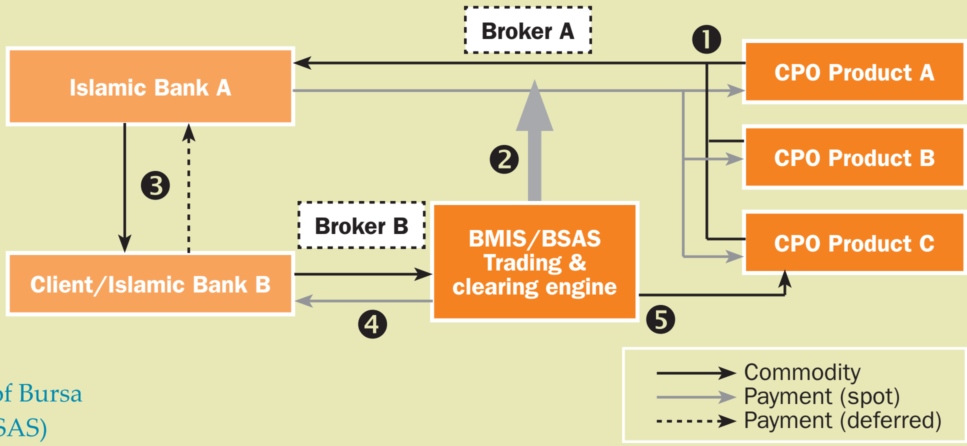


Figure 9.5
Illustration: Mechanics of Bursa Malaysia Suq Al-sila' (BSAS)

1 Pre-market opening – Commodity Supplier Participants (CSPs) shall put offers into the BSAS engine to sell their commodities. The commodities being offered shall be unencumbered in their inventory.
- The market opens from Sunday to Friday at 10:00 a.m. where the Islamic Bank A shall enter its bid to buy certain amounts and types of commodities as per its requirement. Islamic Bank A must become a Commodity Trading Participant (CTP) in order to enter a bid, or if it is not a CTP, it may authorise Broker A, which must be a Commodity Executing Participant (CEP) to enter the bid.
- Order-matching by BSAS engine shall take place. Upon matching, the relevant commodity is sold to Islamic Bank A by the relevant CSPs.
- Islamic Bank A now becomes the owner of the commodity.

2 BMIS ensures the delivery of the commodities, if so requested by Islamic Bank A.
- E-Certificate will be generated detailing the trade information.
- Islamic Bank A pays the price by crediting the proceeds into BMIS' account.

3 Islamic Bank A shall then sell the commodity to its client or another Islamic bank (Islamic Bank B) on a deferred basis. The sale shall take place outside the BSAS engine.
- The client or Islamic Bank B now becomes the owner of the commodity.
- The trade is reported to BSAS. E-Certificate will be generated detailing the trade information.
- BMIS ensures the delivery of the commodities if so requested by the client or Islamic Bank B.

4 Client or Islamic Bank B shall then sell the commodity to BMIS. If they are not a CTP, they shall authorise Islamic Bank A as a CTP or Broker B as a CEP to perform the transactions on their behalf.
- BMIS makes payment by debiting its account in favour of the client or Islamic Bank B.
- BMIS now becomes the owner of the commodity.

5 BMIS shall sell the commodity to the CSPs on random basis. The randomisation shall avoid the commodity from going back to the original supplier.
- The CSPs may or may not re-offer the commodity into the BSAS market for further trading.

6 Bids can be entered by the CTPs or CEPs by 10.20 p.m. and the market shall close at 11.15 p.m.

TAKING DELIVERY OF COMMODITY
- Upon request for physical delivery by the Islamic Bank A or the client/Islamic Bank B, BMIS acknowledges and informs the CSPs of the relevant commodity.
- In order for Islamic Bank A or the client/Islamic Bank B to acquire physical delivery, they must possess the relevant licencing from Malaysian Palm Oil Board (MPOB).
- The delivery document is issued by the CPO supplier.
- The buyer presents the delivery document to the CPO supplier to take delivery.

Source: Bursa Malaysia

Suppose Bank Muamalat Malaysia Berhad (BMMB) has RM5 million surplus funds and wishes to place it out for 30 days. Similarly, assume that Bank Rakyat Malaysia Berhad is in need of a similar amount for the same tenure.

Both banks will then execute their commodity *murabahah* transactions through the Bursa *Suq Al-Sila'*. BMMB will first purchase CPO from Bursa *Suq Al-Sila'* at spot price (RM5 million) and then sell the CPO to Bank Rakyat at deferred payment, say with 5% per annum profit margin. Bank Rakyat will subsequently sell the CPO to Bursa *Suq Al-Sila'* at spot price (RM5 million), thereby generating a placement. At the end of 30 days, BMMB will therefore receive the cost price of RM5 million plus a profit of 5% per annum or RM20,547.95

The profit payable to BMMB is calculated as follows:

$$X = \frac{5{,}000{,}000 \times 5 \times 30}{36{,}500}$$

= RM20,547.95 i.e., a return of 5% p.a.

Figure 9.5
Illustration: Commodity *Murabahah* Interbank Investment

Wakalah Investment

Between Islamic banks, interbank liquidity can be managed using a *wakalah* agency contract. Under a *wakalah* agreement, the *muwakkil* (investing bank) appoints the investee bank (*wakil*) as its agent to invest in *Shari'ah*-compliant transactions on behalf of the *muwakkil*. The investee bank, as the *wakil,* will notify the investing bank of the profits expected to be generated upon placement of funds. Any profits exceeding the quoted expected profits will be retained as an incentive by the investee bank. The investee bank is also entitled to draw an agency fee from the incentive obtained. The investing bank, as principal, shall bear all risks associated with the transactions except for those risks resulting from the investee bank's willful act or gross negligence. The formula to calculate the profit payable to the investing bank under *wakalah* investment is the same as commodity *murabahah* investment.

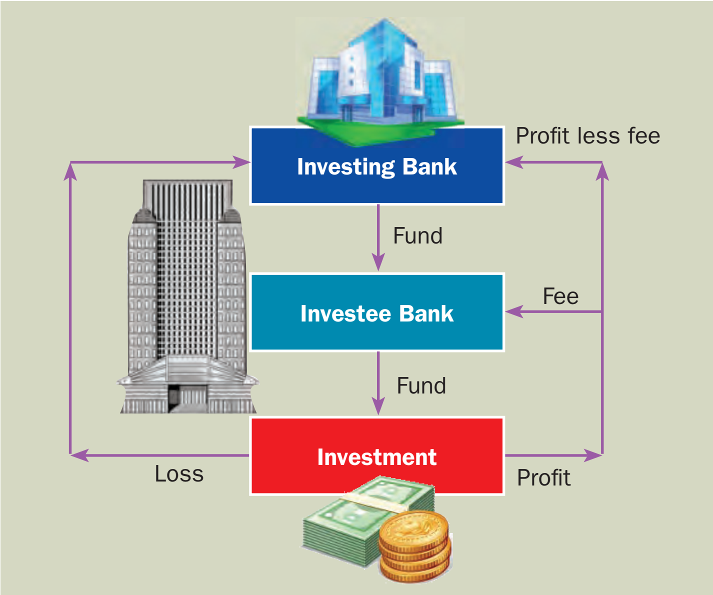


Figure 9.6
Wakalah Investment

Trading of Islamic Money Market Instruments

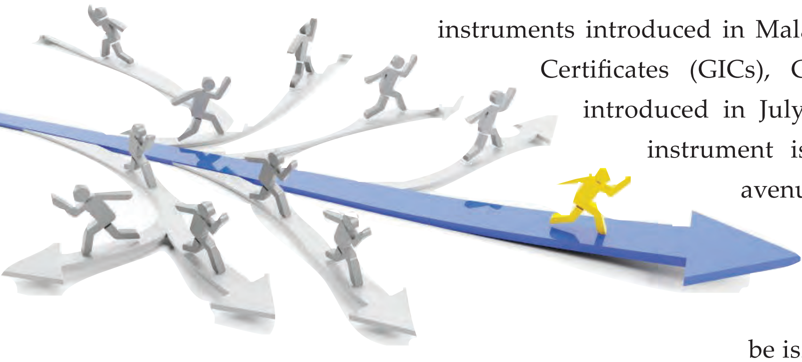
Trading in the Islamic money market instruments represents the second component of the Islamic money market. It is aimed at facilitating placement among the money market players just like the interbank investment but through the issuance/purchase of financial instruments. Money market instrument is more flexible relative to the above interbank investment in the sense that, the instruments can easily be traded in the secondary market. Therefore, this makes it easy for banks that purchase money market instruments to sell or liquidate them whenever they want without waiting until the maturity of the instruments. An active secondary market is, therefore necessary to facilitate the trading of money market instruments before maturity, thereby reducing liquidity risk and enhancing the efficiency in the market.

Unlike interbank investment that is mainly restricted to approved interbank institutions, participants in this market constitute both financial and non financial institutions. The instruments offered in the market are different from one another in terms of risk profile, yield, tenure, marketability and liquidity. It should also be noted that the term money market instruments refers to short-term investment papers including long-term instruments such as government securities that have almost reached their maturity date. Table 9.3 below shows the outstanding amounts for Islamic money market securities in Malaysia.

Table 9.3 Outstanding Amount of Islamic Securities as at 31 December 2009

Financial Instrument	Outstanding Amount (RM million)
ABS (Islamic Bonds)	5,921
CAGAMAS BAISs	1,465
Corporate Bonds/*Sukuk* (Islamic)	72,889
Government Investment Issues	66,000
Islamic Commercial Papers	3,859
Islamic Medium Term Notes	88,614
Khazanah Bonds	1,000
Malaysian Islamic Treasury Bills	2,000
Sukuk Bank Negara Malaysia *Ijarah*	400
Total Outstanding Amount (RM m)	242,148

Government Investment Issues (GIIs)



Government Investment Issues (GIIs) are another example of Islamic money market instruments introduced in Malaysia. Formerly known as Government Investment Certificates (GICs), Government Investment Issues (GIIs) were first introduced in July 1983 in Malaysia. The purpose of this financial instrument is to provide Islamic banks a *Shari'ah*-compliant avenue to meet the statutory liquidity requirement. The Government Investment Act (Malaysia) 1983 under which the certificates are issued, provides certificates with maturities of one year or more to be issued and for dividend instead of interest, to be paid on the certificates. The original GIC was issued under the principle of *qard hasan* (benevolent loan) which restricts its trading in the secondary market. Financial institutions needing liquidity will have to surrender or sell their GICs back to the central bank after which dividend will be paid. The determination of dividend is not ex-ante but rather ex-post.

The above constraints led BNM to replace GIC with GII in 2001. GII is structured based on the contract of *bay' al-'inah* (sale and buyback). For example, the central bank will identify a *Shari'ah*-compliant asset and then invite tenders from Islamic financial institutions for the asset. The IFI which offers the most competitive price will be selected to be the buyer cum investor and gets to buy the asset on spot sale. The investing bank will in turn re sell the asset back to the central bank on the principle of *bay' bithaman ajil* (deferred sale) if the coupon is to be paid periodically or *murabahah* (cost plus) if the GII is a zero-coupon instrument. The debt incurred by the central bank through the deferred buy back is securitised in the form of GII. Thus, the spot price paid by the investing bank will be at face value if the GII is issued on the principle of *bay' bithaman ajil* or discounted value if the GII is issued under *murabahah*. The investing bank can either hold the GII until maturity or sell it in the secondary market. At maturity, the central bank redeems the security by paying the full purchase price of the assets (or face value of GII) to GII holders.

The price of GII is given below:

Price =
(Discounted Value of Redemption Value at Maturity) + (Discounted Value of Stream of Coupon Payments)

$$\text{Price} = \left\{ \frac{RV}{\left[1 + \frac{r}{200}\right]^{N-1+T/E}} \right\} + \left\{ \sum_{K=1}^{N} \frac{c/2}{\left[1 + \frac{r}{200}\right]^{K-1+T/E}} \right\}$$

Where,

RV = Redemption value (= FV, if redemption is at par)

c = Coupon rate

r = Market yield for a similar maturity period

N = Number of semi-annual coupon payments between the value date and maturity date

T = Number of days from the value date to the next interest payment date

E = Number of days in the coupon period in which settlement takes place

K = Time period in which the coupon or principal payment occurs.

BMMB purchases a GII with the following details:

Issuance date	: 7 April 2006
Maturity date	: 7 April 2009
Transaction date	: 15 October 2007
Coupon	: 6% per annum, paid semi-annually
Maturity value	: RM100
Yield	: 7% per annum

What is the price for this instrument?

Answer:

$$\text{Price} = \left\{ \frac{100}{\left[1 + \frac{7}{200}\right]^{3-1+(175/183)}} \right\} + \left\{ \sum_{K=1}^{N} \frac{3}{\left[1 + \frac{7}{200}\right]^{3-1+(175/183)}} \right\}$$

$$= \text{RM}98.75$$

Figure 9.7
Calculation of GII Price

Malaysian Islamic Treasury Bills (MITBs)

In the conventional sense, treasury bills are short-term government securities which are traded on yield basis. The maturities of treasury bills range from three, six and 12 months. Issued at a discount from their par value, the investors derive their yield from the increase in the value of the treasury bill between the time of purchase and the time it matures.

Malaysian Islamic Treasury Bills (MITBs) are short-term securities issued by the government of Malaysia as an alternative to the conventional treasury bills. Unlike GIIs, which are issued to finance the development expenditure of the Malaysian government, MITBs are issued to finance the government's operating expenditure. The MITBs are structured based on the *bay' al-'inah* principle where BNM, on behalf of the Malaysian government, will sell the identified government's assets on competitive tender basis, to form the underlying transaction of the deal. The allotment is based on highest price tendered (or lowest yield). The price is determined after the profit element is imputed (discounting factor). The successful bidders will then pay cash to the government.

Malaysian Islamic Treasury Bills are usually issued weekly with original maturities of one year and priced on a discounted basis.

The bidders will subsequently sell back the assets to the government at par based on credit term. The government will issue MITBs to bidders to represent the debt created. MITBs are usually issued weekly with original maturities of one year and priced on a discounted basis. Both conventional and Islamic institutions can buy and trade on MITBs. The discounting formula shown below is used to determine the proceeds of MITBs:

$$\text{Proceeds} = FV\left[1 - \frac{r \times t}{365}\right]$$

Where:

FV = Face value
r = Discounting rate
t = Number of days remaining to maturity

Find the price of an MITB that has a face value of RM5,000,000 and is sold at a discount rate of 4.8% assuming that, the number of days to maturity is 30 days.

Answer:

$$\text{Proceeds} = \text{RM}5{,}000{,}000\left[\frac{1 - 4.8\% \text{ x } 30}{365}\right]$$

$$= \text{RM}5{,}000{,}000\ (1 - 0.00395)$$

$$= \text{RM}5{,}000{,}000\ (0.996)$$

$$= \text{RM}4{,}980{,}250$$

Figure 9.8
Calculation of Proceeds on MITBs

Bank Negara Monetary Notes (BNMNs)

These are short-term money market instruments issued by BNM to replace the Bank Negara Negotiable Notes (BNNN). The underlying contract used to be *bay' al-'inah* but has now been replaced with *murabahah*. The issuance of BNMN is based on commodity *murabahah* as explained earlier. The issuance is normally made through publication in the Fully Automated System for Issuing/Tendering (FAST) and the tenure for this instrument ranges from one to 12 months although now it has been extended to three years. The debt created from the commodity *murabahah* is tradable in the secondary market under the concept of *bay' al-dayn* (sale of debt). New issuance may be based on discount or coupon-bearing. Discount-based BNMN is traded using a convention similar to the existing BNNN and the Islamic Treasury Bill (ITB), while profit-based BNMN is traded using the market convention of GII.

Discount-based BNMN is traded using a convention similar to the existing BNNN and Islamic Treasury Bill (ITB), while profit-based BNMN is traded using the market convention of Government Investment Issue.

Exhibit 9.2 What is *Bay' Al-Dayn?*

"*Dayn*" means "debt" and "*Bay'*" means sale. "*Bay'al-dayn*", therefore, connotes the sale of debt. According to Majalah Al-Ahkam Al-Adliyyah, No 158, *dayn* is defined as a thing due, i.e, the amount of money owed by a certain debtor. *Bay' al-dayn* or debt-trading or sale of debt can be defined as the sale of payable right or receivable debt either to the debtor himself, or to any third party. This type of sale is usually for immediate or deferred payment. *Shari'ah* permits the selling of debt by its equivalent in quantity and time of maturity by way of *hawalah*. This form of debt-trading is accepted by all schools of Islamic law with the condition it is paid in full, and hence gives no benefit to the purchaser. The rationale for this ruling is that the financial transactions involving debt should never allow deferred payment, as this would amount to *riba* or *bay' al-kali bi al-kali'* which is prohibited by the Prophet (peace be upon him).

The view of most Hanafi, Hanbali and Shafi'i jurists is that the sale of *bay' al-dayn* to a non-debtor or a third party is not permissible. However, the Malikis, and some Hanafis and Shafi'i jurists deem selling of debt to a third party permissible as long as the following conditions are satisfied:

1. The seller is able to deliver the debts.
2. The debt must be *mustaqir*, or confirmed, and the contract must be performed on the spot.
3. The debt is not created from the sale of currency (gold and silver) to be delivered in the future and the payment is not of the same type as debt, and if it is so, the rate should be the same to avoid *riba*.
4. The debt should be goods that are saleable, even before they are received. This is to ensure that the debt is not of the food type that cannot be traded to the debtor.

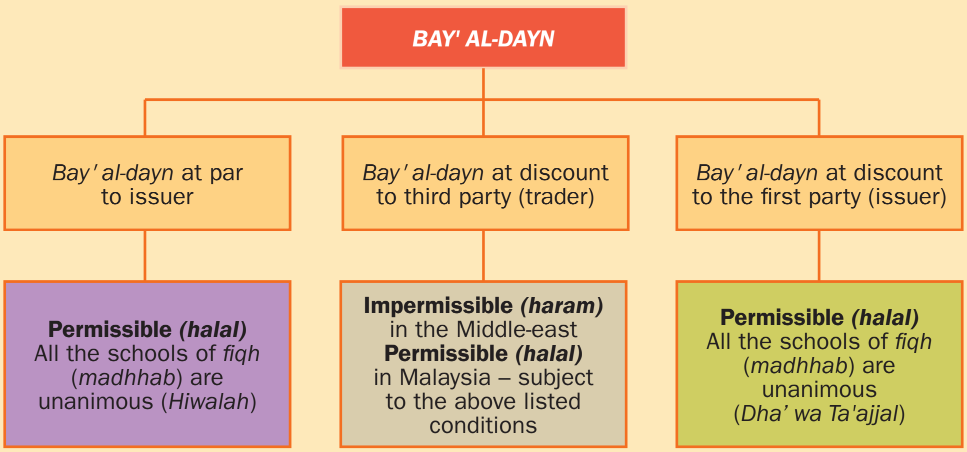


Figure 9.9
Bay' Al-Dayn

Exhibit 9.3 What are *Sukuk*?

Sukuk in general may be understood as *Shari'ah*-compliant certificates which can be seen as an Islamic equivalent of a bond. The Accounting and Auditing Organization for Islamic Financial Institutions defines *sukuk* as: "*Certificates of equal value representing, after closing subscription, the receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity.*" (AAOIFI Standard 17). *Sukuk* generally implies transferable certificates representing a share in the ownership of assets or business ventures that give entitlement to the *sukuk* holders to receive periodic fixed returns and full redemption upon maturity of the *sukuk*. *Sukuk* can be structured based on the principles of contracts of exchange (e.g., *ijarah*, *murabahah*, *istisna'*) and contracts of participation (e.g., *musharakah* and *mudarabah*).

In order to comprehend the subject of *sukuk*, it is imperative to understand the distinction between an asset-backed *sukuk* and an asset-based *sukuk*. Moody's distinction is worth highlighting: "*In an asset-backed* sukuk*, investors enjoy asset-backing, they benefit from some form of security or lien over the assets, and are therefore in a preferential position over other, unsecured creditors. In other words, in the event the issuer were to default or become insolvent, the note-holders would be able to recover their exposure by taking control of and ultimately realising the value from the asset(s). It also requires the element of securitisation to be present – true sale, bankruptcy remoteness and enforceability of security.*"

However, "*in an asset-based* sukuk*, the originator undertakes to repurchase the assets from the issuer at the maturity of the* sukuk*, or upon a pre-defined early termination event, for an amount equal to the principal repayment. In such a repurchase undertaking, the true market value of the underlying asset (or asset portfolio) is irrelevant to the* sukuk *note-holders, as the amount is defined to be equivalent to the notes. In this case, note-holders have no special rights over the asset(s) and rely wholly on the originator's creditworthiness for repayment, either from internal sources or from its ability to refinance. Thus, if the originator is unable to honour his or her obligation to repurchase the assets, the note-holders are in no preferential position to any other creditors, or indeed in no weaker position to any other unsecured creditor stressing the importance that the purchase undertaking ranks* pari passu *with any other of the originator's senior unsecured obligations*".

Sukuk structures have recently come under criticism and some scholars have questioned *sukuk's* level of compliance with the *Shari'ah*. In the light of those criticisms, especially by Sheikh Muhammad Taqi Usmani, AAOIFI has issued rulings which are to be adhered to by the issuers in order to achieve *Shari'ah*-compliant *sukuk* structures. AAOIFI rulings stipulate that in order for *sukuk* to be tradable, "*it must be owned by the* sukuk *holders, together with all of the rights and obligations that accompany such ownership. The manager of a* sukuk *issuance must establish the transfer of ownership of such assets in its books, and must not retain them as its own assets*". Furthermore, "Sukuk *must not represent receivables or debt except in the case of a trading or financial entity selling all of its assets, or a portfolio with a standing financial obligation*". Hence, AAOIFI rulings imply that from the *Shari'ah* perspective, it is essential that *sukuk* are backed by a specific, tangible asset throughout their entire tenure and *sukuk* holders must have a proprietary interest in the assets which are being financed. Chapter 10 deals extensively with the subject of *sukuk*.

Sukuk Bank Negara Malaysia *Ijarah* (SBNMI)

This is an Islamic money market instrument that is issued under the *ijarah* (lease) principle. To facilitate the issuance of SBNMI, BNM established a special purpose vehicle named BNM *Sukuk* Berhad (BNMSB). The first stage of the *sukuk* issuance involves BNM selling the identified assets to BNMSB and BNMSB paying BNM for the assets from the proceeds of the *sukuk* issuance. The assets will then be leased to BNM for rental payment consideration, which is distributed to investors as a return on a semi-annual basis. Upon maturity of the *sukuk ijarah*, which will coincide with end of the lease tenure, BNMSB will then sell the assets back to BNM at a pre-determined price. One advantage of using *ijarah* principle is that the rental can be set as fixed or variable thus mimicking a floating rate bond.

The inaugural issuance took place on 16 February 2006 with an issue size of RM400 million. The pricing formula for a fixed rental SBNMI is similar to the fixed rate GII.

Islamic Negotiable Instruments (INIs)

The Islamic Negotiable Instrument (INI) is a *Shari'ah*-compliant instrument equivalent to the conventional Certificate of Deposits (CDs). A certificate of deposit refers to a bank-issued short-term security that documents a deposit and specifies the interest rate and maturity date. The CDs, also referred to as bearer instruments, imply that whoever possesses the instrument upon maturity, will receive the principal and interest. Consequently, since charging and giving of interest is not allowed from the *Shari'ah* viewpoint, an alternative structure is created to serve the same purpose. An INI may be issued based on *bay' bithaman ajil* or *mudarabah*. The instrument based on *bay' bithaman ajil* is called the Negotiable Islamic Debt Certificate (NIDC) whilst the one based on *mudarabah* is called the Islamic Negotiable Instrument of Deposit (INID). The explanations of both are discussed below.

Negotiable Islamic Debt Certificates (NIDCs)

The Negotiable Islamic Debt Certificate is a document issued by an IFI to evidence that a sum of money has been deposited with the issuer for a specific period. The NIDC stipulates that the issuer has the obligation to pay the bearer, the amount deposited together with profit at a specified future date. This document is issued based on *bay' bithaman ajil*. The issuing bank will first identify an asset whose value is based on the amount to be deposited, and sells this asset to the investor at an agreed cash price.

Subsequently, the investor agrees to resell the same asset back to the issuing bank at the original sale price plus mark up which is payable on a deferred basis. To evidence the indebtedness from the deferred sale, the issuing bank issues an NIDC to the investor. Upon maturity, the investor or bearer presents the NIDC to the issuing bank against payment for its nominal value plus the profit portion.

NIDCs are bearer instruments and are initially issued to the investee bank. They can be resold at a discount prior to maturity. The NIDC is traded on price basis which means the principal value is quoted in terms of price per RM100 nominal value.

The formula below is used to calculate the price of an NIDC that has less than one year maturity:

$$Price = \frac{RV}{1 + \left[\frac{T \times Y}{36{,}500}\right]}$$

(Prices are rounded off to 4 decimal places.)

Where:

RV = Redemption value per RM100 nominal value

T = Number of days from settlement date to maturity date

Y = Yield or Profit rate

Determine the price of an NIDC purchased by BIMB with a nominal value of RM1,000,000 and has the following details:

Issuance date = 7 March 2009
Maturity date = 7 July 2009
Transaction date = 7 April 2009
Yield = 4% p.a.

Answer:

$$P = \frac{100}{1 + \left[\frac{91 \times 4}{36{,}500}\right]}$$

$$= \frac{100}{1.00997}$$

$$= 99.0128$$

$$\text{Proceeds} = \frac{1{,}000{,}000 \times 99.013}{100}$$

$$= 990{,}128.419$$

Note: T = 91 days, i.e., from 7 April 2009 to 7 July 2009

Figure 9.10
Calculation of the price of an NIDC of less than 1 year

The formula to calculate an NIDC with maturity of more than one year is shown below:

$$\text{Price} = \frac{RV}{\left[1 + \frac{YLD}{m}\right]^{n-1+DSC/DCC}}$$

Where:

RV = Redemption value per RM100 nominal value
YLD = Yield in % pa
DSC = Number of days from settlement date until next quasi coupon date
DCC = Number of days of quasi coupon period (Note: In the event that the first quasi coupon profit period has a duration of less than six months, the start date of DCC should be backdated accordingly to create a quasi semi-annual period)
n = Number of remaining quasi coupon profit periods
m = Period to maturity

KFH purchases a long-term NIDC instrument with the following details:

Issuance date : 20 March 2007
Maturity date : 20 March 2009
Transaction date : 20 March 2008
Maturity value : RM1,500,000
Yield : 4% p.a.

What is the price for this instrument?

Answer:

$$\text{Price} = \frac{100}{\left[1 + \frac{4}{2}\right]^{2-1+\frac{62}{184}}}$$

$$\text{Price} = \frac{100}{[3]^{1.3369}}$$

$$= \frac{100}{1.0268}$$

$$= 97.389$$

$$\text{Proceeds} = \frac{1{,}500{,}000 \times 97.389}{100} = \text{RM}1{,}460{,}835$$

Figure 9.11
Calculation of price of an NIDC with maturity of more than one year

Case Study 3 Islamic Negotiable Instruments of Deposit in Malaysia

The Negotiable Instrument of Deposit (NID) was introduced in Malaysia in 1979. It was initially designed as an avenue for commercial banks, eligible finance companies and merchant banks to mobilise domestic savings from the public. Due to its marketability and liquidity features, the NID also contributed towards the development of the domestic money market. Due to rapid development of Islamic banking since 1993 and the setting up of an Islamic money market, the demand has increased for marketable deposit instruments similar to the NID. In this respect, an Islamic version of the NID has been developed with similar objectives to that of the NID.

The Islamic Negotiable Instruments (INIs) are structured along the concept *bay' bithaman ajil* (deferred payment sale) for Negotiable Islamic Debt Certificate (NIDC) and the concept of *Al-Mudarabah* (profit-sharing) for Islamic Negotiable Instruments of Deposit (INIDs). NIDC refers to a sum of money deposited with the banking institutions (BIs) and repayable to the bearer on a specified future date at the nominal value of NIDC. Similarly, INID is a bearer instrument that implies that a sum of money has been invested with the BIs and repayable to the bearer on a specified future date at the nominal value of INID plus declared dividend.

MODUS OPERANDI OF ISLAMIC NEGOTIABLE INSTRUMENT OF DEPOSIT

The total outstanding issue of INIs issued by the Issuer shall not exceed the issue limit specified by BNM, which in principle is set at five times the Issuer's approved capital funds. The issue limit is to be applied on an aggregate basis for both the conventional and Islamic Negotiable Instruments of Deposit. For determining compliance with the issue limit, the valuation basis for INID is based on the nominal value.

The *modus operandi* is as follows:

1 The customer deposits his money with the BI.

2 The BI accepts the customer's deposit and issues an INID to the customer as evidence of the deposit.

3 Upon maturity, the customer will present the INID to the BI and receive the nominal value of the INID and the declared dividend.

As far as purchase and redemption are concerned, the issuer may redeem the INID prematurely only on a profit date (the date on which a profit rate ends and a new profit rate is determined) and upon redemption, the INID may be cancelled.

Day 1	Customer approaches BI with an amount, say RM1 million as deposit placement.
	BI accepts deposits and issues INID of RM1 million with the following terms: (a) Tenure 6 months (b) Profit-sharing ratio: 80 : 20 (80% to customer) (c) Dividend payment: Quarterly basis
Day 180	Customer presents matured INID to BI. BI declared a net dividend rate of 7.5% p.a. (gross dividend rate of 9.375%) and pays customer RM1,018,750 of which RM18,750 is the dividend received for the last dividend period.

Figure 9.12 A Practical Illustration

Source: BNM

Islamic Negotiable Instruments of Deposit (INIDs)

The Islamic Negotiable Instrument of Deposit (INID) is a *Shari'ah*-compliant version of its conventional counterpart – the Negotiable Instrument of Deposit (NID). As mentioned earlier, this instrument is created as a result of bank deposits. NIDs are issued by a bank with the purpose of enabling these deposits to be traded on the secondary market. NIDs are issued privately and they offer higher yields than treasury bills.

The INID is a certificate representing a sum of money deposited by an investor with an issuing bank which is repayable to the bearer on a specified future date, at the nominal value of the instrument plus profit. It is issued based on the *mudarabah* or profit-sharing principle. The investor is the *rabbul mal* whilst the *mudarib* is the issuing bank. Just like the NIDC, the INID is a bearer instrument and is traded on a price basis – that means the principal value is quoted in terms of price per RM100 nominal value. The price of an INID is computed using the following formula:

$$Price = FV\left[\frac{(a+b)}{36{,}500}+1\right]\times 100$$

Where:

a = Expected dividend rate

b = Number of days from the issue date or last dividend date to the value date of the transaction

Issue date : 13 December 2008
Maturity date : 13 December 2009
Nominal value : RM5,000,000
Profit-sharing ratio : 75:25
Expected dividend rate : 11.5%
Profit date : quarterly with the first dividend date on 31 March 2009

$$\text{Price} = \left[\frac{(8.625 \times 90)}{36{,}500} + 1\right] \times 100$$

$$= 102.1267$$

The proceeds to be paid by the buyer will be computed as follows:

Proceeds = RM5,000,000 x 102.1267/100
= RM5,106,335

Figure 9.13
Illustration: Calculation of Proceeds for an INID

Islamic Accepted Bills (IABs)

The Islamic Accepted Bill (IAB) is a bill of exchange drawn on or drawn by a bank, payable at a specific date in the future, to evidence the debt that arises out of a trade transaction.

The Islamic Accepted Bill (IAB) is the *Shari'ah* equivalent to the conventional Banker's Acceptance (BA). In a conventional space, a BA is an order to pay a specified amount of money to the bearer on a given date. They have been in use since the twelfth century. They are used for the sole purpose of financing goods which are yet to be transferred from the seller to the buyer. BAs are short-term zero coupon debt papers issued by companies. Since the BAs are payable to the bearer, they can be bought and sold until they mature. They are sold at a discounted price life of treasury bills.

The IAB is a bill of exchange drawn on or drawn by a bank, payable at a specific date in the future, to evidence the debt that arises out of a trade transaction.

These bills may be used as part of the trade finance facilities by importers to finance their imports/purchases, or by exporters to finance their exports/sales. Among the conditions set by BNM for the issuance of IABs are the following: the financing facility must be for genuine trade, the goods involved must be tangible and *Shari'ah*-compliant, it must not involve the selling or purchasing of services, and the parties involved must not be a single entity. Under the current BNM rules, the minimum denomination for an IAB is RM50,000 and they are issued in multiples of RM1,000.

Import and Local Purchases

In import IABs, the Islamic bank will first appoint the customer as its agent to purchase the required asset from the exporter or seller on behalf of the bank. The asset is consequently resold to the customer on a *murabahah* basis at a marked-up price with the agreement to repay based on deferred payment which can be up to 365 days. Upon maturity, the customer pays the bank the cost of the goods and the bank's profit margin. The sale of goods by the bank to its customer on a deferred basis represents debt securitised in the form of a bill of exchange that is drawn by the bank and accepted by the customer for the full amount of the selling price to be paid upon maturity. The Islamic bank as the drawer of the IAB can hold the IAB until maturity where it will receive the full selling price or alternatively sell the IAB prior to its maturity at a discount to any investor using the principle of *bay' al-dayn*.

Export/Local Trade

After an exporter has obtained the approval of his bank for export trade finance facilities and fulfilled the export documentations required under the export or sale contract, the documents are sent to the importer's bank. The exporter later draws on his bank, new bills of exchange as a substitution bill that represents the IAB. The acceptance by the bank indicates a promise that it will pay the full value of the bill to the bearer upon maturity. Then, the bank purchases the IAB from the exporter at a discount, based on the Islamic principle of *bay' al-dayn*. The bank can hold the IAB until maturity and receive the full selling price or it can sell the bill before maturity to a third party at a discount.

The price of IAB under *bay' al-dayn* is calculated using a discounting formula shown below:

$$\text{Proceeds} = FV\left[\frac{1 - r \times t}{365}\right]$$

Where:

FV = Face value

r = Discounting rate

t = Number of days remaining to maturity

Suppose an IAB with a face value of RM3,000,000 is sold at a discount of 5% and has 42 days remaining to maturity. What is the price (P) for this IAB?

$$P = \text{RM}3{,}000{,}000\left[1 - \frac{5\% \times 42}{365}\right]$$

$$= \text{RM}3{,}000{,}000\,(1 - 0.005753)$$

$$= \text{RM}2{,}982{,}741$$

Figure 9.14
Illustration: Price calculation of IAB under *Bay' al-dayn*

Sell and Buyback Agreement (SBBA)

This is similar to a conventional Repurchase Agreement (REPO) but structured in a *Shari'ah*-compliant way. REPO in conventional banking is an agreement under which a seller of securities sells the securities to a buyer at an agreed price and repurchases the securities from a buyer at a specified price on a future date. The difference between the repurchase price and the original sale price is the interest earned by the buyer who is also a lender. Under the Sell and Buy-Back Agreement (SBBA), the transacting parties enter into two separate agreements. The first agreement is between the seller (owner) of securities and the buyer (investor) who buys the securities at a specified price agreed by both parties. The second agreement is a forward purchase agreement whereby the buyer (investor) promises to sell back the securities to the original owner, and the latter promises to buy them back at a specified price on a specified future date. The first contract is an outright sale and thus the securities will cease to be part of the seller's investment portfolio. BNM requires that, at least one of the parties to an SBBA transaction must be an Islamic banking institution whilst the tenure for the SBBA transaction must not exceed one year and the minimum value must be at least RM50,000.

The proceeds from the SBBA transaction are computed using the following formula:

$$P = FV\left[1 - \frac{rt}{36{,}500}\right]$$

Where:

P = Market price

FV = Face value

r = Annual rate of profit

t = Number of days

Assume Maybank Islamic Berhad enters into an SBBA agreement on 8 March 2007 to sell IAB security to Bank Islam Malaysia Berhad with an undertaking that Maybank Islamic will purchase the same securities back on 17 March 2007. What is the value of the proceeds if the rate of profit is 4% and the face value is RM1,000,000?

$$\text{Price} = \text{RM}1{,}000{,}000\left[1 - \frac{4 \times 70}{36{,}500}\right]$$

$$\text{Price} = \text{RM}1{,}000{,}000(1 - 0.00767123)$$

= RM992,328 (total proceeds paid by Bank Islam on 8 March 2007)

Upon the maturity of the SBBA contract on 17 March 2007, Maybank Islamic will buy back the IAB from Bank Islam at a price computed as follows:

$$\text{Price} = \text{RM}1{,}000{,}000\left[1 - \frac{4 \times 61}{36{,}500}\right]$$

$$= \text{RM}1{,}000{,}000\ (1 - 0.0066849)$$

= RM993,315.1 (total proceeds paid by Maybank Islamic on 17 March 2007)

The total proceeds earned by Bank Islam for nine days of short term placement via SBBA is RM987.1 (RM993,315.1 – RM992,328)

Figure 9.15
Illustration of Sell and Buyback

Cagamas *Sukuk*

Cagamas Berhad, the National Mortgage Corporation, was established as a special purpose vehicle to mobilise low-cost funds to support the national home ownership policy and spearhead the development of the private debt securities market in Malaysia. To that end, Cagamas issued a number of Islamic fixed income securities that are traded in the money market. The securities are *Sanadat Mudarabah* Cagamas and *Sanadat* Cagamas.

Sanadat Mudarabah Cagamas (SMC)

This is an asset-based *sukuk* issued by Cagamas Berhad under the concept of *mudarabah*. The main objective of this instrument is to finance the purchase of Islamic housing debts issued under the principle of *bay' bithaman ajil* and the purchase of Islamic hire purchase debts issued under the principle of *ijarah thumma al-bay'*. Based on the *mudarabah* concept, the *sukuk* holder bears any losses that result in a reduction of the value of the *sukuk* while the *sukuk* holders and Cagamas share the profit according to the agreed profit-sharing ratio. The coupon is paid semi-annually on a coupon day. The *sanadats* are redeemable at par on a maturity date unless there is principal diminution. The maturity of *sanadat* can run up to ten years. Price and proceeds of SMC are calculated using the following formula:

$$P = \left[\frac{100\left(100 + \left(\frac{C+E}{365}\right)\right)}{100 + \left(\frac{r \times T}{365}\right)} \right] - FV\left(\frac{C \times t}{36{,}500}\right)$$

$$\text{Proceeds} = \frac{NV \times P}{100} + NV \times \left(\frac{C \times t}{36{,}500}\right)$$

Where:

P	=	Price per RM100 face value
C	=	Indicative coupon for current coupon period
E	=	No. of days in current coupon period
T	=	No. of days from transaction date to next coupon payment day
r	=	Yield to maturity
t	=	No. of days from last coupon payment date to the value date
NV	=	Nominal value of SMC transaction

Maybank Islamic Berhad bought RM25 million SMC with the following details:

Issuance date : 7 April 2006
Maturity date : 7 April 2008
Transaction date : 20 August 2006
Next coupon date : 7 October 2006
Indicative coupon : 5.47%
Yield to maturity : 5.57%

What is the price for this instrument?

Answer:

$$\text{P} = \left[\frac{100\left(100 + \left(\frac{5.47 \times 184}{365}\right)\right)}{100 + \left(\frac{5.57 \times 48}{365}\right)} \right] - 100\left(\frac{5.47 \times 74}{36{,}500}\right)$$

$$= \left(\frac{10{,}275.7479}{100.7325}\right) - 100\ (0.011089)$$

$$= 102.01025\text{-}1.1089$$

$$= 100.9014$$

$$= 100.90$$

$$\text{Proceeds} = \left(\frac{\text{RM}25{,}000{,}000 \times 100.90}{100}\right) + \left(\text{RM}25{,}000{,}000 \times \frac{5.47 \times 74}{36{,}500}\right)$$

$$= \text{RM}25{,}225{,}000 + \text{RM}277{,}246.5753$$

$$= \text{RM}25{,}502{,}246.58$$

Figure 9.16
Illustration: *Sanadat Mudarabah* Cagamas (SMC) calculation

Sanadat Cagamas

Sanadat Cagamas, also known as Cagamas BAIS, are another type of Islamic securities issued by Cagamas to finance the purchase of Islamic housing finance debts and Islamic hire purchase debts. These *sanadat* are, however, issued under the principle of *bay' bithaman ajil* where the cost of the assets purchased is equivalent to the par value of the *sanadat*, and the profit earned is equivalent to the coupons of the *sanadat*. Coupons are paid semi-annually whilst the par value is redeemable upon maturity. The tenure of the *sanadat* can be up to ten years. The pricing formula for these *sanadat* is similar to the fixed rate of GIIs if the *sanadat's* tenure is more than one year, whilst if the tenure is less than one year, the pricing formula will be based on the NIDC's which has a tenure of more than a year.

Islamic Corporate *Sukuk*

These are *Shari'ah*-compliant bonds or *sukuk* (plural of *sakk*). They can be structured based on a number of Islamic finance contracts such as *bay' bithaman ajil*, *murabahah*, *salam*, *istisna'*, *ijarah*, *mudarabah*, *musharakah* and *wakalah*. These *sukuk* can be issued on either a discounted basis or profit or rental basis. Hence, the pricing formula will also be based on the type of *sukuk* issued, and the relevant formula as discussed earlier, will be applied accordingly. The descriptions and mechanisms of *sukuk* shall be discussed in the next chapter.

Summary

1 The role of the Islamic money market and how it fulfills the three important functions: liquidity management, avenue for trading of Islamic money market instruments and channel for the central bank to transmit its monetary policy.

2 The two main components of an Islamic money market are the Islamic interbank market and the trading of Islamic money market instruments.

3 The developments of various Islamic money market instruments.

4 The issue of limited availability of *Shari'ah*-compliant money market instruments as well as the variability of instruments among member countries. In some countries, money market participants tend to buy and hold these securities until maturity rather than trade because of the attractive yield of these instruments and the scarcity of papers generally. Hence, this creates a liquidity problem and hinders the process of determining prices of securities.

5 If the Islamic money market is to fulfil its many functions, it has to have many types of participants, varieties of Islamic securities based on different risks, yields, and tenure, and various interbank investment market.

Key Terms and Concepts

Money Market
Wakalah Investment
Commodity *Murabahah*
Islamic Interbank Market
Islamic Money Market
Negotiable Islamic Debt Certificates
Islamic Treasury Bills
Sell and Buy-Back Agreement
Negotiable Islamic Debt Certificates
Mudarabah Interbank Investment
Government Investment Issue
Islamic Negotiable Instruments

Further Readings

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Review Questions and Problems

1 Why is there a need for an Islamic money market?

2 List and explain the three main functions of the Islamic money market.

3 Explain and present diagrammatically the concept of commodity *murabahah*.

4 Explain the significance of the second component of an Islamic money market (Trading of Islamic MM Instruments) and briefly mention the participants in this market.

5 Compare the Islamic Negotiable Instrument of Deposit (INID) and the Negotiable Islamic Debt Certificate (NIDC) and briefly explain each instrument.

6 What is an Islamic Accepted Bill? Explain the mechanism of an IAB and show how it facilitates trade (export/import).

7 What do you understand by the *wakalah* concept? How can *wakalah* be used as a liquidity management tool?

8 If a Malaysian Islamic Treasury Bill has a face value of RM3,000,000 and is currently being sold at a discount of 5.5 % with 30 days to maturity, what is its price?

9 Compare and contrast the IIMM with its conventional counterpart. What are some of the differences and what are the similarities?

10 Given Malaysia's dual banking system and the fact that non-Islamic entities have access to the IIMM, how different can profit rates in the IIMM be, relative to yields in the conventional money market?

Chapter 10

Sukuk Market

Preview

This chapter will highlight one of the fastest growing segments of the Islamic capital market, the *sukuk* market. The chapter begins with the *Shari'ah* framework of Islamic securities, wherein the concept of *sukuk* is examined in detail. Besides defining basic terms and examining the growth of the market, *sukuk* are also compared to bonds and asset-backed securities, the two most common debt capital market instruments in the conventional space. Following this, the key features and key documents adopted in various *sukuk* structures are elaborated. The main categories of *sukuk* discussed include sale-based *sukuk*, lease-based *sukuk* and equity-based *sukuk*. Where relevant, case studies are brought to light to illustrate how the various *sukuk* are employed in practice. Finally, the chapter delineates a number of challenges and opportunities that the *sukuk* market is facing.

The Umayyad Mosque in Damascus, Syria, was built during the Umayyad Caliphate. The usage of *sukuk* can be traced back to the Umayyad Caliphate during the 1st century.

Learning Outcomes

At the end of this chapter, you should be able to:

- Explain the features of *sukuk* and compare them to bonds and asset-backed securities.
- Discuss the *Shari'ah* issues for various types of *sukuk*.
- Analyse the challenges that are prevalent in the *sukuk* market.

Shari'ah Framework for Islamic Securities

Sukuk, usually translated as Islamic bond, has been the most active Islamic debt market instrument.

An active capital market is vital to provide an alternative funding avenue (besides bank funding) for corporate entities and the government. Tapping into the capital market allows a fund-raising entity to reach a wider investor base, thus enjoying a larger funding amount at a competitive rate. Besides larger funding amounts, capital market instruments also provide liquidity to investors as they can trade them in the secondary market. The Islamic financial system began with commercial banking activities and expanded into capital market activities since the late 1990s. In general, the Islamic capital market comprises two main components: the debt market and the equity market. *Sukuk*, usually translated as Islamic bonds, have been the most active Islamic debt market instruments. On the equity side, the equity market has been growing since 1999 with the establishment of screening indices for shares.

Definition of *Sukuk*

The most common Arabic term used for Islamic securities in the market today is *sukuk* (plural of *sakk*). Literally, *sukuk* means certificates. Some have defined *sukuk* as papers representing financial obligations arising from trade and other commercial activities[1] while others have defined *sukuk* as similar to trust certificates which represent a share in an asset or business venture. Let us analyse the three most authoritative definitions available.

Securities Commission Malaysia, in its Guideline on Islamic Securities 2004, defined *sukuk* as a "document or certificate which represents the value of an asset".

The Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI), in its *Shari'ah* Standard 17(2), defined investment *sukuk* (*Sukuk Istithmar*) as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, assets of particular projects or special investment activity". The Islamic Financial Services Board (IFSB), in its Capital Adequacy Standard (IFSB 2), defined *sukuk* as "certificates that represent the holder's proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such asset". Securities Commission Malaysia (SC), in its Guideline on Islamic Securities 2004, defined *sukuk* as a "document or certificate which represents the value of an asset".

If we compare the three definitions above, we can say that the definition provided by the SC is the broadest and encompasses the other two definitions. A *sukuk* is a certificate that represents the value of an asset. There are, however, differences in the types of asset that can qualify under the global standard setting bodies' (AAOIFI & IFSB) definition

1 Refer to (Kamil, 2008) for examples.

and the SC's definition. The AAOIFI and IFSB do not recognise financial assets (i.e., receivables) as assets that would qualify to form the underlying assets of a tradable *sukuk*, while the SC does allow such assets. We will elaborate further on this difference in the later part of the chapter.

Exhibit 10.1 Differences of Opinion Regarding Tradability of *Sukuk*

In paragraph 5/2/15 of *Shari'ah* Standard No. 17, AAOIFI acknowledges *sukuk murabahah* but does not allow their trading after the delivery of the *murabahah* asset to the buyer. The paragraph reads:

> "It is not permissible to trade in *Murabaha* certificates after delivery of the *Murabaha* commodity to the buyer. However, trading of *Murabaha* certificates is permissible after purchasing the *Murabaha* commodity and before selling it to the buyer."

Paragraph 194 of IFSB 2 does not mention *sukuk murabahah*. It reads:

> *Sukuk* can be broadly categorised into:
>
> (a) asset-based *sukuk*, where the underlying assets offer fairly predictable returns to the *sukuk* holders, such as the case of *salam*, *istisna'* and *ijarah* (Note: the assets in question may be held by a *musharakah* or *mudarabah* transaction which is securitised. This is not the same as the *musharakah* or *mudarabah sukuk* mentioned below); and
>
> (b) equity-based *sukuk*, where the returns are determined on a profit-and-loss-sharing in the underlying investment which does not offer fairly predictable returns (e.g., *musharakah* or *mudarabah* for trading purposes).

On the other hand, paragraph 196 of IFSB 2 states that a *salam sukuk* is not tradable:

> A *salam sukuk* represents fractional ownership of the capital of a *salam* transaction, where the *salam* capital is constituted by an advance payment to a counter-party as the supplier of a commodity (the subject matter) to be delivered at a future date. This type of *sukuk* is non-tradable, since the subject-matter is considered to be a financial asset (a receivable). The gross returns to the *sukuk* holders consists of the margin or spread between the purchase price of the subject matter and its selling price following delivery. In certain *sukuk* issues, a third party gives an undertaking that the subject matter will be sold at a price exceeding the purchase price by a specified margin. This may be achieved by means of a parallel *salam* transaction in which a third party purchases the subject matter for delivery on the same delivery date as stipulated in the original *salam* contract.

The SC allows a *Shari'ah*-compliant debt to be sold at a discount in a securitisation exercise. However, this is not permissible according to the global *Shari'ah* standard due to differences in opinion regarding sale of debt (*bay' al-dayn*). This is stated in *Resolutions of the Securities Commission Shari'ah Advisory Council (2nd Ed.)*:

> At its 2nd meeting on 21 August 1996, the *Shari'ah* Advisory Council (SAC) unanimously agreed to accept the principle of *bay' al-dayn,* i.e., debt trading as one of the concepts for developing Islamic capital market instruments. This was based on the views of some of the Islamic jurists who allowed this concept subject to certain conditions. In the context of the capital market, these conditions are met when there is a transparent regulatory system which can safeguard the *maslahah* (interest) of the market participants.

Origin of *Sukuk*

Although *sukuk* are generally viewed as a contemporary class of Islamic financial instruments, their usage can be traced back to the 1st Century AH during the Umayyad Caliphate. Exhibit 10.2 highlights the *hadith* that was recorded in Al-Muwatta' by Imam Malik mentioning the term *sukuk*.[2]

Exhibit 10.2 *Hadith* in *Muwatta'* that mentioned *Sukuk*

وَحدَّثَنِي عَنْ مَالِكٍ، أَنَّهُ بَلَغَهُ : أَنَّ **صُكُوكًا** خرَجتْ لِلنَّاسِ فِي زَمَانِ مَرْوَانَ بْنِ الْحكَمِ مِنْ طَعَامِ الْجَارِ فَتَبَايَعَ النَّاسُ تِلْكَ **الصُّكُوك** بَيْنَهُمْ، قَبلَ أَنْ يَسْتَوْفُوهَا، فَدَخلَ زَيْدُ بْنُ ثَابِتٍ، وَرَجُلٌ مِنْ أَصْحَابِ رَسُولِ اللهِ، فَقَالَا : أَتُحِلُّ بَيْعَ الرِّبَا، يَا مَرْوَانُ؟ فَقَالَ : أَعُوذُ بِاللَّهِ، وَمَا ذَاكَ؟ فَقَالَا : هَذِهِ **الصُّكُوكُ** تَبَايَعَهَا النَّاسُ، ثُمَّ بَاعُوهَا قَبْلَ أَنْ يَسْتَوفُوهَا، فَبَعَثَ مَرْوَانُ الْحَرَسَ، يَتْبَعُونَهَا يَنْزِعُونَهَا مِنْ أَيْدِي النَّاسِ، وَيَرُدُّونَهَا إِلَى أَهْلِهَا.

Yahya related to me from Malik that he had heard that receipts ***(sukuk)*** were given to people in the time of Marwan ibn al-Hakam for the produce of the market at al-Jar. People bought and sold the receipts ***(sukuk)*** among themselves before they took delivery of the goods. Zayd Thabit and one of the Companions of the Messenger of Allah, may Allah (subhanahu wa ta ala) bless him and grant him peace, went to Marwan ibn al-Hakam and said, "Marwan! Do you make usury *halal*?" He said, "I seek refuge with Allah! What is that?" He said, "These receipts ***(sukuk)*** which people buy and sell before they take delivery of the goods." Marwan therefore sent a guard to follow them and to take them from people's hands and return them to their owners.

Source: Al-Muwatta' Book 31, Number 31.19.44.

A number of authors[3] have highlighted this type of *sukuk*, which is known as *sukuk al-badai*. It refers to grain/commodity coupons that was used to pay soldiers during the Umayyad period. The soldier could present these coupons to collect grain upon maturity. Some soldiers sold these *sukuk* prior to their maturity to obtain cash. Since the *sukuk* represent food (grain), the trading of such *sukuk* prior to maturity was seen to contradict the prohibition of selling food items before taking possession. Nonetheless, the concept of *sukuk* itself, where a certificate is used to represent the value of an underlying asset, was not prohibited. We will discuss the issue of trading of *sukuk* in the later part of the chapter.

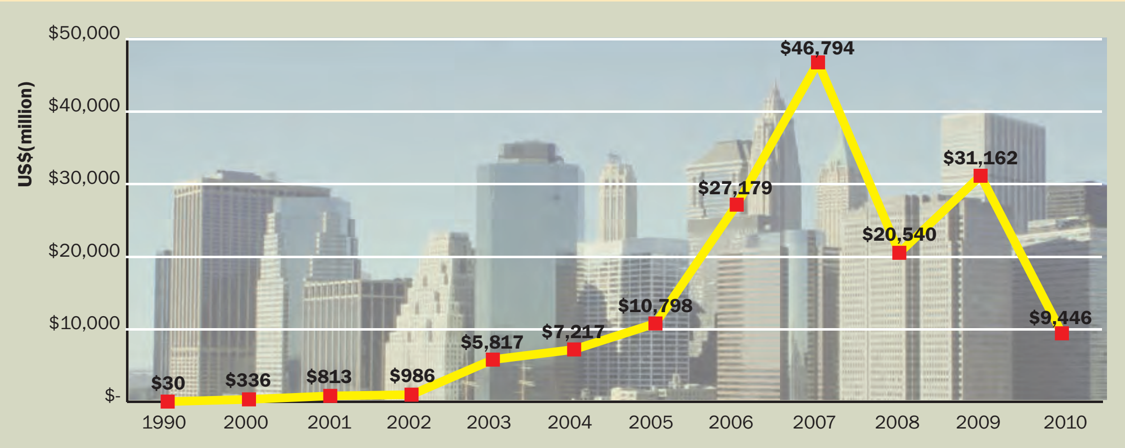
2 Imam Muslim also mentioned the idea of *sukuk* in his *hadith*. However, he used a slightly different term, i.e., (*sikak*). Refer to Sahih Muslim, Book 010, Number 3652.

3 Refer to (Adam & Thomas, 2004), (Kamali, 2007) and (Haneef, 2009) for examples.

Exhibit 10.3 Growth of *Sukuk* Market

The *sukuk* market is a fairly new development in the Islamic financial system. Based on data provided by Islamic Finance Information Service (IFIS), Shell MDS (Malaysia) issued *sukuk* in 1990, but there were no active issuances by other players or countries until the year 2001, in which a number of institutions, including Majlis Ugama Islam Singapura (MUIS) and the Government of Bahrain, issued *sukuk.* The first global corporate *sukuk* was issued by Guthrie Malaysia. This marked the beginning of an active *sukuk* market. Cumulative *sukuk* issued since the beginning of the market up to end-April 2010 amounted to US$161 billion.

Figure 10.1 depicts the growth of the *sukuk* market globally. The issuance grew 145% in 2006, compared to 2005, to reach US$27 billion. The *sukuk* market peaked at US$47 billion in 2007 and dropped by 55% (to US$21 billion) in 2008. The global market turmoil, drying up of liquidity, widening of credit spreads, and investors' wait-and-see attitude are some of the factors which attributed to the sharp decline in 2008. The market recovered in 2009 to reach a total issuance of US$31 billion, which was higher than the total issuance in 2006. The data for 2010 only represents issuance up until April, which stands at about US$9.4 billion.



Source: Author's own based on the Islamic Finance Information Service (IFIS) *Sukuk* Database.

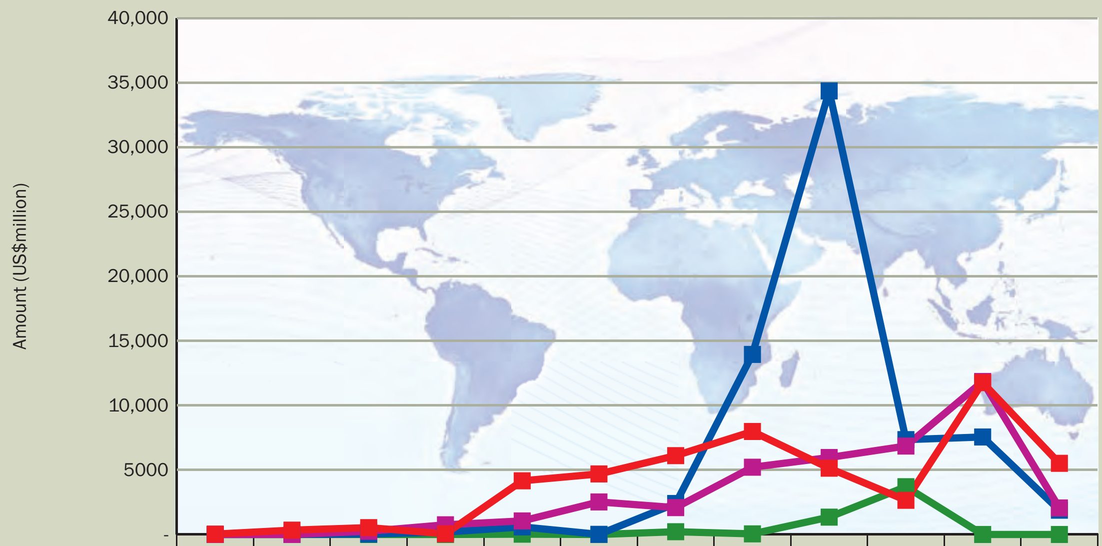
Figure 10.1 Growth of *Sukuk* Market until April 2010

If we analyse the type of *sukuk* issued, the market has experimented with various structures. These can be classified into three main clusters: sale-based *sukuk* (includes *murabahah, bay' bithaman ajil* (BBA) *bay' al-'inah, istisna'* and *salam*), lease-based *sukuk* (*ijarah* and a mixture of *ijarah* and *istisna'* structures) and equity-based *sukuk* (includes *musharakah, mudarabah* and *wakalah bi istithmar*).

In the early years of the *sukuk* market, sale-based *sukuk* dominated the type of issuance. These were all from the Malaysian market. In 2002, when the Malaysian government came to the market with its US$600 million *sukuk ijarah*, the lease-based cluster took the lead; representing 76% of *sukuk* issued. Nonetheless, from year 2003-2005 the sale-based cluster took the lead again with an average of about 60% of the *sukuk* issued each year. Starting in 2006 the equity-based cluster took the baton and peaked in 2007 when it represented 73% of *sukuk* issued. However, in 2008, the equity-

Exhibit 10.3 Growth of *Sukuk* Market (continued)

based *sukuk* took a sharp dive and only represented 38% of the *sukuk* issued. They were still the highest type of *sukuk* issued but did not lead with a large majority. In 2009, sale-based *sukuk* and lease-based *sukuk* shared the podium. Figure 10.2 below illustrates this trend.



	1990	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Sale Based	30	336	530	50	4,157	4,689	6,105	7,977	5,134	2,647	1,1761	5,511
Lease Based	-	-	250	750	1,050	2,520	2,080	5,209	5,961	6,848	11,850	2,055
Equity Based	-	-	33	186	587	9	2,400	13,946	34,355	7,346	7,551	1,880
Unidentifiable	-	-	-	-	23	-	213	47	1,343	3,700	-	-

Source: Author s own based on IFIS *Sukuk* Database

Figure 10.2 Illustration of *Sukuk* Trend

Figure 10.3 shows the market share of issued *sukuk*. Malaysia is a major player (58%), followed by United Arab Emirates (UAE) (18%) and Saudi Arabia (8%). Malaysia issues a large number of *sukuk* (mostly in MYR) in smaller denomination in contrast to UAE issuances that are less frequent but are large ticket issuances. Central Bank of Bahrain issues *sukuk ijarah* and *sukuk salam* on a very frequent basis to provide Islamic banks in Bahrain liquid instruments to invest in. Besides countries with growing interest in Islamic financial markets (Pakistan, Indonesia, and Brunei), non-Muslim affinitive countries have also tapped into the *sukuk* market. For example, a German Federal State (Saxony-Anhalt) issued US$123 million *sukuk ijarah* in 2004. Corporations in America have tapped into the *sukuk* market twice — first in 2006 when East Cameron, a Louisiana-based oil and gas company, issued US$167 million *sukuk musharakah*. More recently, General Electric (GE), a large American conglomerate, issued US$500 million *sukuk ijarah* in November 2009.

Exhibit 10.3 Growth of *Sukuk* Market (continued)

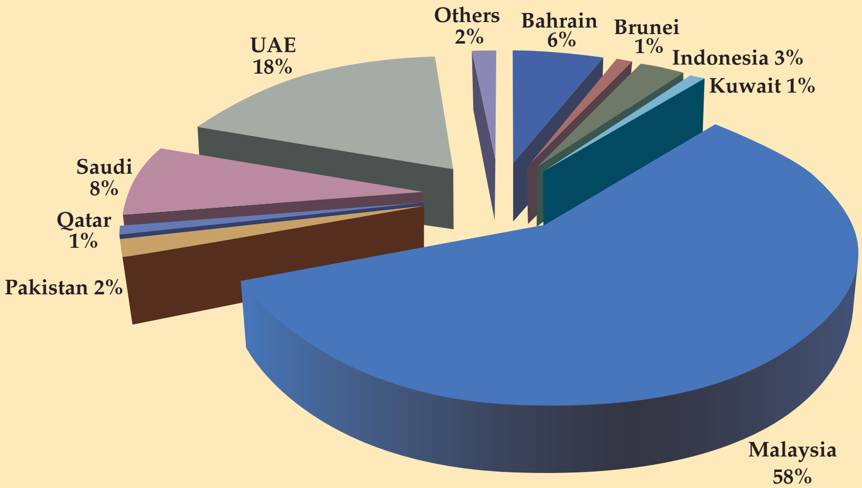


Figure 10.3
Market Share of *Sukuk* Issued until April 2010

Source: Author's own based on IFIS *Sukuk* Database.

Meanwhile, the Ottoman Empire issued *esham* (plural of *sahim*[4]) to fund its budget deficit in 1775 after its defeat by the Russians. The Ottoman Empire securitised the tobacco custom collection, in which the investors received annuity (variable return) for the rest of their life. The Ottoman Empire also had no obligation to buy back the *sahim*; as such there was no certain maturity of the *sahim*. It could buy back at its discretion.[5] This was another example of the early application of *sukuk* to raise funding. Although it was called *sahim* rather than *sukuk*, it works along the same idea, a certificate to represent an underlying asset or venture.

Role of *Shari'ah* Framework in *Sukuk* Structuring

In this section, we will first briefly discuss the differences between the conventional banking market and the debt capital market in general. Then, we will explain conventional debt capital market instruments (bond and asset-backed securities) and highlight the *Shari'ah* issues that arise from them. This will provide a general framework on the *Shari'ah* requirements in structuring *sukuk*.

Generally, to raise funds for operation in the conventional financial market, firms either approach banks (to obtain loans) or tap into the capital market. The conventional banking market is known as an *indirect financing* market because the firms deal with banks, which

4 *Sahim* refers to shares.
5 INCEIF Monthly Seminar by Professor Murad Çizakça on 20/3/09.

The capital market is known as the direct financing market because the firms deal directly with the investors, rather than going indirectly via the banking market.

act as intermediaries, i.e., collecting surplus funds and channelling them to the firm. The capital market is known as the *direct financing* market because the firms deal directly with investors rather than going indirectly via the banking market.

Banks have limits on the amount that can be financed per customer, per sector, etc. Larger funding amount will either require syndication (where several banks provide funding to a firm) or tapping into the capital market (where there is a large investor base). When a financial crisis hits an economy, the banking market usually faces constraints in providing funding to firms. In Malaysia, for example, an active bond market was developed due to the liquidity constraints that the Malaysian banking sector experienced during the Asian Financial Crisis. The Malaysian government established the National Bond Market Committee in 1999 to develop the bond market in Malaysia. Then in 2002, the Japanese government also initiated the Asian Bond Market Initiative (ABMI) to develop the bond market in Asia in an effort to provide alternative long-term funding avenues besides the banking market.

The Malaysian government established the National Bond Market Committee in 1999 to develop the bond market in Malaysia.

Nonetheless, the conventional debt market and the conventional banking market have similarities. Since both offer products that are debts in nature, the bank (in the conventional banking market) or the investors (in bond issuances) provide a loan to the firm in need of funds. In other words, bonds are evidence of a loan from the investor to the issuer; similar to a loan that a bank provides to a firm. The repayment of the bond consists of loan capital (principal) plus interest. Even in zero coupon bonds, the investors will receive accumulated interest at maturity as the bond will be issued at a discount. Bonds are usually unsecured, i.e., there is no collateral backing the loan and the recourse is to the issuer. However, there are also secured bonds. A secured bondholder will have security interest on assets of the issuer. If the issuer fails to pay, secured bondholders can enforce the claim on the asset to recover the debt due (outstanding capital plus accrued but unpaid interest). Simply put, we can say that bonds are evidence of indebtedness. The repayment of the loan capital/principal and interest are legally confirmed, thus giving the investors the status of creditors.

Bonds are usually unsecured, i.e., there is no collateral backing the loan and the recourse is to the issuer. However, there are also secured bonds.

We can observe a *Shari'ah* issue in this primary relationship in bond issuance. In *Shari'ah*, loan contracts are interest free. Any additional contractual benefit to the lender is considered *riba* and is prohibited in *Shari'ah*. The prohibition comes directly from the *Qur'an* as well as sayings of the Prophet (p.b.u.h.). Therefore, *sukuk*, unlike bonds, will not normally use loans as the underlying relationship since the investors cannot enjoy any returns in such cases.[6] It will utilise other underlying contracts (sale, lease, partnership, etc.) to enable the investors to enjoy a return over their investment.

Sukuk, unlike bonds, will not normally use loans as the underlying relationship since the investors cannot enjoy any returns in such cases.

6 An exception was issued by Petronas Dagangan (Malaysia) in 1994. For more information, please refer to Bakar & Engku Ali, 2008.

In addition, bonds are evidence of debt, whereas *sukuk* are broader as they can include debts (from sale) as the underlying assets (only in Malaysia[7]) and non-debt assets as the underlying (global standard). In Malaysia, before the issuance of the Islamic Securities Guideline in 2004, *sukuk* had to represent debt. However, with this new guideline, *sukuk* can represent debt or non-debt assets as the underlying.

Having understood the *Shari'ah* issue in bonds, let us analyse another instrument in the conventional debt capital market: asset-backed securities (ABS). In ABS, the originators (owners of income generating pool of assets) are not raising loans in the capital market. Instead, they sell assets that they own via a securitisation transaction which must fulfill two important criteria — true sale and bankruptcy remoteness. The sale of the underlying asset (securitisation transaction) must be a "true sale" from the legal perspective. True sale requirements differ from jurisdiction to jurisdiction and depend on the underlying asset used. Legal true sale[8] will ensure that the creditors of the originator cannot claw back the asset sold if the originator faces bankruptcy. In other words, legally true sale provides bankruptcy remoteness to investors.

ABS simply refers to the monetisation of the originators' asset. The repayment to the investors in ABS comes from the cash flow generated by the asset. The investors will have recourse only to the underlying asset and will not have recourse against the originator.

In the conventional ABS market, the majority of assets that are used as underlying are receivables, be it mortgages, credit card receivables and other loans. To facilitate Islamic ABS issuances, no *Shari'ah* scholar in any jurisdiction would allow the sale of conventional debt. However, there are differences of opinion between the Malaysian market and the Middle East or the Gulf Corporation Council (GCC) market when it comes to the sale of *Shari'ah*-compliant debt (*bay' al-dayn*). In general, the Middle East or GCC scholars do not allow trading of *Shari'ah*-compliant debt at a discount or

7 We will elaborate this in the next section.
8 Legal true sale may not necessarily be the same as accounting true sale. The criteria for accounting true sale have been evolving and take into consideration the different market incidents rather than just the legal form. Accounting true sale usually scrutinises the concept of control (US GAAP) and the transfer of risk and reward (IFRS).

premium. This is mainly because the debt (being monetary debt) would trigger the issue of *riba* when it is traded at other than par value. Therefore, in the Middle East or GCC, using *Shari'ah*-compliant debt as the sole underlying asset to issue *sukuk* is not permissible. Nonetheless, if one uses underlying assets other than debt in ABS issuances, then such securitisation transaction (i.e., selling off assets to raise funds) is permissible in the Middle East or GCC. The official ruling in Malaysia, in contrast, allows using *Shari'ah*-compliant debt as the underlying asset for an Islamic ABS. We will discuss the reason behind the differences of opinion in the next section.

The official ruling in Malaysia, in contrast, allows using *Shari'ah*-compliant debt as the underlying asset for an Islamic ABS.

In conclusion, when structuring *sukuk*, one has to first pay attention to the relationship in the primary market. If the investors want to enjoy returns, the primary relationship cannot be a loan transaction. Furthermore, the underlying asset according to global *Shari'ah* standard, should not include receivables that are traded at discount (or premium). Next, to ensure that *sukuk* can be traded in the secondary market, it is important to look at the underlying asset they represent. If they represent a debt, the global *Shari'ah* standard does not allow the secondary trading of such *sukuk*.[9] Table 10.1 provides some of the differences between bonds, asset-backed securities (ABS) and *sukuk*.

Table 10.1 Differences between Bond, Asset-Backed Securities and *Sukuk*

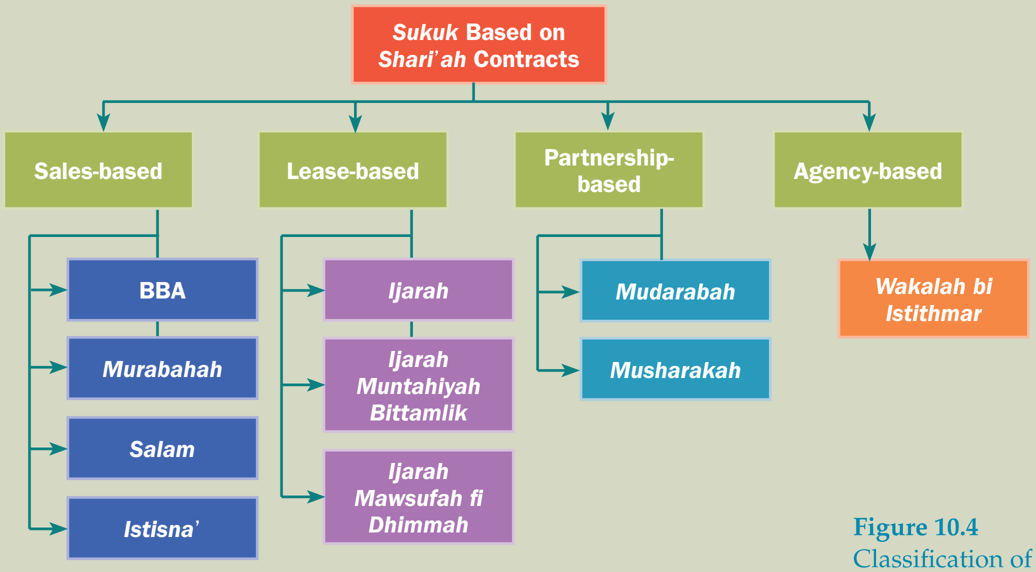
	Bond	Asset-Backed Securities (ABS)	*Sukuk*
Primary level relationship	Loan	Sale of debt or an income generating asset	Variety of contracts but rarely uses a loan
Return to investors	Interest on loan. (Recourse to issuer – unsecured)	Income generated from underlying asset (recourse to asset)	Profit elements in sale, lease or partnership contracts
Tradability in secondary market	Sale of debt	Sale of debt or income generating asset	Depends on nature of underlying asset. Global *Shari'ah* standard does not allow sale of debt with discounting, but allows sale of tangible assets, some intangible assets and interest in ventures.

Sukuk Structures

One of the most common *sukuk* classifications is based on the underlying *Shari'ah* contracts. These include BBA, *murabahah*, *salam*, *istisna'*, *ijarah*, *musharakah*, *mudarabah* and *wakalah*. Refer to Figure 10.4. We have to keep in mind that these contracts are not

9 We should note that when it comes to trading of shares, some markets in the GCC do not prohibit trading of shares of listed companies although the company has high debt (high leverage) or the assets comprise mostly of account receivables.

unique to the *sukuk* market. They can also be utilised in Islamic banking, asset management, the money market, etc. In other words, one *Shari'ah* principle can be used in different Islamic finance activities. From the *Shari'ah* perspective, there is no preference for the usage of one contract over the other. Therefore, the type of *Shari'ah* contract chosen by an issuer depends on other factors besides the *Shari'ah* requirement. Among the factors that will be considered are the economic objectives of the issuer, the availability of assets and the level of debt that the company has, the credit rating of the issuer, the legal framework in the jurisdiction and the tax implication of a structure.



Source: Securities Commission Malaysia, 2009, p. 48.

Figure 10.4
Classification of *Sukuk* based on *Shari'ah* Contracts

However, *sukuk* classification does not necessarily need to be tied to the type of contract. The *sukuk* types may also take into account the type of issuers (corporate, sovereign) or other features of the *sukuk* (exchangeable/convertible *sukuk*, subordinated *sukuk*, asset-backed *sukuk*, stapled *sukuk* and project finance *sukuk*). These *sukuk* types are summarised in Figure 10.5. In this alternative *sukuk* classification, multiple *Shari'ah* contracts can be used for a particular type of *sukuk*. For example, under the category of corporate *sukuk*, we can have a *murabahah* corporate *sukuk*, ijarah corporate *sukuk*, etc. Similarly, under the category of convertible *sukuk*, the underlying contract involved may be *ijarah, mudarabah* or *musharakah*, etc.

In addition to the above *sukuk* classifications, *sukuk* have also been commonly characterised as asset-based instruments. This is not strictly an independent classification on its own. Rather, it is a terminology coined to describe the specific features of *sukuk* that are not based on mere loans but the use of certain underlying asset to facilitate the transaction. The term "asset-based *sukuk*" should not be confused

The term "asset-based *sukuk*" should not be confused with "asset-backed *sukuk*".

Corporate

- Issuers are incorporated companies which are non-government firms.

Sovereign

- Issuers are government or sovereign entities.

Exchangeable and Convertible

- *Sukuk* may be converted into shares (equity) at maturity or other trigger events.

Subordinated

- The repayment of the *sukuk* is subordinated to the creditor or depositor.

Stapled

- Two instruments are attached together and cannot be traded separately.

Asset-Backed

- Are securities backed by an income generating asset with stable cash flow. This involves true sale securitisation where the recourse is to the asset and not the originator.

Project Financing

- Proceeds of *sukuk* is used to finance a project. Repayment to investors comes from cash flow generated from the project.

Figure 10.5 *Sukuk* Classification based on Commercial Function

with "asset-backed *sukuk*". Let us analyse the distinction between asset-based and asset-backed *sukuk*, which has received much attention lately, especially with the occurrence of *sukuk* defaults in the market. Rating bodies have published a number of reports on this distinction. Exhibit 10.4 highlights the description by Rating Agency Malaysia (RAM) while Exhibit 10.5 explains the definition by Moody's.

Simply put, asset-backed *sukuk* are similar to asset-backed securities with the necessary securitisation elements present. The originator who wants to raise funds sells the income generating asset to a special purpose vehicle (SPV) under a legal true sale. As a result of the legal true sale, the investors (i.e., *sukuk* holders) enjoy bankruptcy remoteness where the creditors of the originator cannot claw back the asset from the *sukuk* holders if the originator is facing bankruptcy. Therefore, the underlying assets are the sole recourse to the *sukuk* holders and the actual performance of the underlying asset will determine the return to the *sukuk* holders. If the underlying asset is performing while the originator is facing bankruptcy, the *sukuk* holders' payment will be uninterrupted. If the underlying asset is not performing (i.e., impaired) the *sukuk* holders are affected because they have no recourse to the originator. Throughout this chapter, when we use the term asset-backed *sukuk*, we are referring to *sukuk* that took the securitisation path and the investors' recourse is to the asset and not the originator.

Exhibit 10.4 Definition of Asset-Based and Asset-Backed *Sukuk* by RAM

"Asset-backed *sukuk* are characteristically **non-recourse *sukuk*, with the underlying assets forming the lone source profit and capital payments**. The credit risk of this type of *sukuk* will be solely determined by the performance and credit quality of the underlying asset, i.e., the asset's cashflow and, in some various situations, expected value at maturity given various stress situations and scenarios. *Sukuk* investors generally do not have access to the asset owner (i.e., originator), likewise they are safeguarded from the latter's financial plights, made certain by the transaction's structural and legal make-up. Asset-backed *sukuk* must encompass the **essential securitisation elements**, which establish that the credit-risk profile of the *sukuk* is effectively delinked from that of the asset originator and is, instead, determined solely by the performance of the underlying asset.

In asset-based *sukuk,* the asset is present for the purpose of *Shari'ah* fulfillment rather than to serve as a source of profit and capital payments, the credit risk assessment will typically be directed towards the entity with the obligation to redeem the *sukuk*. Usually, this will be the issuer. In some cases, however, the task may fall on the originator, sponsor or lessee via the existence of a purchase undertaking agreement. In this instance, an analysis of the asset will be consequential, rather, the **credit quality of the issuer will be the key driver affecting the credit quality** and rating of the s*ukuk*".

Source: Mohd Noor, 2008, p. 152.

Exhibit 10.5 Definition of Asset-Based and Asset-Backed *Sukuk* by Moody's

"In asset-backed *sukuk*, investors enjoy asset-backing, they benefit over some form of security or lien over the assets, and are therefore in a preferential position over other, unsecured creditors. In other words, in the event the issuer were to default or become insolvent, the note holders would be able to **recover their exposure** by taking control of and ultimately realising the value from the asset(s). It also requires the **element of securitisations** to be present — true sale, bankruptcy remoteness and enforceability of security ...

In asset-based *sukuk*, the originator undertakes to repurchase the assets from the issuer at maturity of the *sukuk*, or upon a pre-defined early termination event, for an amount equal to the principal repayment. In such a repurchase undertaking, **the true market value of the underlying asset (or asset portfolio) is irrelevant** to the *sukuk* note holders, as the amount is defined to be equivalent to the notes. In this case, note holders have no special rights over the asset(s) and rely wholly on the originator's creditworthiness for repayment, either from internal sources or from its ability to refinance. Thus, if the originator is unable to honour its obligation to repurchase the assets, the note holders are in no preferential position to any other creditors, or indeed in no weaker position to any other unsecured creditor stressing the importance that the purchase undertaking ranks *pari passu* with any other of the originator's senior unsecured obligations."

Source: Lotter, Philipp; Howladar, Khalid; 2007, pp. 5-6.

Under the asset-based *sukuk*, if the asset is not performing, the issuer may still have to pay the expected return by exercising the credit enhancements.

In an asset-based *sukuk*, although an asset may be used in the structure, it does not necessarily drive the return to the *sukuk* holders. Through a number of credit enhancement features (purchase undertaking, liquidity facility, etc.), the recourse of the *sukuk* holders is not to the asset but to the issuer. If the asset is not performing, the issuer may still have to pay the expected return by exercising the credit enhancements. If the issuer defaults, the *sukuk* holders will only have limited right of disposal because they will be required to sell the asset (if any) to the issuer. Asset-based *sukuk* attempts to emulate the behaviour of bond issuance in the conventional space.

In the next section, we will examine the features of different types of *sukuk* according to the different *Shari'ah* contracts: sale-based *sukuk*, lease-based *sukuk* and equity-based *sukuk*. We will go through examples of asset-based and asset-backed *sukuk* in each cluster.

Sale-Based *Sukuk*

Commonly, there are four types of contracts that are frequently used in sale-based *sukuk*: BBA, *murabahah, salam* and *istisna'*. BBA and *murabahah* are widely used in Malaysia. From the *Shari'ah* perspective, both concepts refer to a sale transaction of goods that are in existence.

Refer to Table 10.2 for an example of an asset-based *sukuk murabahah* issued by Sunway City, a well-known property developer in Malaysia. In this deal, there was no SPV used. Instead, Sunway itself was the issuer. Sunway obtained approval from SC on 10 October 2007 to issue RM500 million *sukuk murabahah* under a medium-term note (MTN) programme. This allows Sunway to raise *sukuk* in different amounts within a span of 15 years. The first *sukuk,* however, must be issued within two years of approval.

Table 10.2 Sunway RM500 million *Sukuk Murabahah* Transaction Summary

Issuer	**Sunway City – A property development company incorporated in Malaysia on 13 July 1982. Paid-up capital was RM415 million as at 31 October 2006.**
Lead Arranger/Facility Agent	HSBC Bank Malaysia
Trustee	Mayban Trustee
Amount	Up to RM500 million
SC Approval	10 October 2007
Profit Payment	Semi-annual
Identified Asset	Shares in subsidiary (Sunway Damansara/Sunway Pyramid) or other assets

Source: Sunway, 2007.

Every time Sunway wants to raise funds, it will sell an identified asset to HSBC (facility agent acting on behalf of the investors) on a spot basis. An asset purchase agreement (APA) will be signed. It is called a purchase agreement as it reflects the investors' perspective. They are buying the asset. HSBC will pay the purchase price to Sunway with the proceeds raised from the issuance of *sukuk*. Since now investors own the asset, they will sell it back to Sunway (via HSBC) on a deferred basis. The deferred selling price will be higher than the spot purchase price. Finally, Sunway will issue the *sukuk murabahah* to evidence its obligation to pay the deferred selling price. Once the sale has taken place, investors do not own the underlying asset used to facilitate the transaction anymore. What they own is the entitlements/rights to the sales price due (i.e., receivable) from Sunway.

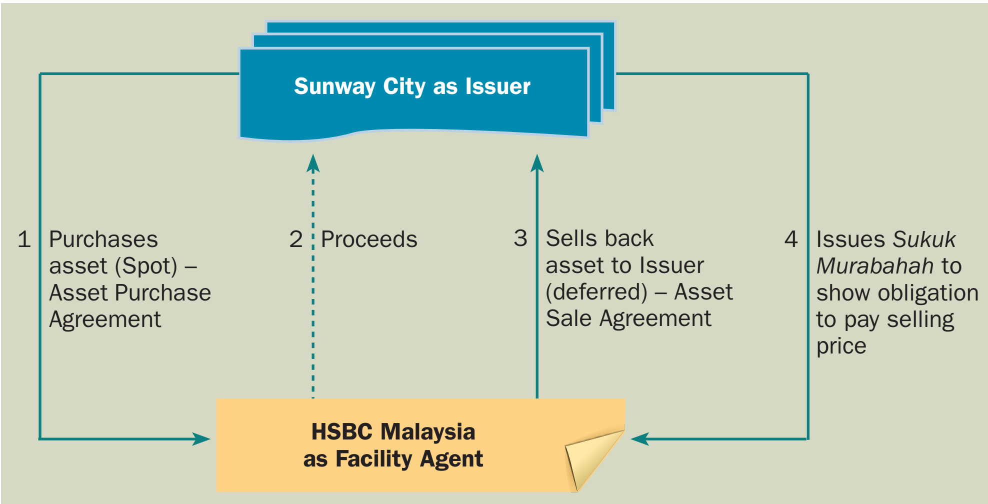


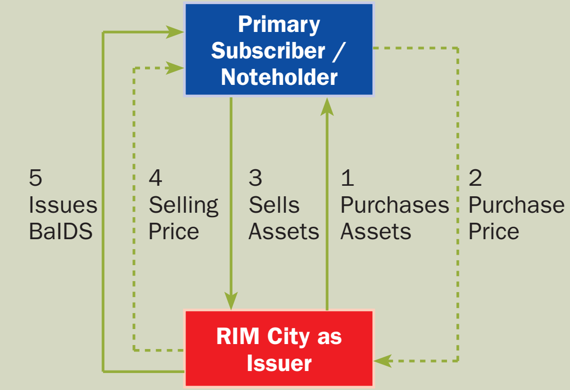
Figure 10.6 Sunway RM500 million *Sukuk Murabahah* Structure

Let us compare Sunway's *sukuk murabahah* to RIM City's *sukuk* BBA, another property developer involved in the Iskandar Development Project in Johor. Table 10.3 and Figure 10.7 provide the transaction summary and transaction structure.

Table 10.3 RIM City RM1 billion BBA Islamic Debt Securities (BaIDS) Transaction Summary

Issuer	RIM City – A property developer company incorporated in Malaysia on 23 July 2007. Paid-up capital was RM20 million as at 10 August 2008.
Lead Arranger/ Primary Subscriber	CIMB
Trustee	Not applicable as it is bought by the primary subscriber
Amount	Up to RM1 billion
SC Approval	30 September 2008
Profit Payment	Monthly
Identified Asset	*Shari'ah*-compliant assets of issuer

Source: RIM City, 2008.



Step 1	For each issuance, the Primary Subscriber and the Issuer shall execute a Purchase Agreement under which the Primary Subscriber shall purchase the identified Assets at the Purchase Price (PP) from the Issuer. The value and the PP of the identified Assets shall comply with the ending SC's *Shari'ah* Advisory Council Pricing Guidelines dated 31 December 2000 and April 2004.
Step 2	The PP shall be the amount disbursed to the Issuer.
Step 3	Immediately thereafter, the Primary Subscriber shall sell the identified Assets to the Issuer of an agreed Selling Price through the execution of a Sale Agreement.
Step 4	The Selling Price shall consist of the PP plus the profit margin (which is based on a Ceiling Profit Rate), payable on a deferred basis over a period of time. If for any profit payment period, the Effective Rate is below the Ceiling Profit Rate, the Noteholder will grant an *Ibra'* (rebate) so that the profit portion payable by the Issuer in respect of such profit payment period will equal to such amount based on the Effective Rate. The Issuer's obligation to pay the Selling Price subject to the *Ibra'* (rebate) will be evidenced by the Notes.
Step 5	The Issuer shall issue BaIDS to the Note holder. The BaIDS shall evidence the Selling Price payment obligation of the Issuer.

Source: RIM City, 2008, p. 23.

Figure 10.7
RIM City RM1 billion BaIDS Structure

Similar to Sunway, RIM City itself was the issuer. RIM City obtained approval from SC on 30 September 2008 to issue RM1 billion BaIDS programme which allows RIM City to raise *sukuk* in different amounts within a three-year period. Similar to Sunway, the RIM City BBA structure involves RIM City selling assets to the primary subscriber on a spot basis and buying them back on a deferred basis. Then RIM City issues *sukuk* BBA to evidence its obligation to pay the deferred selling price. This similarity (in structure) is true for all *sukuk* BBA and *sukuk murabahah* in Malaysia.

Before making an analysis of the *Shari'ah* issues that arise in the structure, let us first look at an asset-backed *sukuk* BBA. Recall that an asset-backed *sukuk* follows the path of securitisation. In Malaysia, all asset-backed securities (conventional and Islamic) must abide by the ABS Guideline issued by the Securities Commission Malaysia. Among the important features that are required for securitisation are true sale, bankruptcy remoteness and non-recourse to the originator. Table 10.4 and Figure 10.8 provide information on ABS Plantation Assets, which utilised a combination of BBA and *ijarah* structures.

In Malaysia, all asset-backed securities (conventional and Islamic), must abide by the ABS Guideline issued by the Securities Commission Malaysia.

Table 10.4 ABS Plantation Assets RM175 million BBA *Sukuk* Transaction Summary

Issuer	ABS Plantation Assets – An SPV incorporated on 3 March 2005 for facilitating the securitisation exercise with RM2 paid-up capital.
Originator	Benta & Subsidiaries, which are involved in oil palm cultivation and processing in Perak
Lead Arranger/ Facility Agent	Deutsche Bank (Malaysia)
Trustee	HSBC (Malaysia) Trustee
Amount	Up to RM175 million
SC Approval	8 September 2005
Profit Payment	Semi-annual
Identified Asset	Seven lots of plantation land in Perak

In this deal, an SPV, ABS Plantation Assets was the issuer. Benta and two of its subsidiaries (Syarikat Kaum Melayu Hilir Perak and Tahir, Rozlan & Tasariff) are oil palm plantation companies which are the originators in this deal. Benta is in turn, a subsidiary of Multi Vest. ABS Plantation Assets obtained approval from SC on 8 September 2005. To raise funds, Benta and its subsidiaries sold seven lots of plantation lands in Perak to the issuer, ABS Plantation Assets. The sale was at market value and legal true sale opinion was obtained to ensure this. ABS Plantation Assets in turn sold the land plots to the primary subscriber on a spot basis. Immediately thereafter, the primary subscriber sold back the land plots to ABS Plantation Assets on a deferred basis. The sale price consisted of the capital and the required profit. ABS Plantation Assets then issued *sukuk* BBA to evidence its obligation to pay the deferred selling price.

The proceeds from the issuance of *sukuk* were used to pay the originators the price of land purchase. Finally, the issuer leased back the lands to the originators. The lease payments were used to pay the *sukuk* holders' capital and profit. Simply put, ABS Plantation Assets bought the lands from the originators. To fund the purchase, the issuer entered into a sale and buy back transaction with the primary subscriber. The issuer then leased back the land to the originators. Figure 10. 8 illustrates the structure of the deal.

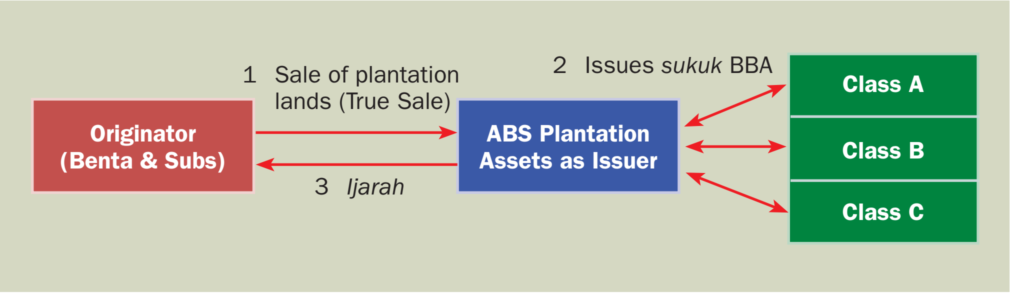


Figure 10.8 ABS Plantation Assets RM175 million BBA *Sukuk* Structure

We should note that there were three classes of *sukuk* issued in this deal: Class A (RM50 million), Class B (RM45 million) and Class C (RM80 million). There was no cash raised on Class C as it was subscribed by the originators. The price on Class C was set off against the price that ABS Plantation Assets needed to pay for the purchase of the land from the originators. This means, the originators only raised RM95 million cash despite the issuance size of RM175 million. The different classes reflected the priority of payment. Class A would be paid first, followed by Class B and finally Class C. Besides that, Multi Vest, the holding company of the originators, also provided a guarantee on the lease payment by the originators. Multi Vest (or any of its nominees) also has the option to buy the plantation lands, during Year 3 to Year 9 of the life of the *sukuk* (exercise period). However, option to purchase was at fair market value at the time of purchase (in accordance with an independent valuation) subject to a minimum of the fair market value at the time of *sukuk* issuance.[10] The pricing of the option at fair market value is important as this would ensure that there is no recourse to the originator (via Multi Vest). If Multi Vest did not exercise this option, ABS Plantation Assets will proceed to sell the lands in the open market and use the proceeds to redeem the *sukuk*. Recall that there will be no recourse to the originators. Thus the value of the properties will be vital to ensure that the issuer can redeem the *sukuk*.

Shari'ah Issues in the Primary Issuance of Sale-Based *Sukuk*

If we look deeper into all three structures discussed above (Sunway *sukuk murabahah*, RIM City *sukuk* BBA and ABS Plantation Assets *sukuk* BBA), we can observe that in the primary market they actually involve a sale and buy back structure. In addition, the spot sale will always have a lower price than the deferred sale price. This sale-and-buy-back transaction known as *bay' al-'inah,* literally means sale of cash. In the Islamic capital market, *bay' al-'inah* structure requires the client to have an asset that can be sold and bought back. If the client (i.e., issuer) does not have the asset, they will try to source it on a temporary basis from either subsidiaries or parent companies. Most commonly, the parent/subsidiaries of the issuer will provide the asset to the issuer using a *hibah* contract (gift). The issuer will sell and buy back the asset. Thereafter, the issuer will return the asset to the original owner through another *hibah* transaction.[11]

As discussed in detail in Chapter 6, *bay' al-'inah* is a highly controversial contract. Only the Shafi'i and Zahiri schools validated this instrument while the Hanbali, Hanafi and Maliki schools prohibited it on the basis that it is a trick to allow borrowing money and paying *riba*. The *Shari'ah* Advisory Council of SC, after deliberating the various

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10 Refer to p. 20–21 for details on the option to purchase.

11 Refer to Straight A's Portfolio (SAP) RM200 million *sukuk murabahah* issued in April 2007, Horizon Hills (Arapesona) RM270 million *sukuk murabahah* issued in June 2007 and DESB Marine RM120 million *sukuk murabahah* issued in October 2007 for example.

opinions in the schools of Islamic law finally adopted the Shafi'i view to allow the application of *bay' al-'inah* in the Islamic capital market activities. Refer to Chapter 6 for detailed discussion of *bay' al-'inah*.

The global Islamic capital market, however, does not utilise *bay' al-'inah*. As an alternative, they use *tawarruq* in an arrangement known as commodity *murabahah* as an underlying structure in the primary market. In brief, *tawarruq* involves two separate sale contracts, one spot and one deferred. However, unlike *bay' al-'inah* that involves two parties, *tawarruq* involves three parties. When *tawarruq* is used in a commodity *murabahah* arrangement, it will be coupled with a *murabahah* transaction. The transaction will start with the investors buying the commodity on a spot basis and selling it to the client (i.e., issuer) on a deferred basis with a mark up (i.e., *murabahah*). The issuer then sells this commodity on a spot basis to a third party, usually a commodity broker. Malaysia has established an exchange, namely Bursa Suq al-Sila', on the Bursa Malaysia, to facilitate commodity trading activities.

The global Islamic capital market, however, does not utilise *bay' al-'inah*. As an alternative, they use *tawarruq* in an arrangement known as commodity *murabahah* as an underlying structure in the primary market.

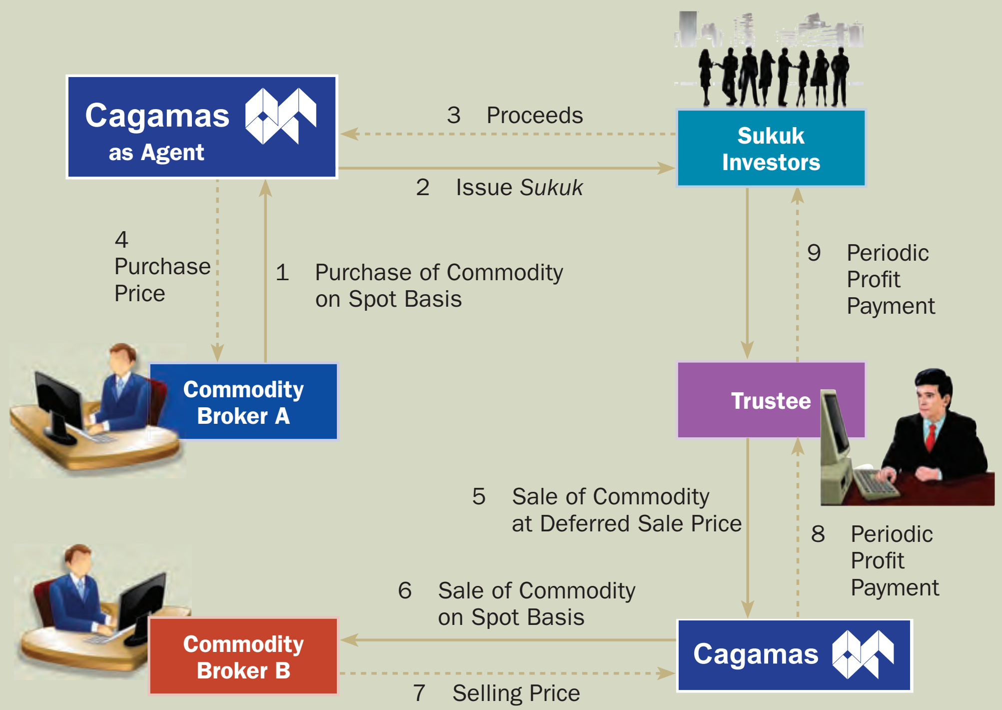
Generally scholars have viewed *tawarruq* more favourably compared to *bay' al-'inah*. Nonetheless, organised *tawarruq* in commodity *murabahah* has been increasingly criticised. The latest includes the Organization of the Islamic Conference (OIC) *Fiqh* Academy's disapproval of the structure in April 2009. The main argument raised by the OIC *Fiqh* Academy against organised *tawarruq* is that the pre-arrangement makes it synthetic, similar to *bay' al-'inah*. However, the AAOIFI *Shari'ah* Standard allows *tawarruq* subject to certain control mechanisms.[12]

Let us analyse an example of *sukuk* commodity *murabahah* (with *tawarruq* features) which was issued by Cagamas. A similar structure is also used globally. Refer to Table 10.5 and Figure 10.9 for details.

Table 10.5 Transaction Summary for Cagamas ***Sukuk*** Commodity ***Murabahah*** (***Tawarruq***)

Issuer	**Cagamas – The Malaysian National Mortgage Corporation incorporated on 2 December 1986. Cagamas' principal activities include purchase of mortgage loans, hire purchase and leasing receivables (conventional and Islamic) from primary financiers and the issue of bonds and notes (conventional and Islamic) to finance these purchases.**
Joint Lead Arrangers	Aseambankers, CIMB & HSBC Malaysia
Facility Agent	Cagamas
Trustee	PB Trustee Services
Amount	Up to RM20 billion for the aggregate CP (Conventional & Islamic) Up to RM40 billion for the aggregate MTN (Conventional & Islamic)
SC Approval	25 June 2007

12 Refer to AAOIFI *Shari'ah* Standard No. 30 on Monetisation (*Tawarruq*) for the details on the control mechanisms.



1	Cagamas, as Agent (*Wakil*) of *sukuk* investors, shall purchase commodity on a spot basis from Broker A at Purchase Price.
2	Cagamas ("Issuer") shall issue *sukuk* to investors to evidence their ownership of the commodity.
3 & 4	Proceeds received from *sukuk* investors are used or deemed to have been used to pay the purchase price of the commodity.
5	Trustee, on behalf of *sukuk* investors, shall sell the commodity to Cagamas at Deferred Sale Price repayable on deferred payment basis.
6	Cagamas sells the commodity to Broker B on a spot basis at Selling Price.
7	Proceeds received from the sale of commodity (Selling Price) are used to fund Cagamas' Islamic operations.
8 & 9	Cagamas makes periodic profit distribution (e.g., semi-annual basis) to the Trustee on account of its obligation to pay the Deferred Sale Price. Upon maturity, Cagamas will pay the principal to redeem the *sukuk*.

Source: Cagamas Berhad.

Figure 10.9
Cagamas *Sukuk* Commodity *Murabahah*

On 25 June 2007, Cagamas obtained approval to issue both Islamic and conventional commercial papers (CPs) and medium-term notes (MTN). Cagamas, being the national mortgage corporation in Malaysia, will use the proceeds from the *sukuk* and bond issuance to purchase receivables from Malaysian financial institutions. As the Islamic funds in Malaysia can only be used to buy Islamic assets, the *sukuk* proceeds will only be used to buy receivables (originating from mortgages, hire purchase and leasing activities) from Islamic financial institutions. Since the approval was for a large amount and this involved a programme issuance, Cagamas had the option of using various Islamic principles for the different issuances.

In the deal, Cagamas bought commodity (crude palm oil) on a spot basis on behalf of the investors (*sukuk* holders) and issued *sukuk* as evidence of the ownership of commodities. The proceeds from the *sukuk* issuance will be used to pay the commodity broker. Next, the trustee (acting on behalf of the *sukuk* holders) will sell the commodity to Cagamas on a deferred basis. The selling price will include the profit required by the *sukuk* holders. To obtain cash, Cagamas will sell the commodity to another broker. Cagamas will make periodic distributions to the trustee (i.e., the profit portion) and redeem the principal via a bullet payment at maturity.

Shari'ah Issues in the Secondary Market of Sale-Based *Sukuk*

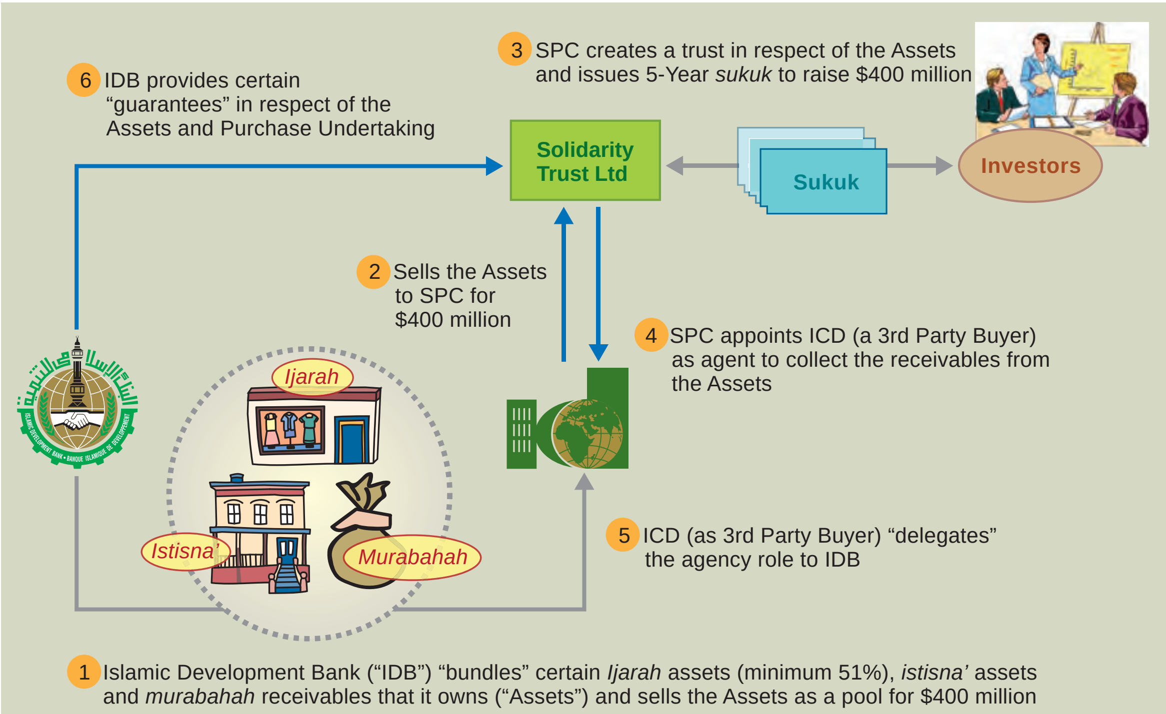
Under both *bay' al-'inah* and *tawarruq* structures, *sukuk* holders own the underlying asset only at the onset of the issuance date. Upon the sale of the asset, the *sukuk* holders no longer own the asset. Instead, they own debts due from the issuer. As both *sukuk* are debt in nature, they are categorised as sale of debt, i.e., *bay' al-dayn*. They cannot be traded in the secondary market in some jurisdictions, especially in the Middle Eastern market.

Sale of debt to a third party are amongst the contentious issues that were discussed in detail in Chapter 6. In summary, only the Maliki and Shafi'i classical scholars have allowed the sale of a debt to third parties, provided that it meets certain conditions. In addition, contemporary rulings allow sale of debt given that it is free from *riba* and *gharar*. Due to the prohibition of *riba*, sale of debt to third parties at a discount is not permissible. The OIC *Fiqh* Academy viewed the receivable as monetary in form. Thus selling this in exchange for payment of money would require it to be on a spot basis and for an equal amount. If discounting occurs, the buyer of the debt will obtain more money in the future compared to what he paid for the debt.

On the contrary, the *Shari'ah* Advisory Council of SC has approved the sale of debt even with discounting as long as it is a cash transaction. The SAC considers debt to be as good as an asset (*haqq maliyy*) and, therefore, it can be freely traded. Therefore, in Malaysia, *sukuk murabahah* holders can trade this *sukuk* in the secondary market and it can be sold at any price. If the investors in *sukuk murabahah* were to sell it to other investors, it can only be done at par to avoid invoking *Shari'ah* issues pertaining to *bay' al-dayn*.

Table 10.6 IDB US$400 million *Sukuk al-Istithmar* Transaction Summary

Issuer	**Solidarity Trust Services Limited** – Incorporated in Jersey on 6 March 2003 as a charitable trust solely for the purpose of issuing Trust Certificates. It has issued capital of £2.
Originator	**Islamic Development Bank (IDB)** – An Intra-governmental Islamic bank providing project financing, trade financing and technical assistance to Islamic member countries and Muslim population in non-member countries.
Joint Lead Arrangers	Citigroup
Issuance Date	12 August 2003
Amount	US$400 million
Underlying asset	*Ijarah* asset worth US$264 million. *Murabahah* receivable worth US$123 million. *Istisna'* receivable worth about US$14.



Source: Haneef, 2009, p. 112.

Figure 10.10 IDB US$400 million *Sukuk Istithmar* Structure

To date, various efforts have been made to continuously structure *sukuk* that are freely tradable in the secondary market according to global *Shari'ah* standard. These include the effort made by the Islamic Development Bank (IDB) which pioneered the hybrid *sukuk* known as *sukuk al-istithmar* (i.e., investment *sukuk*). This *sukuk* issurance comprised a mixed portfolio of *ijarah* properties and receivables. On 12 August 2003, IDB (via an offshore SPV[13]) issued a trust certificate worth US$400 million with a maturity of five years. IDB, being an intra-governmental Islamic bank, had portfolios of assets from the various financing provided to its client. The *Shari'ah* Board of IDB ruled that IDB can sell a mixed portfolio of *ijarah* properties (tangible asset) and receivables (*murabahah* and *istisna'*) given that the *ijarah* properties are at least 51%. The majority tangible asset with receivable attached to it was viewed as tradable in the secondary market.

On the issuance date, 65.8% of the *sukuk* assets were in the form of *ijarah* and IDB undertook that the *ijarah* contract proportion in the *sukuk* asset would not fall below 25%. IDB sold this mixed portfolio to Islamic Corporation for the Development of the Private Sector (ICD), a member of the IDB Group, who then sold the asset to the issuer, Solidarity Trust Services, an SPV incorporated in Jersey. The SPV issued the US$400 million *sukuk* to fund the purchase. It also declared that it holds the asset in trust for the *sukuk* holders.

The SPV then appointed ICD to manage the portfolio. ICD then delegated this task to IDB. The IDB *sukuk istithmar* was trying to emulate a securitisation structure by selling an asset which generates cash flow. However, due to additional credit enhancing features that gave recourse to IDB, the deal is not considered a securitisation structure. The credit enhancements include a liquidity facility (whereby IDB undertakes to make an interest-free loan to the trustee to ensure timely payment of periodic distribution), a guarantee (whereby IDB undertakes to cover any shortfall in collection) and a purchase undertaking (whereby IDB undertakes to buy back the asset). Figure 10.10 illustrates the IDB *sukuk istithmar* structure. In June 2005, IDB issued another *sukuk istithmar* worth US$500 million, with only 30% *ijarah* asset. This is in line with the minimum ratio of tangible asset in the hybrid *sukuk* according to the AAOIFI standard.[14]

13 Special Purpose Vehicle (SPV) and Special Purpose Company (SPC) are used inter-changeably in this chapter.

14 For further details, refer to AAOIFI *Shari'ah* Standard No. 21 on Financial Papers (shares and bonds) – paragraph 3/1 and *Shari'ah* Basis No. 18 in the same standard.

Exhibit 10.6 *Sukuk Al-Amanah Li Al-Istithmar* (ALIm)

Issues of acceptability and tradability of *sukuk* have been causing contention within the Islamic finance industry in the Middle East. This resulted in a need for widely accepted and tradable *Shari'ah*-compliant *sukuk* structures. In 2010, Cagamas Berhad, Malaysia's mortgage corporation, successfully issued one such *sukuk* — *Sukuk Al-Amanah Li Al-Istithmar* (ALIm).

Sukuk ALIm, which is considered an innovative Islamic capital market instrument, harmonises the differences in *Shari'ah* compliance in the Islamic capital market between Malaysia and the Middle East. Apart from conforming with various *Shari'ah* standards including those of the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), the *Sukuk* ALIm structure is unique in that it precludes principles which may not be accepted by some *Shari'ah* scholars such as *'inah* (sale and pre-determined buy-back), *bay' al-dayn* (debt trading), *tawarruq munazzam* (pre-arranged transactions between multiple parties) and *wa'd* (undertaking). Even though these elements are excluded from *Sukuk* ALIm, its characteristics, behavioural aspects and risk profile are at par with other comparable *sukuk* and is acceptable to the market. This was evident in the maiden issuance of *Sukuk* ALIm by Cagamas Berhad which amounted to RM1 billion in August 2010. The issuance was oversubscribed by 2.7 times.

The distinctive feature of the Sukuk ALIm structure is that it comprises two steps i.e., property investment and commodity trading transaction. The issue of tradability in the secondary market (while avoiding the issue of *bay' al-dayn*) is addressed with the requirements of more than 50% tangible assets (i.e. real estate properties) which are commingled with receivables arising from the commodity trading. Furthermore, the creation of trusts with clear documentation to describe the roles of each party involved in the transaction structure avoids the issues relating to *'inah* and *wa'd* that are common in other *sukuk* structures. *Sukuk* ALIm also involves a genuine commodity trading transaction between four different parties, thus avoiding issues relating to *tawarruq munazzam*.

The primary objective of the transaction is to create an international *Shari'ah*-compliant structure that is widely accepted and tradable in the Islamic capital market. The diagram below gives an overview of a *Sukuk* ALIm transaction.

Structure of *Sukuk* ALIm

Transaction Steps:

1. Cagamas shall constitute an Asset Trust comprising the identified properties with the Asset Trustee as trustee.
2. Asset Trustee issues an Asset Certificate to Cagamas as evidence of Cagamas' undivided interest in the Asset Trust.
3. *Sukuk* investors pay cash into a *Sukuk* Trust for the purpose of investment with the *Sukuk* Trustee as trustee.
4. Cagamas issues *sukuk* to *sukuk* investors as evidence of their undivided interest in the *Sukuk* Trust.
5. *Sukuk* Trustee utilises part of cash in *Sukuk* Trust to purchase the Asset Certificate from Cagamas.
6. Asset Trustee (on behalf of the *Sukuk* Trustee) will lease the properties to Cagamas and appoints Cagamas as the Service Agent.
7. Cagamas makes periodic rental payments relating to the leased Properties.
8. Cash balance in the *Sukuk* Trust is injected into the Asset Trust.
9. Asset Trustee purchases commodities from Vendor A on spot basis.
10. Asset Trustee sells the commodities to Cagamas on deferred basis.
11. Cagamas sells the commodities to Vendor B on spot basis.
12. Cagamas makes periodic payments relating to its obligations to the commodities purchased on deferred basis.

Exhibit 10.6 *Sukuk Al-Amanah Li Al-Istithmar* (ALIm) (continued)

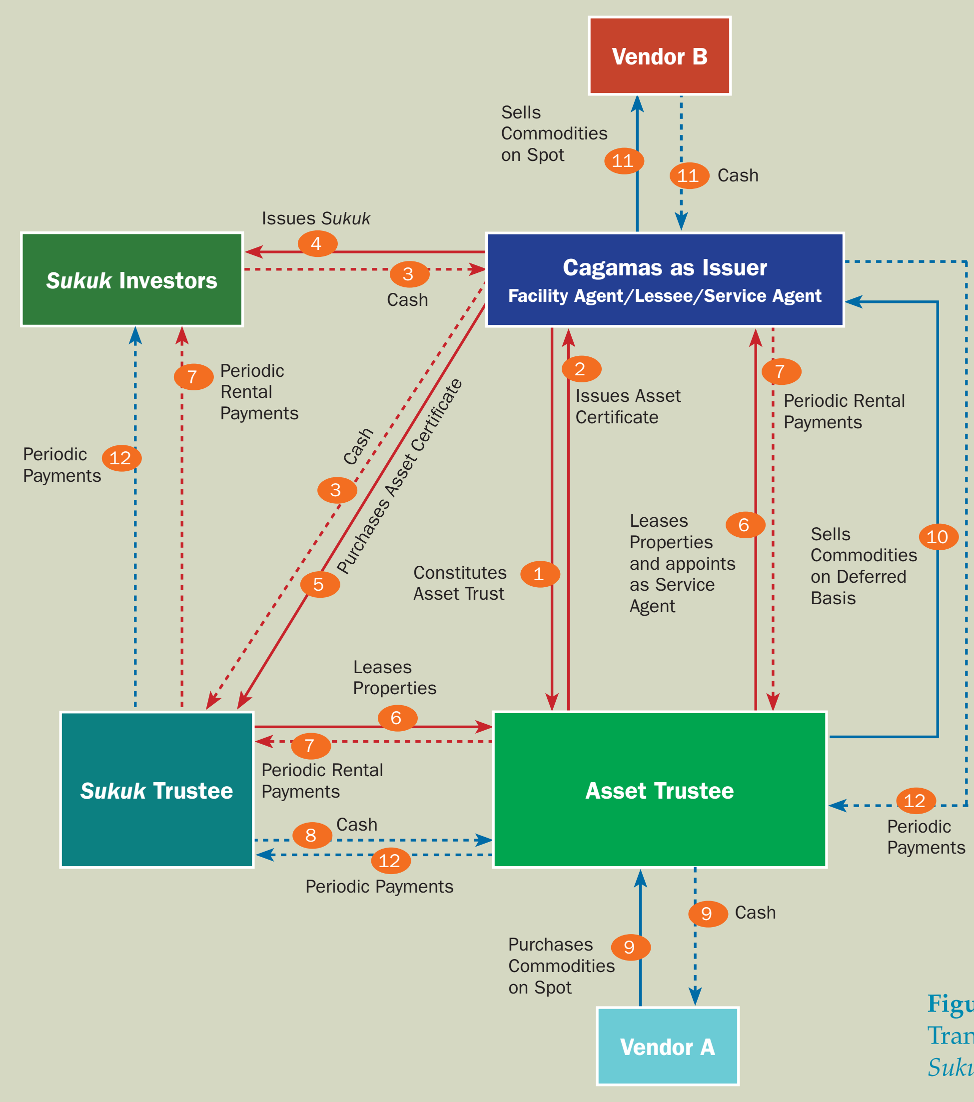


Figure 10.11 Transaction of *Sukuk* ALIm

To sum up, basically there are a few post-transaction remarks which are worth highlighting:

Firstly, inaugural issuance attracted strong interest of 43% from offshore investors, with 33% from Middle Eastern investors. Secondly, due to its unique structure, Sukuk *ALIm is acceptable to a wider range of domestic and international investors including investors from Saudi Arabia, where* Shari ah *requirements are viewed to be stricter. This sets a new benchmark for future* sukuk *issuances on and beyond local shores. Finally,* Sukuk *ALIm complies with the requirements of various* Shari ah *standards including AAOIFI.*

As evidenced by the maiden issuance by Cagamas Berhad, the above described structure of *Sukuk* ALIm appears to be appealing to international investors including those from the Middle East. *Sukuk* ALIm represents a step forward towards *Shari'ah* harmonisation as it sets a new benchmark for future *sukuk* issuances.

Exhibit 10.6 *Sukuk Al-Amanah Li Al-Istithmar* (ALIm) (continued)

Source: Cagamas Berhad.

Other Sale-Based *Sukuk – Istisna'*

Besides *sukuk murabahah, sukuk istisna'* also falls under the sale-based *sukuk* cluster. MRCB Southern Link Berhad, a company incorporated to undertake the construction of highway in Johor Bahru, issued RM900 million senior *sukuk istisna'* in June 2008 to fund the construction.

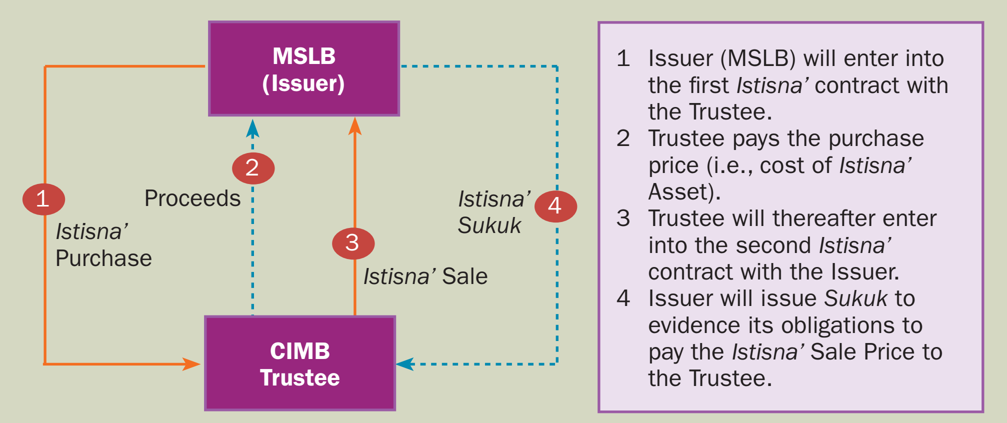
Table 10.7 RM900 million MSLB *Sukuk Istisna'* Transaction Summary

Issuer	**MRCB Southern Link Berhad (MSLB) – An SPV incorporated on 28 November 1995 in Malaysia to undertake the construction, development, design, project management and financing of the expressway known as Eastern Dispersal Link, Johor Bahru.**
Lead Arranger	CIMB and HSBC Malaysia
Trustee	CIMB Trustee
Amount	Up to RM900 million
SC Approval	23 June 2008
Profit Payment	Semi-annual
Identified Asset	The Expressway known as the Eastern Dispersal Link, Johor Bahru

In this deal, MSLB entered into the first *istisna'* agreement[15] with the trustee (who acts on behalf of the investors) on a spot basis. Under this agreement, MSLB agreed to construct and deliver the *istisna'* asset (i.e., the highway) to the trustee. The trustee then enters into a second *istisna'* agreement,[16] on a deferred basis, where the trustee agrees

15 There is a tendency to call this agreement *istisna'* Purchase Agreement because it is viewed from the investors' perspective.
16 There is a tendency to call this agreement *istisna'* Sale Agreement because it is viewed from the investors' perspective.

to construct and deliver the *istisna'* asset. MSLB then issues *sukuk istisna'* to evidence its obligation to pay the selling price. Simply put, this structure involves a sale-and-buy-back structure like Sunway, RIM City and ABS Plantation Assets described earlier. The only difference in the *istisna'* sale-and-buy-back structure, is that the asset is under construction. It should be noted that *istisna'* is a sale and purchase contract. Thus, in the first *istisna'* agreement the trustee is buying the asset under construction on a spot basis. Then the trustee sells the asset under construction on a deferred basis. This again is a *bay' al-'inah* structure. Figure 10.12 shows the structure.



Source: MRCB, 2008, pp. 3-4.

Figure 10.12
MSLB *Sukuk Istisna'* Structure

In the global space, the MSLB *sukuk istisna'* would have an issue in both the primary and secondary market. In the primary market it utilised a *bay' al-'inah* structure to create the debt. In the secondary market, according to global *Shari'ah* standard, the *sukuk* holders can only trade the *sukuk* at par. A majority of *sukuk istisna'* issued in Malaysia utilised a *bay' al-'inah* structure. To manage these issues, an alternative structure was used in the global market. In the Tabreed deal for example, an *istisna'* and *ijarah* structure was used to fund the construction of a cooling plant.

Table 10.8 US$200 million Tabreed *Sukuk* Transaction Summary

Issuer	**Tabreed 06 Financing Corporation – An SPV incorporated on 7 June 2006 in Caymans Island to facilitate the *sukuk* issuance.**
Obligor	**National Central Cooling Company (Tabreed)**. Incorporated on 17 June 1998. Tabreed designs, engineers, finances, constructs and operates district cooling facilities that supply chilled water for air conditioning in UAE, Qatar, Bahrain and Saudi Arabia
Joint Lead Managers	CIMB, HSBC and Dresdner Kleinwort
Amount	US$200 million
Issuance Date	20 July 2006, maturity 5 years
Profit Payment	Semi-annual (January & July)
Trust Asset	Construction works and/or equipment and/or machinery forming part of cooling plants in Abu Dhabi

The SPV (Tabreed 06 Financing) will first issue the *sukuk* and raise US$200 million. The issuer (on behalf of the investors) will then enter into an *istisna'* agreement with Tabreed, whereby Tabreed agrees to construct and deliver the cooling plant. In other words, the SPV is buying the cooling plants from Tabreed. The payment to Tabreed is done in instalments.

Under the *istisna'* agreement, Tabreed was required to pay a security amount (US$1.25 million) on each payment date (two days before the periodic distribution date) to secure its obligation under the *istisna'* agreement. This means as long as the plant is under construction, Tabreed will pay this security amount. In addition, upon completion and delivery of the plant at each stage, the SPV will lease it to Tabreed, for which Tabreed will make lease payments. This security amount and the lease payment will be used to fund the periodic distribution to the *sukuk* holders.

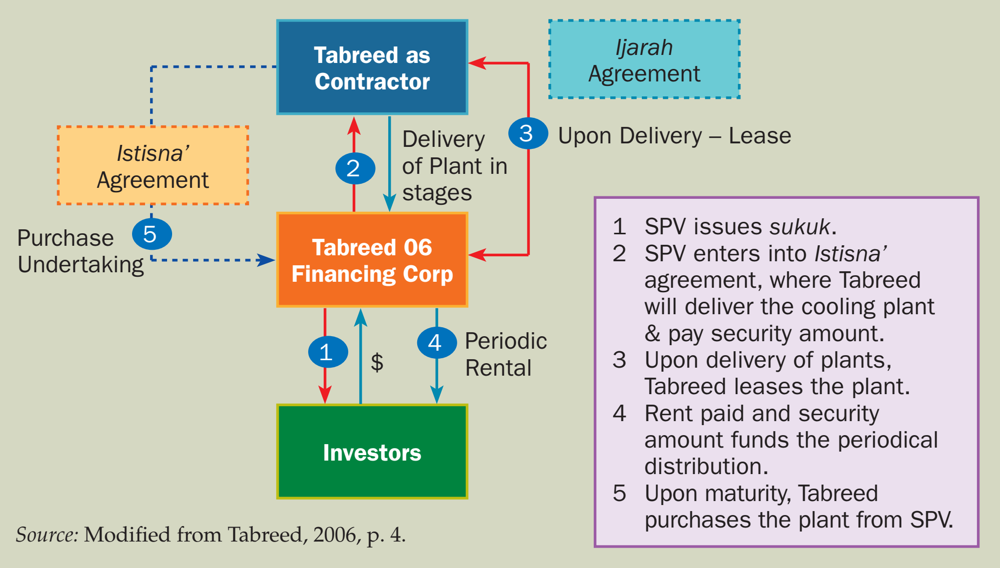
Besides the *istisna'* and *ijarah* agreements, Tabreed also provided a purchase undertaking to the issuer (SPV) agreeing to purchase the following:

1 The portion of cooling plant that has been constructed and delivered to the SPV if a default occurs during the construction (*istisna'*) stage, at a price corresponding to the value thereof.

2 The cooling plant at the price of the outstanding principal value of the *sukuk* if default occurs after the completion and during the leasing (*ijarah*) stage.

3 The cooling plant at the price of outstanding principal value of the *sukuk* at maturity.

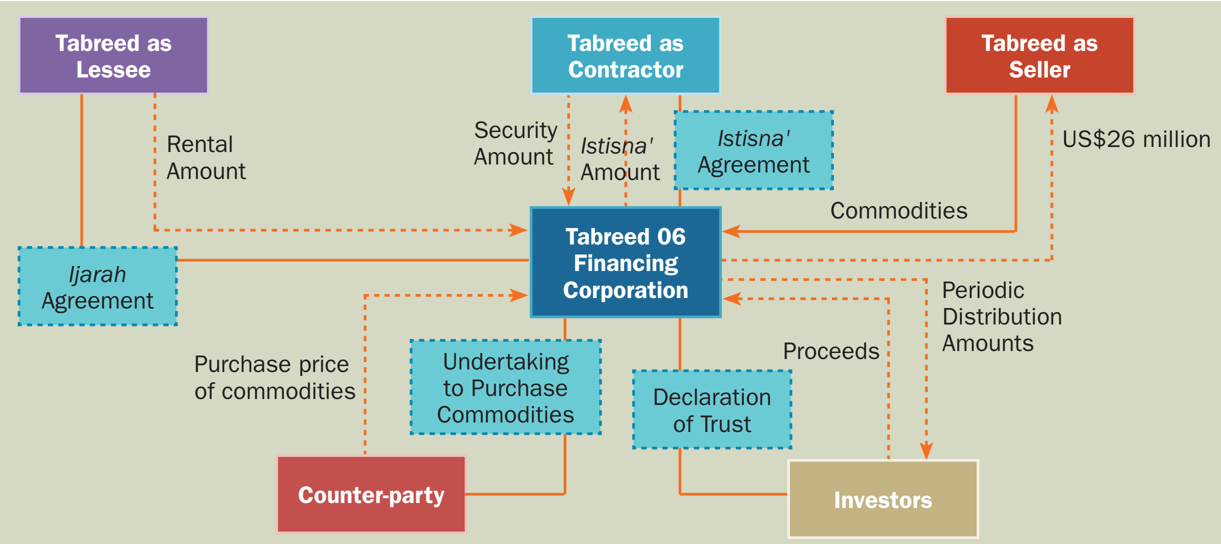
The amount obtained from the execution of this purchase undertaking will be used to redeem the *sukuk*. Figure 10.13 shows the structure of the Tabreed *sukuk.*



Source: Modified from Tabreed, 2006, p. 4.

Figure 10.13 US$200 million *Istisna'* and *Ijara Tabreed Sukuk*

Since this deal involved assets under construction, it still faced restrictions for secondary trading. Recall that the *sukuk* was issued for US$200 million. On the issuance date, the SPV paid US$40 million to Tabreed for the partially completed cooling plant (which was also the first instalment under the *istisna'* agreement). In order for the *sukuk* to be tradable, the *Shari'ah* board required that at least one third of the *sukuk* be in the form of tangible assets. US$40 million (which was in the form of a partially completed plant) represented only about 20% of the *sukuk*. To achieve the one-third benchmark, an additional tangible asset was introduced in the asset pool. To facilitate this, Tabreed first bought palladium worth US$26 million from either HSBC or a third party broker. Tabreed then sold this to the SPV for US$26 million. With this palladium and the US$40 million partially completed plant, the total tangible asset that backed the *sukuk* was exactly one third. This allowed the *sukuk* holders to freely trade the *sukuk* in the secondary market. The remaining cash (US$144 million) was kept in a permitted investment account (Islamic capital protected deposits). The SPV also obtained a purchase undertaking from HSBC that on the first distribution date (on 20 January 2007), which also coincides with the delivery and payment of the second stage of completion of the plant, HSBC would buy the palladium from the SPV at US$26 million. The SPV used the cash to pay Tabreed the second instalment under the *istisna'*. When the second stage of the plant was completed, the *sukuk* was backed with the required one-third tangible assets and thus it could be freely traded in the secondary market. Figure 10.14 illustrates the completed Tabreed *sukuk* structure with the additional feature (buying commodities) to allow the *sukuk* to be traded in the secondary market.



Source: Tabreed, 2006, p. 4.

Figure 10.14
Complete Tabreed *Sukuk* Structure

Other Sale-Based *Sukuk* – *Salam*

On 28 October 2008, the Central Bank of Gambia also followed the footsteps of CBB in issuing *sukuk salam* worth GMD5 million with a three-month maturity.

The last type of *sukuk* that would be in the sale-based *sukuk* cluster is *sukuk salam*. This type of *sukuk* was used mainly by the Central Bank of Bahrain (CBB) for its monetary policy instrument. On 28 October 2008, the Central Bank of Gambia also followed the footsteps of CBB in issuing *sukuk salam* worth GMD5 million with a three-month maturity. However, that was the only time CBG came to the market.

Sukuk salam is issued by the Central Bank of Bahrain every month, with a maturity of three months. This *sukuk* is used to affect the level of Bahraini Dinar current account balances of banks with the CBB. Since the *sukuk* is issued every month, at any time there will be three outstanding *sukuk salam*. The issuance amount for each year will be determined by the Ministry of Finance while the return will be set by the Monetary Policy Committee.[17]

As at 31 March 2010, there were BD36 million *sukuk salam* outstanding. On 28 April 2010, CBB issued *sukuk salam* No. 108 for BD12 million. Ever since the programme began on 13 June 2001, it has been consistently oversubscribed. For example, for the issuance in April, an order of BD37 million was received for the *sukuk* of BD12 million, evidencing an oversubscription of 308%.

Table 10.9 Transaction Summary on *Sukuk Salam* No. 108 by CBB

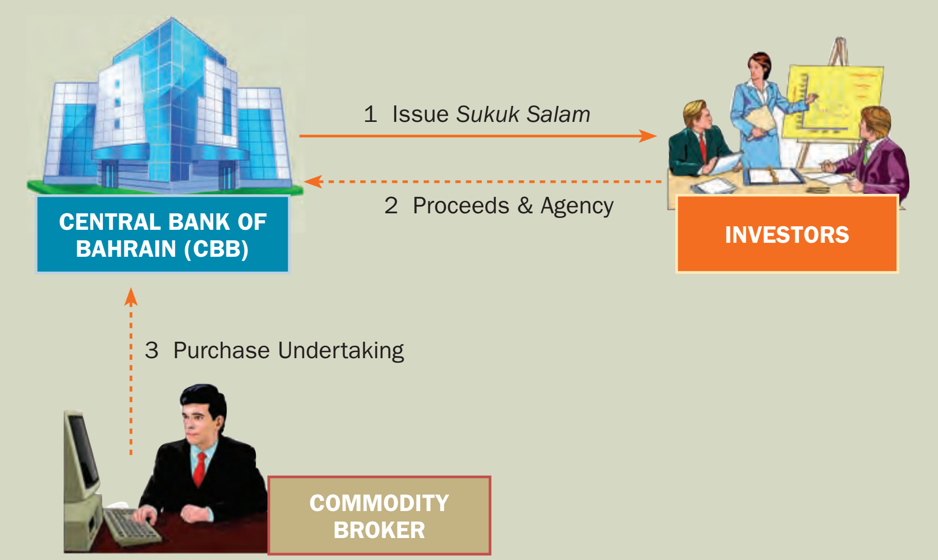
Issuer	Central Bank of Bahrain (CBB)
Sukuk Salam	No. 108
Date Issued	28 April 2010
Maturity	28 July 2010
Expected return	0.8%
Amount issued	BD12 million
Amount subscribed	BD37 million (308% over-subscribed)

Source: CBB, 2010.

CBB applies a tendering process for the *sukuk salam*. Thus it will first circulate an invitation letter with details on the issuance to the financial institutions in Bahrain that are eligible to invest in the *sukuk*. Upon receiving the tender, CBB will allocate the quantity on a pro-rata basis. Then the settlement of *sukuk salam* is processed. In other words, the *sukuk* is issued and investors pay the proceeds. The *sukuk* issuance evidences that CBB agrees to deliver a commodity (aluminium) in 90 days in exchange for the purchase price received from the investors.

17 Refer (IFSB, 2008), p. 77 for details.

The investors also appoint CBB as an agent to sell the commodity once received. To manage this process, CBB obtains an undertaking from a commodity broker (or other third parties) that he will purchase the commodity in the future. The investors will only obtain their return at maturity when the commodity is sold to the commodity broker at a higher price compared to their investment amount. Figure 10.15 illustrates the structure of CBB's *sukuk salam*.



Source: Adapted from Farook, 2009 and IFSB, 2008.

Figure 10.15
Central Bank of Bahrain *Sukuk Salam*

Salam is the transaction in the primary market. To determine whether the *sukuk* can be traded in the secondary market or not, we have to determine what the *sukuk* represents. In the above structure, the *sukuk salam* represents commodities to be received in future. This is categorised as a debt in kind. It means that there will be restrictions in trading this *sukuk* in the secondary market according to the global *Shari'ah* standard. It can only be done at par.

Lease-Based *Sukuk*

The next cluster that we will look into is the lease-based cluster, i.e., *sukuk ijarah*. Unlike sale contracts that transfer ownership instantaneously, *ijarah* contracts do not transfer ownership on its own. The most common structure of *sukuk ijarah* applied in the market is a sale and leaseback structure. Thus, an issuer that wants to raise *sukuk* would have to identify assets to sell and leaseback. Let's examine the first Malaysian global *sukuk*[18] that was issued in 2002.

18 The authors would like to thank Mahendran A Kanagaratnam from Malaysian Electronic Clearing Corporation Sdn Bhd, an institution under Bank Negara Malaysia, for providing comprehensive background information on this deal.

From the year 1999 onwards, in the midst of the Asian Financial Crisis, Malaysia issued two international bonds (Malaysia 09 and Malaysia 11) and experienced an outstanding success. This then motivated the Malaysian government to issue *sukuk* that would allow it to not only tap into a broader investor base but also promote Malaysia's unique role in the Islamic capital market. Thus, in June 2002, the Malaysian government issued the first global sovereign *sukuk* worth US$600 million. This deal is usually cited as the first global *sukuk* because, although the Bahrain government and the Guthrie group issued *sukuk ijarah* prior to this, both deals did not tap into the wide investor base that the Malaysian government *sukuk* did.[19] In addition, this deal also gave rise to the asset-based *sukuk* concept whereby, although there are underlying assets used in the *sukuk*, the investors would rank *pari passu* to an unsecured creditor. Both the Bahrain and Guthrie *sukuk* investors had recourse to the asset, and thus ranked *pari passu* to a secured creditor.

Unlike sale contracts that transfer ownership instantaneously, *ijarah* contracts do not transfer ownership on its own.

Table 10.10 US$600 million Malaysian First Global *Sukuk* Transaction Summary

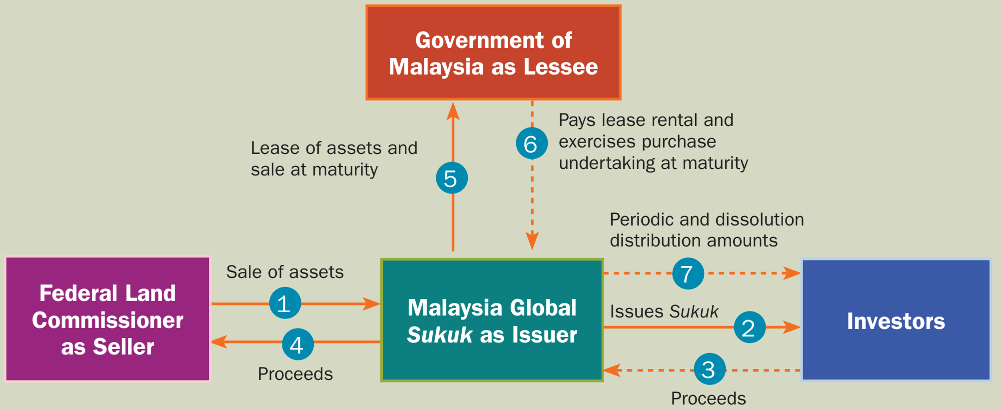
Issuer	Malaysian Global Sukuk (SPV)
Obligor	Government of Malaysia
Joint Lead Managers	HSBC
Amount	US$600 million
Issuance Date	June 2002, 5 years maturity
Profit Payment	Semi-annual, LIBOR + 95bp
Rating	Baa2 (Moody's) and BBB (S&P)
Underlying Asset	Prime Minister's depatment's staff quarters (Jalan Dato' Onn), two hospitals in Klang

In Malaysia, the Federal Land Commissioner (FLC) holds the title to the Malaysian government's landed properties. To enable the *sukuk* issuance, FLC sold the beneficial title of the Prime Minister's Department's staff quarters in Jalan Dato' Onn and two

19 Recall that in 2001, the Bahrain government issued US$250 million *sukuk ijarah*. However, it did not follow international bond documentation standard and thus was bought mostly by domestic investors. In December 2001, the Guthrie Group from Malaysia also issued US$150 million *sukuk ijarah*. Although the Guthrie *sukuk* followed international bond documentation, it did not reach a wide investor base because it was not rated by international rating bodies and did not go through a clearing house. Refer Haneef, 2009, for details.

hospitals in Klang to an SPV, Malaysia Global *Sukuk.* Sale of beneficial title means that FLC still holds the legal title but it was held for the benefit of the investors. In other words, FLC was just a bare trustee of the assets. The SPV funded the purchase by issuing a floating rate trust certificate (*sukuk*), representing beneficial ownership of the asset. The SPV (acting on behalf of the investors) then leased the asset to the Malaysian government. The lease was priced at LIBOR + 95bps, which reflects the credit rating of the Malaysian government (BBB) at the time of the issuance.

In addition to the lease contract, the Malaysian government also gave an irrevocable undertaking (*purchase undertaking*) to the SPV, which said that at maturity or event of default, it would buy back the assets at par value. The purchase undertaking implied that in the event of default or maturity, the investors could only sell the assets back to the government and no other third parties. As lessee, the government of Malaysia paid rental semi-annually to the SPV, which in turn paid semi-annual floating rate distributions to investors. This *sukuk* utilised bullet redemption upon maturity; thus the periodic rental only represented the profit payment to the investors. The investors obtained back their principal amount only upon maturity. Figure 10.16 illustrates the structure of the deal.



Source: Bank Negara Malaysia.

Figure 10.16 US$600 million Malaysian First Global *Sukuk* Structure

Originally, the Malaysian government wanted to raise only US$500 million. However, when the *sukuk* was brought to the market, the demand was outstanding. In total, there was demand of US$1.1 billion, with 51 accounts from 17 different countries. Due to this, the Malaysian government decided to increase the size of the *sukuk* from US$500 million to US$600 million. Despite the market turbulence at the time of the issuance, the deal was well accepted and was priced in line with its existing international bonds. Another interesting feature about this deal was the fact that it complied with Reg-S and Rule 144A formats. In the international bond issuance process, there are three formats that issuers can choose from: Reg-S, 144A or 33 Act. The features of all the formats are summarised in Table 10.11.

In the international bond issuance process, there are three formats that issuers can choose from: Reg-S, 144A or 33 Act.

Table 10.11 International Bond Issuance Format

	Reg-S. Eurobond	Eurobond with 144A Tranche	33 Act Registered Global Bond
Fixed/Floating Rate	Both	Both, Fixed preferred	Both, Fixed preferred
Maturity	1-10 Years	1-30 Years	10-30 Years
Main Currencies	US$, Euro	US$	US$
Investor Base	Europe, Middle East, Asia	Europe, Middle East, Asia and US qualified institutional buyers	Adds ability to sell US retail investors and retail funds as well as worldwide institutional investors
Rating(s) Required by Investor Base	At least one rating, two preferred	One minimum, two preferred for large size issues	S&P or Moody's
Future Issuer Requirements	Very little after initial offering	Very little once issued	Ongoing SEC disclosure requirements
Timing Flexibility	Fastest execution	More intensive due diligence process	SEC review process adds at least two weeks to the Eurobond process
Disclosure Required	Lowest	Higher level of due diligence and disclosure required	Highest (SEC level disclosure required)

Source: Adam & Thomas, 2004, p. 154.

The Malaysian global *sukuk*, having followed Rule 144A, managed to tap into the US qualified investor base. The majority of *sukuk* buyers were from the Middle East (51%), followed by Asia (30%), Europe (15%) and America (4%) investors.

As highlighted, this deal gave rise to the concept of asset-based *sukuk*, which means that the *sukuk* holders would not have recourse to the assets used in the deal. Rather than intentional, this was due to the fact that the Malaysian government had issued international bonds that were still outstanding during the *sukuk* issuance. These international bonds were unsecured bonds (i.e., the bondholders did not have any recourse to any asset of the Malaysian government), and they contained a negative pledge clause which prevented the Malaysian government from issuing other bonds (or securities) that were secured (i.e., have recourse to assets of the Malaysian government). Haneef (2009) provided an excellent summary of the legal view that was taken in the deal to allow the *sukuk*, despite having assets backing it, to achieve a ranking similar to unsecured creditors and thus avoiding the breach of the negative pledge:

> The *sukuk* holders (in Malaysian Global *Sukuk)* would have beneficial ownership of the assets held through the *sukuk* trustee during the life of the *sukuk*. This would meet the *Shari'ah* requirements of asset ownership under *ijarah* principles. However, in the event of default by the Federation of Malaysia, the *sukuk* trustee's sole recourse to the assets would be to dispose

of the assets only to the Federation of Malaysia and seek payment. The *sukuk* trustee would not have the power to retain or sell the assets to any third party. Once the *sukuk* trustee has disposed of the assets to the Federation of Malaysia, the *sukuk* holders would in law be treated as unsecured creditors. This was viewed by many as not an ideal solution, but given the prevailing circumstances, it was the only possible solution.

Today, the majority of *sukuk* are asset-based, i.e., the investors do not have recourse to the underlying asset except in the case where such assets are charged as security. The prevailing circumstances that required this innovation to take place during the Malaysian global *sukuk* issuance has since then become the industry standard. On 19 May 2010, the Malaysian government launched the second global *sukuk* known as the 1Malaysia *Sukuk*.

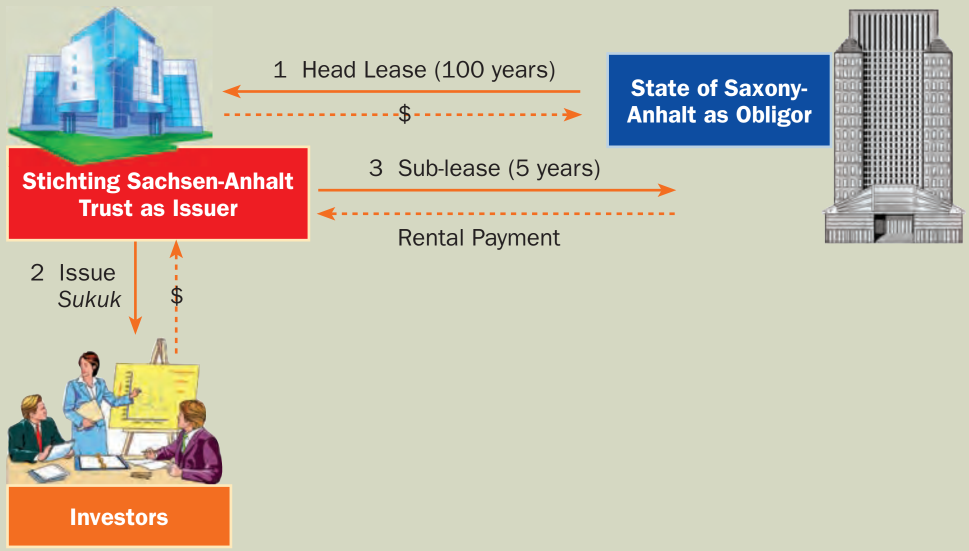
Lease and Lease-back *Sukuk Ijarah*

While the sale and lease-back structure is the most prominent *sukuk ijarah* structure, the market has also experimented with a lease and lease-back structure. A German state, Saxony-Anhalt issued a 100 million *ijarah*-based *sukuk* on a lease and lease-back structure. Table 10.12 provides information on the deal.

Table 10.12 100 million Saxony-Anhalt *Sukuk Ijarah* Transaction Summary

Issuer	Stichting Sachsen-Anhalt Trust – A foundation established by Saxony-Anhalt under the laws of the Netherlands to facilitate the *sukuk* issuance.
Obligor	The Federal State of Saxony-Anhalt, a state in Germany
Arranger	Citigroup
Amount	100 million
Issuance Date	June 2004, 5 years maturity
Profit Payment	Semi-annual, 6m Euribor + 1%
Rating	AAA (Fitch) and AA- (S&P)
Underlying Asset	Land and buildings, such as tax offices, under the use and control of Saxony-Anhalt State in Germany.

Saxony-Anhalt, first entered into a head lease agreement for 100 years with the issuer, Stichting Sachsen-Anhalt Trust (similar to an SPV). The underlying assets that were leased are office buildings owned by the state. To fund this head lease, the issuer issued the *sukuk* and paid the proceeds to Saxony-Anhalt. Then the issuer entered into a sub-lease agreement with Saxony-Anhalt for five years. Saxony would pay a semi-annual rental based on Euribor+1% and bullet redemption of the principal at maturity. The structure is depicted in Figure 10.17.



Source: Author's own based on Saxony-Anhalt, 2004.

Figure 10.17 100 million Saxony-Anhalt *Sukuk Ijarah* Structure

We should note that a lease and lease-back structure may invoke the issue of *bay' al-'inah* because two parallel leases are entered between the same parties (known as *ijaratan*). To manage this issue, the structure used one lease agreement that is substantially longer than the other lease agreement (100 years vs five years). Nonetheless, since the longer tenure lease (the head lease) will usually be terminated upon the termination of the shorter term lease (sub-lease), some scholars dislike the lease and lease-back structure.

Equity-Based *Sukuk*

As we noted in the introduction of this chapter, the word *sukuk* is usually translated as Islamic bonds, and thus inherits a close tie to fixed income instruments in the minds of investors, issuers and other market participants. Certainty of return and certainty of capital are the two most important features of fixed income (or debt) instruments. When *sukuk* are structured using sale-based and lease-based contracts, certainty of return and certainty of capital are easily achieved. The fund-raising entity, however, needs to provide an asset to obtain funding. The need to have underlying assets puts a limit to the amount of funding that can be raised, especially in lease-based *sukuk* because the same asset cannot be reused until the *sukuk* matures.

When *sukuk* is structured using sale-based and lease-based contracts, certainty of return and certainty of capital are easily achieved. The fund-raising entity, however, needs to provide asset to obtain funding.

When we use equity-based contracts (*musharakah*, *mudarabah* and *wakalah*) to structure *sukuk*, there is a fundamental challenge to match the *Shari'ah* requirement and the fixed income nature of debt instruments. As discussed in Chapter 7, the *Shari'ah* does not allow guarantee of capital or return in these instruments. This inherited equity feature conflicts with the nature of debt instruments. Nonetheless, the market has appended a number of credit enhancements to these equity-based instruments to fit them in the fixed income box. These instruments can be used to structure debt-like return as long as the identified underlying venture or activity provides or generates income, either a variable or fixed cash flow. Let us examine a few deals that have been brought to the market to analyse how these structures are implemented.

Equity-based *Sukuk* – *Mudarabah*

As highlighted in Chapter 7, *mudarabah* is a contract which is made between two parties to undertake a business venture. The parties are a *rabbul mal* (investor), who solely provides the capital, and a *mudarib* (entrepreneur) who solely manages the project. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. In the event of a business loss, the loss shall be borne solely by the provider of the capital. Figure 10.18 below depicts a basic illustration of a *mudarabah sukuk* transaction structure.

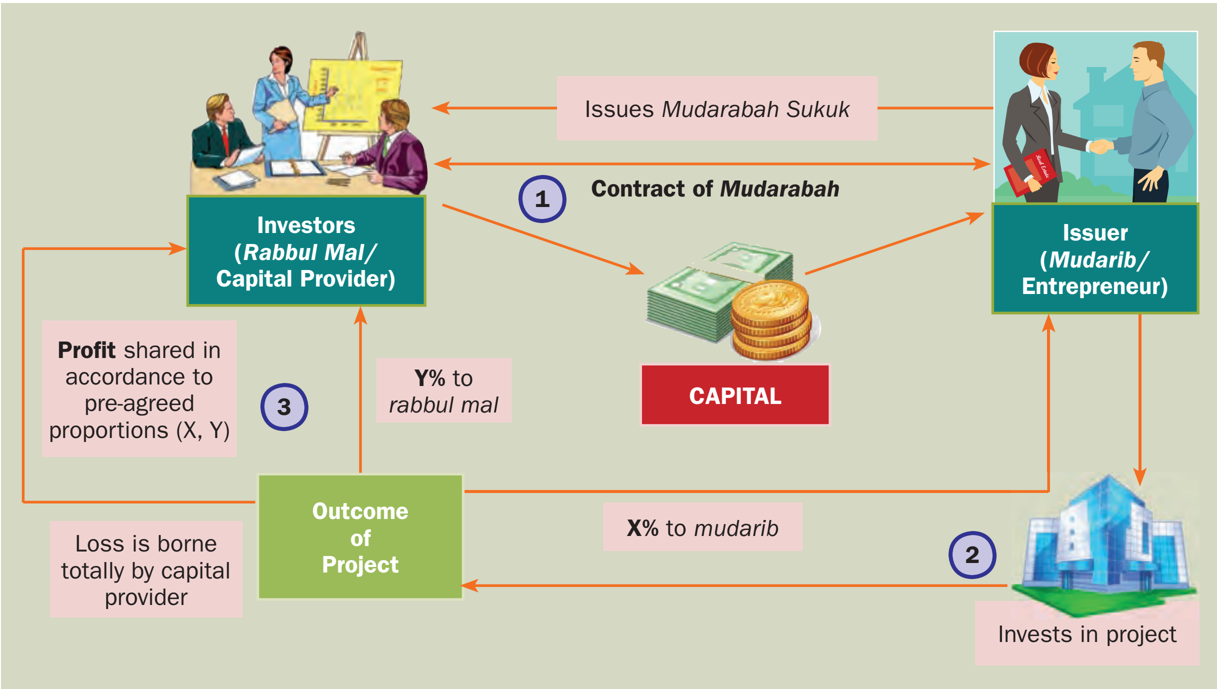


Figure 10.18
Sukuk Mudarabah

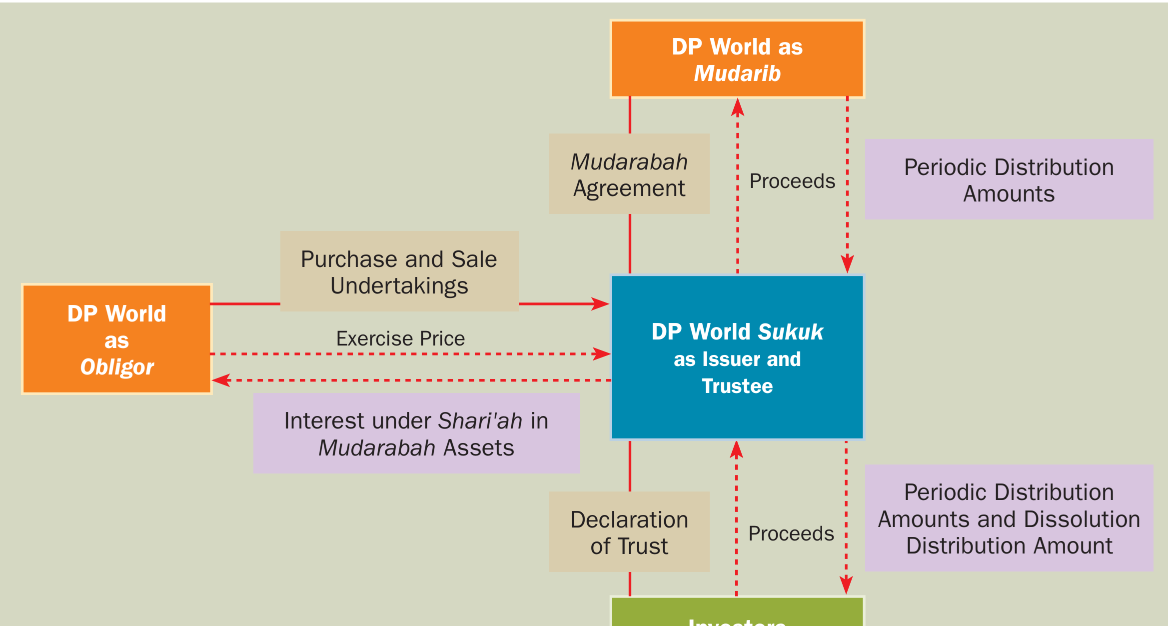
As depicted in Figure 10.18, the issuer will first call for investors to participate in the *mudarabah* contract. The issuer acts as the manager (*mudarib*) and the investors are the capital provider (*rabbul mal*). The *mudarabah sukuk* is issued by the issuer to evidence the proportionate capital contribution by the investors (*rabbul mal*) to the *mudarabah* and their subsequent rights in the *mudarabah* project or investment activities. The issuer as *mudarib* will then invest the *mudarabah* capital in an agreed project. Normally, the *mudarabah* project has already identified projected cash flow, and this allows the issuer to indicate an expected rate of profit to the investors upon initial issuance of the *mudarabah sukuk*. The expected rate of profit should be calculated based on a pre-agreed profit-sharing ratio that is tentatively applied to the projected return of the project. After the project starts to generate profit, the issuer will apply the profit-sharing ratio and pay the profit share of the investors as periodic coupon distribution, normally at the expected profit rate. However, if the project suffers a loss, it will be borne solely by the investors, except when the loss is caused by the negligence or mismanagement of the *mudarib*.

To facilitate our understanding of the *mudarabah sukuk*, we provide an illustration of DP World *Sukuk Mudarabah*. DP World is the holding company for ports-related commercial activities of Dubai World (owned by the Government of Dubai). It was established in the Dubai International Financial Centre (DIFC) on 9 August, 2006 pursuant to a restructuring plan designed to separate the ports-related commercial and regulatory activities of the Government of Dubai. Following the restructuring, DP World, together with its operating subsidiaries, conducts all of the ports-related commercial activities of Dubai World while Dubai Ports Authority (DPA), an affiliate of DP World, conducts all of the ports-related regulatory activities of the Government of Dubai.

Table 10.13 US$1.5 billion DP World *Sukuk Mudarabah* Transaction Summary

Issuer	**DP World *Sukuk* – An SPV established in Cayman Islands on 17 May 2007 as a charitable trust to facilitate the sukuk issuance.**
Obligor	DP World – Established in DIFC on 9 August 2006 pursuant to a restructuring plan designed to separate the ports-related commercial and regulatory activities of the Government of Dubai
Joint Lead Mangers	Barclays Capital, Citibank, Deutsche Bank, Dubai Islamic Bank
Amount	US$1.5 billion
Issuance Date	2 July 2007
Profit Payment	Semi-annual (January & July)
***Mudarabah* Venture**	Invest into DP World business operation which includes investment in Terminal 2, a second terminal adjacent to the current Jebel Ali Terminal within the Jebel Ali Free Zone.

On 2 July 2007, DP World tapped into the *sukuk* market to raise US$1.5 billion using a *mudarabah* structure. DP World *Sukuk* (a Cayman Islands-based SPV) first issued the *sukuk* and forwarded this to DP World as *mudarabah* capital (on behalf of the investors). DP World (as *mudarib*) invested the capital in its business operation (i.e., port related activities). Among others, the investment plan includes developing Terminal 2, a second terminal adjacent to the current Jebel Ali Terminal within the Jebel Ali Free Zone. DP World was also entitled to commingle its own assets with the *mudarabah* assets. The profit sharing ratio between the SPV and DP World was 99:1. The *mudarabah* was expected to generate an average net profit of 6.35% per annum. According to the profit-sharing ratio, the investors expected to receive 6.25% per annum. Figure 10.19 illustrates the structure of DP World *sukuk mudarabah*.



Source: DP World, 2007.

Figure 10.19 US$1.5 billion DP World *Sukuk Mudarabah* Structure

To support the *sukuk*, DP World provided a liquidity facility whereby if the profit payable to the issuer is greater than the periodic distribution amount, the issuer agrees to forego the excess profit. If the profit is insufficient, then DP World will provide *Shari'ah*-compliant funding to the issuer to ensure a smooth payment of the profit. The variable return in the original *mudarabah* arrangement is smoothened into the fixed income instrument through the application of liquidity facility. In other words, appending the liquidity instrument to *sukuk mudarabah* allows the investors to enjoy a certainty of return.

In addition, DP World *Sukuk* also used purchase undertaking and sale undertaking. Under the purchase undertaking DP World promised that it would purchase the issuer's interest in the *mudarabah* venture at maturity, in the event of default or in the event the Dubai government cease to own 50% of Dubai World. The purchase undertaking was priced at outstanding principal plus any accrued but unpaid return. In the sale undertaking, the issuer promised that it would sell its interest in the *mudarabah* to DP World if a tax redemption event occurs (i.e., there is a change in the tax regulation that causes the *sukuk* holders to pay additional tax). The price of the sale undertaking is similar to the price of the purchase undertaking.

The purchase undertaking, priced at outstanding principal plus accrued but unpaid return, provides the investors with certainty of capital and thus establishes recourse against the obligor. If defaults occur, investors (via the trustee) can ask DP World to buy back their interest in the venture. This unconditional purchase undertaking now becomes a legal instrument for the investors to recoup their investment amount and any unpaid returns. Regardless of the performance of the venture, the *sukuk* holders may have a legal avenue to obtain their capital and return.[20]

Equity-Based *Sukuk – Musharakah*

Similar to the concept of *mudarabah sukuk,* a *musharakah sukuk* is also an equity-based *sukuk*. Neither *sukuk* represents debt receivables, but rather in specific investment projects or assets. In the case of *musharakah,* the originator can be an equity partner in the venture that will be formed, by contributing capital in cash or kind. As discussed in Chapter 7, *musharakah* is a partnership arrangement between two parties or more to undertake a business venture whereby all parties contribute capital either in the form of cash or in kind. Any profits derived from the venture will be distributed based on a pre-agreed profit-sharing ratio, but a loss will be shared on the basis of equity participation. Figure 10.20 depicts a basic illustration of a *musharakah sukuk* transaction structure.

In a *musharakah sukuk* transaction, both the issuer and investor may contribute to the capital of the *musharakah* project. The *musharakah* project is normally managed by either the issuer or a third party. Alternatively, a *musharakah sukuk* transaction can also be structured with all investors contributing capital in a *musharakah* project and then appointing the issuer as their agent to manage the *musharakah*. This structure can also be classified as an investment agency *sukuk* (*sukuk wakalah bi istithmar).*

20 Readers should note that the enforcement of the undertakings will be subject to court judgement in different jurisdictions.

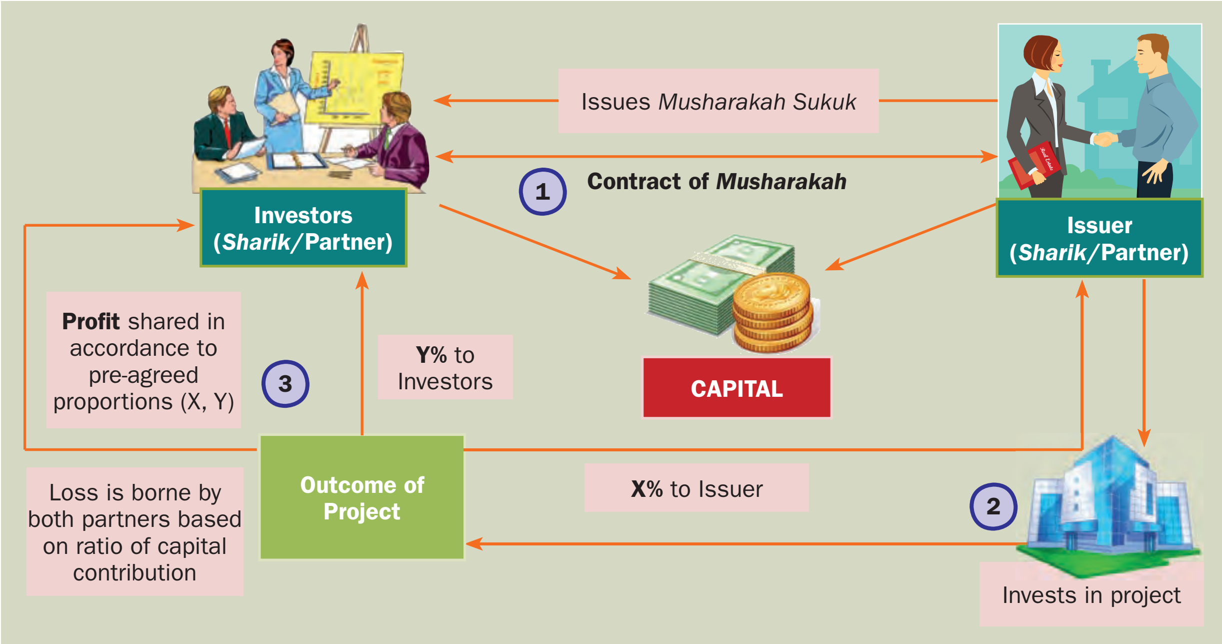


Figure 10.20 *Musharakah Sukuk*

Let us examine Cagamas MBS *Sukuk Musharakah* as an illustration to further enhance our understanding. Refer to Tables 10.14 and 10.15.

Table 10.14 Transaction Summary of the First Cagamas MBS *Sukuk Musharakah*

Issuer	Cagamas MBS – An SPV incorporated on 8 June 2004 for the purpose of undertaking the purchases of mortgage assets and Islamic mortgage assets from the Government of Malaysia and the issuance of residential mortgage-backed securities and Islamic residential mortgage-backed securities to finance the purchases.		
First Cagamas MBS *Sukuk Musharakah*			
Size	RM2.05 billion		
Book Size	RM13.5 billion (5.4 times over-subscription)		
Issuance Date	8 August, 2005		
Investors	5% Foreign, 95% Domestic		
	Size (RM mil)	**Profit**	**Spread over MGS (bp)**
3-year Note	250	3.41%	27
5-year Note	215	3.84%	46
7-year Note	260	4.24%	47
10-year Note	515	4.71%	51
12-year Note	410	5.01%	68
15-year Note	400	5.27%	73

Source: Cagamas Berhad.

Table 10.15 Transaction Summary of the Second Cagamas MBS *Sukuk Musharakah*

Second Cagamas MBS *Sukuk Musharakah*			
Size	RM2.11 billion		
Book Size	RM10 billion (4 times over-subscription)		
Issuance Date	29 May 2007		
Investors	20% Foreign, 80% Domestic		
	Size (RM mil)	**Profit**	**Spread over MGS (bp)**
3-year Note	330	3.63%	17
5-year Note	255	3.70%	22
7-year Note	270	3.78%	22
10-year Note	400	3.90%	24
12-year Note	245	4.02%	28
15-year Note	320	4.17%	31
20-year Note	290	4.34%	29

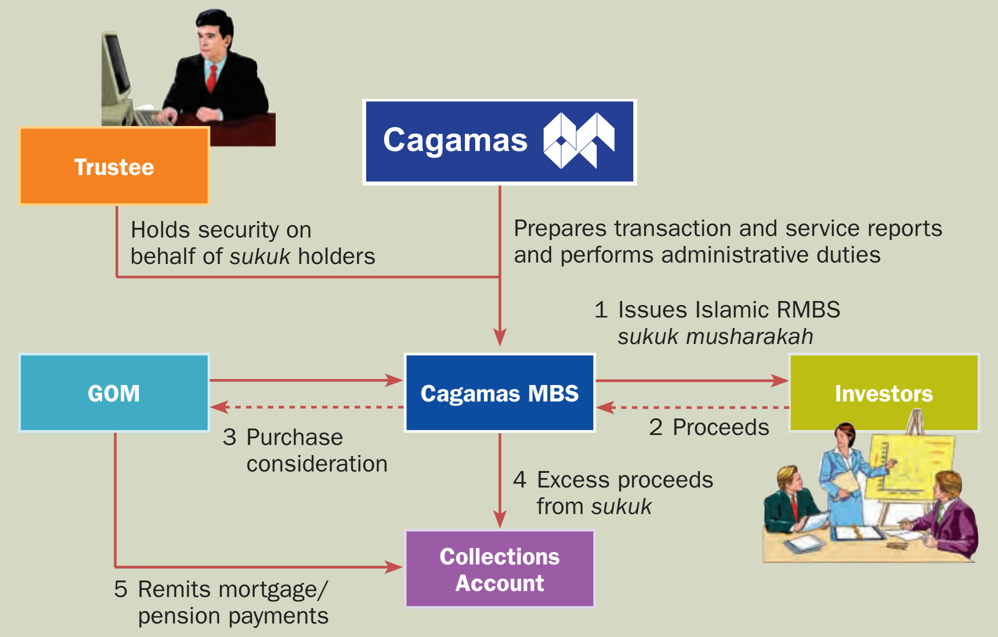
Source: Cagamas Berhad.

Since 2005, Cagamas has issued two Islamic Residential Mortgage Backed Securities (IRMBS) based on *musharakah*. The first issuance was done in August 2005 for RM2.05 billion while the second issuance was done in May 2007 for RM2.11 billion. Both deals were rated AAA by RAM and MARC (the Malaysian rating bodies), which translated into strong demand, with four to five times over-subscription. The second *sukuk musharakah* had a tranche with 20 years maturity, which at the time of issuance, was the longest maturity in Malaysia. Table 10.14 and Table 10.15 show the transaction summary of both the first and second Cagamas MBS *Sukuk Musharakah*.

Both *sukuk* utilised the same structure. The issuer was Cagamas MBS Bhd, a wholly owned RM2 subsidiary of Cagamas with capital, established for the purpose of the securitisation. The originator was the Government of Malaysia (GOM), namely the Treasury Housing Loan Division that provides home financing to government servants. GOM provides both Islamic and conventional home financing. The Islamic home financing was based on a BBA contract, a contract based on *bay' al-'inah* which is widely used as a financing tool for the purpose of providing home financing facilities in Malaysia.

This deal is called *sukuk musharakah* because the investors will form *musharakah* among themselves. This model of *sukuk musharakah* is very common in Malaysia. The investors will then appoint the issuer (i.e., Cagamas MBS) as their *wakil* (i.e., agent) to acquire a pool of government staff Islamic home financing (GSIHF) from the GOM. Recall that since the home financing was based on *bay' al-'inah,* the assets involved would be receivables due from the government servants. These receivables were bought at a discount from GOM.

The sale was a "true sale" by way of an equitable absolute assignment for legal purposes and as such, no notification was required to be given to the obligors. The issuer pays GOM the purchase price and keeps the excess proceeds in a reserve account. GOM was appointed as the servicer to manage the portfolio via a servicing agreement. GOM will remit the collection from the portfolio into a collection account which will be used to pay the *sukuk* holders. In addition, Cagamas managed all the administrative function of the SPV and the trustee holds the asset on behalf of the investors. Figure 10.21 shows the structure of Cagamas MBS *Sukuk Musharakah*.



Source: Cagamas Berhad.

Figure 10.21 Cagamas MBS *Sukuk Musharakah* Structure

Simply put, the deal involved issuing *sukuk* and buying receivables (based on Islamic home financing) from the GOM. Although the deal relates to the issue of *bay' al-dayn,* the *sukuk* was well accepted in Malaysia, Singapore and Hong Kong. The structure may be acceptable to other jurisdictions especially to the Middle Eastern investors, if the underlying asset (i.e., what the SPV buys) is tangible in nature or a mixed portfolio of assets is used.

Note that Cagamas MBS *sukuk musharakah* did not use any liquidity facility (to smoothen the return) nor any purchase undertaking (to provide certainty of capital). In an asset-backed *sukuk* issuance, detailed due diligence and stress testing of the underlying asset is vital to ensure it is sufficient and robust enough to provide the *sukuk* holders with the expected return and capital redemption. However, no guarantee will be given as the performance of the asset will drive the return to the *sukuk* holders. This is different from asset-based *sukuk* where the performance of the underlying venture may not truly drive the return to the *sukuk* holders.

Shari'ah Issues in Equity-Based *Sukuk*

We have looked at a number of equity-based *sukuk* comprising asset-based and asset-backed *sukuk*. As we highlighted at the beginning of this section, the most fundamental *Shari'ah* challenge that equity-based *sukuk* face is to structure them in a way that provides certainty of return and certainty of capital. In DP World, a formal liquidity facility arrangement was used to achieve the certainty of return because if there is a shortfall, the deficit will be funded by DP World. Besides, if there is more than the expected return, the excess will be given to the obligor as an incentive fee. The use of liquidity facility and incentive fee clause is very common in many equity-based *sukuk*.

As for certainty of capital, an unconditional purchase undertaking at par is used to achieve the effect. "Unconditional" means that, regardless of the performance of the venture, the obligor will have to buy back the assets or interest in the venture if the investors exercise the purchase undertaking. In addition, the triggers for these unconditional purchase undertakings always include default. In asset-backed *sukuk*, either there will be no purchase undertaking used or the purchase undertaking will be conditional. A conditional purchase undertaking means that it can be exercised only if the venture is performing.

A conditional purchase undertaking means that it can be exercised only if the venture is performing.

In November 2007, Taqi Usmani, chairman of AAOIFI, raised concerns over both practices above (liquidity facility and purchase undertaking at par) in equity-based *sukuk*. Following this, in February 2008, AAOIFI produced a formal pronouncement on *sukuk* reiterating its standards. Besides highlighting that a tradable *sukuk* must represent tangible assets or tangible assets with receivables appended to it, the pronouncement clearly highlighted the parameters that must be observed in applying the liquidity facility and purchase undertaking in equity-based *sukuk* (EBS comprising *musharakah*, *mudarabah* and *wakalah*).

According to AAOIFI, the usage of liquidity facility and the purchase undertaking at par contradicts the nature of EBS. The liquidity facility is viewed as providing assurance to the return. AAOIFI does not allow the obligor to provide a liquidity facility. However, it allows the utilisation of reserves from actual operation to manage fluctuations in income.

As far as purchase undertaking is concerned, AAOIFI views this as providing assurance of capital. This is because the undertaking by the obligor (at the beginning) to re-purchase the assets from *sukuk* holders for its nominal value would assure the principal/capital invested by the *sukuk* holders remains intact. For equity-based *sukuk*, AAOIFI only allows the purchase undertaking to be priced at the net value of assets, its market value, fair value or price to be agreed in future.

For equity-based *sukuk*, AAOIFI only allows the purchase undertaking taking to be priced at net value of assets, its market value, fair value or price to be agreed in future.

The pronouncement clearly states that for equity-based *sukuk* that use an *ijarah* portfolio as the underlying asset, it is allowed to have the purchase undertaking at remaining rental value. In addition, for *sukuk ijarah*, AAOIFI allows the purchase undertaking to be at nominal value.

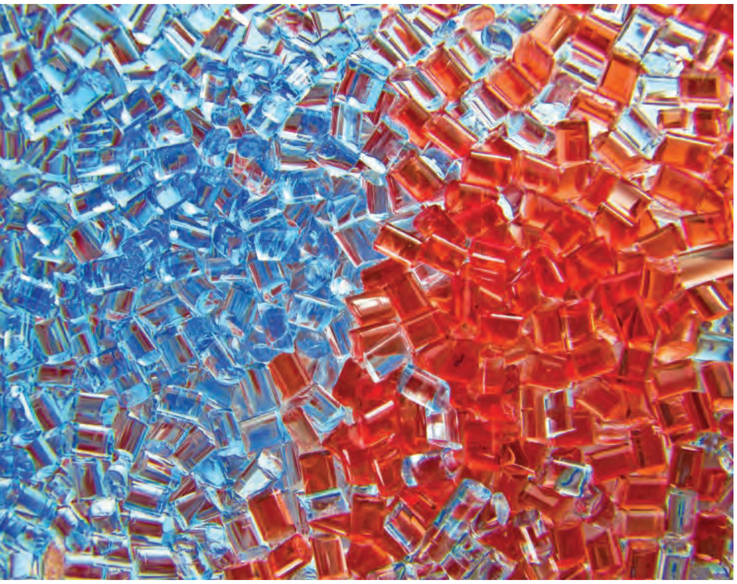
Unlike sale-based and lease-based instruments, equity-based instruments do not require the existence of assets. In other words, the investors do not have to buy assets from the obligor. The investors can just provide monetary capital. The purchase undertaking at par and the liquidity facility then makes equity-based *sukuk* very bond-like. This is the rationale behind the AAOIFI pronouncement. That is why for equity-based *sukuk* that have an *ijarah* portfolio as the underlying asset or for *sukuk ijarah* (that require assets to be existent) the parameter for the purchase undertaking is more lenient.

We should note that there are other views on the issue of purchase undertaking in equity-based *sukuk* besides AAOIFI's. There are jurisdictions and scholars that still allow the application of purchase undertaking at par in equity-based *sukuk* because they view the purchase undertaking as a mere promise and not a binding contract. Therefore, it is not construed generally as a provision of guarantee.

After the AAOIFI pronouncement, the application of equity-based *sukuk* in the global space reduced substantially. They dropped from 73% in 2007 to 38% in 2008. The investors and arrangers in the global *sukuk* market prefer to use *sukuk ijarah* as they are less controversial, even with the use purchase undertaking at par and liquidity facility. The application of liquidity facility is much easier to manage even with the AAOIFI pronouncement. However, the issue of purchase undertaking at par has posed interesting challenges for the market players that wish to comply with AAOIFI. For a summary of how the market coped with this issue refer to Mokhtar, *A Synthesis of* Shari'ah *Issues and Market Challenges in the Application of* Wa'd *in Equity-based* Sukuk, 2009. Nonetheless, not all jurisdictions and market players wish or seek to comply with AAOIFI. This segment of the market adopts the alternative view on purchase undertaking and continues to apply it for equity-based *sukuk*.

Equity-Based *Sukuk* – Innovative Structure

Finally, let us examine Saudi Basic Industries Corporation (SABIC) *sukuk istithmar*, which utilised unique underlying assets. SABIC also used reserves instead of liquidity facility to manage the fluctuation in return to the *sukuk* holders.



The SABIC Group's principal business is the manufacture and sale of basic chemicals, intermediates (including industrial gases), polymers, fertilisers and metals. However, SABIC is a holding company and thus does not have many tangible assets. Nevertheless, SABIC has a marketing unit which is responsible for conducting marketing and sales activities for most of its affiliates and subsidiaries incorporated in Saudi Arabia. Under the marketing agreements, SABIC is in charge of the complete sales cycle — pre-sale (customer contact, promotion, etc.), current (execute sales, collection, etc.) and post-sale services (warranty, claims, etc). In return for this service, SABIC is paid a fee and is entitled to deduct its business expenses. It was these marketing agreements (13 in particular) that were utilised as the underlying assets for the SABIC *Sukuk.*

As at the end of year 2009, SABIC had three *sukuk* outstanding: SAR3 billion issued in 2006, SAR8 billion issued in 2007 and SAR5 billion issued in 2008. All the three *sukuk* utilised the same 13 marketing agreements. Nonetheless, each *sukuk* utilised a specific portion of the assets. Thirty percent of the marketing agreements were allocated for the first *sukuk*, while 47% was utilised for the second *sukuk*. The third *sukuk* used the remaining 23%. Table 10.16 shows the transaction summary for all the three *sukuk.*

Table 10.16 SABIC *Sukuk* Transaction Summary

Issuer	Saudi Basic Industries Corporation (SABIC)		
	SABIC I	SABIC II	SABIC III
Issuance Date	29/7/2006	6/8/2007	26/5/2008
Lead Manager and Book Runner	HSBC Saudi & Riyad Bank	HSBC Saudi & Riyad Bank	HSBC Saudi & Calyon Saudi Fransi
Amount	SAR3 billion	SAR8 billion	SAR5 billion
Price	3 mth SIBOR + 0.40%	3 mth SIBOR + 0.38%	3 mth SIBOR + 0.48%
Marketing Agreement Allocated	30%	47.06%	22.94%

Source: SABIC Offering Circulars.

All the three *sukuk* used the same structure. First, SABIC would transfer the marketing agreements to SABIC *Sukuk*, a wholly owned company of SABIC, that acts as the custodian of the asset on behalf of the *sukuk* holders. The function of the custodian is similar to that of a trustee. It was formed according to Saudi law, which does not have any trust law. Then, SABIC issued the *sukuk,* representing ownership of the *sukuk* asset. The tenure of the *sukuk* was for 20 years. The *sukuk* holders would obtain return from the net income of the marketing business. Refer to Table 10.17 for an example of allocation of the marketing fee income for SABIC I and SABIC II investors.

Table 10.17 Extract of Marketing Fee Income for SABIC I and SABIC II

Year	Total marketing fee income (SAR in 000's)	Marketing fee income allocated to *Sukuk* I and II (SAR in 000's)
2005	2,140,600	–
2006	2,504,485	396,002*
2007	3,432,464	1,635,047**

Note

* 30% of the total marketing fees were allocated to SABIC *Sukuk* LLC in its capacity as custodian for the *sukuk* holders in respect of *Sukuk* I for the period from 29 July 2006 to 31 December 2006.

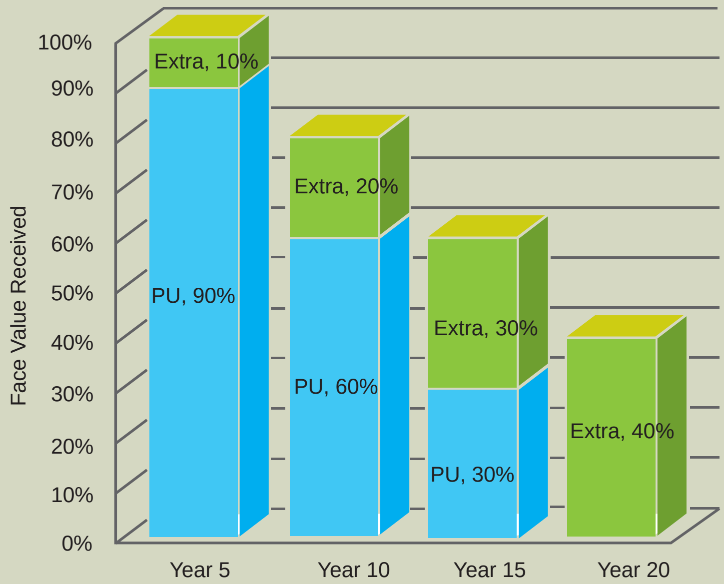
** 30% of the total marketing fees were allocated to SABIC *Sukuk* LLC in its capacity as custodian for the *sukuk* holders in respect of *Sukuk* I for the period from 1 January 2007 to 31 December 2007; and

47.06% of the total marketing fees were allocated to SABIC *Sukuk* LLC in its capacity as custodian for the *sukuk* holders in respect of *Sukuk* II for the period from 6 August 2007 to 31 December 2007.

Source: SABIC, 2008, p. 39.

Each quarter, the *sukuk* holders would be paid a return according to the three months SIBOR plus the agreed margin (refer for the margin). Any excess would be kept in a reserve account, which SABIC will maintain as an accounting entry and not as a separate bank account. SABIC can use this reserve. However, it will be considered as a liability of SABIC. The reserve is kept as a buffer against any drop in the marketing income in future. In addition, the reserve is also used to redeem 10% of the *sukuk* at the end of every five years (Year 5 date) until maturity. This is known as the "extra amount". Once the *sukuk* is redeemed, any excess reserve will go to SABIC as an incentive fee.

In addition to the 10% extra amount paid to *sukuk* holders every five years, SABIC also provides a purchase undertaking promising to purchase the *sukuk* at Year 5, Year 10 and Year 15 at different prices (90% of face value at Year 5, 60% of face value at Year 10, and 30% of face value at Year 15). The purchase undertaking gives the individual investors the right to ask SABIC to buy his or her portion of the *sukuk*, without the need for the majority investors to exercise the purchase undertaking. Therefore, different investors may exercise the purchase undertaking differently at each five-year interval. Figure 10.22 shows the total capital amount (i.e., in addition to the quarterly return) that the investors will obtain at each five-year interval. The extra amount and the purchase undertaking is structured in a way that provides incentive for the investors to exercise the purchase undertaking at Year 5 because they will get back 100% of the face value invested.



Source: Kamal & Al Sudairy, 2006, p. 20.

Figure 10.22
Face Value Received by Investors at Each 5-Year Interval

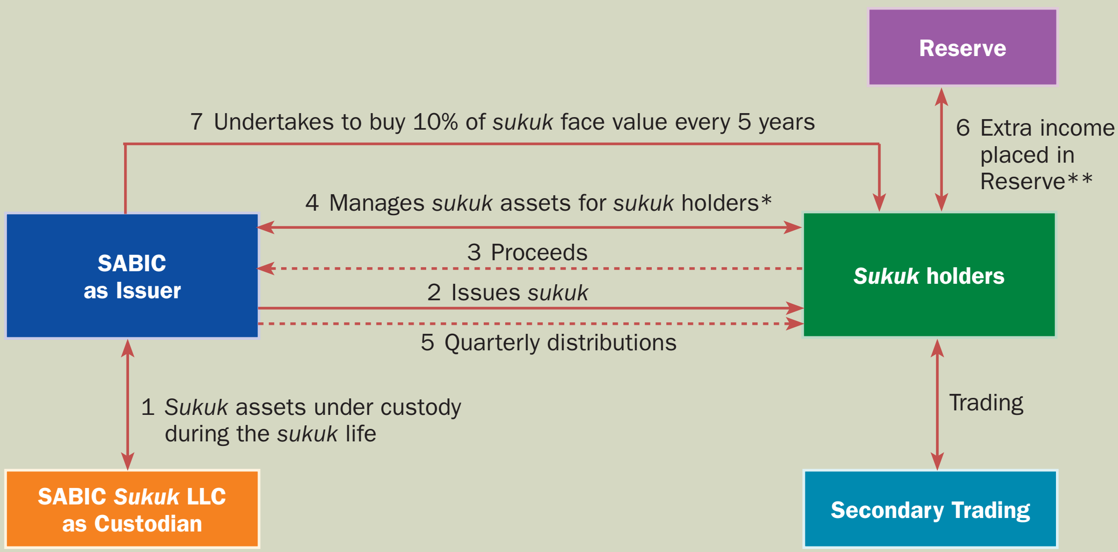


Figure 10.23
SABIC *Sukuk* Structure

* Income from *sukuk* assets expected to comfortably exceed coupon and extra amount.
** Upon maturity and after making all *sukuk* related payments, any amount remaining in the reserve goes to SABIC for managing the *sukuk* assets.

Issues, Opportunities and Challenges in the *Sukuk* Market

In this section, we will discuss a number of issues that the *sukuk* market faces. We have discussed *Shari'ah* issues in the previous section, and now we will highlight market development and market infrastructure issues.

Sukuk — Debt or Equity

Without denying the importance of *Shari'ah* requirements, market and commercial considerations have a big influence on whether *sukuk* behaves like a debt or an equity instrument. As far as the issuers are concerned, when they issue *sukuk*, they are not necessarily looking to raise equity. More often than not, they want to raise debt as they want to structure a more efficient capital structure for their firms. From the investors' perspective, there are different investors with different risk appetites. Currently, *sukuk* are sold mostly to institutional investors that are looking for fixed income instruments. These investors do not necessarily want to be exposed to the asset risk (used as the underlying asset in *sukuk ijarah*) or the business risk of the issuer (in equity-based *sukuk* for example). However, they would welcome the idea of having assets as collateral to protect the debt due from the issuer.

Next, in the regulatory environment, if the regulators are not proactive, the issuer and the investors may have to incur additional costs in order to issue *sukuk*. For example, will the sale of the underlying asset in *sukuk ijarah* attract transfer tax? What about *sukuk* holders' return? Will it be treated as a return from debt instrument or will it be taxed as in the case of an equity's dividend? Sometimes *Shari'ah* scholars allow the documents to reflect *sukuk* as a debt instrument although from the *Shari'ah* perspective, it is viewed as an equity instrument. East Cameron *Sukuk Musharakah* is a perfect example of this point.

From the *Shari'ah* perspective, the East Cameron *Sukuk* was viewed as equity participation in East Cameron's business. However, if the deal had been overtly identified as equity participation, the investors would have had to pay 30% withholding tax on the *sukuk* return as well as the *sukuk* redemption. For this reason, Yusuf De Lorenzo, a leading *Shari'ah* scholar from North America, allowed the *sukuk* to be treated as debt to East Cameron for US federal income tax purposes.

Many countries are restricted from developing their *sukuk* market due to their tax legislation issues which do not accommodate Islamic finance.

Many countries are restricted from developing their *sukuk* market due to their tax legislation issues, which do not accommodate Islamic finance. Malaysia, for instance, has amended its tax legislation and implemented tax neutrality which enables it to develop *sukuk* in this market. The UK has also issued a legislative framework for the regulation of alternative finance investment bonds (*sukuk*) to be treated as debt instruments for tax purposes. It is not *Shari'ah* that states whether *sukuk* be treated as a debt or an equity instrument. It is the legal framework that does so.

Sukuk Trading

Currently, there is limited secondary trading of *sukuk*. Most investors buy the *sukuk* and hold it to maturity. Although the *Shari'ah* requirement is the main screening criteria in determining secondary trading of *sukuk*, there are other market factors that influence whether or not a *sukuk* is actually traded in the secondary market. One of the most frequently cited reasons is the insufficient supply compared to demand. That is why, in many instances, when *sukuk* are issued, they are oversubscribed. We can observe this trend (of oversubscription) not only with sovereign *sukuk* issuances (like Central Bank of Bahrain *Sukuk*, Malaysian Global *Sukuk*, Indonesian Global *Sukuk*, etc.) but also with strong corporate issuances. Since there is limited supply, the investors would prefer to hold the *sukuk* because they may not find an equivalent alternative investment if they liquidate their holdings.

The higher the turnover ratio, the more active the secondary market trading is.

Malaysia, having developed an active *sukuk* market with frequent issuances, has had better *sukuk* trading. However, this is true for conventional bonds in Malaysia as well. To measure liquidity, we can examine trading volume of *sukuk*. However, for comparison purposes it is better to examine turnover ratio, which looks at trading volume compared to outstanding bonds or *sukuk*. This ratio would allow us to compare how much trading was done in the conventional and Islamic space for example. The higher the turnover ratio, the more active the secondary market trading is.

Table 10.18 shows the turnover ratio (based on ringgit amount) for the year 2008 to 2010 in Malaysia. The ratio compares the amount of *sukuk* or bonds traded as a percentage of average outstanding *sukuk* or bonds. This is also known as the market liquidity ratio, a ratio that measures the depth of the market. It seems that the conventional bond is more actively traded compared to *sukuk* in Malaysia. Nonetheless, trading for both conventional and Islamic bonds is showing a declining trend. For example, the total traded amount of conventional bonds has declined from 209% in 2008 to 194% in 2010. For *sukuk*, the trading has increased from 88% to 93%. A ratio of more than 100% shows that the amount traded was higher than the outstanding amount. In other words, the *sukuk* or bond was traded a number of times within the year. It seems that BNM securities are most actively traded. Nonetheless, it seems that other *sukuk* (besides BNM and government) are more actively traded compared to other bonds. The trading of this type of *sukuk* has consistently outdone conventional bonds in the same category.

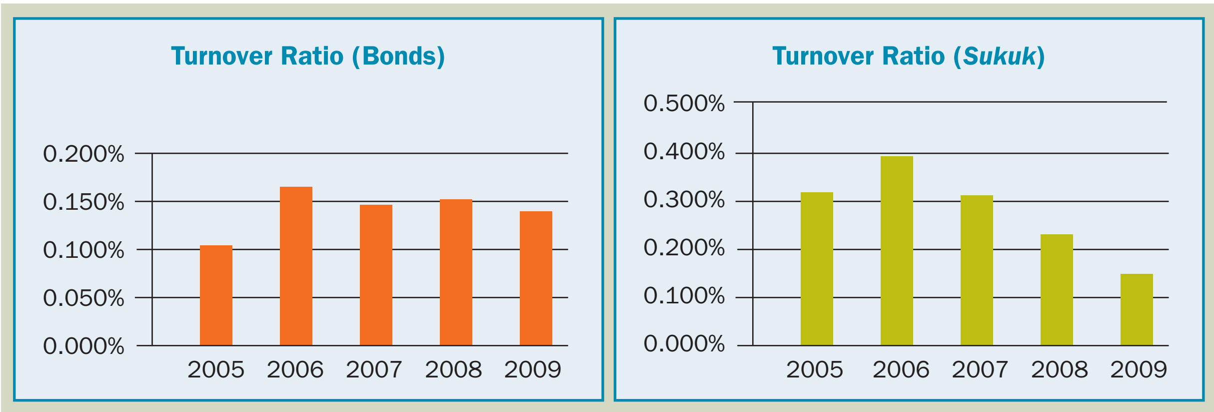
Table 10.18 Turnover Ratio – *Sukuk* and Bond in Malaysia

	2008		2009		2010	
	Bond	***Sukuk***	**Bond**	***Sukuk***	**Bond**	***Sukuk***
BNM	1077%	665%	1307%	336%	1007%	-
Government	141%	98%	126%	109%	140%	150%
Others	24%	30%	19%	44%	24%	78%
Total	209%	88%	176%	71%	194%	93%

Source: Bond Info Hub, 2010.

The availability of a sovereign *sukuk* is also cited as another factor[21] that contributes to more active *sukuk* trading since a sovereign *sukuk* provides a pricing benchmark for other *sukuk*. In Malaysia, there are frequent issues of BNM *sukuk* and government investment issues.

The above is annual data. If we compare this to daily data, the trading may be limited. Figure 10.24 shows the daily turnover ratio for *sukuk* and bonds in Malaysia. On a daily basis, there is less than 1% bond and *sukuk* traded. If we compare bond and shares trading, for example, bond trading is still far behind. For example, on 20 May 2010, there were 50 trades out of 2,499 bonds and *sukuk* (2%). In comparison, there were 980 trades out of 1,363 stocks (72%).[22]



Source: Bond Pricing Agency Malaysia.

Figure 10.24 Daily Turnover Ratio for Bonds and *Sukuk* in Malaysia

21 Refer (Rabindranath & Gupta, 2010).
22 (Meor Ayob, 2010).

Lastly, the trading platform may to a certain extent influence *sukuk* trading, but this does not always hold. Unlike shares, not many of today's *sukuk* are listed. Rather, they are traded over-the-counter (OTC), similar to bonds. If *sukuk* are listed, it is only for primary placement purposes. The secondary trading almost always takes place OTC. There has been an increasing trend of electronic/exchange bond trading recently. In March 2008, Bursa Malaysia launched Electronic Trading Platform (ETP) to allow certain bonds (MGS and GII) to be listed and traded similar to shares. Other bonds are still traded OTC, but information will be submitted once the trade is done. In June 2009, Tadawul, the Saudi Stock Exchange, launched an automated *sukuk* and bond trading platform. On 1 February 2010, the London Stock Exchange (LSE) launched Order Book for Retail Bonds (ORB) that allows retail investors to trade selected bonds similar to trading shares. Nonetheless, if there is not enough supply, trading may not be that active. Saudi is a good example on this point. Despite having a bond trading platform, *sukuk* were not actively traded because only six *sukuk* worth SAR28.7 billion are available, and most of them were held by institutional investors.

In March 2008, Bursa Malaysia launched Electronic Trading Platform (ETP) to allow certain bonds (MGS and GII) to be listed and traded similar to shares.

In summary, besides the *Shari'ah* requirement on *sukuk* trading, a number of factors affect it. These include the amount of *sukuk* in the market, frequency of *sukuk* issuance, type of investors (retail/institutional), risk appetite, trading platform and others. This is a rich area for research since analysis could be done on factors that affect *sukuk* trading in various markets.

Sukuk Pricing

Currently, *sukuk* are viewed as debt instruments. Thus, investors will usually require a return based on a spread over a certain benchmark. If we recall the SABIC deal, for example, it was priced at three months SIBOR plus 0.40%. In many global *sukuk* deals, LIBOR is a frequently used benchmark. *Shari'ah* scholars allow using the conventional interest rate benchmark as this is the market custom and there is no agreed alternative to it. Besides, scholars accept that the use of this benchmark does not taint the underlying *Shari'ah* contracts as it is merely a reference to arrive at an agreed price.

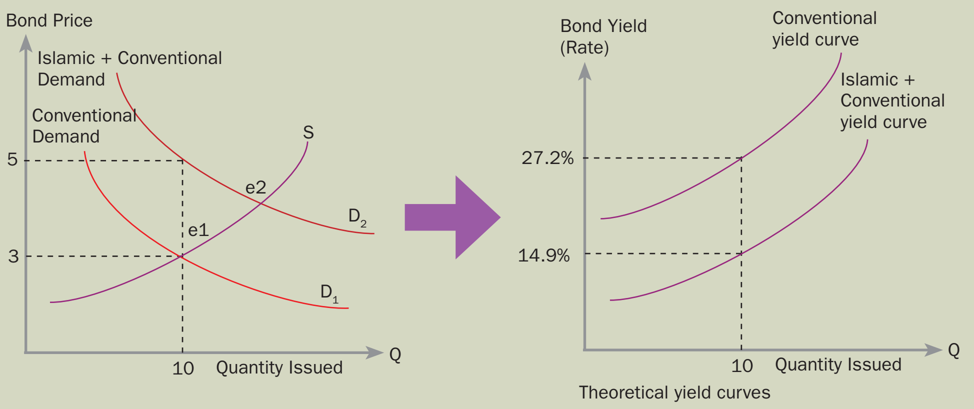
Similar to factors that affect bond pricing, the riskiness of the issuer (as reflected in its rating) and tenure are the two most common factors that influence the cost that the issuer will have to pay. In addition, liquidity premium may also be incorporated in determining the margin charged to the issuer. Generally, a more liquid instrument will enjoy a thinner liquidity premium (i.e., a smaller bid-ask spread), which will translate into tighter pricing for the issuer.

Generally, a more liquid instrument will enjoy a thinner liquidity premium (i.e., a smaller bid ask spread), which will translate into tighter pricing for the issuer.

Furthermore, supply and demand plays a vital role in determining the price that an issuer would have to pay in raising *sukuk*. Figure 10.25 illustrates how demand would affect the issuer positively. If an issuer is going to issue *sukuk*, they have the advantage of tapping into a broader group of investors because both Islamic and conventional investors can buy *sukuk*. In contrast, only conventional investors can buy a conventional bond.

For illustration purposes, let us assume that the issue is a zero coupon bond or *sukuk* (i.e., there will be no periodic distribution; all the profit will be paid at maturity). A zero coupon bond/*sukuk* will always be issued at discount. Thus, the issuer will obtain less proceeds compared to the face value. Let us assume that an issuer is considering issuing either a bond or *sukuk*. The face value of the five-year zero coupon security is US$10 billion.

In Figure 10.25, the graph on the left shows that, if the issuer taps into the bond market, the issuer can only obtain US$3 billion in proceeds. If the issuer taps into the *sukuk* market, where both conventional and Islamic investors demand such an instrument, the issuer can raise higher proceeds — US$5 billion. The amount payable at maturity would be the same — US$10 billion. However, the amount raised will be more if the issuer issues *sukuk*. If we look at this in terms of yield, the issuer will be paying a lower yield (14.9%) if he issues a *sukuk* compared to a bond (27.2% yield).



Source: Abdul Ghani & Hussain, 2009, p. 6.

Figure 10.25
Theoretical Effect of Demand on *Sukuk* Pricing

In Malaysia, *sukuk* issuers, depending on their rating, pay 3 to 20 basis points less compared to what they would pay if they issued a conventional bond. However, in the global *sukuk* market, this may not be true. On the contrary, the issuer in the global space may have to pay 20 to 50 basis points higher if they were to issue *sukuk*. Some practitioners have highlighted that among others, this phenomenon in the global *sukuk* space is caused by distorted demand via leakage of Islamic funds through commodity *murabahah* (*tawarruq*).

In the global space, Islamic banks with excess funds may enter into a *tawarruq* deposit with a conventional bank. Since there is no regulation that requires the conventional banks to invest these deposits in *Shari'ah*-compliant assets only, the conventional banks may then use them to invest elsewhere. In other words, the Islamic deposits may be used

Exhibit 10.7 Sukuk Valuation Process

The theory behind conventional bond pricing is to calculate the present value of future cash flows. In a bond, the cash flows are periodic interest payment and redemption of principal (either at maturity or amortising manner). If we analyse *sukuk*, as it is currently practised, it also involves profit payment and redemption of principal. At this point, the same bond pricing formula can be applied for *sukuk* pricing as well. Figure 10.26 illustrates this similarity.

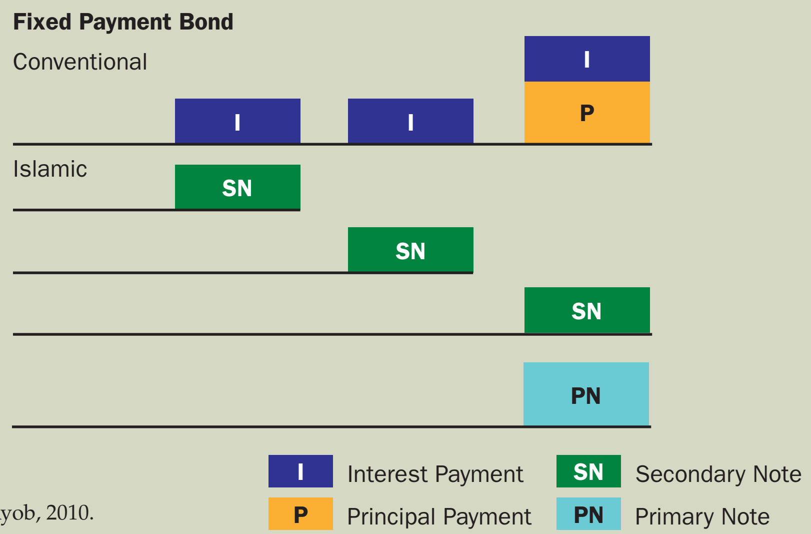


Figure 10.26 Cash Flow Decomposition in Bond & *Sukuk* Pricing Process

Source: Meor Ayob, 2010.

Nonetheless, we recall that not all *sukuk* are debt instruments. In *sukuk ijarah* for example, the *sukuk* holders are the owners of the asset. Does this introduce additional risk that needs to be taken into account? If we look at equity-based *sukuk*, the expected return is not guaranteed from the *shari'ah* perspective. Will this require additional risk dimension to be captured in formula? Although it is theoretically possible to come up with a different valuation, taking into consideration the various unique component of *sukuk*, the investors however prefer that at this stage, the valuation is done similar to a conventional bond.

Source: Bond Pricing Agency Malaysia.

to chase non-Islamic assets, thus the term "leakage". This then may reduce demand for *sukuk* (one of the Islamic assets) because the conventional banks that collected the deposit may or may not buy *sukuk*. Islamic banks with excess liquidity do not buy *sukuk* because they have already placed their excess cash in *tawarruq*.[23]

In Malaysia, the "leakage" is not possible. Regulation requires that if a conventional bank collects funds from the Islamic banks or clients (using *tawarruq*, *bay' al-'inah*, etc.),

23 Refer to Mohamad Mokhtar, 2008, pages 7-8, for further explanation.

the funds must be applied to invest only in Islamic assets. This ensures that the true demand for Islamic assets is not distorted and is reflected in better pricing for issuers.

In relation to this issue, Exhibit 10.7 provides a summary of the process of *sukuk* valuation.

Sukuk Default

The Islamic financial industry was spared from direct exposure to the Western financial market meltdown. Nonetheless, as the effect of the financial crisis reached other sectors of the economy, we have seen *sukuk* defaults in the market. As at end-April 2010, based on the IFIS *sukuk* database, there were sixteen issuers that have defaulted in the market, with a total amount of US$1.56 billion. If we compare this with the total *sukuk* issued in the market (about US$161 billion), the default represents only about 1% of the market. Table 10.19 shows the details of the defaulted *sukuk*. This list does not include *sukuk* that were near default like Nakheel (which managed to pay the amount due with emergency funding from Abu Dhabi) or Tabreed, which is in the midst of restructuring its AED1.7 billion *sukuk* that is due in 2011.

Out of the US$1.56 billion default, the highest percentage is attributed to the Saad Golden Belt *Sukuk* worth US$650 million. Saad is based in Saudi Arabia. This is followed by Kuwait and Malaysia with 19% share (about US$300 million) each. Kuwait's defaults involved two issuers — The Investment Dar (TID) and International Investment Group (IIG), both in the financial services industry. There were nine issuers in Malaysia with small ticket issuances that are facing difficulties. East Cameron's default brought the US into the picture as well. Last but not least, there are two issuers in Pakistan that are facing difficulties — New Allied Electronics and Maple Leaf Cement Factory. Figure 10.27 depicts the default market share.

There is a misconception that because *sukuk* are based on *Shari'ah* principles, they will be safe from default. This is not an accurate concept. Recall that depending on the underlying structures, *sukuk* can be utilised to provide debt financing to the issuers. This is especially true for sale-based. As far as lease-based *sukuk* and equity-based *sukuk* are concerned, the application of purchase undertaking and liquidity facility has altered the risk profile of these instruments.

There is a misconception that because *sukuk* is based on *Shari'ah* principles, it will be safe from default.

Table 10.19 *Sukuk* Default as at end-April 2010

Date Issued	Issuer	Domicile	Type of Issued *Sukuk*	Amount (US$ m)	Sector
6/6/2007	International Investment Group (IIG)	Kuwait	*Mudarabah*	200	Financial Services
3/10/2005	The Investment Dar Company K.S.C	Kuwait	*Sukuk Al Musharakah*	100	Financial Services
28/1/2005	Tracoma Holdings Bhd	Malaysia	*Bay' Bithaman Ajil (BBA)*	26.32	Automobile
19/10/2004	BSA International Berhad	Malaysia	*Murabahah*	39.47	Manufacturer of Automotive components
28/10/2005	Memory Tech Sdn Bhd	Malaysia	*Bay' Bithaman Ajil (BBA)*	84.21	Consumer Products
9/7/2004	Ingress Corporation Bhd	Malaysia	*Sukuk Al Ijarah*	13.16	Manufacturer of Automotive components
9/7/2004	Ingress *Sukuk* Berhad	Malaysia	*Sukuk Al Ijarah*	13.16	Manufacturer of Automotive components
9/7/2004	Ingress *Sukuk* Berhad	Malaysia	*Sukuk Al Ijarah*	15.8	Manufacturer of Automotive components
26/9/2005	Englotechs Holding Bhd	Malaysia	*Murabahah*	13.05	Manufacturing
8/3/2005	M-Trex Corporation Sdn Bhd	Malaysia	*Murabahah*	15.8	Manufacturing and Investment Holding Company
13/11/2009	Oilcorp Bhd	Malaysia	*Murabahah*	5.91	Oil and Gas
9/10/2009	Oilcorp Bhd	Malaysia	*Murabahah*	11.79	Oil and Gas
29/4/2005	Oxbridge Height	Malaysia	*Murabahah*	13.16	Property And Real Estate
29/4/2005	Oxbridge Height	Malaysia	*Murabahah*	27.37	Property And Real Estate
12/11/2004	The Royal Mint of Malaysia Sdn Bhd	Malaysia	*Murabahah*	12.1	Trading & Services
3/12/2007	New Allied Electronics (NAE)	Pakistan	*Sukuk*	12.25	Electronics
3/12/2007	Maple Leaf Cement Factory Limited	Pakistan	*Sukuk*	129.44	Cement
25/7/2007	New Allied Electronics (NAE)	Pakistan	*Sukuk*	10	Electronics
18/6/2007	Golden Belt 1 *Sukuk* Company BSC	Saudi	*Sukuk Al-Manfa'ah*	650	Real Estate
15/6/2006	East Cameron Gas Company	USA	*Sukuk Al Musharakah*	167.67	Oil and Gas

Source: IFIS *Sukuk* Database.

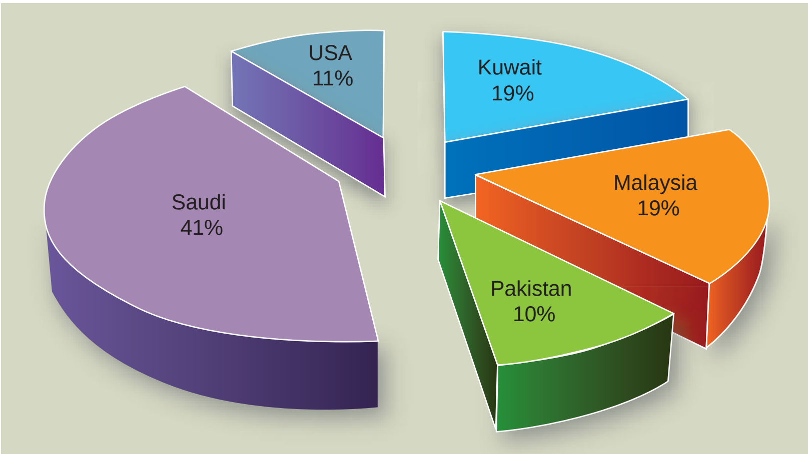


Figure 10.27 Market Share of *Sukuk* Defaults

In addition, there are growing concerns about investor protection in cases of *sukuk* default. This is where the issue of asset-based and asset-backed emerges again. As stated above, East Cameron, an asset-backed *sukuk musharakah* has defaulted. The deal was structured as a true sale securitisation according to US law. There was neither a purchase undertaking nor a liquidity facility. East Cameron, the originator, an oil and gas company in Louisiana, filed for Chapter 11 Bankruptcy on 16 October 2008 and argued that the sale of the hydrocarbon was for financing purposes only and thus it should be included in its bankruptcy estate. On the contrary, the US Bankruptcy Court in Western Louisiana judged that the sale was a true sale and thus the underlying assets that were used for the *sukuk* should not be included in the bankruptcy estate. This provides evidence that true sale securitisation is upheld in the US and the *sukuk* holders are protected from the bankruptcy of the originator.

In comparison, default cases that involve asset-based structures have not been brought to court. Thus, it is not yet clear if the *sukuk* holders' interest in the underlying asset will be recognised or not.

Summary

1 Although *sukuk* have been actively used as an Islamic financial instrument since the year 2000, their origin can be traced back to the early days of the Islamic civilisation. The main concept of *sukuk* is that they represent ownership of an asset.

2 In the primary market, the relationship between the issuer and the investors must be made clear. *Sukuk* seldom utilise a loan as the underlying relationship. Instead, sale-based, lease-based or equity-based contracts are used to enable the investors to enjoy returns on their investment. Malaysia approves the use of *bay' al-'inah* in the primary market. However, the global market opts for *tawarruq* as an alternative to this.

3 In the secondary market, the main concern is whether investors can freely trade *sukuk*. This depends on what the *sukuk* represents. In a sale-based *sukuk*, the ownership is transferred back to the obligor on the date of the issuance; thus the *sukuk* will represent the debt due. Only Malaysia allows the trading of this type of *sukuk*. The global market restricts it due to differences of opinion in the issue of *bay' al-dayn*. The holders of lease-based *sukuk* are free to trade them in the secondary market as they are the owners of the asset. Equity-based *sukuk* holders are free to trade the *sukuk* if the underlying asset consists of at least one-third tangible assets. Some *Shari'ah* boards may require 51% tangible assets.

4 The application of purchase undertaking at par and liquidity facility in equity-based *sukuk* has raised some serious concerns in the market that brought about the AAOIFI pronouncement in 2008. There also exist segments in the market that differ with AAOIFI's view and continue to apply purchase undertaking at par with the approval of the same *Shari'ah* scholars.

5 The difference in asset-based and asset-backed *sukuk* lies in the role of the asset in the structure and the recourse available to *sukuk* holders. In asset-backed *sukuk*, the underlying assets will be the sole recourse for the investors. In asset-based *sukuk*, the *sukuk* holders may not necessarily obtain the asset in cases of default except in the case where such assets are charged as security. Their recourse will be to the obligor because in cases of default the asset will be sold back to the obligor at par.

6 Besides *Shari'ah* issues, the *sukuk* market also faces market development and infrastructure issues. These include the challenge for *sukuk* to break away from the fixed income box, limited *sukuk* trading, effect of leakage on *sukuk* pricing and trading, efficiency of *sukuk* pricing and finally, the ability to manage and restructure *sukuk* defaults.

Key Terms and Concepts

Bond
Sale-based *Sukuk*
Asset-based *Sukuk*
Unsecured Creditor
Non-recourse
Bankruptcy Remoteness
SPV
Trustee
Collateral
Sukuk Default
Credit Enhancement
Capital Markets
Securitisation
Equity-based *Sukuk*
Beneficial Ownership
True Sale
Primary market
Originator
Purchase Undertaking
Trust Asset
Sukuk Turnover Ratio
Leakage of Islamic Funds
Sukuk
Lease-based *Sukuk*
Asset-backed *Sukuk*
Secured Creditor
Sukuk al-badai
Secondary Market
Obligor
Sale Undertaking
Fixed Income Instruments
Sukuk Pricing
Liquidity Facility

Further Readings

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Review Questions and Problems

Multiple Choice Questions:

1 Identify statements which are true or false.

(a) *Sukuk* were initially introduced as an alternative to the Islamic equity market.
(b) Although *sukuk* are viewed as fixed income instruments in practice, some types of *sukuk* may not really fit the requirement of fixed income instruments.
(c) In the global market, the assets represented by *sukuk* could include both financial assets (like receivables) and non financial assets (tangible assets, usufruct and services).
(d) Bonds are evidence of asset ownership.
(e) *Sukuk* structures and their underlying contracts are very similar to bonds.
(f) *Sukuk* are wider than bonds because they include both debt and non-debt assets.
(g) There is no secondary trading of *sukuk* because *Shari'ah* does not allow any *sukuk* to be sold to third parties except at par value.

2 Which of the following is most accurate?

(a) *Sukuk*, being an Islamic bond, refers only to a debt instrument similar to the conventional bond.
(b) Only asset-backed *sukuk* are truly *Shari'ah*-compliant.
(c) The discussion regarding issues in the secondary market of *sukuk* would revolve around the tradability of *sukuk*.

3 The following are true about sale-based *sukuk*, EXCEPT:

(a) *Sukuk murabahah* represents rights of claim on accounts receivable.
(b) *Sukuk salam* are freely tradable in the secondary market according to the global *Shari'ah* standard.
(c) The Malaysian version of *sukuk istisna'* is not acceptable in the GCC.

4 Which of the following is most accurate about *sukuk ijarah*:

(a) The issuance price of *sukuk ijarah* has no relationship with the value of the underlying asset.
(b) *Sukuk ijarah* represents the rental income to be received.
(c) The *sukuk* holders are responsible for major maintenance and insurance of the asset, however, they could appoint the obligor as the servicing agent to manage this.

5 Which of the following is least accurate?

(a) AAOIFI only allows purchase undertaking to be made at market price or value to be agreed in future for equity-based *sukuk*.

(b) In cases where the return on a project is not sufficient to pay the *sukuk* holder the expected return, AAOIFI allows the arrangement of a liquidity facility.

(c) *Sukuk al ijarah* could have a purchase undertaking at par according to the recent AAOIFI statement.

Discussion Questions:

1 What are the similarities between banking and the bond market?

2 What are the differences between banking and the capital market?

3 Are *sukuk* similar to bonds or securitisation?

4 Identify and discuss two issues that are contentious problems in *sukuk murabahah.*

5 What is the difference between asset-based and asset-backed *sukuk*?

6 *Sukuk* and fixed income instruments are a perfect fit. Do you agree?

7 *Shari'ah* restriction in secondary trading is the only factor that prevents the development of an actively traded *sukuk* market.

8 Discuss how the recent AAOIFI pronouncement on *sukuk* has affected the market.

9 Because *sukuk* are backed by assets, they should not default. Do you agree?

10 Is it possible for *sukuk* to break away from the fixed income box?

Islamic Equity Market

Preview

This chapter primarily discusses the fundamental characteristics of Islamic equities and the different instruments used in the Islamic equity market. It looks at modern day joint-stock corporations and discusses how these can be accepted according to *Shari'ah* principles. The chapter also looks at theories on pricing and equity valuation, risks involved in equity markets, *Shari'ah* screening, equity market index and the issues and challenges in the contemporary Islamic equity market, including that of speculation.

To start with, the equity market is a market where company shares, securities, and other instruments are traded under a stock exchange or in the over-the-counter (OTC) market. The market facilitates the flow of funds from individuals and institutional investors to corporations, as well as between investors. The market allows those with surplus funds to put their money into investments which give them returns and enables corporations to finance investments and new business ventures. Apart from company shares, Islamic equity markets have witnessed a growth of various equity fund instruments. This is evidenced by the emergence of unit trusts or mutual funds, real estate investment trusts (REITs), exchange traded funds (ETFs), venture capital funds, investment funds and structured products based on *Shari'ah* indices.

Islamic equity products must be structured according to *Shari'ah*, whereby the features of the products must follow the rules of specific underlying concepts or contracts of the products.

Learning Outcomes

At the end of this chapter, you should be able to:

- Distinguish between Islamic and conventional equity instruments.
- Describe the distinctive features of Islamic equity products.
- Discuss the *Shari'ah* requirements of Islamic equity structures and practices.
- Analyse and deliberate *Shari'ah* issues pertaining to Islamic equity instruments.

The Characteristics of Islamic Equity

Share is interpreted as *sahm* in Arabic. It represents the ownership of the proportionate share for the shareholder in the company's assets.

Equity-based contracts involve partnership and the sharing of risks and rewards in a venture. Islamic contracts involved in such sharing are usually classified under *mudarabah* and *musharakah*. The profits are derived from capital gains when the purchased shares or securities are later sold at higher prices. Profits can also be obtained through dividends if and when these are distributed by the issuing companies.

Essential Characteristics of Islamic Equity

1 The business must be *halal*, i.e., it is generally not involved in prohibited activities like gambling, sale of alcohol or businesses that involve *riba* and *gharar*. The question that may arise is: what if the main business is *halal* but some parts of the business involve interest-based activities (for example, a loan is raised through the conventional way)? Some scholars are of the view that the purchase and sale of such stocks are not permissible since such a business activity implies that the shareholder is in agreement or condones practices which are against *Shari'ah*.

However, under current realities it is very rare to find companies which are 100% *Shari'ah* compliant in the sense that every aspect of their business is in full conformity to *Shari'ah*. A strict operational definition of what *halal* business means would result in a very small universe of *Shari'ah*-compliant stocks that an investor can invest in. Many *Shari'ah* scholars also argue that a joint-stock company is different from a partnership where the large number of shareholders who are owners do not have as much power to influence the decisions of the company compared to one that is based on a partnership model, hence the decisions taken by the company cannot be wholly attributable to individual shareholders. Thus, many scholars are of the opinion that if some parts of the business are involved in non-permissible activities, it does not necessarily make the whole business non-*halal*. Thus, *Shari'ah* decisions on compliant equities do take into account current realities of the society and *maslahah* of the *Ummah*.

The logical follow-up question would then be: what is the proportion of non-*halal* activities that is allowed for a share to be deemed *Shari'ah*-compliant? In a market where the regulatory framework is more established, this is clearly defined.

Examples in this context could be cited from regulatory authorities in the US, Malaysia and Pakistan. In Malaysia, *Shari'ah* compatibility of securities is determined by the *Shari'ah* Advisory Council (SAC) of Malaysia's Securities Commission (SC). Meanwhile, in the US and Pakistan, the Dow Jones Islamic Index and Meezan Islamic Fund Criteria, respectively, constitute the standards. Although these three standards have different levels of stringency, the results arising from their individual screening process are unlikely to be substantially different.

2 Islamic equity products must be structured according to the *Shari'ah*, whereby the features of the products must follow the rules of specific underlying concepts or contracts of the products. This means that not only must the funds be invested in *halal* activities, the way the funds are structured must conform to Islamic principles. This also includes the *Shari'ah* endorsement and certification processes.

3 Instead of emphasising fixed return on capital, profits should be shared on a pro-rata basis. Neither the principal nor rate of profit can be guaranteed. The principles of profit-and-loss-sharing depend on the kind of contract, whether it is *mudarabah* or *musharakah* (refer to Chapter 7).

4 The shares of a company are negotiable only if the company owns some illiquid assets. If all or a substantial proportion of assets are in liquid form (in the form of money), they cannot be purchased or sold except at par value. This means that ownership interest is related to ownership of real business and this is reflected in the existence of real assets. If shares consist of money assets only, then the money cannot be traded except at par value. This requirement indicates an emphasis of *Shari'ah* that money is a medium of exchange and it cannot be used to breed more money.

While it is now a foregone conclusion that contemporary equity markets are generally deemed as permissible forms of investment in the eyes of *Shari'ah*, this was not necessarily the case during the inception stages of Islamic finance. The following discussions briefly describe the issues that were subjected to deliberation by scholars.

Shari'ah Permissibility of Modern Day Corporations

Joint-stock corporation is a type of business entity involving two or more legal persons.

An essential question that needs addressing is: does the *Shari'ah* recognise and accept the concept of modern day joint-stock corporations? A joint-stock corporation is a type of business entity involving two or more legal persons. Certificates of ownership (or stocks) are issued by the company in return for each financial contribution, and the shareholders are free to transfer their ownership interest at any time by selling their stockholding to others. If the answer to the aforementioned imperative question was negative, an Islamic equity market would be non-existent. In this regard, the Organization of the Islamic Conference (OIC) Islamic *Fiqh* Academy has approved share companies and by doing so has accepted two Western legal concepts – artificial personality and limited liability.

An artificial or judicial personality or legal entity is the characteristic of a non-human entity regarded by law to have the status of a person. A legal person has rights, protections, privileges, responsibilities and liabilities under law, just as natural persons (humans) do. Limited liability is a concept whereby a person's financial liability is limited to a fixed sum, most commonly the value of a person's investment in a company. In other words, if a company with limited liability is sued, then the plaintiffs are suing the company, not its owners or investors. In the case of limited liability, it was initially argued that there stood a basic Islamic tenet that (debt) obligations are irreducible and indestructible without agreed release or forgiveness from the creditor. This renders the notion of a limited liability shield objectionable from an Islamic standpoint. In some cases, bankruptcy and liquidation proceedings do in fact not only suspend claims by creditors, but also extinguish them. Nonetheless, approving jurists argued that parties dealing with such companies are aware of their limited capacity for liability and presumably consent to that character.

Shari'ah Permissibility of Secondary Market Trading

Ribawi items refer to the commodities below, used either as money or food, exchanges of which are prohibited if there is any increase because of difference in quantity, quality and/or time:

1 Gold
2 Silver
3 Wheat
4 Barley
5 Dates
6 Salt.

Tradability of shares in secondary markets is crucial, otherwise liquidity concerns will severely limit the attractiveness of equity markets. While classical Islamic law encourages trading and markets of all tangible goods, it restrains the trading of financial interests. Given the fungibility and liquidity of shares, would a share be construed as a *ribawi* item? That is, are shares equivalent to money? If so, Islamic law will impose strict constraints in the manner of their trading, and this would diminish the efficiency and effectiveness of an equity market substantially. Again, jurists have approved secondary market trading of shares by advocating one of two approaches explained below.

Approach 1: Shares as Reflecting Partnership Interest

Scholars have rationalised that the relationship between shareholders can be construed as a *musharakah* arrangement, whereas the relationship between shareholders collectively and company management can be viewed as that of *rabbul mal* and *mudarib (mudarabah* arrangement), respectively, or principal and agent (*wakalah* arrangement). Classical Islamic law holds that partnerships must be terminated and liquidated upon the withdrawal of a partner. If this requirement is strictly applied, sale of shares in the secondary market is, for all practical intents and purposes, not possible. Jurists have addressed this aspect by arguing that the rationale for the partnership termination requirement is for the determination of the partners' equitable share in the partnership. In the context of modern day equity, stock valuation techniques can satisfy this condition. In practical terms, it is presumed that prevailing market prices of shares represent the equitable value of a partner's share in the partnership. Furthermore, partners' consent to the regular and recurring entry of new partners can be obtained in advance. Essentially, a new shareholder is a new party to the *musharakah* contract.

Another issue may arise in interpreting shares as partnership interest. In modern day equities, dividends are typically paid on the basis of par value, whereas shareholders (who purchased shares in the secondary market) would invariably pay different prices for the same stock. Thus, dividend yields would be different among shareholders. Dividend yield is a financial ratio that shows how much a company pays out in dividends each year relative to its share price. It is calculated by dividing the annual dividends per share with the price per share. This would imply inconsistency or inequity in the realised profit-sharing ratio. A more serious concern surfaces when one considers the situation of a loss. *Fiqh* rules stipulate that in the event of a loss, *musharakah* partners must strictly bear losses according to their respective capital contributions. This goes against the established convention wherein liability of equity holders is apportioned by par value, not by the particular price at which the stock was purchased. On this issue, jurists have reasoned, on the basis of *istihsan*, that avoidance of hardship in the calculation and determination of actual cost to each shareholder justifies the distribution of loss by nominal (par) value.

Istihsan refers to juristic preferences, i.e., disregarding a ruling backed by a *dalil* (proof) and resorting to another ruling that is sounder.

Notwithstanding some jurists' assertion that shares can be interpreted as *musharakah* partnerships, it is important to note some key conceptual differences between modern day equity and *musharakah*. Firstly, equities are assumed to have an infinite life (the going-concern assumption) whereas *musharakah* generally has a fixed time period. Secondly, *musharakah* partners are entitled to a share in partnership profits whereas equity holders typically seek capital gains in addition to profit distribution (in the form of declared dividends). Thirdly, in a *musharakah* partnership, the agreement of all partners is needed for financing decisions (such as raising new capital), whereas in equities, such decisions can be ratified by a simple majority. Despite these differences, the *Fiqh* Academy ruling of 1996 has approved modern day equities.

Approach 2: Shares as Ownership of Enterprise

Shareholding can also be interpreted as ownership of an enterprise which in turn is equated to the undivided co-ownership of the company's net assets. As such, co-owners (shareholders) can sell their interests to third parties without the permission of other co-owners. This is in line with the concept of *sharikah milkiyyah* (partnership in ownership) in *fiqh mu'amalat*. However, there is an underlying assumption that shares represent ownership of tangible goods and property that are freely tradable (allowed by *Shari'ah*). In some cases, the nature of a firm's balance sheet may contravene the aforementioned condition. The following are some examples:

1 A new business, where the majority of funds are in the form of cash that is yet to be invested.

2 A company that has divested a significant portion of its business for strategic reasons, and in the transition period, while new business ventures have yet to be identified, assets are primarily in the form of cash.

3 A significant portion of the company's assets are in the form of accounts receivable.

4 A company whose value is reflected in intangible assets (intellectual property, goodwill, future income streams) – consider the case of technology stocks, pharmaceuticals or biomedical research companies.

Shirkah al-milk refers to a joint ownership by two or more persons due to any cause of ownership. For example, when two people buy a property or the property is given to them as a gift, it becomes jointly owned by them. It is also known as *sharikat al-shuyu*.

In this regard, the OIC Islamic *Fiqh* Academy issued a resolution (*fatwa*) that, in effect, allowed trading of shares in such companies, provided that the assets of the firm are in greater part, by value, real assets as opposed to cash or debt obligations (*dayn*).

The conclusion that can be made from the previous discussions is that the majority of scholars have approved the secondary market trading of shares.

Equity Valuation

Valuation is a process of determining the intrinsic or the "true" value of equities in order to assist investment decisions of buying or selling a stock. In other words, how are the prices of securities determined in the market and do these market prices reflect their intrinsic value? The purpose of valuation is to determine the real meaning of the disclosed profit or to determine the true future value of the security, company or asset. Valuation not only helps us to understand the real value but also what are the sources of the value. Valuation is also important for the issuing companies as it can illustrate successful company operations, e.g., during the launch of a new product and to establish the company's performance track record.

Valuation is an important part of the investment process. The market can be more efficient and investors can make informed choices when proper valuation is made. An estimate of the value of the stock is thus necessary to establish the probable gain of investing in the stock. According to John Maynard Keynes, stock valuation is not a prediction but a convention which serves to facilitate investment and to ensure that stocks are liquid, despite being underpinned by an illiquid business and its illiquid investments, such as factories.

Since prices of stocks can be influenced by many factors and not necessarily economic fundamentals which directly influence the business performance of such stocks, under-pricing and over-pricing can always occur. Basically, investors are motivated to buy under-priced stocks to reap the returns from price appreciation, assuming that there will be market corrections and prices will appreciate. Speculation can drive share prices and asset bubbles can occur and burst. This has happened frequently enough in modern history to show that prices do not always reflect market or business fundamentals.

Speculation is a matter of degree, but excessive speculation invites elements of *gharar* (ambiguity) and *maysir* (gambling), which are prohibited in Islam. A good and fair method of valuation is thus necessary for Islamic equities so that the market is transparent and speculative activities, which tend to drive a big wedge between intrinsic values and market prices, are avoided or minimised and asset bubbles are less likely to occur.

As Islamic finance in the modern economy is still in its infancy, much of the valuation process is still based on the conventional way of valuation. This means that as long as securities can be declared *Shari'ah*-compliant through some kind of *Shari'ah* screening by various jurisdictions, there is at present no distinct way of valuing them which can be claimed as the "*Shari'ah*-based" way.

As Islamic finance grows and becomes a bigger part of mainstream finance, the market forces of supply and demand that determine securities' prices would reflect the underlying *Shari'ah* issues and concerns of the day. A proper valuation and pricing theory that takes into account the essential principles of Islamic finance must be developed. As theory development is guided and influenced by the development of the market, there should be more "happenings" in the market before one starts to see a distinct "theory of Islamic equity valuation" evolving. As for now, techniques and models in conventional finance are still relevant and very much used in the valuation process. These models need to be assessed not only in terms of their efficiency and ability to predict the value of financial instruments including that of equity, but also whether the concerns for *Shari'ah* compliance and bigger objectives of *maqasid al-shari'ah* would give rise to a different valuation perspective. For example, how does the *Shari'ah* view the theory of the time value of money and incorporate it into the valuation of equities?

Supply, Demand and Price of Equity

The price of a stock fluctuates fundamentally, according to the theory of supply and demand. Like all commodities in the market, the price of a stock is sensitive to demand. However, there are many factors that influence the demand for a particular stock. The fields of fundamental analysis and technical analysis attempt to understand market conditions that lead to price changes, or even predict future price levels.

At any given moment, a stock's price is strictly a result of supply and demand. The supply is the number of shares offered for sale at any one moment. The demand is the number of shares investors wish to buy at exactly that same time. The price of the stock moves in order to achieve and maintain equilibrium. When prospective buyers outnumber sellers, the price rises. Eventually, sellers attracted to the high selling price enter the market and/or buyers leave, achieving equilibrium between buyers and sellers. When sellers outnumber buyers, the price falls. Eventually buyers enter and/or sellers leave, again achieving equilibrium. Thus, all investors voting with their money determine the value of a share of a company at any given moment. If more investors want a stock and are willing to pay more, the price will go up. If more investors are selling the stocks, and there are not enough buyers, the price will go down.

But what influences demand and supply of Islamic equities? The set of influencing factors may be somewhat different from those governing the market forces for non-

Shari'ah stocks. Investors for Islamic investments can be divided into three groups. The first comprises *Shari'ah*-compliant investors who would only put their money in investments that comply with Islamic law. The second group consists of "*Shari'ah*-compliant preferred investors" who would invest in both conventional and Islamic products but would always have preference for *Shari'ah*-compliant products and the third group comprises returns-sensitive group of investors who would only take up Islamic investments if their returns are better than other investments. The first and second group of investors could be influenced by religious or ethical beliefs while the third is purely guided by returns and performance and regard Islamic investments as just another asset class. The good track record of many Islamic financial asset classes, such as stocks and unit trusts and their superior risk-bearing features, especially during the economic downside, have attracted not only "faith-based" investors who now feel less of a trade-off between ethics and returns, but also those who are purely returns-sensitive.

The rapid increase of the Muslim population and their financial activities, the rise in the number of high net worth individuals (HNIs), the availability of huge liquidity surpluses in the form of petrodollars from the Gulf as well as the post-September 11 scenario that resulted in many of these HNIs seeking alternative forms of investments in financial centres other than the US, UK and Europe are all demand factors that have resulted in the phenomenal growth of Islamic equity funds. In fact, the emerging interest in Islamic finance among many non-Muslim countries such as Singapore, Hong Kong, Korea and South Africa illustrate the desire to capture this global new movement of the flow of funds into Islamic investment.

Certainly, the demand for Islamic equities, which is just like the demand for any financial instrument, is also influenced by a set of global and national economic factors. Therefore, shocks and economic downturns affect the demand for Islamic investment as much as they do other types of investments. However, there are some evidence from the global financial crisis of 2007–2009 that suggests that Islamic financial assets tend to outperform conventional assets during a downturn.

The supply of Islamic equity funds which satisfy the needs of sophisticated investors are still limited. Furthermore, the fact that different countries and regions have different regulations and diverse *Shari'ah* interpretations despite recent initiatives of *Shari'ah* harmonisation would mean that certain products issued in certain countries do not have a global appeal. In this sense, the supply of Islamic equities is further reduced in size if we consider *Shari'ah* complaint are not deemed as such by others the global market as a whole. The stocks that some investors consider *Shari'ah* compliant are not deemed as such by others, and therefore they do not constitute the total supply of available Islamic stocks for the latter group.

Models of Pricing and Equity Valuation

In professional investment circles, the efficient market hypothesis (EMH) continues to be popular, despite its being widely criticised in the academic world. Efficient market hypothesis says that investing is overall rational; that the price of a stock at any given moment represents a rational evaluation of the known information that might have a bearing on the future value of the company, and that the share prices of equities are priced efficiently. This means that they represent accurately the expected value of the stock, based on the information that is best known at any given moment. Hence, prices are the result of the discounting of expected future cash flows.

If the EMH model is true, two consequences are possible. First, because financial risk is presumed to require at least a small premium on the expected value, the return on equity can be expected to be slightly higher than that available from non-equity investments (such as debt-based instruments). Otherwise, rational calculations would drive equity investors to shift to safer non-equity investments that could be expected to give the same or better returns at lower risk. Second, because the price of a share at any given moment is an "efficient" reflection of the expected value, then relative to the curve of expected return, prices will tend to follow a random walk determined by the emergence of information randomly available over time. Professional equity investors, therefore, immerse themselves in the flow of fundamental information, seeking to gain an advantage over their competitors by more intelligently interpreting the emerging flow of information.

The EMH model, however, does not accurately describe the process of equity price determination. For example, we can observe that stock markets are more volatile than the EMH would imply. In recent years, it has come to be accepted that share markets are not perfectly efficient. This is especially so in emerging markets or other markets characterised by high information asymmetry and a scarcity of well-informed professional investors.

Does *Shari'ah* assume the markets to be efficient? Or put it another way, does *Shari'ah* compliance promote market efficiency? If this is so, then the adoption of more Islamic financial instruments can lead to prevailing market prices being closer to what is predicted by the EMH model.

Another theory of share price determination comes from the field of behavioural finance. According to behavioural finance, humans often make irrational decisions, particularly related to the buying and selling of securities. This is because, transacting in securities is often based upon fears and misperceptions of outcomes. The irrational trading of securities can often create prices of securities that vary from rational, fundamental price valuations. For instance, during the technology bubble of the late 1990s (which was followed by the dot-com bust of 2000–2002), technology companies were often bid beyond any rational fundamental value because of what is commonly known as the "greater fool theory". The "greater fool theory" holds that, because the pre-dominant method of realising returns in equity is from the sale to another investor, initial holders should select securities that they believe someone else will value at a higher level at some point in the future. This is regardless of the reasons or the basis for the other party's willingness to pay a higher price. Thus, even a rational investor may bank on others' irrationality. Can we expect *Shari'ah*-compliant investors to be more sophisticated and ethical so that their behaviours are less speculative and, hence, less likely explained by the "greater fool theory"? If this is so, then the rise of Islamic investors can contribute toward a higher level of stability and efficiency of the market as decisions are made more on rational or fundamental reasons rather than irrational reasons or based on the "herd mentality". This is probably an empirical question that can only be validated with research.

In financial markets, there are several methods used to calculate theoretical values of companies and their stocks. The main use of these methods is to predict future market prices, or more generally, potential market prices to profit from price movement. Stocks that are judged under-valued (with respect to their theoretical value) are bought, while stocks that are judged over-valued are sold in the expectation that under-valued stocks will, on the whole, rise in value, while over-valued stocks will, on the whole, fall.

Fundamental Analysis

Stock valuation based on fundamentals aims to give an estimate of the intrinsic value of the stock, based on predictions of the future cash flows and profitability of the business. The analysis assumes that the company's profitability will determine the path that the share prices will take in the future. The value of the share is made through an analysis of the earnings and dividend prospects of the company, expectation of profit rates and the risk exposure of the firm. An under-valued stock implies that the true value of the share is higher than the market price, and hence there is an advantage in the early purchase of the share. A fundamental analyst believes an under-valued share will see market correction and the price will appreciate over time. Fundamental analysis therefore, puts emphasis on the "fundamentals" of the share and is more interested in the long-run prospects of the company rather than short-run trends and market excitement. However, this analysis is associated with buying and holding of shares for a long time and there will be holding costs involved.

Technical Analysis

Technical analysis is concerned with perceived value, hence what is perceived by people is not necessarily based on fundamentals. The assumption is that the buying and selling of shares, and hence the price of shares is influenced by the mood and sentiment of the market. Technical analysis basically involves the study of stock market prices and volumes of shares traded through the use of charts in an attempt to predict future price movements. Prices are examined to identify if there are patterns or recurring trends based on past and emerging trends. By identifying the pattern, future price movements for a particular share are predicted and this gives indication as to the best timing for share trading.

Discounted Cash Flow Model

The income valuation or the discounted cash flow (DCF) model is often considered to be the most theoretically sound stock valuation method. It involves adding up the amount of the profits (dividends, earnings, or cash flows) that the stock will bring to the stockholder in the foreseeable future, and discounting it to present value. The discounted rate normally includes a risk premium, which is commonly based on the Capital Asset Pricing Model (CAPM).

Discounted cash flow calculations have been used in some form since money was first lent at interest in ancient times. As a method of asset valuation, it has often been opposed to accounting book value, which is based on the amount paid for the asset. Following the stock market crash of 1929, discounted cash flow analysis gained popularity as a valuation method for stocks. Irving Fisher in his 1930 book, *The Theory of Interest* and John Burr Williams's 1938 text *The Theory of Investment Value* first formally expressed the DCF method in modern economic terms.

In finance, discounted cash flow (DCF) analysis is a method of valuing a project, company, or asset using the concept of the time value of money. All future cash flows are estimated and discounted to obtain their net present values (NPV). The expected future cash flow is the expected profit which is equal to the expected sum of stream of the revenue net of all costs. Hence, the value of a firm's stock is equal to the present value of all expected future profits discounted at the shareholders' required rate of return:

$$V_0\,(\textit{Shares outstanding}) = \text{NPV} = \Sigma_{t=1}^{n} \frac{\textit{cash flow}}{(1+k)^t}$$

Using DCF analysis to compute the NPV takes input cash flows and the discount rate and gives output as a price. The opposite process, i.e., taking cash flows and the price and inferring a discount rate is called the yield.

The discount rate reflects two things:

- Time value of money (risk-free rate) – according to the theory of time preference, investors would rather have cash immediately rather than wait and must therefore be compensated through payment for the delay.

- Risk premium – this reflects the extra returns investors demand because they want to be compensated for the risk that the cash flow might not materialise.

Exhibit 11.1 Islamic Perspective on the Time Value of Money

Islamic law recognises the selling price differences between a cash payment sale and a deferred payment sale (such as *murabahah*), whereby the latter can be higher than the former. The majority of Muslim jurists agree that a higher price can be charged in a deferred payment sale due to the time factor involved in determining the value of the contracted item (*al-ma'qud 'alayh*). This is evidently expounded in various classical texts of Islamic jurisprudence. The following highlights several quotations of the jurists' opinion on the time value of money from the Islamic perspective.

1 Al- Dasuki of the **Maliki School** mentioned that:

وَجَبَ عَلَى بَائِعِ الْمُرَابَحَةِ بَيَانُ (الأَجَلِ) الَّذِى اشْتَرَى إِلَيْهِ لِأَنَّ لَهُ حِصَّةً مِنَ الثَّمَنِ.

Meaning: "The seller in a *murabahah* (transaction) should explain the (deferred) period that he bought from, as it has a portion in (determining) the sale price."

2 Al-Kasani of the **Hanafi School** wrote that:

وَلَوْ اشْتَرَى شَيْئًا نَسِيئَةً لَمْ يَبِعْهُ مُرَابِحَةً حَتَّى يُبَيِّنَ، لِأَنَّ لِلْأَجَلِ شُبْهَةَ الْمَبِيعِ وَإِنْ لَمْ يَكُنْ مَبِيْعًا حَقِيْقَةً.. أَلَا تَرَى
أَنَّ الثَّمَنَ قَدْ يُزَادُ لِمَكَانِ الْأَجَلِ فَكَانَ لَهُ شُبْهَةٌ أَنْ يُقَابِلَهُ شَيْءٌ مِنَ الثَّمَنِ.

Meaning: "If someone buys something on a deferred basis, he cannot sell it (using) *murabahah* sale unless he clarifies (the deferred period). This is because the (deferred) period is ambiguously similar to the object of the sale, although it is not actually an object of sale … as you notice that the price increases according to the (deferred) period, therefore, it has the ambiguity of being equivalent to a part of the sale price."

3 Al-Sharbini of the **Shafi'i School** stated that:

وَكَلَامُهُ يَقْتَضِى اشْتِرَاطَ تَعْيِيْنِ قَدْرِ الْأَجَلِ مُطْلَقًا وَهُوَ كَذَلِكَ لأَنَّ الْأَجَلَ يُقَابِلُهُ قِسْطٌ مِنَ الثَّمَنِ.

Meaning: "His statement requires a total stipulation in determining the extent of (deferred) period, as the (deferred) period is equivalent to a portion of the sale price."

4 Ibn Taymiyyah of the **Hanbali School** said that:

وَإِذَا بَاعَهُ إِيَّاهُ بِالْقِيمَةِ إِلَى ذَلِكَ الْأَجَلِ فَإِنَّ الْأَجَلَ يَأْخُذُ قِسْطًا مِنَ الثَّمَنِ.

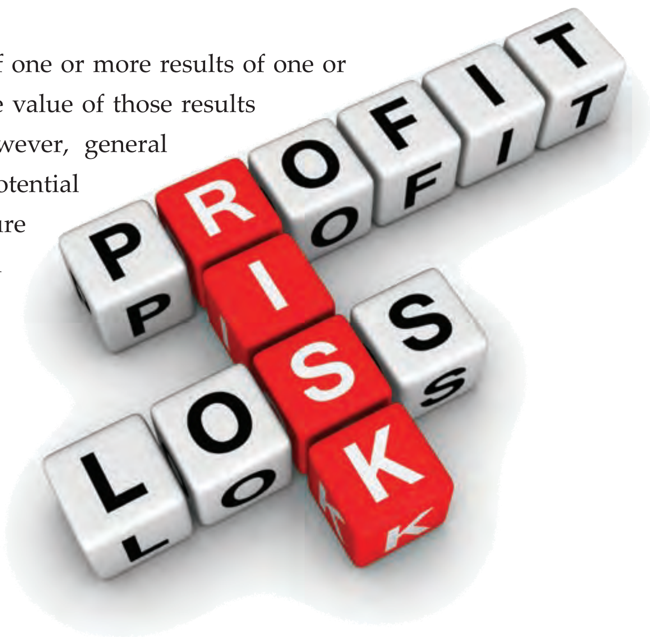
Meaning: "If he sells it to him (buyer) with an amount for that (deferred) period, then the (deferred) period takes a portion of the sale price."

Source: Al-Dasuqi, n.d., p 266; Al-Kasani, 2000, p 4:466; Al-Sharbini, 2003, p 2: 107; Taymiyyah, 1998, p 15: 275.

How does *Shari'ah* view time value of money, which besides constituting much of the basis of modern finance, is profoundly related to the theory of interest rate determination as well as asset valuation? It can be said that *Shari'ah* does not completely rule out the concept of time value of money. This is evidenced by the fact that Islam does not prohibit any increment in a sale contract to be paid at a future date. What is prohibited, however, is making money's time value an element of any lending relationship, whereby a repayment of loan involves paying more than the principal to compensate for the time involved. This is based on the principle of *Shari'ah* that money cannot breed money and that interest attached to the loan is prohibited not because of the principle of time value of money but because it involves paying extra for an exchange of money/currency. This is based on a *hadith* that the exchange of money (gold, silver or any other *ribawi* item) or currency of the same *type* must be of the same value but if of a different *type*, the exchange can take place at a certain rate of exchange (not necessarily at par) but it must be on spot basis. Here, the fact that *Shari'ah* allows the credit sale price of any goods or commodity to be different from the spot price implies a recognition of the time value of money. The "extra" money paid does not constitute *riba* here because it arises from the sale and purchase on deferred payment and not for the loan of money. Thus, the concept of time value of money is taken into consideration in the pricing of Islamic assets, and this is permissible. What is not permissible is its use in compounding the interest for the lending of money.

Understanding and Measuring Risks

Risk concerns the expected value of one or more results of one or more future events. Technically, the value of those results may be positive or negative. However, general usage tends to focus only on the potential harm that may arise from a future event, which may accrue either from incurring a cost ("downside risk") or by failing to attain some benefit ("upside risk").



In finance, risk is the probability that the actual return from an investment will be different from the expected return. This includes the possibility of losing some or all of the original investment. Some regard the calculation of the standard deviation of the historical return or average return of a specific investment as providing some historical measure of risk. Basically, there are two types of risks: financial risk, which is market-dependent, determined by various market factors and operational risk, which results from fraudulent behaviour (for example, the case of Bernard Madoff).

A fundamental idea in finance is the relationship between risk and return. The greater the potential return, the greater the risk. This is reflected in the free-market pricing principle of an instrument: strong demand for a safer instrument drives its price higher (and its return proportionately lower), while weak demand for a riskier instrument drives its price lower (and its potential return, thereby, higher). For example, a sovereign bond like a US Treasury bond is considered to be one of the safest investments and when compared to a corporate bond, provides a lower rate of return. The reason for this is that a corporation is much more likely to default than the US government. Since the risk of investing in a corporate bond is higher, the bond-issuing corporations would have to offer a higher rate of return in order to attract investors.

A common risk measurement is Value-at-Risk (VaR). There are different types of VaR – Long-term VaR, Marginal VaR, Factor VaR and Shock VaR. The latter is used in measuring risk during extreme market stress conditions. Depending on the nature of the investment, the type of "investment" risk will vary.

A common concern with any investment is that the initial amount invested (also known as "the capital") may be lost. This risk is therefore often referred to as capital risk. Many forms of investment may not be readily saleable on the open market (e.g., commercial property) or the market has a small capacity and may therefore take time to sell. Assets that are easily sold are termed liquid; therefore this type of risk is termed as liquidity risk. This type of risk is an important consideration in equity investment. This is because an investor who purchases an illiquid stock may find difficulty in selling the stock (or selling it at a price acceptable to the investor) when he or she needs the money.

Equity risk is the risk that an investor's investments will depreciate because of stock market dynamics causing the investor to lose money. The measure of risk used in the equity markets is typically the standard deviation of a security's price over a number of periods. The standard deviation will delineate the normal fluctuations one can expect in that particular security above and below the mean, or average.

Does *Shari'ah* stock screening provide another risk for Islamic investors? If *Shari'ah* screening does what it stands for, it could perform the role of screening out bad investment. Since *Shari'ah* principles in investment promote transparency and the sharing of risks and profit-and-loss, *Shari'ah* screening could actually reduce much of the risks that usually emanate from the larger universe in financial investment.

This includes the risks that come from speculation which forms a big feature of modern finance.

Nevertheless, practitioners often point to the existence of *Shari'ah* risks to include among others, the complexity of structuring a product to be compliant. This becomes a reality since there exists potential risks that the product may not be approved as targeted, and hence the associated costs involved in such undertaking. *Shari'ah* risks may also refer to the different jurisdictions governing different Islamic products and the risks that some products are not accepted in certain markets purely on the basis of *Shari'ah* issues. This could also ensue from the possibility that certain authorities in certain jurisdictions may declare an Islamic product "*Shari'ah*-non-compliant" based on new information or line of interpretation. From the foregoing, it is obvious that *Shari'ah* screening may add to the costs of structuring an Islamic financial product and may even have *Shari'ah* risks. As such, it could be argued that the required rate of return, and hence the discount rate in the calculation of the NPV would have to be higher for an Islamic fund than a conventional one. But as initiatives for global *Shari'ah* harmonisation increase and as the market matures to allow for more understanding of the industry and the products as well as the development of expert human capital including *Shari'ah* scholars and practitioners, the risks related to *Shari'ah* issues are expected to diminish.

Islamic Equity Market Instruments

Shares or Stocks

Table 11.1 below briefly outlines the different types of shares (also called stocks).

Table 11.1 Different Types of Shares

Type of stock	Definition and Features
Common	A share giving the holder the right to vote on matters of corporate policy and composition of members of the board of directors. Also known as voting share or ordinary share.
Preferred	A stock that has priority in terms of dividend and rights on liquidation, over common stocks. Terms are negotiated between the corporation and investors. Also known as preference shares. Other important features include fixed rate of dividend, carries no voting rights and option of convertibility into common stock (in some cases).
Cumulative Preferred	Type of preferred stock in which the dividends are cumulative, that is, if the dividend is not paid in a given financial year, it will accumulate for future payments in subsequent year(s).
Non-cumulative Preferred	A type of preferred stock with similar characters as common stocks but the dividends are fixed and non-cumulative. Dividends will not accumulate if one or more payments are missed.

Preference Shares

A preference share, sometimes called preferred stock, is a hybrid instrument that typically accords its holders a fixed dividend, priority in the event of liquidation and no voting rights. The rationale from the investor's perspective is a more secure source of income as well as less risk should there be financial distress. From the issuer (company)'s viewpoint, it makes sense in instances when the firm feels it is not prudent to assume additional debt, and there is a need to address regulatory restrictions on voting rights applied to foreign shareholders.

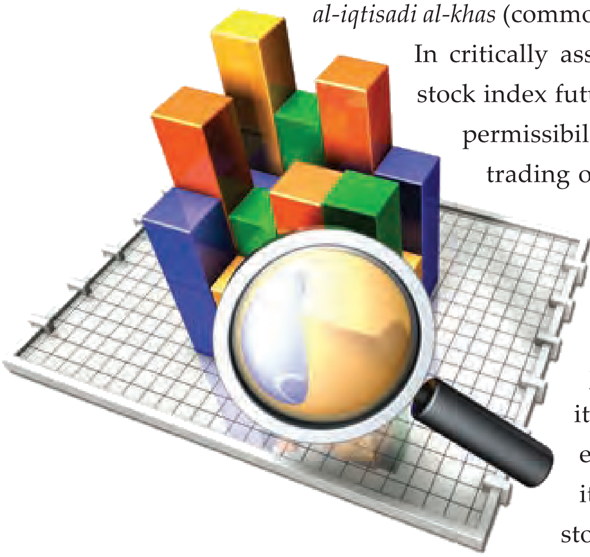
Some *Shari'ah* authorities have approved the issuance of non-cumulative preference shares, on the basis of *tanazul* (to drop claims to right). It is said that during the annual (or extraordinary) general meeting to approve issuance of preference shares, ordinary shareholders give their agreement. There is, however, dissenting opinion. Priority in liquidation appears to violate the principle that losses should be borne by partners in proportion to their capital contribution (assuming that shares are interpreted as embodying a *musharakah* partnership). Some scholars opine that the notion of a hierarchy of capital suppliers is repugnant, and not in the spirit of Islamic partnership. In addition, while a higher payout ratio is acceptable, a fixed rate of dividend could be interpreted as being tantamount to *riba*.

Tanazul refers to the act of waiving certain rights in favour of another contracting party.

Stock Index Futures

There are a number of *Shari'ah* issues that question the permissibility of stock index futures. Firstly, the object of trade (*mahallul 'aqd*) is merely a computed number, hence the question arises as to whether it qualifies as a property (*al-mal*) which can be subjected to trade. Secondly, trading in stock index futures may entail the selling of something that one does not own. Thirdly, there is the issue of *qabd* (taking of goods into possession before resale). A buyer can sell a futures contract before expiration of that futures contract or its delivery date (termed as closing or netting off of a position). Fourthly, offsetting transactions typical in futures trading may entail *bay' al-dayn bil dayn* (sale of debt for debt) which is frowned upon by scholars.

Despite these apparent objections, the SAC of Malaysia's SC has allowed stock index futures on the basis of *hikmah al-tashri'iyyah* (it creates *maslahah* to the investor, in particular and to the economic system, in general, by serving as a hedging instrument) and *'urf*



al-iqtisadi al-khas (common practices specifically occurring in economic activities). In critically assessing the justification given, it can be argued that if stock index futures are indeed used purely for hedging purposes, their permissibility appears warranted. However, if on the other hand, the trading of stock index futures is speculative in nature, then such *Shari'ah* endorsement should be reconsidered. There is benefit (*maslahah*) in genuine hedging activities, but one cannot ignore the costs associated with potential pure speculative stock index futures trading. Moreover, just because something is customary (*'urf*) does not make it necessarily valid from an Islamic viewpoint. One could even go as far as questioning hedging as a valid motive in itself. In the first place, is not the purpose of investing in stocks to accept some degree of risk in exchange for potential return? There is a legal maxim in Islamic jurisprudence that states – *al-ghunm bil ghurm* (the taking of profit is associated with risk-taking).

Short-selling

Short-selling refers to the practice of the sale of securities (in this case, shares) not absolutely owned by the selling party at the time of sale. Essentially, it entails the trading strategy of "selling high and subsequently buying cheap", typically resorted to during times of rapidly falling prices, in order to make a quick profit. The typical mechanism of short-selling is as follows.

- Mr A assesses stock X as being overpriced at $20.
- Day 0 : Mr A "borrows" 100 shares of stock X from Mr B.
- Day 0 : Mr A short-sells 100 shares of stock *X* to Mr C at $20.
- Day 3 : Price of stock *X* drops to $15, Mr A buys 100 shares.
- Day 3 : 100 shares of stock *X* is delivered to Mr C.
- Day 3 : Mr A "returns" 100 shares of stock *X* to Mr B.
- Mr A makes a profit equalling sale proceeds ($2,000) less the cost of purchase ($1,500) less any transaction costs.

From a financial and economic viewpoint, short-selling has its pros and cons. Short-selling makes arbitrage possible, which can help to eliminate market inefficiencies. For example, when two stocks are mispriced, it takes time for their valuation to align via the market's net buying of the cheaper stock and net selling of the expensive one. With short-selling, punters can short the expensive stock and go long on the cheaper one. Another advantage of short-selling is that it can be used as a tool for hedging by investors with exposure to falling prices of stocks but who cannot immediately sell (for instance, stock option holders, shares that have been pledged as collateral, and shares under moratorium). Short-selling also has its share of drawbacks. From a trading perspective, the potential loss from a short-selling strategy is theoretically infinite. Looking at things from a macroeconomic perspective, unrestrained short-selling pressure could lead to a collapse in share prices.

Securities borrowing and lending (SBL) was introduced by Malaysia's SC at the end of 1995 to regulate short-selling. Securities Borrowing and Lending was subsequently suspended at the end of 1997 following the financial crisis. The SC reinstated SBL and introduced Restricted Short-selling (RSS) in January 2007.

The *Shari'ah* validity of short-selling is still being debated. The SAC of SC permits short-selling on the basis of *istihsan* with *maslahah* (it provides a clear advantage to the original shareholder and provides liquidity to the market) and *istihsan* with *'urf khas* (*'urf iqtisadi khas*), given that short-selling is a customary practice accepted in economic activities. Dissenting opinions, however, cite the *hadith* of the Prophet (peace be upon him) wherein the "selling of what is not with you" was prohibited. These scholars emphasise the ownership and possession of the shares at the time of sale, rather than focusing on mere deliverability. Although short-selling is claimed to bring efficiency to the stock market, it opens up doors to speculative trading and shortened investment horizons. One could ponder, if indeed short-selling brings about benefit (*maslahah*) to society and that it is an accepted custom (*'urf*), why was it suspended in 1997 (in the case of Malaysia)? The suspension was most probably not done because of *Shari'ah* issues. However, the reasons for the suspension are arguably relevant considerations in deliberating the *Shari'ah* perspective pertaining to short-selling.

Unit Trusts or Mutual Funds

A unit trust or mutual fund is a collective investment vehicle, which pools investors' capital into a fund managed by professional managers. This investment instrument has two distinct advantages over direct purchase of shares by investors. Firstly, it allows investors to diversify their investment with only a small capital outlay. If the investor has to resort to direct purchase of shares, he or she would need to invest in say, 15 to 20 different stocks, in order to achieve some kind of diversification of his or her investment portfolio. This would almost certainly require a more substantial capital outlay than say, buying a mere hundred units of a unit trust fund. Secondly, the investor does not need to worry about not having any investment knowledge or competence or time to monitor his or her investment portfolio. The responsibility of managing the portfolio of assets is delegated to a team of professional asset managers.

A unit trust fund is essentially an open-ended fund. An investor purchases units in such a fund directly from the unit trust company or through authorised agents (individuals or financial institutions). Proceeds from the sale of these units are invested in various investment instruments which form the asset portfolio of the fund. Each investor has a share by virtue of owning units in that fund. The unit holder is able to sell back these units to the unit trust company at prevailing prices (quoted by the unit trust company), which fluctuate daily, depending on the performance of the assets under the particular fund. This process of selling back units is commonly called redemption. Most unit trust companies impose two types of charges – one upon initial purchase or subsequent redemption (known as front-end load and back-end load, respectively) — and an annual management fee. Returns to investors of unit trust funds are usually in the form of income distribution (dividends) and/or capital appreciation derived from the pool of assets.

A close-ended fund, on the other hand, issues a limited number of units. Subsequent buying and selling of units take place in secondary markets, that is, the stock exchange. Thus, unlike in unit trust funds where investors sell their units back to the unit trust company, investors of a close-ended fund would sell units to other willing buyers in secondary markets, much like ordinary shares. The price of units in these funds is determined solely by market demand and supply. A good example of close-ended funds are exchange-traded funds (ETFs), which are discussed in a subsequent section.

Another means of categorisation of unit trust funds is the type of assets they invest in, as briefly described in the Table 11.2 below.

Table 11.2 Types of Unit Trust Funds

Type of Fund	Assets invested in
Equity Fund	Shares of listed and unlisted companies.
Fixed Income Fund	Government and corporate debt instruments (e.g., bonds).
Money Market Funds	Short-term money market instruments like treasury bills and commercial papers.
Balanced Fund	Hybrid of equity and fixed income fund – invests in both shares and bonds.
Index Funds	Invests in shares in order to replicate the performance of a given index.

In simple terms, what distinguishes a *Shari'ah*-compliant unit trust or mutual fund from a conventional one is basically the assets invested in by the fund. A *Shari'ah*-compliant unit trust fund can only invest in assets and securities that have been pronounced as compliant to *Shari'ah* principles and guidelines. The following are some aspects that need to be addressed by an Islamic unit trust fund.

1 The fund has to be managed by an Islamic fund manager and authorised by regulators to do so.

2 An independent *Shari'ah* advisor or committee needs to be appointed. This organ is tasked with the responsibility of ensuring the fund complies with the *Shari'ah* in all aspects of its operation, including maintenance of accounts and risk management practices.

3 Purification of earnings attributable to assets owned by the fund may take place.

4 Payment of *zakat* may also be an item of consideration. This can either be done by the fund manager making the necessary calculations and deducting from the fund itself, or it may be left to investors to make the *zakat* payment themselves with advice from the fund manager on the quantum of *zakat* that is payable.

5 Sales and marketing practices also need to receive due attention. The moral dimension should not be overlooked since to be Islamic is to be ethical. There is anecdotal evidence of unethical practices observed in the selling of unit trust products. At the crux of it is the use of emotion to displace rational thinking. Misleading representations and lack of complete disclosure in the form of sweeping statements about potential returns should be curtailed. For a unit trust to be completely "Islamic", distribution channels should address any lack of adequate explanation and, in some cases, the implications of fee structures, as well as the lack of investor education about the realities of unit trust investment (risks and the long-term investment horizon).

Islamic Real Estate Investment Trusts (REITs)

Basic characteristics of an REIT/I-REIT

The Securities Commission Malaysia describes an REIT as "an investment instrument that aims to invest at least 50% of its total assets in real estate, whether via direct ownership or through a single purpose company whose principal assets comprise real assets". Other countries take different approaches in establishing the obligation for an REIT, particularly concerning the ratio of investment in real estate. In the US, for example, a major condition for an REIT is that it is obliged to invest at least 75% of the company's total assets in real estate. As for Korea and Singapore, the minimum ratio of investing in real estate is 70%. Thus, an REIT is an entity that gathers a pool of funds from investors, which is then used to buy, manage and sell assets in the real estate sector.

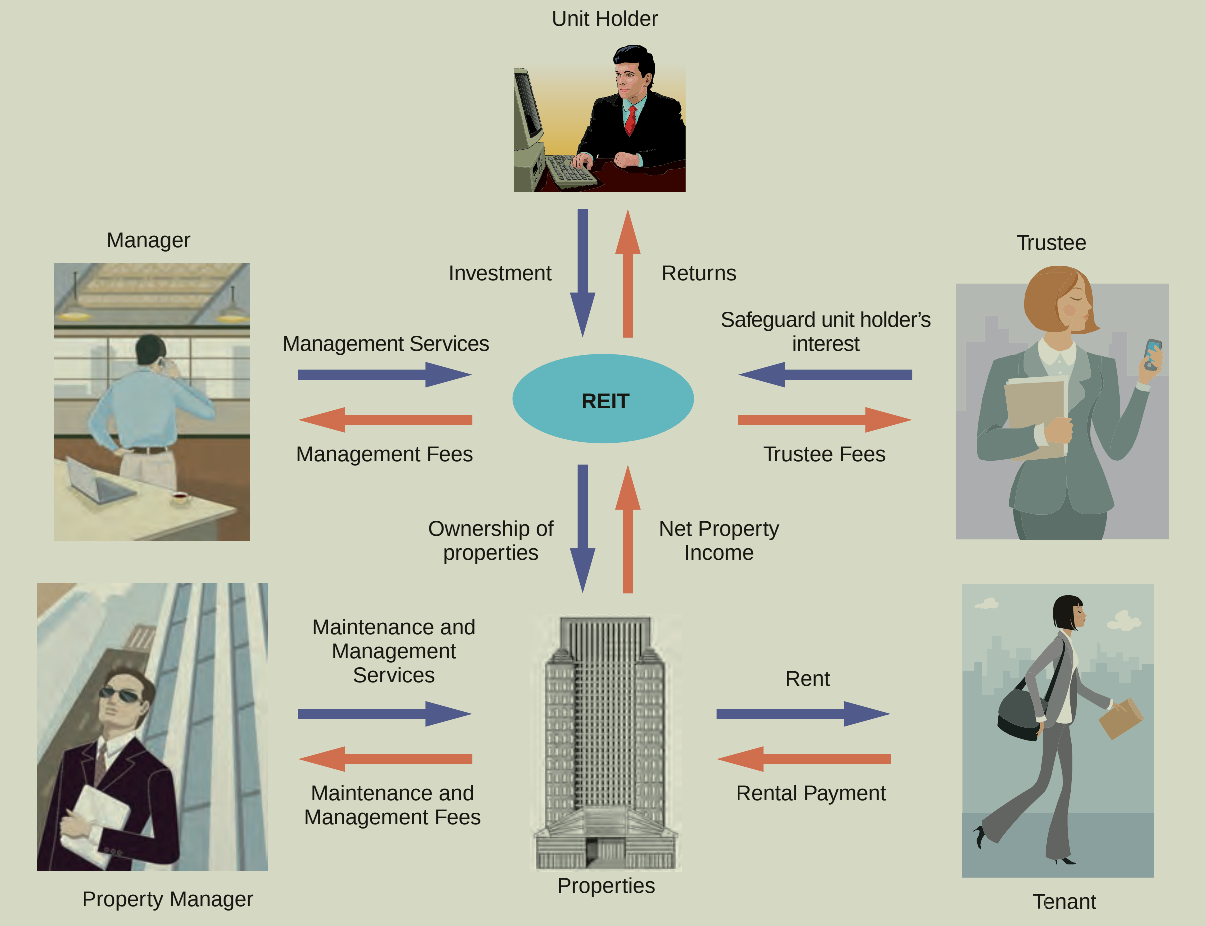
An REIT is an investment instrument that aims to invest at least 50% of its total assets in real estate, whether via direct ownership or through a single purpose company whose principal assets comprise real assets.

According to Asyraf Dusuki (2008), an REIT provides investors a chance to diversify and invest their portfolios in listed real estate securities possessed and managed by it. It invests in income-generating real estate such as residential, commercial, retail properties, plantation land, storage facilities, warehouses, car parks and many more. A one-off investment into these income yielding real estates would otherwise be too costly for any single investor to invest directly. The holder of one REIT unit is in fact buying a fraction of a managed pool of real estate. This pool of real estate then produces income from renting, leasing and selling of property and distributes it directly to the REIT on a frequent basis. Therefore, an investor may obtain returns either in the mode of a dividend or capital gain for the asset during the holding duration.

Fundamentally, an REIT functions like any other trust fund connecting stakeholders such as the management company, trustee and unit holders. The associations between these parties are shaped and governed by a trust deed. The trust deed is a formal document delineating the objectives and principles of the REIT, and the rights and responsibilities of a management company and a trustee correspondingly. The REIT must be run and administered by a management company permitted by regulators. In Malaysia, the management company must be "a subsidiary of either a company involved in the financial services industry in Malaysia; or a property development company; or a property-investment holding company; or any other institution which the SC may permit". Among the major roles of an REIT manager include determining the strategic direction of the REIT, offering recommendations to its trustee on potential possession, divestments or enforcements of assets and guaranteeing fulfilment with relevant policies.

Dusuki (2008) states that it is also obligatory for the REIT to have a trustee who functions as the guardian of the assets of the fund and preserves the interests of the unit holders. This stakeholder is needed for constant supervision and monitoring of the funds managed by the management company. The purpose is to ensure that its operations conform with the goals and the deeds of the fund and all related regulatory requirements and guidelines.

One more vital stakeholder of an REIT is the property manager who supplies property management services and, in return, gets property management fees. Dusuki highlights the main role of a property manager as being management and control of the assets of the REIT, preparation of budgets, keeping financial records of the properties and advising on sale and purchase decisions. Figure 11.1 illustrates the task and functions of the diverse entities engaged in REIT operations.



Source: Dusuki, 2008.

Figure 11.1 Tasks and Functions of Parties in an REIT

Similarities and Differences with Conventional REITs

Islamic REITs share a number of similarities with their conventional counterparts.[1] In terms of tax treatment, both types of REITs receive similar tax treatment on corporate tax, stamp duty and real property gains tax. The major structures for

1 For details, see Ting and Abdul Rahman, 2007.

Case Study 1 Features of *Shari'ah*-Compliant REITs

The 2005 Malaysia's Securities Commission guideline on Islamic REITs is the world's first of its kind. While this points to the level of Islamic capital market development in Malaysia, it is a manifestation of initiatives done to widen and intensify the product base of the global Islamic capital market.

An important aspect of a *Shari'ah*-compliant REIT is the *Shari'ah* committee or advisory panel. This *Shari'ah* committee is responsible to watch over the processes of the Islamic REIT so that it conforms with each feature of *Shari'ah* principles. These include the *Shari'ah* principles on investment, deposit and financing decision for Islamic REITs, purchase and disposal of real estate and rental income and activities. The *Shari'ah* committee is also required to oversee and guarantee that all funds are managed and administered according to *Shari'ah* principles.

The following highlights the main features of a *Shari'ah*-compliant REIT:

1 Non-Permissible Rental Activities

As rental comprises the major income flow for investors, it is important to make sure that rental is obtained from *halal* or allowable sources. Correspondingly, the SAC of SC outlined the rental activities that are classified as non-permissible. The list includes financial services based on interest (*riba*); gambling/gaming; manufacture or sale of non-*halal* products or related products; conventional insurance; leisure activities that are non-permissible according to *Shari'ah*; manufacture or sale of tobacco-based products or related products; stockbroking or share trading in *Shari'ah* non-compliant securities; and hotels and resorts. Apart from these activities, the *Shari'ah* committee or advisors are allowed to use *ijtihad* to decide other activities that are considered as non-permissible.

2 Rental from a Tenant Who Carries Out Mixed Activities

This is a situation of a tenant who operates mixed activities, i.e., one where the core activities are permitted by *Shari'ah*, but there are some other activities that may include a small degree of forbidden aspect. In this case, the *Shari'ah* advisors have to carry out conformity appraisal with extra caution. The requirement is that the rental from non-permissible activities should not surpass 20% of total turnover of the Islamic REIT (based on the most recent financial year).

3 Technique of Calculating the Ratio of Rental of Non-Permissible Activities

Some accepted approaches can be used for calculating the ratio of the rental of non-permissible activities from a tenant operating mixed activities. The techniques comprise the utilisation of space, hours of service and other methods considered suitable by the *Shari'ah* advisors by their own *ijtihad*. In the situation of a supermarket for example, the rental of non-permissible activities such as selling of alcohol can be based on the ratio of area occupied for non-permissible activities to the total area engaged. For instance, if the entire area rented out is 10,000 square metres and the area allocated for the sale of alcoholic beverages is 1,000 square metres, then the ratio of area used for non-*halal* activities is 10%. Thus, the rental from non-permissible activities is 10% of the total rental paid by the supermarket. In this situation, the 10% rental income is judged permissible as it is below the agreeable level of 20% of total turnover of the Islamic REITs.

4 Acquisition of Real Estate

It is not permitted to purchase real estate in which all tenants run non-permissible activities. This rule holds even where the percentage of rental from the said real estate is below the agreeable level of 20% of the total turnover of the Islamic REITs.

5 Renting Out to a New Tenant

The 20% benchmark in deciding the class of mixed rental income need not be applied in the case of renting out to a new tenant. The reason is that an accurate rental receipt from non-permissible activities is still unidentified. Nevertheless, in a clear case whereby the new tenant engages in activities that are considered impermissible, then it is not allowed for the Islamic REIT fund manager to allow such tenant. For instance, a well-known casino operator who intends to rent the real estate of the Islamic REIT should not be allowed as a new tenant.

6 Instruments Used in Investment, Deposit and Financing for Islamic REITs

An Islamic REIT should also ensure that all types of investment, deposit and financing instruments conform to *Shari'ah* principles. For example, in financing the purchase of real estate, the Islamic REIT fund manager must not be involved in *riba*-based instruments that would have an impact on the *Shari'ah* compliance of the Islamic REIT operations.

7 *Takaful* Coverage

A quite illustrative example is the Malaysian practice. Under this jurisdiction, the guideline issued by the SC specifies where an Islamic REIT be obliged to employ *takaful* schemes to insure its real estate. Nonetheless, in cases where *takaful* schemes are incapable of supplying the insurance coverage, then the Islamic REIT is permitted to employ conventional insurance.

8 Risk Management Issues

The Islamic REIT is allowed to take part in forward sales or purchases of currency and is persuaded to deal with Islamic financial institutions (IFIs). If the Islamic REIT deals with IFIs, then it will be obliged by the concept of *wa'd* (a unilateral promise where just one party is required to accomplish his promise or responsibility). The party that is bound is the party that commences the promise. Nevertheless, if the Islamic REIT deals with conventional financial institutions, it is allowed to take part in conventional forward sales or purchase of currency.

Source: Securities Commission Malaysia.

Case Study 2 Al-Hadharah Boustead REIT

Al-Hadharah Boustead REIT is the second Islamic REIT listed on Bursa Malaysia (formerly known as Kuala Lumpur Stock Exchange). It was officially launched on 15 January 2007. Al-Hadharah Boustead REIT is the first Islamic REIT made up of plantation assets, mainly palm oil plantations. Similar to Al-'Aqar KPJ REIT, its early operation engaged a sale and lease back method based on the contracts of *al-bay'* and *al-ijarah*.

Al-Hadharah Boustead REIT purchased plantation assets from Boustead Group involving eight oil palm estates and two palm oil mills, all located within Peninsular Malaysia. Total acquisition consideration for these plantation assets, which form the basis of this Al-Hadharah Boustead REIT fund amounts to RM472 million. To finance the acquisition consideration of the plantation assets, Al-Hadharah Boustead REIT issues units (the undivided interest in Al-Hadharah Boustead REIT as established by the deed) to the vendors (namely the subsidiaries of Boustead Group, which comprises Boustead Properties, Boustead Plantations Berhad and Boustead Heah Joo Seang Sdn Bhd) and through public offering. These assets are then leased back to the subsidiaries of the Boustead Group, who then become tenants based on an *ijarah* agreement (Boustead REIT, 2007). Unlike Al-'Aqar KPJ REIT, whereby safeguarding and management of REIT properties are done by the maintenance manager, Al-Hadharah Boustead REIT employs a plantation advisor to observe the overall situation and condition of all aspects of the plantation assets.

Arising from the nature of its investment assets, fixed rental is the main source of income for Al-Hadharah Boustead REIT. Tenants pay a cumulative fixed rental of RM41.3 million per annum on a bimonthly basis for the first tenancy term of three years. According to the Al-Hadharah Boustead REIT prospectus, the rental is reconsidered at the end of every three years, and the new rental is determined based on historical crude palm oil (CPO) prices, prevailing and expected future crude palm oil prices, cost of production, extraction rates and yield per hectare. All the leasing matters are clearly delineated under the *ijarah* contract between Al-Hadharah Boustead REIT and the vendors.

Besides fixed rental, other sources of revenue for Al-Hadharah Boustead REIT comprise performance-based profit-sharing and capital gains. The former refers to an annual profit-sharing of net incremental revenue based on a formula pegged to CPO prices and fresh fruit bunch (FFB) prices. The profit will be shared on an equal basis (50 : 50) between the tenants and the fund. It is claimed that this profit-sharing payment is the first of its kind in the REIT market and may transform it into more attractive dividend yields for investors. As for the capital gains, the REIT's prospectus states that the fund shall distribute any gains realised from the sale profits of selected plantation assets in the form of bonus dividends. Prior to the distribution of dividends, however, consideration is given to the costs incurred in the operation of the fund.

These comprise fees, charges and expenses incurred in the administration of the fund, as well as manager's fees, plantation advisor's fees and trustee's fee.

As noted previously, all the plantation assets are rented back to the vendors, who are effectively the subsidiaries of Boustead Group. In other words, the entire rental income of Al-Hadharah Boustead REIT under the *ijarah* agreement is derived from only three parties that are within the Boustead Group. Hence, there is a danger of overdependence on a single tenant and related party tenants. This is exceptionally true because the tenants' capacity to pay rental is very much dependent on their performance in the global commodity market. Fluctuations in CPO and palm kernel prices together with volatility of foreign exchange currency rates could negatively influence the capability of the tenants to pay rental, which makes up a substantial proportion of the operating income of the fund.

Source: Asyraf W. Dusuki (2008).

Unique Features of the Al-Hadharah Boustead REIT

Ijarah *Arrangement for the Plantation Assets*

Ijarah is an Islamic lease agreement where rentals are collected for assets leased to the tenant/customer. For this REIT, the plantation assets are leased back to the vendors as tenants for a cumulative term of up to 30 years. For each of the estates and mills, the tenancy is for three years and will be routinely renewed four times up to 12 years, and it is thereafter renewable up to an additional 15 years. As a result of the *ijarah* arrangement, the expenditure of replanting will be borne by the REIT.

Rent Review Linked to CPO Prices and Other Performance Indicators of the Palm Oil Industry

Under the REIT, plantation assets are leased back to the vendors (i.e., Boustead Group) for a three-year renewable contract with a cumulative period of up to 30 years. At the end of every three years, the fixed rental will be reviewed and a new rental will be determined based on historical CPO prices, current and expected future CPO prices, cost of production, extraction rates and yield per hectare.

Profit-sharing

Besides a fixed income, a yearly profit-sharing of net incremental income is based on a formula pegged to CPO and FFB prices. This net incremental income is determined based on the actual CPO price realised for the year, above the reference price of RM1,500 per metric tonne for the first three years. This income is to be shared on a 50 : 50 basis.

Source: Ting, K. H. & Abdul Rahman, M. N. (2007, 9-12 July).

both types of REITs are similar in terms of the requirements of having a trustee, management company, property manager, valuation, as well as the regulatory framework. However, Islamic REITs have to comply with *Shari'ah* stipulations.

The following table summarises the differences between a conventional and Islamic REIT.

Table 11.3 Comparison between a Conventional and Islamic REIT

	Conventional REIT	Islamic REIT
Shari'ah Committee/ Advisors	There is no necessity for any *Shari'ah* committee or advisors.	An Islamic REIT should assign a *Shari'ah* committee/ advisor to certify conformity with *Shari'ah* conditions.
Permissibility of activities performed by tenants	No constraint.	Only allowable activities approved.
Insurance for properties	Conventional insurance with insurance companies as permitted by trustee.	The manager has to be concerned about the availability of Islamic insurance/*takaful* before going for conventional insurance.
Financing	No limitations.	Financing should be *Shari'ah* compliant.

Source: Ting, K. H. & Abdul Rahman, M. N., (2007, 9–12 July).

Islamic Exchange Traded Funds (ETFs)

Basic Characteristics of an ETF

Exchange traded fund or ETF is a listed index-tracking fund structured as a unit trust scheme whose primary objective is to achieve the same return as a particular market index by investing all (full replication) or substantially all (strategic sampling) of its assets in the constituent securities of the index.

An exchange traded fund is an open-ended, index-tracking unit trust fund. The SC's Guidelines on Exchange Traded Funds define an ETF as "a listed index-tracking fund structured as a unit trust scheme whose primary objective is to achieve the same return as a particular market index by investing all (full replication) or substantially all (strategic sampling) of its assets in the constituent securities of the index". Generally, the principal objective of an ETF is to track or replicate the performance of a benchmark index.

An ETF provides investors, in a single transaction, a cost-efficient and convenient way to gain exposure to the basket of securities represented in the index. The main difference is that unlike other unit trust funds, an ETF's units are listed and traded on a stock exchange and are bought and sold during trading hours just like shares.

Hence, ETFs are essentially unit trust funds that are listed and traded on a stock exchange. The difference between ETFs and unit trust funds is in the manner their units are bought and sold. Since ETFs are listed, their units can be bought and sold anytime during stock exchange trading hours. Investors buy and sell ETF units through their stockbroker rather than through unit trust agents. In addition, while unit trusts are actively managed with fund managers picking up stocks that will generate a higher return than the market, most ETFs follow an index fund investment strategy of passive management. In this passive management, managers do not pick stocks based on fundamental analysis. Instead, an ETF manager aims to track the performance of a benchmark index. He does not have to pick his own set of stocks but simply follows the constituents of the index that he is tracking because the aim is to provide investors with the same returns as that of the market.

The following table summarises the essential differences between an ETF and ordinary unit trust fund.

Table 11.4 Differences between an ETF and Unit Trust

	Exchange Traded Fund (ETF)	Unit Trust
Diversification benefits	Yes.	Yes.
Transparency	More transparent.	Less transparent.
Fund information	Market price and trading activity data are readily available via the stock exchange or brokers.	Information is available from the fund manager and the funds' appointed agents.
Liquidity	Generally more liquid.	Generally less liquid.
Entry fee	Brokerage fee, clearing fee and stamp duty are applicable when trading on the exchange, generally lower than unit trust.	Ranges from 3% to 5% (for equity funds).
Management fee	0.4% - 0.5% p.a. of the Net Asset Value (NAV).	0.75% - 5% p.a. of the Net Asset Value (NAV).
Purchase settlement	T + 3 (if through brokers).	Upfront, usually deducted from purchase proceeds.
Trading done via	Brokers or participating dealers.	Agents.
Daily trading period	May change throughout the day.	Fixed throughout the day.

Source: Bursa Malaysia.

The primary advantages of ETFs over regular unit trust or mutual funds are quite appealing. They are passively managed funds and thus incur lower fees. This is despite the fact that they can be transacted in smaller quantities. An ETF enjoys the benefit of diversification since it tracks the performance of an index that is made up of several different companies so that an investor can spread the risk in a single transaction and at a lower cost compared to a managed fund. An ETF can be structured to access any sector or indices. It offers an opportunity to gain immediate exposure to the securities that underlie its benchmark, and an investor can concentrate exposure to a favoured sector while reducing the risk of being exposed to too few companies. It should be noted, however, that ETFs are similar to investing in stocks; thus investors could experience large fluctuations in securities' prices as well as be exposed to the more general risks from the ups and downs of the market. Hence, an ETF may see greater fluctuation as its performance may be directly affected by the performance of its component securities represented in the benchmark index.

Shari'ah-Compliant ETF

The main difference between a conventional ETF and an Islamic ETF is the benchmark index that the Islamic ETF tracks. An Islamic ETF only tracks an Islamic benchmark index whose constituents comprise companies that are *Shari'ah* compliant. An Islamic ETF will be managed under *Shari'ah* principles and guidelines and overseen by an appointed *Shari'ah* advisor or committee. The *Shari'ah* advisor/committee will conduct regular reviews and audits on an Islamic ETF to ensure strict compliance with *Shari'ah* principles and practices.

Since an Islamic ETF tracks a benchmark index comprised wholly of *Shari'ah*-compliant constituents, the fund would have to undergo a comprehensive *Shari'ah*-screening methodology in order to qualify as an Islamic ETF. This involves sector screening to determine that the fund invests only in companies with *halal* businesses and that if these companies are involved with non-permissible activities, the ratio of income from the non-permissible activities to total income should not exceed the stipulated ratio determined by the relevant authority or jurisdiction. Another type of assessment is the financial screening to ensure that interest-based financing and income of these companies do not exceed the tolerated ratio allowed. (See discussion on *Shari'ah*-screening in the next section).

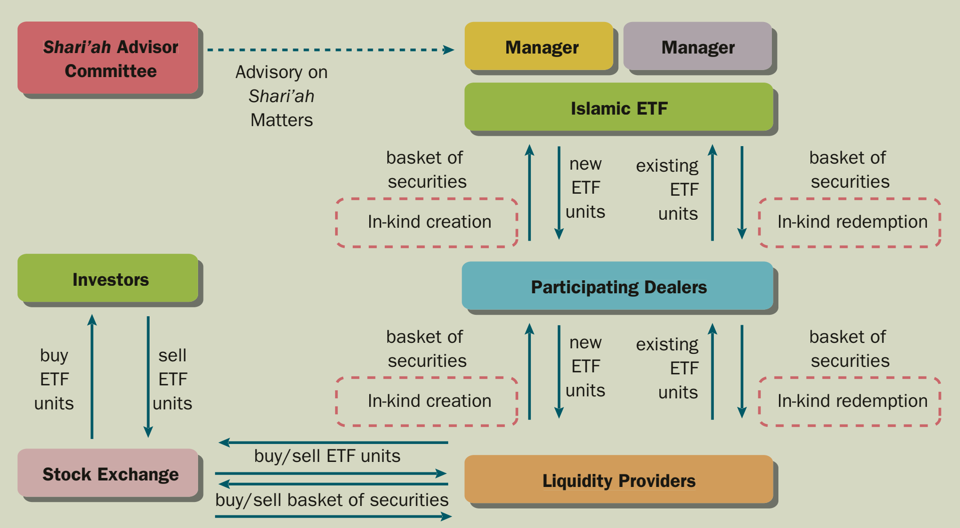
In order to abide by the criterion of *Shari'ah* compliance, the sector and financial screening take place during the time of investment decision and are supposed to be constantly monitored during the investment period. This periodic monitoring also takes into account any changes that might happen as a result of corporate actions like mergers, delisting or bankruptcy.

An instance in this context could be cited from the Malaysian scenario. On 22 January 2008, Malaysia launched the region's first *Shari'ah*-compliant ETF – MyETF Dow Jones Islamic Market Malaysia Titans 25. The benchmark index for this ETF is the Dow Jones Islamic Market Malaysia Titans 25 Index, which is based on the securities of 25 leading (by market capitalisation) *Shari'ah*-compliant companies traded on Bursa Malaysia.

At the global level, in the selection for the Dow Jones Islamic Market Titans 100 Index, the Dow Jones World Index executes a screening of stocks that are *Shari'ah* compliant within large caps from Asia, Europe and the US.

One issue that emerges from the rise of Islamic ETFs is the need to have an alternative SBL. It should be noted that in order to create an ETF, participating dealers need to deliver a basket of securities to the fund manager and it is possible that dealers at times do not have securities readily available. In the conventional market, securities could be borrowed with interest. As Islam prohibits this, it is crucial that an alternative *Shari'ah*-compliant equivalent to an SBL be developed to facilitate the growth of an efficient Islamic ETF market.

Figure 11.2 depicts the general structure of an Islamic ETF.



Source: Bursa Malaysia.

Figure 11.2 Structure of an Islamic ETF

Shari'ah-Screening of Shares

Earlier discussions in the chapter conclude that, in general, investment and trading in modern day equities are permissible. However, not all shares of companies are *Shari'ah*-compliant assets. Thus, to ensure *Shari'ah*-compliant investing, two types of screening are typically applied, namely business activity or sector screening, and financial screening.

Sector Screening

The purpose of sector screening is to exclude, from the universe of investable stock, companies that operate businesses that violate *Shari'ah* injunctions. In almost all cases, shares of firms whose primary business activities are in the following sectors would be deemed as *Shari'ah* non-compliant assets:

1 Conventional or interest-based finance (*riba*).

2 Gambling, gaming, casino operations and number forecasting (*maysir*).

3 Prohibited goods and services such as pork, non-*halal* meat, alcohol and prostitution.

4 Conventional insurance (*gharar*).

5 Tobacco manufacturing or sale.

6 Stockbroking or trading in non-*Shari'ah*-approved securities.

In addition, there are some *Shari'ah* jurisdictions which also consider the following sectors as *Shari'ah* non-compliant:

1 Entertainment deemed non-permissible (this would include adult entertainment, cinemas, the music industry and hotels).

2 Weapons and defence.

In some cases, the company in question operates in a permissible sector but receives revenue from non-permissible activities (originating from a minor division, subsidiary or associate company). In some *Shari'ah* jurisdictions, most notably Malaysia, these so-called "mixed" companies are considered *Shari'ah*-compliant, provided they fulfil certain additional criteria. More specifically, a ceiling benchmark or threshold of non-permissible revenue is applied to determine *Shari'ah* compliance. The benchmarks are applied to both revenue and profit before tax. Table 11.5 below briefly illustrates examples of these benchmarks in the case of Malaysia.

Table 11.5 Benchmarks Applied for "Mixed" Companies – The Case of Malaysia

Benchmark	Application
5%	Mixed contributions from clearly prohibited activities such as conventional banking (*riba*), gambling, liquor, pork and non-*halal* food production.
10%	*Umum balwa* (prohibited element affecting most people and difficult to avoid), for example, interest income from fixed deposits in conventional banks, tobacco-related activities.
20%	Used to assess the level of mixed contributions from rental income derived from activities that are not *Shari'ah* compliant, for example, rental income received from premises selling liquor.
25%	*Maslahah* to the public, for example, hotel and resort operations, stockbroking.

Source: Resolutions of the Securities Commission's *Shari'ah* Advisory Council, 2006.

As further illustration, consider the following companies:

1 ABC Berhad has a small division which is a conventional finance company. The revenue and profit before tax contribution of this division does not exceed 5% of the entire company's total revenue and profit before tax.

2 DEF Berhad is a conglomerate that has a wholly-owned subsidiary involved in the hotel business. Revenue and profit before tax from that subsidiary comprises approximately 20% of the group's revenue and profit before tax.

3 GHI Berhad has investment in an associate company that operates a brewery, which contributes about 8% of the company's total profit before tax.

4 JKL Berhad has a subsidiary that is a licenced distributor of tobacco products. While this subsidiary only contributes 5% of JKL's total revenue, profit before tax from this subsidiary make up about 15% of JKL's profit before tax.

In the above examples, the first two companies would be deemed to be *Shari'ah*-compliant, whereas the last two would be considered as *Shari'ah* non-compliant.

Financial Screening

Upon passing the sector screening, stocks are then subjected to financial screening to evaluate the extent of interest-based financing and interest-based income. It has been reasoned that some portion of *riba*-based financing and revenue should be tolerated. This is because imposing a strict stipulation that *Shari'ah*-compliant companies must not have any form of interest-based financing nor have any interest-bearing investments or deposits would, at the present time, severely constrict the investment universe of investable stocks available to Muslim investors. The use of financial ratios to measure the quantum of interest-based financing and income varies from one index (or *Shari'ah* authority) to another. For illustrative purposes, we look at the following which is employed by the Dow Jones Islamic Indices.

$$\text{Ratio 1: } \frac{\text{Total interest-based debt}}{\text{Trailing 24-month average market capitalisation}}$$

$$\text{Ratio 2 : } \frac{\text{Sum of cash and interest bearing securities}}{\text{Trailing 24-month average market capitalisation}}$$

$$\text{Ratio 3: } \frac{\text{Interest bearing accounts receivable}}{\text{Trailing 24-month average market capitalisation}}$$

For a stock to be considered *Shari'ah*-compliant, the above three ratios must not exceed 33%. Market capitalisation, or sometimes referred to as "market cap" is the total dollar market value of all of a company's outstanding shares. Market capitalisation is calculated by multiplying a company's outstanding shares by the current market price of one share. The investment community uses this figure to determine a company's size, as opposed to sales or total asset figures. The FTSE Islamic Index also stipulates that interest income must not exceed 5% of total income.

Dividend Purification

In addition to sector and financial screening, some *Shari'ah* jurisdictions stipulate that the non-compliant portion of revenues received by *Shari'ah*-compliant stocks need to be "cleansed". The "impure" dividends (profit distribution) should be channelled to charities or avenues of public benefit. Here there are marked variations in practice as well as issues that arise. Firstly, one could ask, should purification be done only on dividends paid out? What about capital gains on sale of shares, as that would constitute a form of return to investors and implicitly contain some portions of tainted income from the company? In some equity markets, dividend payout ratios are typically very low. The bulk of returns to shareholders come in the form of capital gains resulting from appreciation in share prices. Also, some stocks, usually the so-called growth stocks, reinvest their earnings as part of their management's strategy. Secondly, there is the question of how to achieve the purification of interest-based financing. Thirdly, do we interpret interest received as revenue (and hence, allow some "deductions" before we arrive at the amount that requires cleansing), or do we consider interest received as profit? The fourth issue is the debate of deduct versus inform. Who should be responsible for the purification, the company itself, the fund manager (in the case of mutual funds or unit trusts) or the individual investor? Making the necessary purification before distribution to investors is probably more cost-effective, but it makes certain assumptions about the religious convictions of investors, and there is also the issue of taking into account of the interests of non-Muslim shareholders. The fifth issue concerns the debate over purification versus screening. Some would contend that we can do away with screening altogether – why not just purify any and all tainted income, regardless of its quantum? At this juncture, it would suffice to say that controversies are still present and that it is hoped that as Islamic equity markets develop, these unresolved issues would find amicable solutions.

A cursory look at current practices on dividend purification reveals that a common method is simply to purge a portion of dividend paid. This has been argued as representing an incomplete form of purging, and appears to be mere window dressing to sooth the conscience of *Shari'ah*-compliant investors. AAOIFI advocates the following method for dividend purification. First, divide total prohibited income by the number of issued shares of the company. Then, multiply this by the number of shares owned by the investor. The burden of purging is on the shareholder on the last day of the company's financial year. It can be argued that this would constitute an unfair treatment. Although shares may have exchanged hands numerous times during a year, it is the shareholder on that last day of the financial year who carries the onus of dividend purification. Furthermore, such a stipulation may encourage sell-down just prior to financial year-end, thus creating unnecessary and unwarranted share price volatility. One suggestion is to pro-rate the purging quantum by the portion of time that the share is owned.

This section on *Shari'ah* screening of stocks concludes by looking at some examples of *Shari'ah* indices, illustrated in Table 11.6.

Table 11.6 Comparison of Some Examples of *Shari'ah* Indices

Index Provider/ Authority	Securities Commission SAC	Dow Jones Islamic Market Indices	MSCI Islamic Index Series	S&P 500 *Shari'ah* Indices	FTSE *Shari'ah* Global Equity Index Series
Year Launched	1999	1999	2007	2006	2000
Frequency of Review	Twice a year	Quarterly	Annually	Monthly	Quarterly
Sector Screening	Yes	Yes	Yes	Yes	Yes
Financial Screening	Not explicitly	Yes	Yes	Yes	Yes
Dividend Purification	No	Only with the presence of a licence agreement	Applied to dividend reinvestment	Ratio provided to investors	Stipulated at 5%, to be paid by investors

Issues in *Shari'ah* Stock Screening

In some cases, the criteria applied in assessing *Shari'ah* compliance of stocks introduce elements of subjectivity and invite debate. Public perception and image, as well as *'urf* (custom) and the rights of non-Muslim communities, are arguably subjective considerations. Consider, as examples, supermarkets selling cigarettes versus tobacco companies, and hotels serving alcohol versus airlines that provide alcoholic beverages to their passengers.

There is also the issue of a lack of standardisation on some aspects, namely, in the use of financial ratios (some *Shari'ah* jurisdictions do not apply them), sectors deemed as impermissible (hotels and cinemas, for instance) and the practice of dividend purification.

It has also been argued that the criteria used to filter *Shari'ah* non-compliant stocks should not remain static. Some degree of non-permissible activities is tolerated on the basis of the need to promote *Shari'ah*-compliant securities. This compromise should be viewed as transitionary. Efforts should be made to progressively revise current benchmark standards. Otherwise, it could lead to erroneous public perception or understanding that "some *haram* (prohibited) activities are permissible" as a general rule rather than the exception.

Another important issue is the effect of bull and bear markets on financial ratios used to screen stocks, as this could result in potential injustices. In bear markets, market capitalisation typically falls while debt remains constant or rises. Using a trailing 24-month average market capitalisation can delay exclusion but a stock market down cycle can persist. Disinvestment by Islamic funds during a slump may worsen companies' economic woes. Islamic equity funds' performance may be negatively affected since selling shares when prices are falling may not be the best strategy. Conversely, in a bull market, companies with high debt are included by virtue of high stock valuations. Also, prudent management of investment companies may prescribe holding more liquidity in volatile or uncertain market conditions, especially when equity prices are falling. Such prudence may result in non-compliance to the "cash holdings" financial ratio. Competitive market forces may necessitate more aggressive credit sales. For example, car manufacturers such as Ford, General Motors and Daimler-Chrysler have effectively become "banks" because much of their profits are derived from financing vehicle sales through extended payment terms. Such companies may fail the "accounts receivable" financial ratio test. As a whole, it may be unjust to include or exclude companies on the basis of stock market cycles or external market forces, which are beyond the control of individual companies. In order to address these issues, it is timely that market stakeholders develop refinements in the financial ratio analysis to account for market cycles. Perhaps one approach could be to rely more on dividend purification.

It has been suggested that Islamic equity funds should incorporate social responsibility and ethical dimensions into their *Shari'ah* compliance criteria. At present, *Shari'ah* compliance does not necessarily imply the presence of good business ethics. By contrast, ethical investment funds address aspects of corporate social responsibility, environmental protection and conservation, and occupational safety and health in their investment decisions. Nonetheless Islamic equity funds and ethical funds may share some common grounds. Surely the *Shari'ah* compliance connotation can be extended to include all that is good and wholesome. Does the *Shari'ah* condone the following practices – environmental pollution, exploitation of developing countries, avoidable animal testing, and deceptive advertising? In substantiating the answer of "no" to the previous question, there should be emphasis on a positive criteria, rather than negative screening, by favouring investments in companies that do "social good". For example, Islamic mutual funds could divert a sizeable portion of their investment funds to companies that supply basic necessities at reasonable prices, provide goods and services that benefit society, make investments in renewable energy sources, are philanthropic in nature, just to mention a few. Islamic fund managers need to be proactive rather than reactive by engaging corporations or using their financial muscle to influence positive changes in policies. It should be recognised that a purely mechanical application of a set of "ethical criteria" (for example, board composition, hiring practices) would be less effective as there can be plenty of room for abuse or manipulation.

Islamic Equity Market Index

Equity market indices are a mainstay feature of all established equity capital markets the world over. Such an index is basically a number computed, in real time, to reflect the current price level of its designated components. It is often used as a benchmark or bell weather of the performance of a given stock exchange. The indices are frequently quoted in the media when reporting on the performance of equity markets. These indices are also commonly discussed by financial analysts and stock market observers. Famous indices include the Dow Jones, Standard & Poor's 500 and the NASDAQ in the US, FTSE 100 in the UK and the Nikkei in Japan.

Equity market indices serve the following important roles:

1. As a measure of overall performance of an equity market. Indices are often taken to represent the "health" of a financial system (or even the economy). There is generally a positive relationship between index levels and general economic conditions. When there is positive economic outlook, indices tend to be on the uptrend.

2. Indices are often used directly in certain investment instruments such as index-linked unit trust funds or mutual funds and exchange traded funds. The asset composition of such funds depends directly on the make-up of the related index. Thus, the performance of the said "index funds" typically tracks the performance of the index in question closely.

3. Indices are also used as the benchmark or reference point in accountability and gauging of performance of assets or fund managers. The return performance of funds is often compared directly against the performance of indices. Hence, if a given fund outperforms a given established and pertinent index, that fund will generally be viewed favourably by investors and the market.

4. One measure of the risk of a stock is the stock's beta. A common method of computing beta is via regression of the stock's historical returns against the corresponding historical returns of an index. Beta measures systematic or un-diversifiable risk, as defined by the Capital Asset Pricing Model (CAPM). A stock's beta is an important variable in investment or portfolio decision-making.

There are a number of ways of computing or calculating an index. Table 11.7 summarises some of the more common methods.

Table 11.7 Common Methods of Computing an Index

Method	Application
Market Capitalisation Weighting	Shares with higher market cap (either by virtue of a higher share price or larger free-float of shares outstanding, or both) will have a greater impact on the index.
Price Weighting	A particular stock's weighting in the index is solely determined by its price.
Equal Weighting	Each stock that makes up the index will have the same weighting regardless of its size or price.
Capped or Customised Weighting	Some variation of the above types may feature capping of weighting so as not to exceed a certain percentage and may also include volume of trade as a variable to determine weighting.

It should be noted that indices can be broad (in that an index includes a large number of stocks in its computation) or narrow (in that it includes only a relatively small number of stocks). Indices are also often computed for categories delineated by industry or sector (for example, financial, energy, technology, telecommunications, utilities, healthcare, consumer products, etc.).

An Islamic equity market index is simply an index wherein the stocks that make up the index have been designated as *Shari'ah*-compliant or *halal* stocks. In fact, the process of *Shari'ah* stock-screening and the establishment of an Islamic equity market index typically go hand-in-hand. The origins of Islamic equity market indices can be traced back to the 1987 *fatwa* by Sheikh M. Taqi Usmani. Table 11.8 briefly describes some Islamic equity market indices.

Table 11.8 Examples of Islamic Equity Market Indices

Dow-Jones-RHB Islamic Malaysia Index	Jointly developed by Dow Jones Indices and RHB Research Institute Sdn Bhd and launched in June 2005.
FTSE Bursa Malaysia EMAS *Shari'ah* Index	Launched in November 2007, this broad index replaced the Kuala Lumpur *Shari'ah* Index (KLSI).
Dow Jones Islamic Market Index	Part of the Dow Jones Global Indices series, it includes stocks from 46 countries deemed as *Shari'ah*-compliant according to Dow Jones Indices' methodology.
FTSE SGX *Shari'ah* Index Series	Launched by FTSE Group and the Singapore Exchange, this index series is designed to reflect the stock performance of companies in the Asian Pacific region. The initial index in this series is the FTSE SGX Asia *Shari'ah* 100 Index – comprising 100 of the largest *Shari'ah*-compliant stocks from Japan, Singapore, Taiwan, Korea and Hong Kong.
S&P *Shari'ah* Indices	Introduced in 2006 by Standard & Poor's; among the indices in this series are S&P 500 *Shari'ah*, S&P Europe *Shari'ah*, S&P Japan *Shari'ah*, S&P GCC *Shari'ah* and S&P Pan Asia *Shari'ah*.

Issues, Opportunities and Challenges

Speculation in Equity Markets

Investment, Speculation and Gambling

Some are of the opinion that the buying and selling of shares in the stock market is similar to gambling. This perspective is generally viewed by scholars as misconceived, at least from a scholarly point of view, because there are key differences between share trading and gambling, as described in Table 11.9.

Table 11.9 Comparison between Share Trading and Gambling

	Share Trading	Gambling
Underlying asset	Regardless of share price movements, there is almost always an underlying asset.	There is no underlying asset.
Origin of risk	Risk is reflected in the market operation (demand and supply).	Risk is created and built into the contract.
Primary determinant of financial outcome	Free-market of demand and supply.	Random event.
Gain and loss distribution	In the long run and in the aggregate, there is a net gain.	Zero sum game (total gain equals total loss).

Thus, the majority academic opinion is that share trading is categorically not the same as gambling. However, this does not necessarily imply that any and all forms of transactions in the stock market are viewed favourably from an Islamic perspective. In particular, many scholars have voiced their concern and dissent over the practices of speculative trading in the stock market. Here, it is useful to define speculative trading by comparing it to investment in stocks. Table 11.10 elaborates.

The Perils of Speculation

History has witnessed many instances where speculation, at its extreme, led to irrational behaviour and undesirable economic and social repercussions. The South Sea Bubble, the Great Crash of 1929, and the stock market crashes of 1973, 1981 and 1997, are but a few examples. One such instance of heightened speculative exuberance is worth elaborating – the "Tulip Mania", which occurred in 17th century Holland. The tulip is a flower belonging to the onion family, and is the national symbol of the Netherlands. Natural mutations result in unusual colours or patterns and are visually appealing. The tulip's growth is a slow process and supply is often limited while demand can be high. This

Table 11.10 Comparison between Investment and Speculation

Investment	Speculation
Entails detailed analysis and research of quantitative and qualitative data (past share price behaviour, company announcements, economic conditions, analyst reports, etc.).	Typically relies on rumours or unsubstantiated hearsay.
A long-term perspective and investment time horizon is adopted.	Speculation seeks a quick gain.
Based on hard facts and figures.	Often motivated by emotion (hope, hype and greed).
Forecasting the prospective yields of assets over their whole life.	Forecasting the psychology of the market.[2]

flower became the object of price speculation in Holland in the 17th century. Its price began escalating to unprecedented highs. In the 1620s, the price of one tulip was equivalent to the price of about 120 sheep. By 1634, at the height of this speculative mania, the price of one tulip was equivalent in value to about 12 acres of good land. Price fluctuation was engineered to produce huge profits while ordinary businesses of the country were abandoned or neglected. The majority of the population sold their houses, land and valuables to take part in tulip speculation. As with any asset bubble, it was just a matter of time before it burst. In February 1637, rational considerations surfaced and people began to realise their foolishness. Panic pervaded swiftly and there was a rush to sell. Tulip prices fell drastically within a short period of time.

Philosopher George Santayana once said: "Those who do not learn from history are doomed to repeat it." Herein is the purpose of the preceding look at history. There is strong evidence that speculative manias are not merely a thing of the past. For instance, there is the popular argument that lays blame for the surge in oil prices in 2008 on speculative trading of oil futures. In equity markets, some research has shown that contemporary stock markets are indeed deficient in that resources are often misallocated. This is due to a flawed pricing process where information arbitrage efficiency (that all publicly available information is incorporated in share prices so that no abnormal profit can be made) prevails over fundamental valuation efficiency

2 This can be understood by an analogy concocted by famous British economist, John Maynard Keynes. A newspaper ran a competition where contestants were asked to identify the six most beautiful pictures of women posted in the newspaper. The winner is the one whose six choices most closely match the average of all competition entries. Hence, the winner is not the one who can most accurately assess beauty, but rather the one who can predict what the average man would consider as beautiful. This analogy can be extended to stock markets. In a market dominated by speculation, the successful investor is not the one who can accurately assess firms' performance and prospects, but rather one who can correctly predict the trading behaviour of other investors.

(that share prices reflect the real economic worth of companies). This can be argued as symptomatic of pervasive speculative trading. In simple terms, what this translated to was that share prices did not reflect bona fide economic realities. It can be said that no example in recent times more clearly illustrates this than the volatility of the NASDAQ index during the dot-com bubble period earlier this century.[3] Prices could not have been efficient in the fundamental sense. There was evidence that there was no change of the required magnitude in economic fundamentals during that period to justify such escalation in share prices.[4] During the period of 1995 to 2000, Amazon.com made increasing losses in each successive year and yet its share price rose rapidly.

Share price volatility, while conducive for speculative trading, can be said to be a negative feature of stock markets for a number of reasons. Firstly, it reduces the efficiency of price signals in allocating investment resources. Secondly, it increases the risk of investments, and discourages risk-averse corporations from financing growth via equity issues. Thirdly, the use of stock options to align interests of management with those of shareholders becomes less effective. Fourthly, the take-over selection process in the market for corporate control works only to a limited extent on the basis of profitability and stock market valuation. Rather, it operates to a much greater degree on the basis of size. The resource misallocation that resulted from speculative exuberance meant that overvalued dot-com stocks could go on a take-over spree. After the dot-com bubble burst, many of these acquisitions were written off, many jobs were lost, and productive capacities destroyed. At the macroeconomic level, stock market volatility contributes to financial fragility of the whole economy.

Capitalist economic theory advocates that the stock market plays the following important roles:

1 To allocate financial resources efficiently.

2 To promote good management of corporate resources through market discipline (via the take-over mechanism and stock option remuneration).

3 To bolster healthy economic growth and stability.

Some research findings have raised doubts as to whether these roles have been realised. The question is: what went wrong? There is a growing school of thought that attributes observations in the financial markets to idiosyncrasies of human conduct – sometimes called "irrational exuberance". Many writers of this emergent branch of finance, called

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3 The NASDAQ displayed the classic case of share price bubble and burst. The index rose from 1,052.1 in 1995 to 5,060.3 in 2000 and subsequently dropped to 2,175.4 by 2004.

4 A look at technology stocks revealed that from the year 1990 to 2000, while the proportion of market capitalisation of these dot-com stocks rose from 7% to 36%, their share of employment and revenue did not increase by nearly as much (from 6% in 1990 to 9% and 10%, respectively, in the year 2000).

behavioural finance, conclude simply that the stock market, in many instances, has succumbed to the perils of speculation.

While speculative trading is often labeled as an activity of ill repute, there are arguments to justify its existence. In defense of speculation, conceptually, speculative trading is a natural phenomenon. After all, any form of trade and commerce is, to some extent, speculative in nature. Further, it is said that the presence of speculators ensures critical mass necessary to provide adequate market liquidity. It has been argued that greater volume of transactions would lead to a quicker and more accurate price discovery.

Speculation – An Islamic Perspective

In discussing the topic of Islamic equity, one could not reasonably avoid the issue of speculative trading. If the idea of establishing an Islamic stock exchange has any merit, surely it must exist devoid, to the extent possible, of potentially destructive speculative elements. This is because with speculative trading, the stock exchange provides opportunities for gains to be made by profiting from fluctuations in share prices which are not necessarily related to the economic performance of the company. A fundamental precept underlying *Shari'ah* prescriptions is that all financial transactions must represent real economic transactions. Hence, speculative trading, which represents exchanges in an artificial market detached from the economic realities underlying the objects of trade, should not be present in an Islamic economic and financial system.

That being said, however, no law can be enforced against speculation per se, as *prima facie*, it involves lawful activities of buying and selling. It is only the intent of the speculator, which manifests itself later on, that distinguishes speculation from genuine investment and trading. Thus, to keep speculation in check, one feasible approach would be to remove or regulate market mechanisms that sustain or promote speculative trading. These speculation-friendly market mechanisms include short-selling, margin trading and financing, and extensive use of derivatives.

Short-selling promotes market velocity by allowing more buying and selling. It is inherently short-term in its outlook, as sell-and-buy strategies occur within a short time frame. From a *fiqh* perspective, a good number of jurists disapprove of short-selling, citing, among other things, that it represents the selling of something one does not own.

Margin trading and financing provide speculators with a high degree of leverage, enabling them to make larger purchases with a smaller amount of funds. Margin trading expands and contracts the volume of transactions, which contributes to fluctuations in share prices, without there being any real change in supply of stocks or the underlying economic conditions. Variations in margin requirements and interest rates introduce an unnecessary dimension of uncertainty and instability. Typically, share margin financing entails interest-based financing, which is prohibited by the *Shari'ah*, although there have been some IFIs that have developed and offered *Shari'ah*-compliant alternatives.

Derivative instruments like stock index futures and stock options thrive under volatile market conditions. Some jurists allow derivatives on the basis of their use for hedging purposes, but in reality, only a small percentage of derivatives are used for that objective.

In curbing speculation, a number of implementation challenges should be noted. Firstly, a paradigm shift is required. Stakeholders of financial markets need to return to the fundamental purpose of a stock market. Market players are meant to perform a useful economic function. The stock market should not be merely a platform to extort quick gains. There needs to be consensus that market volatility is a negative feature of a stock market. Secondly, the economic interests of exchanges and stockbroking companies have to be adequately addressed. Stock exchanges and stockbroking companies derive revenue from the volume of transactions. Third and finally, we have to ensure that there is sufficient market liquidity (ready buyers and sellers) in the absence of speculators, as thinly traded markets are ineffective as a means of functioning as a market for financial resources. Such markets with limited trading would not only result in gross injustices in terms of pricing and valuation, but they have also been known to eventually die a natural death.

While share trading has been deemed allowable in Islam, such permissibility was construed under a set of circumstances and conditions. One who participates in share trading should be mindful that its *Shari'ah* validity is questionable when it takes the form of irrational speculation. Repercussions of excessive speculation are many – neglect of productive economic activity, effects on social dynamics, misallocation of economic resources, and instability to the financial system, to mention a few. Some useful guidelines can be posited to avoid the pitfalls of speculation. Among them are, having a long-term investment horizon, ensuring that the basis for decision-making should be logic and not emotions, and for the Muslim investor, establishing the motivation or *niyyah* of partaking in equity investments as a form of worship or *ibadah* and not mere greed for material gain. This would be consistent with principles embodied in *maqasid al-shari'ah*.

Summary

1 The central idea underlying Islamic equity is the notion of sharing risks and rewards. The Islamic nominate contracts of *mudarabah* and *musharakah* are important instruments in operationalising Islamic equity.

2 Jurists have generally approved of the concept of modern day corporations and the secondary market trading of shares.

3 In the area of valuation of equity, there is still much reliance on conventional finance theories. Hence, there is a research gap to be filled – Islamic inputs on equity valuation.

4 The use of instruments and practices such as preference shares, stock index futures and short-selling has been allowed by some *Shari'ah* jurisdictions, despite the presence of dissenting opinions and objections by some others.

5 Unit trusts or mutual funds, real estate investment trusts (REITs) and exchange traded funds (ETFs) are important instruments in Islamic equity and have great potential to further develop the Islamic capital market.

6 The *Shari'ah* stock-screening process comprises two main components – sector screening and financial screening – and also raises the issue of dividend purification. There are still a number of issues being debated, thus making *Shari'ah* stock-screening a dynamic process, subject to further refinement and improvement.

7 Equity market indices serve important roles, and their functionalities in Islamic equity markets are no different.

8 Speculative trading in equity markets can have undesirable consequences, and it is envisioned that an Islamic equity market should minimise its prevalence.

Key Terms and Concepts

Equity
Mudarabah
Musharakah
Equity Valuation
Efficient Market Hypothesis (EMH)
Behavioural Finance
Fundamental Analysis
Technical Analysis
Discounted Cash Flow (DCF) Model
Shares/Stocks
Preference Shares
Stock Index Futures
Short-selling
Unit Trusts/Mutual Funds
Real Estate Investment Trusts (REITs)
Exchange Traded Funds (ETFs)
Shari'ah Stock-screening
Sector Screening
Financial Screening
Market Capitalisation
Dividend Purification
Equity Market Index
Investment
Speculation

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Review Questions and Problems

1 Is equity financing superior to debt financing? Does it better serve the objectives of *Shari'ah* (*maqasid al-shari'ah*)? Discuss the ways by which the Islamic finance industry can reduce its current reliance on the debt market and increase its proportion of the equity market.

2 Does *Shari'ah* compliance promote market efficiency? What implications would this have on the Islamic equity market or on the overall finance industry?

3 What conventional models explaining equity valuation are closer to the principles of the *Shari'ah*? Is there any problem if the pricing of Islamic equity products are determined based on these conventional models?

4 Do you think Islamic investors are more likely to rely on the fundamental analysis rather than the technical analysis when making investment decisions? Or are they as likely to be irrational as any other investor?

5 Suppose that a committee has been set up to evaluate and propose improvements to the current criteria used in *Shari'ah* stock-screening and that you have been asked to provide inputs and suggestions. What would you say? In other words, provide some recommendations on how the *Shari'ah* stock-screening process and/or the criteria used can be improved, together with the reasoned justification(s). You may also want to research further on the details of such stock-screening practices.

6 When valuing stocks (and in particular, deciding what stocks to buy and at what price), two basic methodologies can be employed – fundamental analysis and technical analysis. In relation to investments in equity, argue from a *Shari'ah* perspective, which would be more desirable, fundamental analysis or technical analysis?

7 It is often asserted that not all financial market investment assets/instruments are *Shari'ah*-compliant. Do you agree or disagree with this statement? Explain your reasons.

8 While variations exist across *Shari'ah* jurisdictions as to which sectors constitute *Shari'ah* non-compliant business activities, they are unanimous about certain others. What are some of the businesses about which there is no dissent?

9 Secondary market trading of shares is deemed permissible by different *Shari'ah* jurisdictions. What are the arguments upon which the justification is established?

10 In conducting *Shari'ah*-compliant financial screening for mixed businesses, different jurisdictions have introduced official tolerated levels determined by stipulated ratios. Mention and discuss, by citing examples, instances that could trigger *Shari'ah* non-compliance?

11 Despite the innovative developments in *Shari'ah* screening of mixed businesses, some scholars have argued in favour of "purification" as a complementary measure that should go with stock-screening. What are the inherent issues pertaining to dividend purification?

12 It is admitted that, under certain conditions, the *Shari'ah* status of a company's share could shift from being *Shari'ah*-compliant to *Shari'ah* non-compliant or otherwise. What actions are expected of Muslim shareholders dealing in shares that are deemed *Shari'ah* non-compliant?

13 What does *Shari'ah* stock-screening entail? Discuss the different forms of assessments considered under a typical stock-screening exercise.

Chapter 12

Takaful

Preview

This chapter exposes students to the principles and practical framework of *takaful* as one of the important components of the Islamic financial market. As one of the risk mitigation tools, *takaful* complements its counterparts, namely the Islamic banking market, Islamic capital market and Islamic money market. Indeed, mitigation and prudent management of risks are integral parts of Islam in order to achieve justice in the system which is in line with the objectives of *Shari'ah* (*maqasid al-shari'ah*).

To date, the *takaful* market is considered one of the fastest growing service industries, although it needs to work on further improvements in areas such as accounting, regulation, jurisprudence and operation. Nevertheless, due to its growing demand, the *takaful* industry seems to have a bright future awaiting it. This chapter covers the basic conceptual framework of *takaful*, its evolution, models and regulatory framework affecting its proper functioning.

The conventional insurance contract is basically constructed between the insured and the insurance company. *Takaful* differs from conventional insurance in the sense that the *takaful* operator is not the insurer insuring the participants. *Takaful* participants jointly guarantee one another while the *takaful* operator simply functions as the administrator and manager of the *takaful* fund.

Learning Outcomes

At the end of the course, you should be able to:

- Discuss the general *Shari'ah* principles which govern the operationalisation of *takaful* and *re-takaful*.
- Discuss the underlying theories and the conceptual framework related to the *takaful* and *re-takaful* system.
- Explain the operational mechanisms of contemporary *takaful* and *re-takaful* products.
- Analyse issues arising from *takaful* and *re-takaful* operations including *takaful* fund management, legal aspects and regulatory perspectives.

Section 1: Insurance and Risk Management

Concept of Insurance

Literally, insurance as practised in the conventional financial system refers to a financial protection system which involves the execution of contracts (insurance contracts) between the insurer and the insured, in which the insurer agrees to underwrite the subject risk of such contracts.

Mehr (1986) defines insurance as "a device for reducing risk by combining a sufficient number of exposure units to make their individual losses collectively predictable. The predictable loss is then shared by or distributed proportionately among all units in the combination." Based on this definition, there are two important characteristics of the concept of insurance that need to be underlined and highlighted. Firstly, insurance is a tool to reduce uncertainty. Secondly, the uncertainty is reduced because losses are shared by or distributed among the exposure units. Therefore, insurance can be broadly described as a risk management strategy or tool that deals with two aspects of risk: it reduces uncertainty and provides a planned financing technique that distributes losses.

Concept of insurance:
1 Insurance is a tool to reduce uncertainty.
2 The uncertainty is reduced because losses are shared by or distributed among the exposure units.

Insurance as a Risk Management Strategy

Human beings are exposed to all sorts of hazards. A peril is usually a cause of loss. Typical perils include theft, accident, sickness, flood, premature death and fire. When a peril happens, properties may be destroyed and people and animals injured or killed. Any loss of lives or property will invariably lead to financial losses. Although we are continually exposed to perils, we are uncertain as to when such loss producing events will occur. We are also left in the dark on the degree of the losses that may affect us if such perils materialise. In other words, we are uncertain about the loss we may suffer in the future. An uncertainty regarding loss is often termed as risk.

In fact, risk and uncertainty are an integral part of most human behaviours. These risks and uncertainties arise when the future is unknown and most often than not, the outcomes of human actions are unpredictable. Consequently, these risks affect the lives of many individuals in society in a way which is sometimes so devastating and shattering, leaving these unfortunate people vulnerable and helpless. One of the most commonly asked question is: how can we mitigate such a risk?

One of the ways to attend, manage and mitigate risks would be through the application of insurance. Indeed, insurance exists as one of the important instruments in financial markets in managing risks and uncertainties. Before discussing the concept and operation of insurance in-depth, it is imperative to first understand the concept of risk and its various characteristics. The ensuing sections delineate the understanding of the concept of risk.

Types of Risk

There are generally two types of risk, namely pure risk and speculative risk.

Insurance serves as a risk management strategy against pure risk, which for the most part is unavoidable. Pure risk exists in situations in which the outcomes could involve loss or no loss at all. The parties involved do not plan the incident but rather, it occurs naturally.

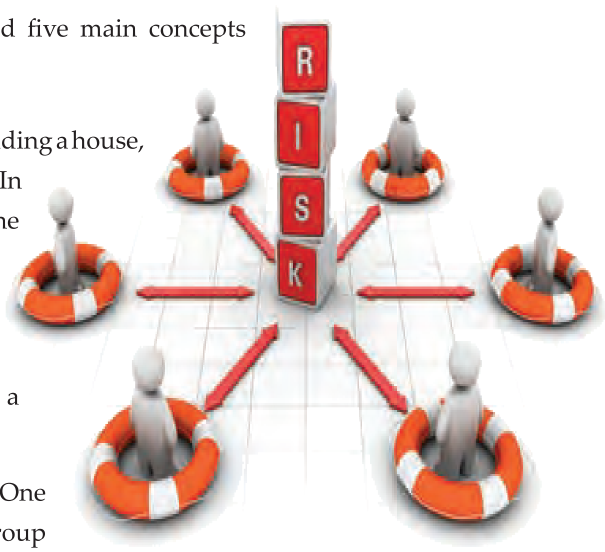
Pure risk exists in a situation where there are only two possible outcomes: loss or no loss at all. This can be personal or collective, direct or indirect. The parties involved do not plan the incident, rather it occurs naturally. Examples include risk of damage to property resulting from fire and risk of premature death. As an illustration, let us take the case of fire. If a property is destroyed due to fire, the owner will suffer losses but if there is no fire, the owner will neither suffer any loss nor gain anything.

Speculative risk involves three possibilities: the possibility of loss, profit or no change in value. These are often planned because the outcome can be manipulated. Examples include investment in stock market or real estate, venturing into a business and betting in a horse race. Let us take the case when a person invested his money in a share market, this money will be used to buy shares for a particular length of time. Here, the investor naturally faces the risk or uncertainty of whether he is able to sell the shares at profit, loss or no change in value. If the market share price increases, he can gain by selling his shares at profit. At the same time, if the market share price declines, he will bear the loss because the value of his holding share is lower than the market value. He also faces the possibility of no change in value, if the share price remains the same.

Table 12.1 Types of Risk

	Pure Risk	Speculative Risk
Nature of Outcome	Loss/No loss	Loss/Gain/No change in value
Origin of Risk	For the most part, unavoidable	By deliberate choice of action
Examples	Death, fire, accident	Fluctuations in market value of trade goods
Common Risk Management Method	Insurance	Use of derivatives

For managing risks, man has developed five main concepts over the centuries. These are:



1 **Prevention of risks –** When building a house, the risk of fire may materialise. In order to mitigate such a risk, one can equip themselves with a fire extinguisher.

2 **Assumption of risks –** One can save money to cater for a possible future loss.

3 **Spread of risk mutually –** One can spread the risk with a group of people sharing the same concern. For instance, a group of boat owners can distribute their commodities among themselves in different boats while transporting their goods.

Five concepts of risk management:
- Prevention of risks
- Assumption of risks
- Spread of risks mutually
- Transference of risk by insurance
- Buying an insurance policy

4 **Transference of risk by insurance –** To transfer the risk to someone else, i.e., to create financial security in the face of a risk is by spreading the risk among a number of persons all exposed to the same risk and all prepared to make a relatively negligible contribution towards neutralising the detrimental effects of this risk which may materialise for anyone or more of their member. This is known as insurance in the economic sense. For instance, a group of soldiers can contribute for their funeral expenses. The pool of money created will be of help to the inflicted family.

5 **Buying an insurance policy –** This is the case where a policyholder enters into an insurance contract with a third party, who takes the responsibility of indemnifying him in case the risk insured materialises, provided he pays a premium to the commercial company. This is the most widely adopted means of mitigating risk which has evolved through the centuries.

Why Conventional Insurance is Not Accepted by *Shari'ah*

Conventional insurance contains *riba* in two situations:
- No equality between insured's and insurer's compensation
- Profit which is received from its involvement in *riba*-related transactions

The present approach to risk mitigation is to buy an insurance policy whereby the insured will transfer his risk to the insurance company which, in exchange for a premium, accepts the responsibility of indemnifying the insured in case the risk insured for materialises. This method of risk mitigation has been declared to be *haram* by most Muslim scholars as it contractually contains *haram* elements such as *riba*, *gharar* and *maysir*.

The main elements which make conventional insurance unlawful are discussed as follows.

Riba (Interest or Usury)

Riba is evident in conventional life policies in two situations. Firstly, the amount of money received by the insured, either on the occurrence of the insured event or upon maturity of the policy, is mostly in excess of total premiums he has actually paid. *Riba* is clearly affecting the two parties to the contract since there is no equality between instalments paid by the insured party and the compensation paid by the insurance company. What the company actually pays may be more, less or equal to that which is paid by the insured and equality is very unlikely. Moreover, since the payments are deferred, the compensation which is greater than the instalments paid by the insured constitutes surplus *riba* (*riba al-fadl*) and credit *riba* (*riba al-nasi'ah*).

Secondly, even if someone may argue that the insurance contract is based on the foundation of charity and cooperation to ameliorate losses and injuries, *riba* is still present in the compensation by the insurance company since the profits of the latter are accumulated through *riba*-related transactions like fixed-income and interest-based transactions.

Gharar (Unknown or Uncertain Factors)

Gharar, or uncertainty in Islamic jurisprudence, refers to purposive cheating and deception as well as ignorance of the object of sale and undeliverability of the object. Professor Al-Zarqa' defines *gharar* as a sale of probable items whose existence or characteristics are not certain due to the risky nature that makes it similar to gambling. Muslim jurists are unanimous in prohibiting *gharar* sales. This prohibition is based on an authentic *hadith* of the Prophet (peace be upon him) narrated by Muslim, Abu Dawud, Al-Tirmidhi, Al-Nasa'i and Ibn Majah on the authority of Abu Hurayrah, whereby the Prophet has forbidden *gharar* sales. However, jurists make a distinction between two kinds of *gharar*: *gharar fahish* (substantial) and *gharar yasir* (trivial). While the former is prohibited, the latter is tolerated since it may be unavoidable without causing considerable damage to one of the parties. *Gharar fahish* is excessive and substantial uncertainties like selling an undeliverable asset or selling something which is not owned and hence prohibited.

Gharar exists in insurance contracts whereby the subject matter of the contract is not certain until the insured event has taken place.

An insurance contract appears to have an element of *gharar* when it is often involved with doubtful and uncertain matters. The element of *gharar* exists in both life and general insurance policies, whereby the subject matter of the contract or *ma'qud 'alayhi* is not certain until the insured event has taken place. This is particularly true since the amounts being paid by the two parties are not known during the contract session. This is the case since an accident may occur immediately after the insured makes the first payment or he may make all the payments without any accidents happening.

The *Shari'ah* requires that all particulars relating to the contract must be known to the parties at the time of the contract, otherwise the contract will become invalid. In such a contract, the policyholder agrees to pay a certain premium sum in consideration that the insurance company guarantees to pay a certain sum of compensation (sum insured) in the event of a catastrophe or disaster. But the policyholder is not informed, for example, of how the amount of the compensation that the company will pay him is to be derived nor is he certain of the amount.

Maysir (Gambling)

Maysir, or gambling, means to court such risk as it involves both the hope of gain as well as the fear of loss, which is not a necessary part of any normal activity in life. Islam also prohibits all kinds of gambling and games of chance. This is based on clear texts in the *Qur'an*. For example:

> *"O you who believe! Intoxicants (all kinds of alcoholic drinks), and gambling, and animals that are sacrificed in the name of idols, and arrows thrown for seeking luck or decision are an abomination of Satan's handiwork. So avoid that (abomination) in order that you may be successful."* (*Al-Qur'an*, 5:90).

Insurance contains an element of *maysir* because policyholders often bet premiums on the condition that the insurer will pay compensation in an amount higher than the premium paid during the occurrence of the insured event.

The nature of insurance is said to contain an element of *maysir* because policyholders are held to be betting premiums on the condition that the insurer will make payment (indemnity) contingent upon the circumstance of a specified event. On the other hand, the insured does not get anything from his premiums if the insured event does not happen at all.

Islamic Alternative to Insurance – *Takaful*

The term *takaful* is derived from the Arabic root word "*kafala*" which means responsibility, guarantee, amenability or suretyship. Hence, *takaful* literally means joint guarantee, shared responsibility, shared guarantee, collective assurance and mutual undertaking, which reflects a reciprocal relationship and agreement of mutual help among members in a particular group.

Thus, there are three aspects of mutuality embodied in *takaful*, namely mutual help, mutual responsibility and mutual protection from losses. So, *takaful* is a system whereby participants contribute regularly to a common fund and intend to jointly guarantee each other, i.e., to compensate any of the participants who are inflicted with a specific risk. It is similar to a mutual insurance in spirit but inclined more towards commercial insurance in its business endeavour. When a person participates in a *takaful* scheme, he does not only seek protection for himself but also jointly cooperates with other participants to mutually contribute to one another in case of need.

Section 2 of the *Takaful* Act of Malaysia 1984 defines *takaful* as "a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose."

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Therefore, *takaful ta'awuni*, or Islamic cooperative insurance, is not a contract of buying and selling where a party offers and sells protection and the other party accepts and buys the service at a certain cost or price. Rather, it is an arrangement whereby a group of individuals each pay a fixed amount of money, and compensation for the losses of members of the group are paid out of the total sum. Hence, it manifests a sense of brotherhood and solidarity amongst the participants who are willing to help and assist one another in times of difficulty and need.

Historical Development of *Takaful*

The basis of shared responsibility in the system of "*aqila*" becomes the foundation of mutual insurance. For example, the accused person's relatives will be held responsible to pay blood money (*diyat*) to the victim's relatives. The payment is pooled from the contributions of the group members.

The essence of *takaful* could be seen in the system of mutual help in relation to the custom of blood money under the ancient Arab tribal custom, and eventually was approved by the Prophet (p.b.u.h.). The basis of shared responsibility in the system of "*aqila*", as practised between Muslims of Mecca (*muhajirin*) and Medina (*ansar*) laid the foundation of mutual insurance. This practice was then followed by the Prophet's companions. *Aqila* is non-commercial in nature and is aimed at helping those in need without demanding contractual payments. Instead, it is motivated by the sense of brotherhood and mutual responsibility to help fellow members of the tribe who are in need of contribution. For instance, in case of unintentional murder involving two different tribes, the accused person's paternal relatives will bear the responsibility of paying the blood money which is pooled from the group members' contributions to the victim's relatives.

In the present day, the spirit of insurance is often portrayed in social work such as cooperation in helping fellow friends or neighbours make a big feast, repair a defective house and lift the belongings of those who are moving out. Likewise in the case of the "*khayrat*" fund, which is usually held by the mosques or rural communities and contributed to by all members in the society to help the local deceased's family.

Concepts of insurance which are acceptable in Islam:
- Mutual cooperation
- Mutual indemnity
- Brotherhood

This way of mutual cooperation and responsibility and the provision of financial benefits are indeed encouraged by Islam. Therefore, a system of mutual help being the basis of insurance and *takaful* is not contradictory to the *Shari'ah*.

The evolution of *takaful* has a long history. The main identifiable phases are:

1979 The first *ta'awuni* model (cooperative) was developed in Sudan.

1984 The *mudarabah* model was developed in Malaysia.

1984 The *wakalah* model was developed in the Gulf.

1996 The *waqf* model was developed in South Africa.

It is interesting to note that most *takaful* models are hybrids of the above models.

Shari'ah Ruling on *Takaful*

In 1965, the Congress of Islamic Research in Cairo discussed the legitimacy of insurance in the Islamic world. In the First International Conference on Islamic Economics held at Mecca, Saudi Arabia in 1976, international consensus was reached that insurance for profit is contrary to the *Shari'ah*. This was confirmed by the Islamic *Fiqh* Academy at Jeddah in 1985: "*The contract of commercial insurance with periodical fixed premium provided by the present day insurance companies is a contract which is void and therefore haram in accordance with the requirement of Shari'ah*."

Besides the above rulings, the academy had also approved mutual insurance, or the *takaful* system, as an alternative form of insurance because it is based on a system of cooperation and mutual help for the good of society. The European Council for *Fatwa* and Research has reaffirmed the rulings: "*Commercial insurance is originally* haram *as agreed upon by most contemporary scholars. It is well-known that in most non-Islamic countries there are co-operative and mutual insurance companies. There is no harm from the Shari'ah point of view to participate in these activities*."

To further uphold the legality of *takaful*, the government of Malaysia, which is committed to promoting the Islamic legal system to govern *Shari'ah*-compliant transactions, has passed the *Takaful* Act 1984. The Act is the first written law in the world to regulate *takaful* business in which it authorises the *Shari'ah* Advisory Council to supervise, monitor and advise on *takaful* operations at the national level and the *Shari'ah* advisory committee, at the institutional level.

In view of the above rulings and the real need for insurance, Muslim jurists have decided that insurance in Islam should be based on the principles of mutuality and co-operation. On the basis of these principles, the Islamic system of insurance embodies the elements of shared responsibility, joint indemnity, common interest, solidarity and so on. This concept of insurance is acceptable in Islam because:

- The participants will cooperate among themselves for their common good.
- Every participant will pay his contribution in order to assist any fellow members who need assistance.
- His contribution is considered a donation (*tabarru'*) to the members in the group.
- The contributed donation is intended to divide losses and spread liability according to the community pooling system.
- The element of uncertainty will be eliminated insofar as the terms in the contribution and compensation are made clear to the participants.
- It does not aim at deriving advantage at the cost of other individuals.

Therefore, the concept of insurance itself is not against the spirit of the *Shari'ah*. In fact, mitigation of risk by adopting the law of large numbers was widely used, particularly in the practice of *"aqila"* as mentioned earlier. However, there are some means and methods used in conventional insurance which are not acceptable to the *Shari'ah*, i.e., elements such as *riba* (interest), *gharar* (uncertainty) and *maysir* (gambling).

Differences Between *Takaful* and Insurance

The fundamental difference between *takaful* and conventional insurance is rooted in the type of contract adopted. The conventional insurance contract is basically constructed between two parties, namely the insured and an insurance company. The insured deals with the insurance company by paying regular instalments (premium) in return for the guarantee to pay compensation, in case the event stipulated in the contract happens. It is thus one of the probabilistic contracts since the compensation is contingent on events that may or may not occur. This definition and nature of conventional insurance invoke many *Shari'ah* issues.

The fundamental difference between *takaful* and conventional insurance is rooted in the type of contract adopted:

- Conventional insurance adopts bilateral contracts, i.e., payment of premium in consideration of payment of compensation in the event of defined loss.
- *Takaful* is based on *tabarru'* (donation contract) which is unilateral in nature. All *takaful* participants mutually insure one another based on the spirit of brotherhood, mutual help and mutual indemnity.

Takaful differs from conventional insurance in the sense that the *takaful* operator is not the insurer insuring the participants. In fact the persons participating in the scheme, or *takaful* participants, mutually insure one another. This is the essence of *takaful* that signifies mutual guarantee, help and cooperation with one another. The *takaful* operator simply functions as administrator of the *takaful* fund and whose responsibility includes managing and investing the fund according to the *Shari'ah* principles.

Table 12.2 Differences between *Takaful* and Conventional Insurance

Takaful	Conventional Insurance
A combination of *tabarru'* contract and agency and/or profit-sharing contract.	Contract of exchange (sale and purchase) between insurer and insured.
Participants are duty-bound to make contributions to the scheme and are expected to mutually share the surplus.	Policyholders are duty-bound to pay premiums to the insurer
Takaful operator earns a return for rendering a service of managing the *takaful* programme and from the *mudarabah* profit-sharing scheme as *mudarib*.	Insurance company makes a profit when there is an underwriting surplus.
Counter value (*'iwad*) is effort and/or undertaking of risk.	No clear valid counter value. Source of profit is anticipating (hoping) that the uncertain future will be in their favour (that total premiums will exceed total claims).
Takaful operator acts as administrator of the *takaful* fund and pays benefits from it. If there is any insufficiency in the fund, the *takaful* operator must provide interest-free loans to rectify the deficiency.	Insurer is liable to pay the benefits as promised from insurance funds and/or shareholders' fund.
Indemnification component is based on mutual contribution, reciprocal donation (*tabarru'*).	Indemnification component is a commercial relationship between the insurance company and the insured.
There is no insurer-insured relationship between *takaful* operator and participants. Participants act as both the insured and the insurer simultaneously.	There is a clear insurer-insured relationship.
Takaful funds must be invested in *Shari'ah*-compliant instruments.	There is no restriction in investment of funds.

Shari'ah and Regulatory Framework for *Takaful*

A *takaful* operator acts as the administrator of the *takaful* fund and thus earns a return for rendering the service. In contrast, an insurance company owns the insurance bonds and is liable to pay compensation in accordance to the insurance contract.

There are three levels of supervision and regulation of the *takaful* industry which are premised on local jurisdiction, the Islamic Financial Services Board (IFSB)'s Standards and the Core Principles of the International Association of Insurance Supervisors (IAIS):

1 **Local jurisdiction** – For instance, countries like Malaysia or Bahrain have special legislation for *takaful* operators while countries such as the UK adopt the fair level playing field, i.e., they do not give any special treatment nor create hurdles but instead allow any *takaful* operator to evolve within the existing legal and regulatory framework without any discrimination against it.

Three levels of supervision and regulation of *takaful*:
- Local jurisdiction, e.g., *Takaful* Act 1984
- IFSB standards
- Core principles of IAIS

2 **IFSB standards:** The IFSB and the IAIS prepared a joint-issue paper in 2006 titled *"Issues in Regulation and Supervision of* Takaful*"* which deals with the application of the IAIS core principles needed to accommodate *takaful* such as corporate governance, financial and prudential regulations, transparency, report and market conduct, and supervisory review process.

In November 2009, the IFSB issued the "*Guiding Principles on Governance for* Takaful *Undertakings*" dealing mainly with governance and prudential issues for *takaful*. In December 2010 the IFSB issued the IFSB Standard 11: Standard on Solvency Requirements for *Takaful* (Islamic Insurance) Undertakings, which aims at establishing solvency rules for *Takaful* and *re-takaful* operators in line with Solvency II. It aims at building up more emphasis on capital adequacy to meet solvency requirements and building confidence in the *takaful* market. There are other relevant standards regarding *Shari'ah* governance such as "*Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services*". This standard addresses issues such as qualities to be displayed by *Shari'ah* scholars sitting on *Shari'ah* boards such as competence, confidentiality, independence, consistency and avoiding conflict of interest. As far as the *Shari'ah* governance is concerned, it remains an unresolved issue because of differences in jurisdictions, nomination or choice of the members of the *Shari'ah* Supervisory Board (SSB) for marketing purposes, willingness or unwillingness of regulators to be involved in religious matters and so on.

3 **Core principles of the IAIS:** In a 2005 paper titled, "*A New Framework for Insurance Supervision*", the IAIS set out different factors of supervision to be considered. According to the documents, the framework for insurance supervision consists of three groups of issues: financial issues, governance issues and market conduct issues. It also encapsulates three aspects in relation to these issues, reflecting three different responsibilities:

The IAIS framework provides three aspects of responsibilities:
- Effective insurance supervision
- Regulatory requirements
- Supervisory actions

(a) Preconditions for effective insurance supervision (e.g., existence of an institutional and legal framework, efficient financial market and an authoritative and independent supervisory body). These preconditions support the finance, governance and functionality of the insurance company in the market place.

(b) Regulatory requirements, which are addressed in the operations of the insurer.

(c) Supervisory actions, which relate to the responsibilities and activities of the supervisory authority.

The distinction between regulatory and supervisory actions are interdependent and may be complementary. Some scholars use them interchangeably. They work hand-in-hand to monitor the risk profiles of insurance and *takaful* operators. Some risks faced by *takaful* operators that need attention are:

1. **Asymmetric Information** – *Takaful* is a blend between a mutual or cooperative insurance and a profit-oriented insurance where the *takaful* operator acts as a *wakil*-cum-*mudarib*. This raises the issue of principal-agent caused by

Prevailing risks faced by *takaful*:
- Asymmetric information
- *Shari'ah* risk
- Solvency risk
- Market risk

asymmetric information. Thus, participants of the *takaful* fund are exposed to a greater risk of wrong governance compared to the mutual insurance or commercial insurance because *takaful* participants own the *takaful* fund and they also jointly guarantee each other. It is not appropriate for regulators to dictate governance issues. They would usually adopt a non-prescriptive regulatory framework. One of the key governance issues faced by a *takaful* operator is *Shari'ah* governance. It would most probably be argued that the shareholders' interest will be more safely guarded than the participants of the *takaful* fund.

2 ***Shari'ah* Risk** – If *Shari'ah* scholars are being paid by the *takaful* operators, they may indirectly tend to side with the company, even though independence is expected from them. Also, there may be a conflict of interest if the *Shari'ah* scholars sit on the *Shari'ah* board of competing *takaful* operators. Various jurisdictions demand that specific *takaful* rules and a specific model be adopted. This also creates regulatory issues. Another area that needs supervision and regulation in *takaful* is the *wakalah* fee or *mudarabah* profit-sharing. The *takaful* operator may tend to underwrite risky participants or invest in a non-compatible-sensitive manner to optimise its interest. It is difficult for supervisors and regulators to be prescriptive on these issues. Perhaps via a thorough *Shari'ah* review, the cost lent need to be reconsidered.

3 **Solvency Risk** – As far as regulation of the financial side of *takaful* operators is concerned, it falls within the ambit of Capital Adequacy and Solvency II (discussed later in the chapter).

4 **Market Risk** – As far as the market conduct (or conduct of business) is concerned, the main focus is on the ways the *takaful* operator deals with the participants of the *takaful* fund (policyholders) as well as other market players and its (referring to operator) behaviour as an investor. With regard to the participants, disclosure of information to them is important so that they can make an informed decision on whether to enter the *takaful* agreement or not. Suitability of the product in favour of the consumer is another factor to be considered by *takaful* operators. The product should not involve *gharar* and should be quite distinct compared to conventional insurance products.

Section 2: Operational Framework of *Takaful*

Some important principles governing the *takaful* contract need to be understood before entering such a contract. These are briefly discussed in the following subsections.

Participants' Benefits

The competency of a person to enter into a *takaful* contract is determined by his legal capacity to contract and his interest in the subject matter covered. It is the participant's pecuniary interest which forms the subject matter of the contract and not the cover afforded.

Utmost Good Faith

The *takaful* contract imposes a duty on the contributor to disclose all material facts bearing on the contract. The duty of utmost good faith applies to both the participant and the *takaful* operator. The contributor is expected not to withhold information *vis-à-vis* the *takaful* operator because this leads him into a less favourable contract which ultimately affects all participants.

Utmost good faith imposes a duty upon both the *takaful* operator and participant to disclose all material facts relating to the *takaful* contract.

Islam demands that good faith be a major component of any transaction. Fairness, justice and honesty should prevail. When deciding which risk to be covered, the *takaful* operator must ensure that the *specific exception* to the risk to be covered should be revealed to the participants and the participants in return should disclose any aspect related to the risk associated with them which needs to be underwritten, e.g., his full health conditions should be disclosed in the case of a medical cover.

Insurable Interest

A person has an insurable interest in something when a loss or damage would cause that person to specifically suffer a financial loss or certain other kinds of loss.

Proximate Cause

The essence of the *takaful* contract is the provision of indemnity for financial loss suffered by the participant as a result of the happening of an event which is covered in the contract. It is necessary to state the perils against which cover is given so that the intentions of the parties are clearly defined.

In *takaful* claims, the question which is often asked is not whether an event (consequence as defined in the contract) has occurred, but whether it was the result of a cause as defined. This means that a claim will be met if the fact for which a claim is brought is the result of the proximate cause included in the perils insured against, or that its liability will be excluded if the proximate cause was an excluded peril. Usually, for a claim to succeed, the participant must show that the loss was proximately caused by the peril covered for.

Indemnity

The *takaful* contract is a contract of indemnity; it is a contract to pay the actual loss sustained by the participant. It is a mechanism by which the *takaful* operator provides financial compensation in an attempt to place the participant in the same pecuniary position he enjoyed right before the loss.

Claims and Distribution

When claims are paid out, especially in the case of family *takaful*, the proceeds disbursed should be distributed to the legal heirs according to Islamic law and not to the stipulated nominee as in the case with conventional insurance.

Contribution and Subrogation

Subrogation refers to a set of rules that facilitates the reimbursement of a *takaful* operator when the operator has indemnified its participants under a contract of indemnity from a third party. This occurs when a third party has caused damages to a participant and the *takaful* operator indemnifies him. The money disbursed is claimable from the third party that has caused the damages.

Contribution from participants (i.e., *takaful* instalments payable by the participants) is the starting point for creating the *takaful* fund from which claims are paid. Once the *takaful* operator pays the claims from the *takaful* fund, the *takaful* operator will have to claim this disbursement from the person who caused the damage. Subrogation refers to a set of rules that facilitates the reimbursement of a *takaful* operator when the operator has indemnified its participants under a contract of indemnity from a third party. This occurs when a third party has caused damages to a participant and the *takaful* operator indemnifies him. The money disbursed is claimable from the third party that has caused the damages. The underpinning purpose of subrogation is to provide the *takaful* operator with a right of recourse.

The *takaful* contract not only upholds the principle of indemnity but also equity. Both the contribution and subrogation principles are corollaries to the principles of indemnity and equity.

Underwriting

This is a process of selection through which the *takaful* underwriter determines which of the risks offered should be accepted, and if so, on what terms, conditions and rates.

Classification of *Takaful* Operations

In general, there are two types of *takaful*: general *takaful* and family *takaful*, which is comparable to life insurance.

General Takaful

Features of general *takaful*:
- Short-term policy
- General *takaful* fund
- *Tabarru'* as the core element
- No savings
- Motor *takaful* and non-motor *takaful*

The general *takaful* contract is normally a short-term policy where *takaful* participants pay contributions and operators undertake to manage the risk. The contributions paid by the participants are credited into the general *takaful* fund, which is then invested and the profits generated are paid back to the fund.

The *tabarru'* element is more apparent in general *takaful* as participants will normally undertake to regard their contributions as donations to fellow participants. All contributions go to a common pool of funds which will be used to compensate *takaful* participants in the event of a loss. There are no savings and investment elements, but the *takaful* operator will distribute any underwriting surplus to the participants on an annual basis. Typically, general *takaful* is short-term but renewable periodically. *Takaful* operators everywhere typically provide a full range of general *takaful* products in both retail and corporate segments. General *takaful* is categorised into two types: motor *takaful* and non-motor *takaful*. Motor *takaful* provides protection for private car, motorcycle and commercial vehicle. Non-motor *takaful* ranges from fire, personal accident, marine, health *takaful* and many others.

Family Takaful

Family *takaful* is a long-term policy for which most participants aim at saving for their long-term needs, for example their children's education, their pension and compensation for dependants in the event of death and disability, amongst others. This type of *takaful* has a long-term time horizon which ranges from 10 to 30 years. In family *takaful*, operators normally divide the contributions into two parts: first, the participant's account (savings account) and secondly, the participant's special account (*tabarru'* account) for meeting losses of fellow participants. In the event of a loss, the participant will be compensated according to a pre-agreed formula. Accordingly, the clause of *tabarru´* is incorporated in the contract. Both accounts are invested in *Shari'ah*-approved securities. Depending on the type of underlying contract, the *takaful* operator may receive a fee or share of investment profit.

Typically, family *takaful* is long-term in nature, loosely comparable to conventional life insurance. If a participant dies prematurely, his family gets the amount in the participant's account plus dividends, and amount in the participant's special account as if he continued contributions until the maturity period. If the participant withdraws from the *takaful* programme, he will get the amount in the participant's account only. Among the most common and typical family *takaful* products offered include savings and educational plans, retirement plans, retirement annuities, *waqf* plans and ancillary benefits added to the main plans, such as protection for critical illness, disability, accidental death, or waiver contribution.

Features of family *takaful*:
- Long-term policy
- Savings and investment elements
- Two funds: participant account (savings) and participant's special account (*tabarru'*)

Underlying Contracts in *Takaful*

Shari'ah provides various types of contracts to suit the needs of contracting parties. Each contract has unique features and rules which are in line with the objective of the respective contract. It is important to choose the suitable and right contracts which are capable to achieve the purpose of *takaful* and fulfil the needs of the parties involved in the *takaful* arrangement. However, the parties cannot simply modify the rules and conditions of each contract as it will change the nature of the contract itself.

From current practice, the contracts adopted depend on the contracting parties. For instance, the *tabarru'* contract, which is a form of mutual indemnity, is used between the participants. Between the participants and the operator, there are a few contracts to choose from depending on their arrangement and interest.

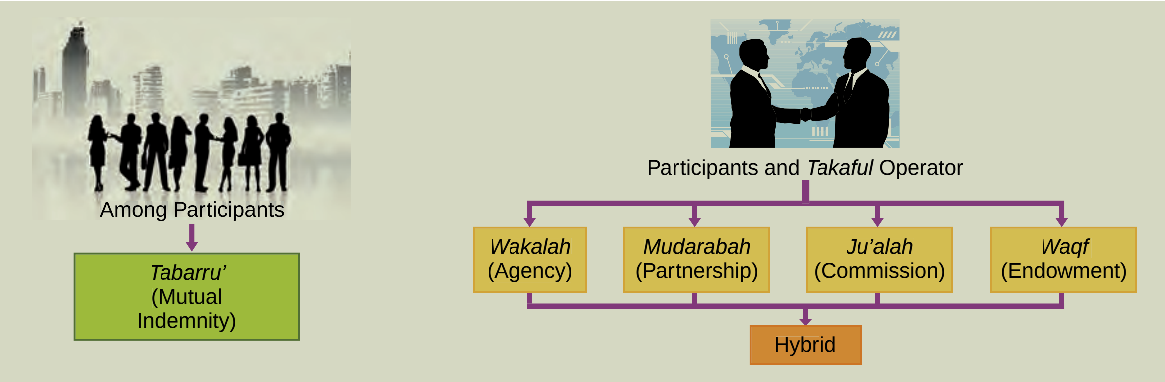

Figure 12.1 Underlying Contracts In *Takaful*

Contract Among *Takaful* Participants: *Tabarru'*

Tabarru' is an agreement by a participant to relinquish, as a donation, a sum of contribution that he or she agrees to pay into a *takaful* fund.

Tabarru' is an agreement by a participant to relinquish, as a donation, a sum of contribution that he or she agrees to pay into a *takaful* fund. Participants give certain portions of their contribution as a donation with the purpose of providing mutual indemnity to *takaful* participants, where the donation acts as a mutual help and joint guarantee should any fellow participants suffer from a defined loss. The current practice does not specify the exact form of donations, whether it is an outright gift (*hibah*) or endowment (*waqf*). According to the Accounting and Auditing Organization for Islamic Financial Insitutions (AAOIFI), the practice is known as *iltizam bit tabarru'* or *nihd*.

It is important to note that a *waqf takaful* model focuses on the *tabarru'* aspect.

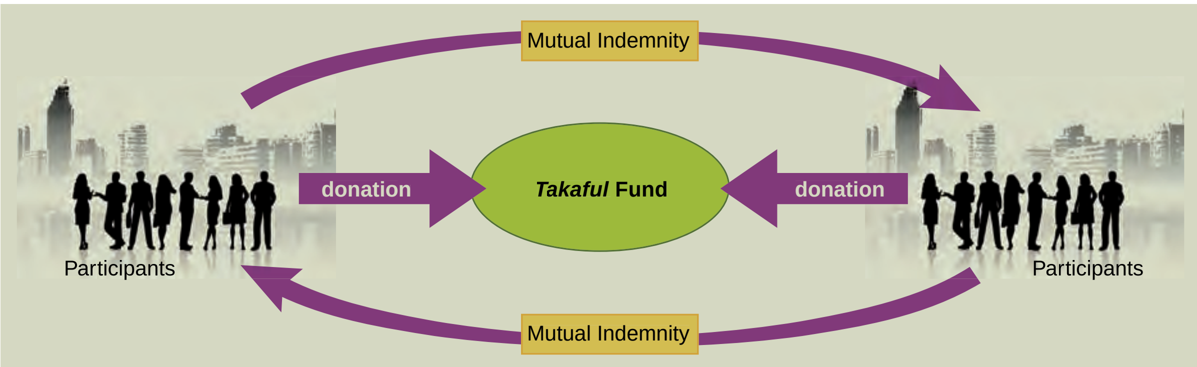

Figure 12.2 Contract Among *Takaful* Participants

Contracts between Participants and *Takaful* Operator

There is no insurer-insured relationship between participants and the *takaful* operator because the participants are insuring themselves. The *takaful* operator is engaged by participants (in a group) to manage the *takaful* scheme for them. The parties can adopt any of the following contracts depending on their needs; namely, *mudarabah*, *wakalah*, *ju'alah*, *waqf*, or a combination of the earlier contracts (hybrid).

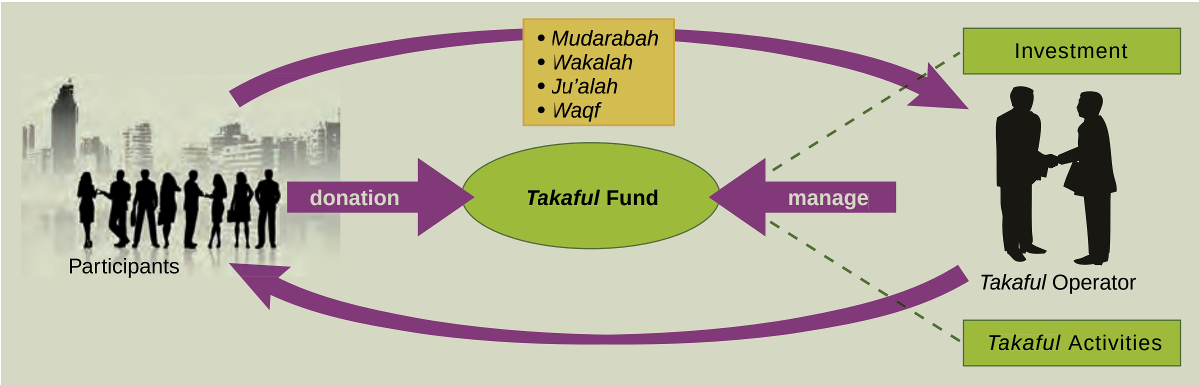

Figure 12.3 Contracts Between Participants and *Takaful* Operators

1 *Mudarabah*

Mudarabah means the giving of capital to another person who will trade with it for the purpose of sharing the profits according to a pre-agreed ratio. Investment is a side activity to optimise the fund. In *takaful*, the capital providers (*rabbul mal*) are the participants and the investment manager (*mudarib*) is the *takaful* operator. The investment manager (operator) must invest in a *Shari'ah*-compliant manner and according to the terms in the *takaful* contract. Profit, if any, will be shared based on a pre-agreed ratio. If there is a loss, it will be borne by the capital provider. However, if the loss is due to the manager's negligence, then the manager must be jointly responsible for the loss.

Contracts between participants and *takaful* operators:
- *Mudarabah*
- *Wakalah*
- *Ju'alah*
- *Waqf*

2 *Wakalah*

Wakalah is a contract of agency, whereby participants remain the actual owners of the *takaful* fund. In this arrangement, the principal is the participant while the agent (*wakil*) is the *takaful* operator. The principal appoints or authorises the agent to manage the *takaful* fund for two main duties, namely, *takaful* activities (underwriting, paying claims, etc.) and investments. As an agent, the operator is entitled to an agency fee (agent's remuneration) and performance fee (agent's commission).

3 *Ju'alah*

Ju'alah refers to a commitment to pay a specified amount of reward for the performance of a prescribed task. On the basis of this contract, the participants collectively appoint the operator to manage the *takaful* fund, in a prescribed manner, for a specified reward if done accordingly. Payment is based on actual output and performance.

4 *Waqf*

Waqf means a unilateral contract to relinquish a right over property and allocate it for general enjoyment of the usufruct by the specified beneficiaries. It can be made applicable in the treatment of a *takaful* fund, while management and operational aspects of the *takaful* fund may still use *wakalah* and *mudarabah* contracts. Participants will give contributions into a *waqf* fund, and thus completely lose the right over their contributions. The *takaful* operator acts as a trustee to the *waqf* fund.

Models of *Takaful*

Models of *takaful*:
- *Mudarabah* model
- *Wakalah* model
- Hybrid *mudarabah* and *wakalah* model
- *Waqf* model

There are currently four *takaful* models operated worldwide which apply to several forms of contract governing the relationship between participants and the *takaful* operator. The most widely practised models are *mudarabah* and *wakalah*. Some *takaful* operators adopt a hybrid model either combining *mudarabah* and *wakalah* or *wakalah* with *waqf* model or even *mudarabah* and *waqf*. However, the most commonly used contracts are *mudarabah* (profit-sharing), *wakalah* (agency) and *waqf* (endowment).

The descriptions of each model of *takaful* are presented as follows:

Mudarabah Model

In a *mudarabah* model, the *takaful* operator must be actively involved in the investment because the main income is generated from a certain ratio of investment profit.

According to the principle of *mudarabah*, the *takaful* operator who acts as an entrepreneur, or *mudarib*, will accept payment of the *takaful* contributions (premium) termed as *ra's-al mal* from *takaful* participants acting as *rabbul mal*. The contract specifies that the share of profit (surplus) from the operations of a *takaful* fund managed by the *takaful* operator is to be distributed between the participants as the providers of capital and the *takaful* operator as the entrepreneur, in accordance with the principle of *mudarabah*. The sharing of such profit (surplus) may be in a ratio of 5:5, 6:4, 7:3, etc., as mutually agreed between the contracting parties. The *Shari'ah* committee approves the sharing ratio for each year in advance. The operator is entitled to a fixed percentage of any investment profit, if any.

Generally, the risk-sharing arrangements allow the *takaful* operator to share in the favourable investment performance of both the participant's account (savings account) and the participant's special account (*tabarru'*). However, if there are losses in the participant's special account, the *takaful* operator provides an interest-free loan (*qard hasan*) that has to be repaid when the participant's special account returns to profitability and before any future surplus is distributed. Therefore, the *takaful* operator must be both prudent and active in investing the *takaful* funds to gain profits because their main income is generated from a certain ratio of such investment profits. Of course, when investing in the funds, the instruments used should be *Shari'ah*-compliant. The *mudarabah* contract is cancellable, and upon cancellation, all cumulative capital plus profit must be returned to the capital provider (participants), after deducting administrative expenses.

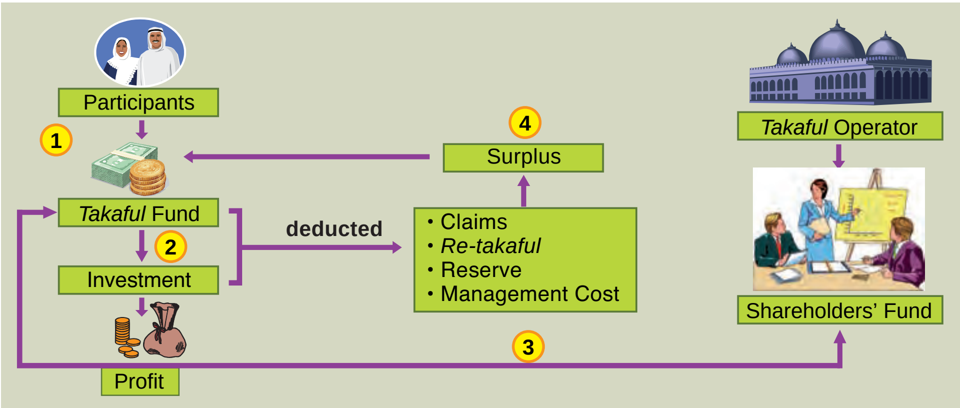

Figure 12.4 Operation of General *Takaful* in a *Mudarabah* Model (Short-term Scheme)

Explanation:

1 Participants pay *takaful* contributions which form a *takaful* fund.

2 The fund will be invested in *Shari'ah*-compliant investments.

3 The profit, if any, will be shared among participants and the *takaful* operator on the basis of the agreed ratio.

4 At year-end, the surplus (after deducting claims, *re-takaful*, reserve and management expenses) will be distributed to the participants (shared with the operator in modified *mudarabah*).

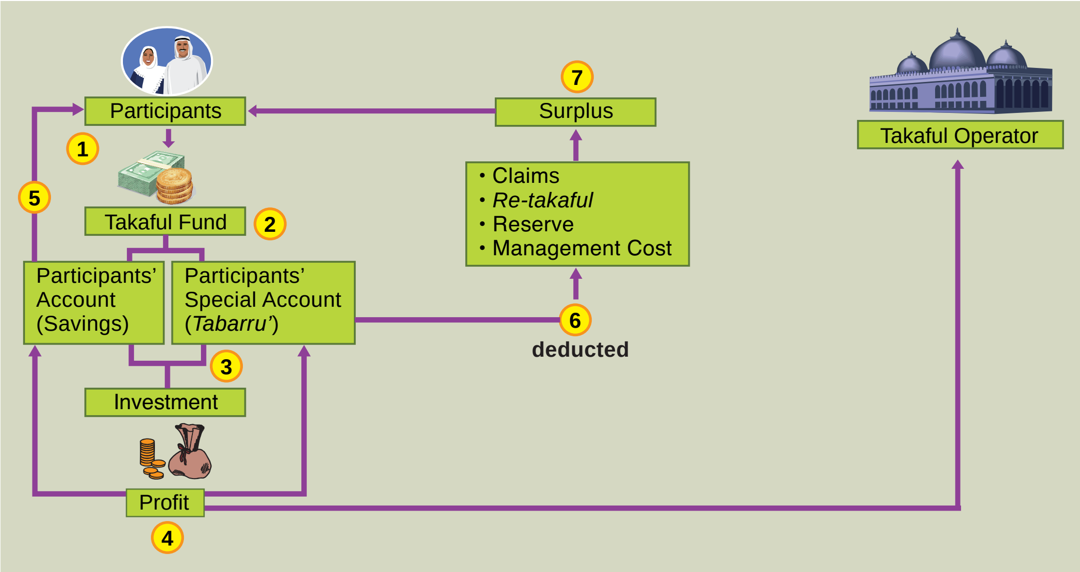

Figure 12.5 Operation of Family *Takaful* in a *Mudarabah* Model (Long-term Scheme)

Explanation:

1 Participants pay *takaful* contributions which form a pool of the participants' funds.

2 Participants' funds are divided into: participants' account for savings; and participants' special account – known as participants' risk account which is based on the *tabarru'* concept. The amounts allocated in these two accounts are based on the agreed percentage decided upfront in the contract.

3 The funds in both accounts will be invested in assets, such as government Islamic instruments, Islamic private debt securities and equities, fixed assets and fixed deposit accounts.

4 Investment profit, if any, will be shared among participants and the *takaful* operator on the basis of the agreed ratio.

5 Amounts in the participants' account will be paid to the participants upon death, or delivery or maturity of a *takaful* scheme.

6 Amounts in the participants' special account will be used for paying claims, *re-takaful*, reserve and management.

7 At year-end, the surplus will be distributed to the participants (and *takaful* operator on the agreed ratio-modified model).

In family *takaful* on the basis of a *mudarabah* model, the participants' contributions are divided into:
1 Participants' Account, which will be paid to participants upon death, or maturity, or early surrender
2 Participants' Special Account, which will be used for paying claims, *re-takaful*, reserve and other costs.

The *mudarabah* model for *takaful* is rapidly losing ground as the *takaful* model of choice. This is due to the current trend among *takaful* operators who are inclined to adopt the *wakalah* model. The *mudarabah* model is suitable for shorter term products, such as one-year renewable products like motor insurance, in which the sharing of surplus happens earlier than that in long-term businesses. Another challenge for *takaful* operators adopting this model is their direct exposure to the ups and downs of business since they share profits from investments.

In Malaysia, of the eight *takaful* operators at the time of writing, Syarikat Takaful Malaysia Berhad (STMB) was operated based on this model since its establishment. However, STMB has changed it to the *wakalah* model recently. Another company that practises *takaful* based on *mudarabah* is Takaful International (Bahrain).

Wakalah Model

The *wakalah* model is one that is becoming increasingly popular. As mentioned earlier, *wakalah* is a contract of agency. Based on this principle, participants remain the actual owners of the *takaful* fund and the *takaful* operator acts as an agent (for the participants) who manages the fund for a defined fee. As an agent, the operator is entitled to agency fee (remuneration) and performance fee (as commission). The surplus of the participants' investment funds goes to the participants. The agency fee rate is fixed annually in advance in consultation with the *Shari'ah* committee of the company. Performance fee, which is related to the level of performance, is given as an incentive for good administration and governance of the participants' fund.

In a *wakalah* model, participants remain the owner of the *takaful* fund and appoint the *takaful* operator as their agent (*wakil*) to manage the fund for a defined fee.

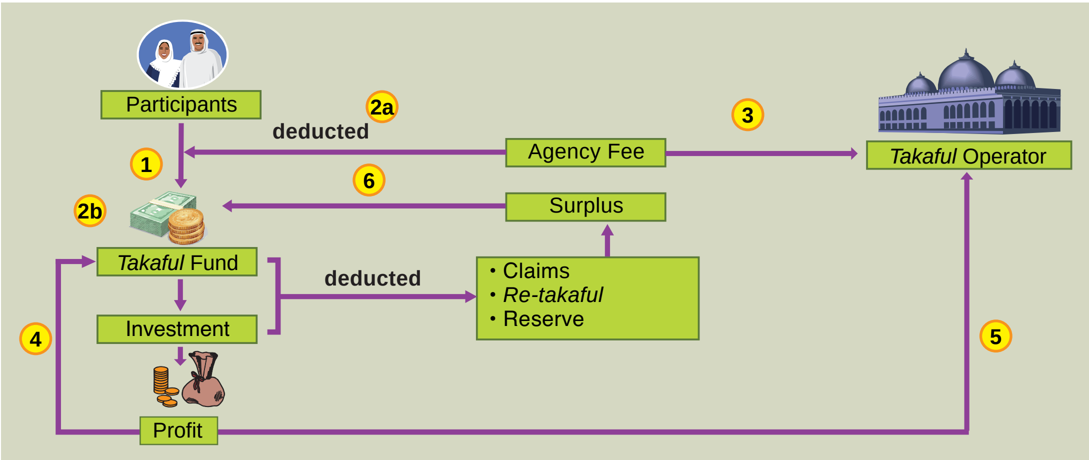

Figure 12.6 Operation of General *Takaful* in a Pure *Wakalah* Model (Short-term Scheme)

Explanation:

1 Participants pay contributions under the *takaful* scheme.

2 The contributions are divided into: (a) agency fee and (b) *takaful* fund. The division is made based on the agreed ratio between the *takaful* operator and the participants in the contract.

3 Agency fee which consists of agent's remuneration and administration expenses will be channelled to the *takaful* operator.

4 The group *takaful* fund will be invested and any income or profit will be returned to the group fund.

5 *Takaful* operator will be entitled to a performance fee (as commission) for managing the investment on behalf of the participants.

6 End of year surplus (after deducting claims, *re-takaful* and reserve) will be distributed to the participants (share with operator in modified *wakalah*).

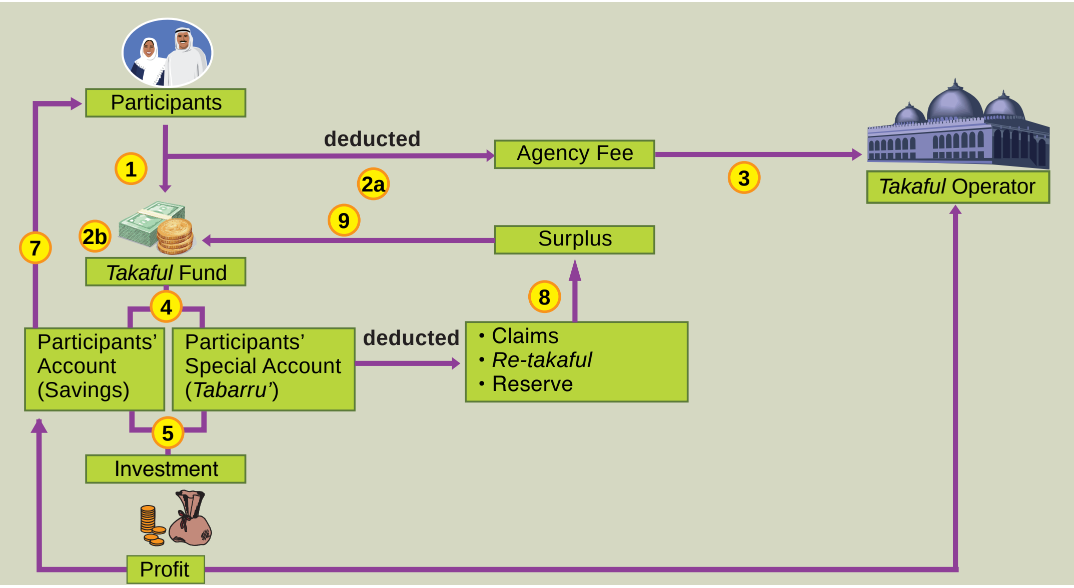

Figure 12.7 Operation of Family *Takaful* in a *Wakalah* Model (Long-term Scheme)

In family *takaful* on the basis of a *wakalah* model, a participant's contribution will be first deducted on an agreed ratio as a *wakalah* (agency) fee while the remaining contributions will be channelled to the Participant's Account and Participant's Special Account.

Explanation:

1 Participants pay contributions under the *takaful* scheme.

2 The contributions are divided into: (a) agency fee and (b) *takaful* fund. The division is made based on the agreed ratio between the *takaful* operator and participants in the contract.

3 Agency fee, which consists of agent's remuneration and administration expenses, will be channelled to the *takaful* operator.

4 *Takaful* fund is divided into: participants' investment account for savings, and participants' special account – known as participants' risk account which is based on the *tabarru'* concept. The amounts allocated in these two accounts are based on the agreed percentage decided upfront in the contract.

5 The fund in both accounts will be invested in assets, such as government Islamic instruments, Islamic private debt securities and equities, fixed assets and fixed deposit accounts.

6 Investment profit, if any, will be returned to the fund. The *takaful* operator will be entitled to a performance fee (as commission) for managing the investment on behalf of the participants.

7 The amounts in participants' account will be paid to the participants upon death, or delivery or maturity of a *takaful* scheme.

8 The amounts in participants' special account will be used for paying claims, *re-takaful*, reserve and management.

9 At year-end, the surplus will be distributed to the participants (and *takaful* operator on the agreed ratio-modified model).

Takaful operators in a *wakalah* model cannot share in the investment profit; rather they are entitled to a fee based on their performance in the investment.

This model is widely used currently, for example, by Bank Aljazira in Saudi Arabia (2001) and Takaful Ikhlas in Malaysia (2003). In fact, Bank Aljazira became the pioneer in the Middle East by introducing *Takaful Ta'awuni,* based on the *wakalah* model.

The main issue in a pure *wakalah* model is that the management and shareholders of a *takaful* operator cannot share in the profits because they merely act as an agent to the participants. However, they may be entitled to a fee based on their performance in the investment. Therefore, many *takaful* operators today attempt to adopt a combination of *wakalah* and *mudarabah* or modified *wakalah* model.

Hybrid of *Wakalah* and *Mudarabah* Model

This model basically combines some features in both the *wakalah* and *mudarabah* model. The *wakalah* principle is applied in underwriting activities while a *mudarabah* contract is used in the investment of the *takaful* funds. Thus, the *takaful* operator is entitled to agency fee for managing the fund as a *wakil* and a share of profit for managing the investment of the fund as a *mudarib*.

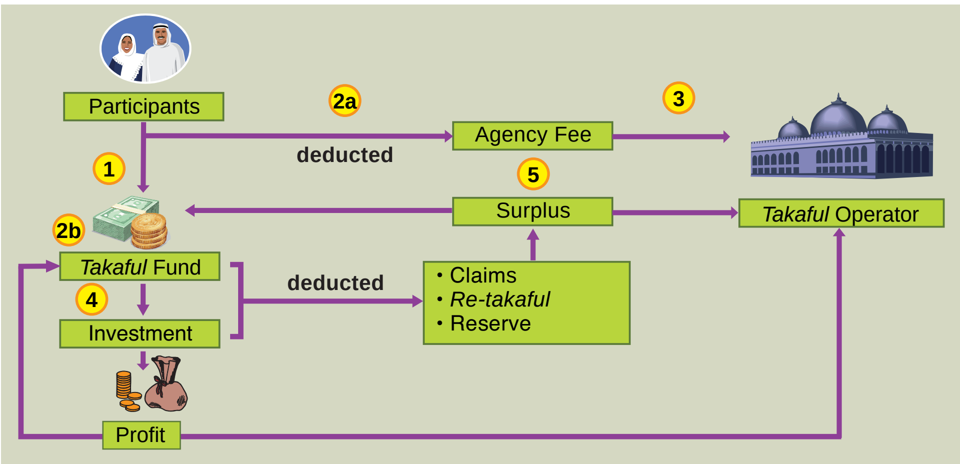

Figure 12.8 Operation of General *Takaful* in a Hybrid of *Wakalah* and *Mudarabah*

Explanation:

1. Participants pay contributions under the *takaful* scheme.
2. The contributions are divided into: (a) agency fee and (b) *takaful* fund. The division is made based on the agreed ratio between the *takaful* operator and participants in the contract.
3. The agency fee, which consists of agency commission and administration expenses, will be channelled to the *takaful* operator's fund.
4. The fund will be invested in *Shari'ah*-compliant investments. The profit, if any, will be shared among participants and the *takaful* operator on the basis of the agreed ratio.
5. At year-end, the surplus (after deducting claims, *re-takaful* and reserve) will be distributed to the participants and *takaful* operator on the agreed ratio in the contract.[1]

In a hybrid of the *wakalah* and *mudarabah* models, the *takaful* operator is entitled to an agency fee for managing the fund as a *wakil* and a share of profit for managing the investment of the fund as the *mudarib*.

This approach seems to be more well-accepted and favourable than the other models and is widely adopted by many newly-established *takaful* operators and international organisations, e.g., Abu Dhabi National Takaful Operator.

Hybrid of *Wakalah* and *Waqf* model

In addition to the earlier models, the latest model that has emerged from Pakistan was introduced by renowned *Shari'ah* scholar, Taqi Usmani. The general concept of the *takaful waqf* plan is designed to enable any individual to save regularly with the aim of accumulating a fund that can be left as a donation under the *waqf* system. In this model, the shareholders of the *takaful* operator will initially make a donation to establish the *waqf* fund. The fund needs to be invested in a *Shari'ah*-compliant investment, and the returns will be used for the benefit of the participants. The *tabarru'* fund from participants' special account also becomes part of the *waqf* fund.

A *waqf* fund consists of shareholders' donations and participants' contributions in which they (shareholders and participants) lose ownership rights because the *waqf* fund can only be used for the benefits of all participants.

Therefore, a *waqf* fund consists of donations from shareholders and participants seeking *takaful* protection. The combined amount will be invested and any profits earned will be returned to the same fund. Based on *waqf* principles, the donors (shareholders and participants) would lose ownership rights on their monetary contributions in the *waqf* fund. The monies eventually become the property of the *waqf* fund which can only be used for the benefit of all the participants.

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1 This is based on the current prevailing practice, though in principle, underwriting surplus under *wakalah* should be distributed to the participants only.

The shareholders, who act as the owners of the *waqf* fund, delegate authority to the operator to become the administrator of the fund, whose function, among others, includes paying claims from the fund. The operator also undertakes the role of investment agent (*wakalah bi istithmar*) when it invests the *waqf* funds and is entitled to a certain percentage of the investment profit as a performance fee.

Generally, there are two types of *waqf* model in respect to surplus sharing, namely:

1. Pakistani model (pure *waqf* model), in which the underwriting surplus is returned to the *waqf* fund, thus not distributed to either the participants or operator.
2. Commercial *waqf* model, in which the terms on surplus-sharing are spelt out in the *waqf* deed in accordance to the intention of the contracting parties involved in the *waqf* arrangement.

Unlike the Pakistani model (pure *waqf* model), the *waqf* deed in a commercial *waqf* model provides the terms of surplus-sharing according to the intention of the contracting parties.

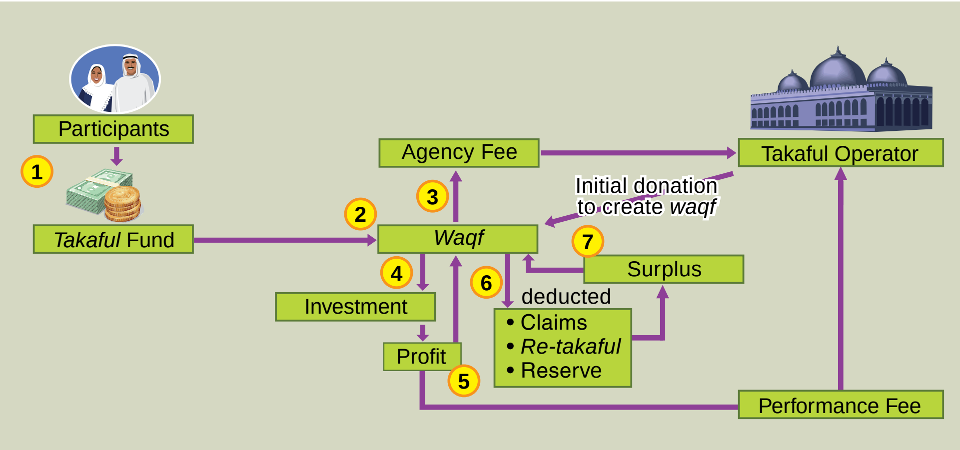


Figure 12.9 Operation of *Takaful* in a Combination of *Wakalah* and *Waqf* Model

Explanation:

1. Participants pay *takaful* contributions which form a pool of the participants' funds.
2. A *waqf* fund, which receives initial donation from the shareholders, followed by the participants, is formed.
3. Agency fee is deducted from the *waqf* fund. The fee which consists of the agent's remuneration and administration expenses will be channelled to the *takaful* operator.
4. *Waqf* fund will be invested in *Shari'ah*-compliant assets investment.
5. Investment profit, if any, will be channelled into the *waqf* fund, while the *takaful* operator (investment agent) will be entitled to a performance fee on the basis of the agreed ratio.

6 Accumulated amounts in participants' account will be paid to the participants upon death, or delivery or maturity of a *takaful* scheme. Amounts in *waqf* fund will be used to pay claims, *re-takaful* and reserve.

7 At year-end, the surplus (after deducting claims, *re-takaful* and reserve) in *waqf* fund will be returned to the same fund again.

The sources of income in this model is similar to that under the *wakalah* model, namely:

- Agency fee for undertaking service as a *wakil* against a defined remuneration payable from the *waqf* fund.
- Performance fee for acting as an agent for investment. This model is relatively new and usually adopted by non-profit organisations.

In addition to the previous operating models, there is one newly proposed model operated on the basis of the *wadi'ah* contract. The *wadi'ah* model mainly aims to overcome some issues in the other models, such as ownership of the *takaful* fund, sharing of surplus, entitlement to the investment profit, etc. This model is currently under review and discussion, and thus, it will be beyond the scope of discussion in this chapter.

Takaful Stakeholders

Takaful stakeholders are the *takaful* operator, participants, nominees and beneficiaries. All these parties are dependent on each other to ensure the smooth running of a *takaful* practice. The main parties to a *takaful* contract are the operator and participants.

Takaful Operator

An operator is the one who undertakes on behalf of all participants, in consideration of contributions paid by the participants, to indemnify or provide a financial security against unexpected peril, which may happen on the subject matter of the policy. A *takaful* operator must observe the following requirements:

1 An individual, a company or a cooperative society wishing to operate *takaful* activities must have contractual capacity provided in the general principles of commercial contracts.

2 An individual, a company or a cooperative society, which intends to operate *takaful* practices as an operator must be registered before the commencement of the operation.

3 An operator must be able to show that it is at all times able to maintain a surplus of assets over liabilities of not less than the amount as may be prescribed from time to time, which may depend on the economic conditions.

4 The operator has to make a deposit before obtaining a licence for its operation. The deposit is a requirement, which is kept for security against an unexpected bankruptcy which might be suffered by the operator.

Participant

The participant pays regular contributions to the *takaful* operator for the purpose of future security of the subject matter at risk. Theoretically, everybody, regardless of age, class, religion, sex or any form of identification, has a natural right to buy a policy for the material security of property, life or business ventures. But in practice, the right of mutual cooperation may not be rendered to some people in society because of some reasons which do not permit them to exercise the equal right of mutual cooperation.

A participant who is competent to enter into a *takaful* contract must fulfil the following conditions:

A *takaful* participant may enter into a *takaful* contract under his own name when he is 16 years old. If he is between 10 to 15 years, he can only affect the *takaful* contract with his parent's or guardian's consent.

1 **Age**: A participant can affect a *takaful* contract under his own name as early as 10 years old but only with his parents' or guardians' consent. He has full capacity to a *takaful* or insurance contract upon reaching the age of sixteen.

2 **Medical Fitness**: A person who is suffering from a serious illness, or is of unsound mind, or has been certified by a doctor as a patient who is unable to manage his own affairs, or is dependent on others to survive, may be regarded as unfit to be a participant to a *takaful* policy.

3 **Legally Qualified**: A person whose debt exceeds the value of his own property may be declared bankrupt immediately once his creditor demands the right of credit from him. It should also be grounds for disallowing one to be a participant. If one is already bankrupt and is subject to the creditor, he is unable to contribute to the *takaful* operator.

4 **Free**: If a person is imprisoned, he has already lost his freedom of the management of his own financial affairs. Therefore, a captive should also cease to have the right of being an insured in a policy.

5 **Authorised**: A person who wishes to protect a particular property or business which is not legally owned by him is not allowed to enter into a *takaful* contract. An unauthorised person shall not be qualified as a participant because this may give an opportunity for him to gain over the property of others, which may disrupt the whole objective of *takaful* to sustain mutual cooperation, solidarity and brotherhood.

Case Study *Mudarabah* with *Waqf* Plan: Syarikat Takaful Malaysia Berhad

The *mudarabah* with *waqf* plan is designed to enable any individual to save regularly with the objective of accumulating a fund that can be left as a donation under the *waqf* system. Under this model, the participants accrue a considerable sum of money through the accumulation of the contributions, paid regularly over a certain period of time, which would then be sufficient to be endowed as *waqf*. Any benefits derived under the plan, either upon the premature period due to unexpected death of the participant or upon its maturity, are to be remitted by the *takaful* operator to the parties named as the *waqf* beneficiaries.

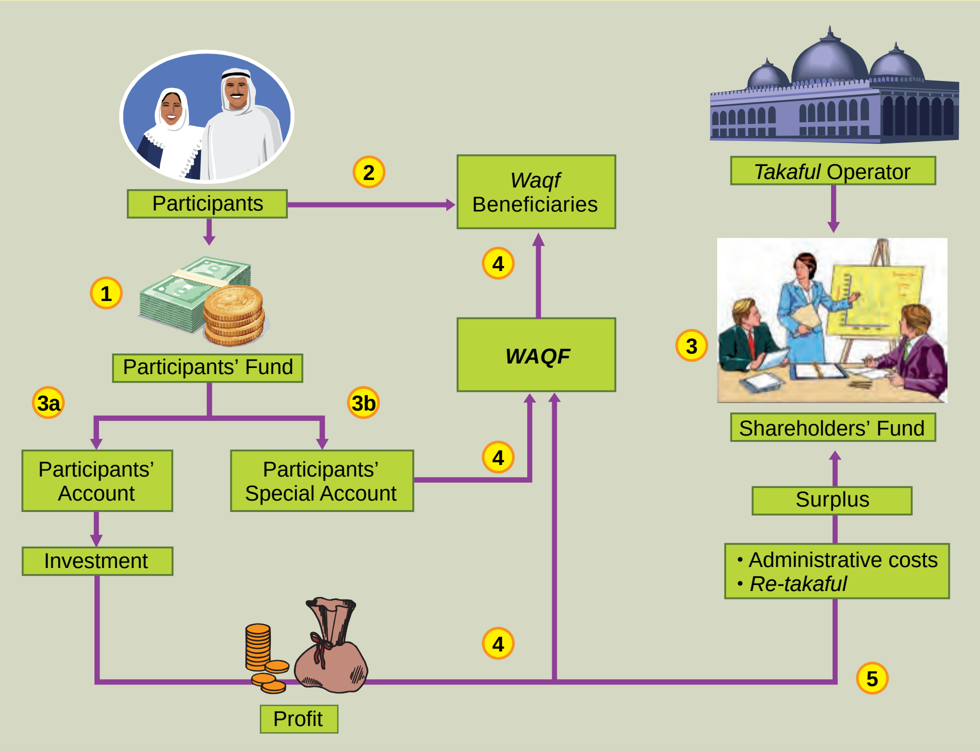


Figure 12.10 Operation of *Takaful* in a Combination of *Mudarabah* and *Waqf* Plan

Major steps in this arrangement may be discussed as follows:

1 Participants enter into a *takaful waqf* plus *mudarabah* plan and pledge a certain amount of payment to be contributed. Participants pay *takaful* contributions which form a pool of the participants' fund. Prior to signing the *takaful* plan, they also need to agree to the time period of the plan. In the case of Syarikat Takaful Malaysia Berhad, participants are allowed to choose the period ranging from 5, 10, 15, and up to 45 years. However, the plan must mature upon the participants reaching the age of 75. Based on this, the regular contributions can be calculated and paid either on a

monthly or yearly basis. Syarikat Takaful Malaysia Berhad offers various methods of contribution payment either to be paid directly to the operator, through salary deduction or a bank standing instruction.

2 Participants must name an institution of their choice as the beneficiary of the *waqf*. In the case of Syarikat Takaful Malaysia Berhad, the participants are confined to the list of institutions provided by the operator which include mosque building funds, orphanages, education funds, etc. This is an element of the *waqf* contract: the contract must be transparent from the beginning.

3 All contributions before their maturity will be divided into two accounts:

(a) **Participants' Account**

The funds in this account will be utilised by the *takaful* operator at its discretion in order to be invested in any appropriate business or investment. This is based on the principle of *mudarabah mutlaqah,* or unrestricted *mudarabah*, in which the capital providers (participants) allow the entrepreneur (*takaful* operator) to use and invest their funds without any restrictions or limitations. The profit is then shared between both parties according to the agreed ratio, while the loss, if any, needs to be borne solely by the participants. If this actually happened, the amount of money in the participants' accounts would be less than what is expected. In the end, they would be unable to donate the intended amount of money for *waqf*.

In the case of Syarikat Takaful Malaysia Berhad, the contract of *takaful waqf* plus *mudarabah* plan stipulates that any monthly profits are to be divided between the participants and the company at the ratio of 70:30. The participants' portion of the profits is further divided between the Participants' Account and the Participants' Special Account.

Based on the *waqf* contract, a participant agrees to relinquish the whole balance in the participant's account, which must be paid to the *waqf* recipient. In other words, the participants are no longer the real owners of whatever amount is available in the account. Therefore, if a participant dies before the plan actually matures, his or her heirs have no right to claim for a disposable inheritance.

(b) **Participants' Special Account**

The remaining amount after deducting a portion of a participant's contributions to the participant's account will be allocated into the participant's special account. This portion is treated as a *tabarru'* or donation portion. In the case of Syarikat Takaful Malaysia Berhad, only 1% of the total contributions are deducted for this account. As the name implies, based on the *tabarru'* principle, the amount is solely treated for the purpose of solidarity, brotherhood and cooperation among the participants.

For example, if any of the participants died before his *takaful* plan matures, the *takaful* operator shall pay to the *waqf* beneficiaries the balance from the participant's account and the unpaid amount of *takaful* contributions for the period from the date of his death until the date of maturity. The payment is actually taken from the participant's special account, i.e., the funds from other participants who are still alive based on the principle of *tabarru'*. This implies that the intention of the deceased to contribute a certain amount of *waqf* before his death can still be fulfilled even though he died before the maturity of his plan.

4 Upon maturity of the plan, the *takaful* operator will pay the *waqf* recipient the balances from the participant's account including the actuarial surplus (if any) arising from the participants' special account.

5 The source of income for the *takaful* operator is derived from its share of profit realised from the investment, after deducting the costs of managing the plan and *re-takaful* expenses.

Source: Hashim, 2007.

Beneficiary

The beneficiary must be a living person. An artificial entity or unborn child is disqualified as beneficiary because it has no capacity to a *takaful* benefit.

Under Islamic law, the beneficiary in a *takaful* policy cannot be determined based on a nomination clause. A beneficiary must have an insurable interest in the policy and simultaneously be nominated by the participant in the policy. The current practice seems to recognise those who are entitled to the deceased's estate as having a legitimate insurable interest, although this point is not clearly expressed in any regulation or guidelines. Therefore, a beneficiary who has an insurable interest but is not nominated, may be disqualified from receiving any benefits from the policy as he is not considered as a legal beneficiary. Another condition is that the beneficiary must be an ordinary and living person. So, an artificial entity or unborn child cannot be nominated as beneficiary because it has no capacity to a *takaful* benefit. The right of the beneficiary in any kind of policy should first go to the participant who pays regular contributions as savings for future security against unexpected risk. Once the participant dies, the right of the beneficiary over the benefits of the policy may move from the participant.

In *takaful*, the nominee acts as a trustee who holds the *takaful* benefits as a trust and distributes the benefits when the beneficiaries have attained full capacity to receive such benefits.

Nominee

The nominee is a trustee and the governing principles of nominee under Islamic law could be derived from the doctrine of *al-amanah.* The word *al-amanah* means reliability, trustworthiness, good faith, honesty, and fidelity. If a person is being entrusted or nominated to hold the minor's property as a trustee, it is the nominee's responsibility to hand over the property upon confirming the maturity of the minor. The nomination shall not constitute a gift or an ownership over the benefits of the policy but only a mere trust in the policy and distribute them among the beneficiaries of the participant.

Re-Takaful

In conventional insurance, it is common for insurance operators to collectively share the risks they have taken on. These risks are "transferred" to an even larger pool of risks, managed by a larger insurance operator. This process is known as the re-insurance process. *Takaful* operators have also been known to resort to re-insurance as a method of risk management.

Re-takaful is an agreement among *takaful* operators to contribute into a larger fund (*re-takaful* fund) which assumes the task of covering part of the risks encountered by the participating *takaful* operators.

Re-takaful is a form of mutual assistance among participating *takaful* operators in which the operators pay certain amount of contributions into the *re-takaful* fund in order to share a certain defined risk in a specified category if these exceed prudent underwriting limits. Item 2/1 of *Shari'ah* Standard No. 41, AAOIFI 2010 defines Islamic re-insurance (*re-takaful*) as:

> "… the agreement among insurance companies, on behalf of the insurance funds under their management, to devise a mechanism for avoidance of part of the risks which the insurance funds may encounter. On the basis of such agreement, a re-insurance fund which has a distinct legal personality and independent financial liability is formed through making contributions out of the insurance funds paid by the insurance clients on the basis of donation. The re-insurance fund thus formed, assumes the task of covering part of the risks encountered by the insurance funds."

Obviously, the present *re-takaful* industry is very small and mainly dominated by very large conventional re-insurance companies. There are only a few *re-takaful* operators, and these are considerably smaller and operate only at national and regional markets. The process of sharing the insured risk between the *takaful* operator and other conventional insurance companies is either due to lack of sufficient insurance capacity for such risk, or because of regulatory requirements of risk-sharing with regard to the magnitude of the risk in question. This poses an issue that the re-insurance process as executed by conventional re-insurance companies may not observe the *Shari'ah* principles of *takaful*.

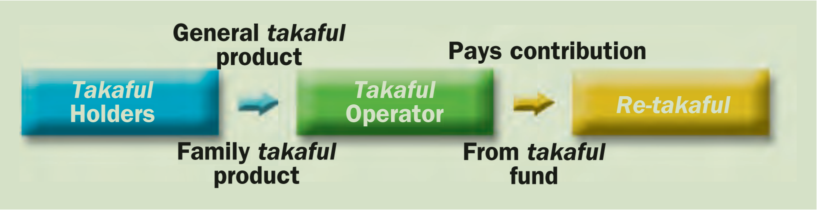


Figure 12.11
Re-*takaful* Arrangement

Methods of *Re-Takaful*

Re-takaful currently adopts two main methods, namely, facultative and treaty. Facultative method is affected only in special cases and placed on an individual risk basis, e.g., individual family, group family or mortgage *takaful*. The second method is treaty in which the *takaful* operator agrees to cede during a specified period, and the *re-takaful* operator agrees to accept all risks included within the terms of the *re-takaful* contract up to a specified amount.

Both methods are acknowledged by Item 4 of *Shari'ah* Standard No. 41, AAOIFI 2010 which provides that *re-takaful* can use one of the following methods:

In the facultative method, the *re-takaful* operator may accept or decline any offer from the *takaful* operator that wants to cede its risk to the *re-takaful* operator. Prior to that, the *re-takaful* operator must first study the *takaful* operator's application and information so that the *re-takaful* operator becomes committed to what it accepts.

1 Selective method (facultative): the operator presents the individual risk which constitutes the subject matter of *re-takaful* to the *re-takaful* operator along with a summary of all the information related to it, so that the *re-takaful* operator can study the information and decide whether to accept the risk or not. The *re-takaful* operator becomes committed to what it accepts.

   Facultative method is a type of *re-takaful* for individual policy or risk. This arrangement can be on a proportional basis, which is the original form, or non-proportional basis. Facultative means "optional", i.e., the power to act according to a free choice. So, the facultative underwriter of a *re-takaful* operator is free to accept or decline any offer from a *takaful* operator that wants to cede its risk to such *re-takaful* operator.

   Example of facultative *re-takaful* operation:

• Risk	70% retained by TO	30% placed facultatively to RTO
• Contribution	70% retained by TO	30% paid to facultative RTO
• Loss	70% paid by TO	30% paid by facultative RTO

   Note:
   TO – *Takaful* operator
   RTO – *Re-takaful* operator

2 Comprehensive method (*re-takaful* agreement/treaty): the *re-takaful* operator assumes the commitment to accept all the risks which fall within the scope of the agreement signed with the *takaful* operator.

There are four ways of applying the treaty method:

1 **Quota share**: When the *takaful* operator and *re-takaful* operator share each and every risk proportionately on the original terms and conditions.

2 **Surplus**: When the *takaful* operator by arrangement with the *re-takaful* operator cedes only that portion of each and every risk which it does not like to retain in its own account.

3 **Excess of loss**: When a *takaful* operator bears all claims arising to a specified amount and only when this ultimate net loss (after taking into account all recoveries) exceeds this amount, can they recover from the re-insurer up to a specified maximum. In this case, there is no proportional sharing of risk between the *takaful* operator and the *re-takaful* operator.

4 **Stop loss**: The *re-takaful* operator will not be responsible for any loss, big or small, until the loss ratio for the year reaches an agreed percentage of the premium.

Table 12.3 Comparison between Facultative and Treaty Methods of *Re-Takaful*

Facultative	Treaty
• Not an automatic cover	• Automatic cover
• Optional – *re-takaful* operator can accept or decline	• Obligatory – *re-takaful* operator must accept valid cessions
• Single risk – may be grouped together in a cover	• Many risks – portfolios may include thousands of risks
• Full details – must be disclosed with each placing	• No details – except special cases

Source: Nor Azman Nusi, 2009, MNRB Re-*takaful.*

Shari'ah Opinions on *Re-takaful*

Item 3/2 of *Shari'ah* Standard No. 41, AAOIFI 2010 provides that *takaful* operators are not allowed to re-insure with conventional re-insurance companies, except when such re-insurance is sought as a transitional arrangement stemming from public need which amounts to necessity. The basis for such permissibility includes:

Takaful operators are not allowed to re-insure with conventional re-insurance companies, except when such re-insurance is sought as a transitional arrangement stemming from a public need which amounts to necessity.

1 Such a re-insurance coverage is based on a legal maxim which is consistent with the *hadith* stating that *"No harm and no reciprocal harm"*. This is also affirmed by the principles of Islamic *fiqh* which stipulate that coverage should be for the actual harms and not at all for making wealth out of it.

2 The re-insurance agreement embodies the *tabarru'*, or donative nature, of a *takaful* contract.

3 It is endorsed by the *fatwas* issued by competent bodies such as *Fatwa* No. 3 of the 10th Seminar of Al-Barakah and the *fatwas* issued by the *Shari'ah* boards of Islamic banks and insurance companies, e.g., the *fatwa* issued by Faisal Islamic Bank of Sudan (*Fatwa* No. 5/3).

As such, the practice of *takaful* operators to re-insure with conventional re-insurers is permissible with certain conditions. Sheikh Wahbah Al-Zuhaily also concurred with the *fatwa* which ruled that re-insurance is valid since it satisfies a need that cannot be satisfied otherwise, as determined by the banks' experts. However, the ruling is conditional on the following stipulations:

1 That payment to re-insurance companies be kept to the minimum possible amount to satisfy the need, following the rule: "Necessities are measured by their degree." The evaluation of the amount needed to satisfy this need is left to the bank's experts to determine.

2 That the *takaful* operator does not collect a profit commission, or any other commission, from the re-insurance companies.

3 That the *takaful* operator does not keep any reserves with the re-insurance company for natural (heavenly) disasters, since keeping such reserves would lead to interest payments to the re-insurance companies.

4 That the *takaful* operator should not be involved in determining the investments of the reinsurance companies. It should not demand any share in the profits they gain from such investments, nor ask about any losses they incur.

5 That the contract with the re-insurance company be for the shortest possible period.

6 That the *takaful* operator works towards the establishment of a *re-takaful* operator that would allow it to avoid dealing with conventional re-insurance companies.

Takaful operators must work towards the establishment of a strong *re-takaful* operator that would allow them to avoid dealing with conventional re-insurance companies.

In addition, Item 6 of *Shari'ah* Standard No. 41, AAOIFI 2010 provides certain guidelines to the *takaful* operator which re-insures with conventional re-insurance companies. Those conditions are:

1 *Takaful* operators should re-insure first with *re-takaful* operators, to the largest possible extent.

2 *Takaful* operators should not keep any cash reserves for ongoing risks that belong to conventional re-insurance companies and on which interest has to be paid. Nevertheless, an agreement can be reached between the *takaful* operator and the conventional re-insurance company in order to specify a certain portion of the premiums payable to the conventional re-insurance company to be retained by the Islamic insurance company.

3 The *takaful* operator can invest retained funds through *mudarabah* or investment proxy, where the *takaful* operator assumes the role of the *mudarib* and the conventional re-insurance company assumes the role of *rabbul mal.* When profit is distributed as per the ratio agreed upon, the share of the conventional re-insurance company is to be added to its account with the *takaful* operator, whereas the share of the profit earned by the *takaful* operator for performing the investment as an independent personality is to be added to the account of the participants.

4 The periods of the re-insurance agreements sought by *takaful* operators from conventional re-insurance companies should commensurate with the actual need.

5 Before signing agreements with conventional re-insurance companies, *takaful* operators should seek the approval of their *Shari'ah* boards.

6 *Takaful* operators should stick to the minimum size of re-insurance with conventional re-insurance companies, and *Shari'ah* boards should undertake the follow-up in this matter.

It is important to note that, while in the previous years, there were only a few active *re-takaful* operators in the global *re-takaful* market, which was the reason why most *takaful* operators did primarily cede to re-insurance companies based on the *darurah* principle (necessity allows what is prohibited), that is not the case in the present day. There is significant increase in multinational *re-takaful* operators with a strong capital base and financial ratings in the market. Therefore, the exemption may need to be reviewed. In fact, this is also based on the maxim, "harm is measured by its degree". So, if harm is able to be minimised or removed, then resorting to prohibited things based on *darurah* is no longer permissible.

In the present day, there is a significant increase in *re-takaful* operators with a strong capital base and financial ratings in the market. Therefore, the principle of "*darurah*" (necessity) may not be applicable based on the maxim, "harm is measured by its degree". If harm (inexistence of *re-takaful* operator) is able to be minimised or removed, then resorting to prohibited things (conventional re-insurance companies) based on *darurah* is no longer permissible.

The IFSB in Item 91 of Guiding Principles on Governance for *Takaful* (Islamic Insurance) Undertakings (2009) states that:

> "*Takaful* operators shall ensure that any *re-takaful* arrangement duly serves the purpose of the *takaful* undertakings and is undertaken with the interests of *takaful* participants as the foremost consideration. The pricing and protection offered by the *re-takaful* operator shall be consistently reviewed from time to time to ensure that it commensurates with the needs and requirements of the *takaful* undertakings. As far as possible, *takaful* operators should strive to use *re-takaful* operators, rather than conventional re-insurers, in support of a fully *Shari'ah*-compliant financial system for the *takaful* undertakings."

Challenges in the *Re-Takaful* Industry

In view of its relatively new presence in the market, *re-takaful* faces five challenges identified as follows:

Challenges of the *re-takaful* industry:
- Limited capacity
- Competition
- Lack of rating
- Lack of expertise
- Lack of transparency in reports

1 **Limited Capacity**: The current scenario shows that existing *re-takaful* is inadequate to meet the needs of *takaful* operators. Therefore, it needs national will and efforts to establish more re-*takaful* operators with sufficient funds to support the needs of *takaful* players today.

2 **Competition**: *Re-takaful* faces certain constraints to stay competitive in terms of *Shari'ah*-compliance. *Re-takaful* must therefore find its own way to increase its competitive advantage.

3 **Lack of Rating**: Very few *re-takaful* operators get a minimum of A-rating. Thus, *re-takaful* operators need to strengthen their financial condition and improve underwriting practices to achieve a good rating.

4 **Lack of Expertise**: This is a major weakness of the industry in terms of asset management, underwriting, accounting and marketing staff. It is proposed that re-*takaful* providers develop proper educational tools and conduct continuous staff training.

5 **Transparency in Reports:** Globalisation requires the standardisation of accounting methods, management and corporate governance. *Re-takaful* operators must have a great respect for the ethical aspect in operations.

Section 3: Issues, Opportunities, and Challenges

Shari'ah Issues in *Takaful*

Despite the *takaful* industry expanding at an exponential rate, and with a few models developed reflecting its versatility, there are still some *fiqh* issues which some Muslim jurists have raised. The fact that *takaful* operation differentiates itself on the premise of *tabarru'* rather than premium, this raises some *fiqh* discussions. The nature of donations has been viewed with scepticism by some Muslim scholars as it is supposed to be a unilateral rather than bilateral contract, unlike the conventional insurance contract. Consequently, it is argued that if a claim is made because one has made a donation, then this changes the nature of the *takaful* transaction into one of a bilateral contract of exchange because the claim is based on the donation made. Hence, this type of transaction will be considered as an "*'aqd al-mu'awadah*" (contract of exchange) which then attracts *riba*, *gharar* and *maysir* because money is exchanged for money and also the quantum of money paid as premium or compensation paid are unknown (this will cover for *gharar* and *maysir*). Another concern is if *tabarru'* and joint-guarantee are unilateral contracts, how can these be demanded and claimed legally? The Malikis view of giving a binding force to a promise *(wa'd)* is used. This raises the validity of such promises in commercial transactions. The answers given by the Muslim scholars who endorse *takaful* transactions to those concerns are:

1 Firstly, it is argued that the *takaful* agreement is an *'aqd al-mu'awadah* because there is still a contractual nexus between the donation and the compensation one receives from the fund. As the compensation is claimable, it is thus argued that it is a bilateral contract, or a contract of exchange. Hence, the money received from the pool may still contain *riba* (interest) and *gharar*

(uncertainty). The famous legal maxim "*al-ibratu bi al ma'ani la bi al-alfaz*" (one should look at the end result of a contract and not at its wordings) is used to back up this objection. That is, one can name the money given to the insurance company as donation or contribution but in fact it is a premium because the participants are still being indemnified on that basis. It is a question of form over substance. Practically, the donation is similar to the premium the way it is calculated and enforced in the conventional insurance industry. So the burning question is, how can these voluntary acts of donating a *tabarru'* qualify as an obligation?

The answer given by those endorsing the *takaful* transaction is that the principle of obligating voluntary acts is from the *Shari'ah* principles adopted by the Maliki *Madhhab*. Allamah Hatab has compiled the *Masail* of undertakings in his book, *Tahreerur Kalam fi Masail Iltizam.* Imam Hatab says: "That which is known of the Madhhab of Imam Malik and all of his companions in regards to a person who obligates something upon himself, then that ruling will be applied to him as long as he does not pass away or become insolvent." Based upon the Maliki principles of jurisprudence, the payment of contributions from the members will be considered as *iltizam bi al-tabarru'* (self-imposed donation) based on this principle because it is from one side (unilateral); therefore it is not a contract of exchange (*'aqd al-mu'awadah*). Similarly, the payment of compensation from the *takaful* operator in the event of a calamity in conformity to the principle will be considered as *iltizam bi al-tabarru'* from one side and there is no inter-relation of one *iltizam* to the other.

The participants' contributions are considered *iltizam bi al-tabarru'* (self-imposed donation); whereby the payment of compensation from the *takaful* operator in the event of a calamity is similarly considered as "*iltizam bi al-tabarru'*" on behalf of the other participants.

2 Secondly, the issue of *wa'd* (promise) has also been questioned by many scholars. They argue that if a *wa'd* is a not a contract, why should it be taken as a contract so that a contractual claim may arise? The same answer given above has been used to answer this objection, it is a unilateral promise which is binding. This is analogous to the English law whereby if a promise is made under a deed, it will be binding. A self-imposed promise is enforceable according to the Maliki School of Law. The issue that a promise is legally binding was resolved in the year 1409 by the Islamic *Fiqh* Academy.

3 The third issue raised is that *gharar* (excessive uncertainty) still persists in *takaful*. For instance, one does not know exactly when the risk will materialise for which he or she is making a *tabarru'*. Here, the answer lies in the question of quantifying the extent of *gharar*. Many scholars have argued that *gharar yasir* can be calculated and thus it will be tolerable. Also, they argue in favour of a non-zero sum game theory, in that if the *gharar* is not a win-lose situation, i.e., only one winner and one loser, then it will be acceptable. In the case of a *takaful* transaction, it can be argued that there is *gharar yasir* or no *gharar* at all

The issue of uncertainty (*gharar*) in *takaful* is tolerable because of the unilateral contractual nature of *tabarru'* and joint guarantee among all *takaful* participants.

because of the unilateral contractual nature of *tabarru'* and joint guarantee. The legal maxim used is that "uncertainties are tolerable in the gratuitous contract". Others argue that the real issue is not that of *gharar* but that of *ghurn* (effort to justify a counter value in the transaction).

Underwriting surplus should remain in the fund as reserves because:
1 It will be used to pay claims in the following years if there is deficit in the fund
2 The subsequent contributions can be reduced
3 The contribution reduction and pricing will make *takaful* more competitive.

4 Fourthly, there is the issue of underwriting surplus. Technically, the bulk of the money in the fund is due to no claims from the donations. So can one take his own donation back or is one allowed to share it as a profit? Different views exist to this question. The most commonly held opinion is that the money should remain in the fund as reserves for three reasons:

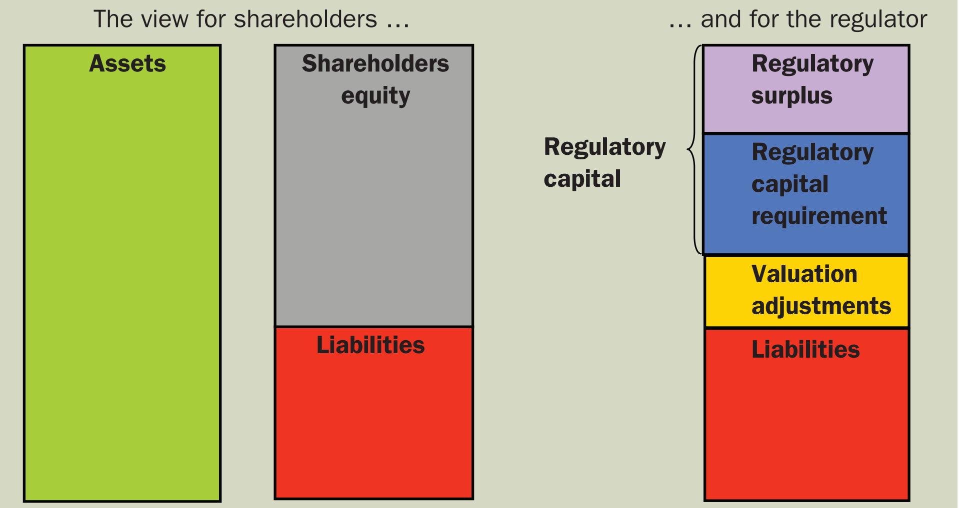
(a) it consolidates the fund for the following year to pay claims.

(b) the subsequent contributions can be brought down due to that reserve which means less financial burden on the participants regarding their contributions.

(c) the drop in the pricing makes the *takaful* industry more competitive.

5 The fifth point is the concern that *takaful* allows for a contract of indemnity in a *mudarabah* model. So have we really resolved the issues against the contract of *takaful* being a contract of indemnity? The same argument will apply that this is not an indemnity but a mutual help among the participants.

Capital Adequacy Ratio and Solvency



Source: Casey, 2009:196.

Figure 12.12
The Relationship between Shareholders' Surplus and Regulatory Surplus

The terms capital adequacy ratio and solvency ratio are often used interchangeably. Solvency or capital adequacy ratio is a form of prudential regulation aimed at ensuring that regulated entities operate safely and soundly. The essence of the solvency test is a comparison between an institution's capital (the excess of its assets over liabilities) and a required minimum amount. Regulators want to ensure that *takaful* operators are able to meet their liabilities. In doing so, there should be regular assessment of their risk profile. The assets and liabilities are measured according to a prescribed valuation, which may differ depending on accounting rules. This determines the extent of solvency.

Solvency is needed because:

1 It creates a level of confidence in the market for people to take economic risks.

2 It helps in preventing big enterprises needing *takaful* cover from collapsing, which may have a domino effect in the economy if such risks are not mitigated.

3 It helps redressing the imbalance due to information asymmetry that exists in the retail financial markets between retail financial institutions and consumers by reassuring them that financial institutions are safe.

4 Solvency margin buys time. The solvency requirements provide some comfort to consumers regarding the risks which materialise over long periods and can be dealt with by insurance companies.

Solvency requirements affect *takaful* operators due to the way *takaful* operators' capital is construed for risk management. Capital is treated as residue, according to an accounting theory, representing the difference between the assets and the liabilities. Current international thinking is that in modern insurance regimes, it should be made explicit that the undertaking should be given probability of meeting all its liabilities over a defined period (such as 99.5% over a year). Hence, the risk profile should be well gauged. It is in this spirit that the risk-based capital is being adopted as the new prudential regulation focusing on solvency issues. The essence of the solvency test is a comparison between an institution's capital (the excess of its assets over its liabilities) and a required minimum amount. To this end, what the regulator considers to be an asset may be different from what the accounting standards consider, hence adjustments are needed.

Solvency requirements affect *takaful* operators due to the way *takaful* operators' capital is construed for risk management. Capital is treated as residue, according to an accounting theory, representing the difference between the assets and the liabilities.

The regulator aims at reducing the amount available for surplus and fits in the true regulatory surplus which would only be the amount by which the available excess of assets over liabilities exceeded the required margin of solvency or regulatory requirements.

A *takaful* operator consists of a two-tier structure, which is a hybrid of a mutual and proprietorship company.

A *takaful* operator consists of a two-tier structure which is a hybrid of a mutual and proprietorship company. The issue is that there will be two funds, a shareholders' fund and a participant fund where the *tabarru'* goes. In order to ensure that the solvency requirements are being met, the devise of *qard* (benevolent loan) from the *takaful* operator or shareholders' fund to the participants' risk fund has been suggested. This nevertheless has its own *fiqh* issues that need to be addressed, such as forcing the *takaful* operator to make available a benevolent loan. It is suggested that the *wa'd* (unilateral promise) mechanism can be used to resolve some of the *fiqh* issues in this line. Therefore, as far as solvency is concerned, the *takaful* operator should hold enough capital to cover up for any *qard* needed to supplement the participant fund required if there is deficiency of any reserves for that purpose. Thus, the participants' claim would rank above any *qard* in case of insolvency.

To manage the solvency issue, the IFSB has suggested some standards in its *Standard on Solvency Requirements for* Takaful *(Islamic Insurance) Undertakings* (December 2010). You can refer to the five key features discussed in the abovementioned IFSB documents.

The risks to which *takaful* funds are exposed are discussed next. Based on these risk exposures, some mathematical formulae have been suggested to calculate them, both for the participant risk fund and the shareholders'*takaful* fund. Risks faced by the respective funds in a *takaful* undertaking are described in Table 12.4. As can be seen, more risks can be attributed to the personal risk fund (PRF).

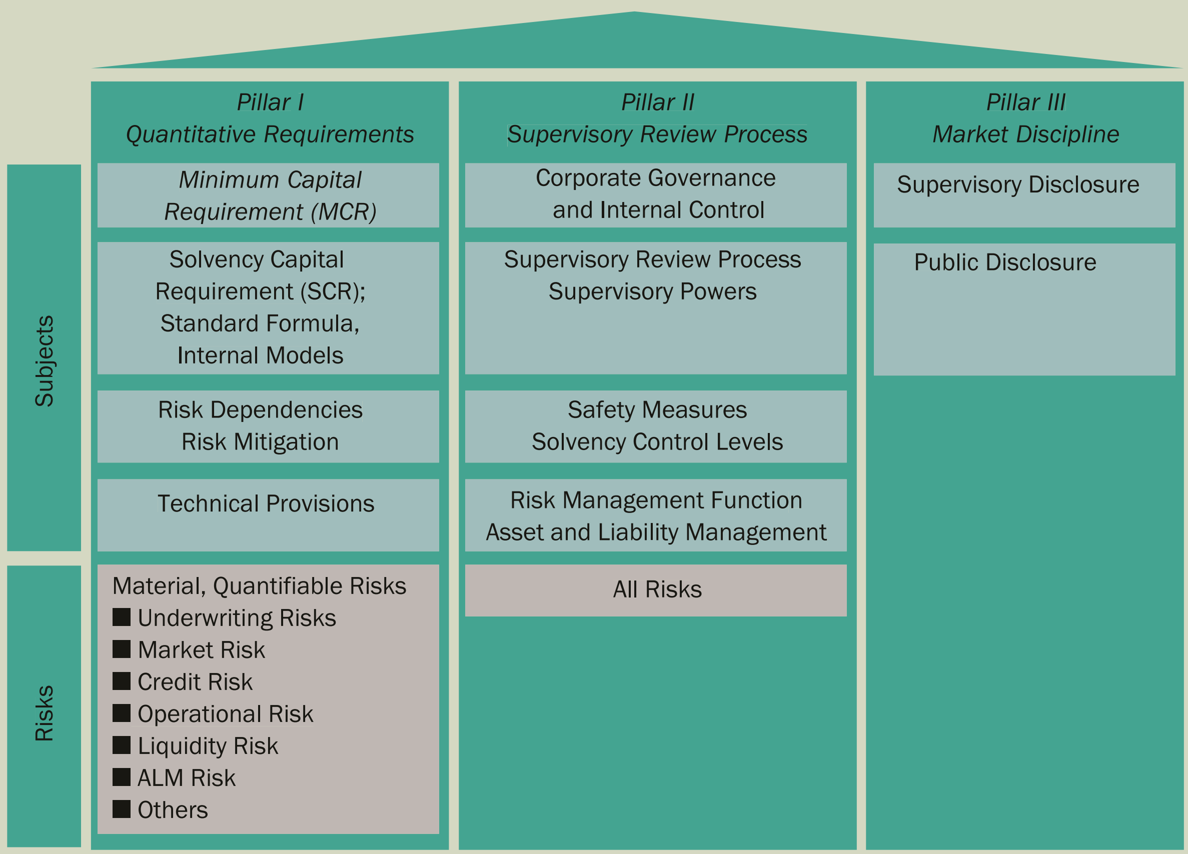
The underwriting surplus transferred to reserves forms part of equity. There are two main issues with regard to a *takaful* fund. Firstly, the *takaful* operator accepts *tabarru'* into the *takaful* risk fund which is owned by the participants themselves and secondly, *tabarru'* is treated as capital because it is the participants' money. So what should be used as a buffer to absorb loss? Should it be the shareholders' capital or the participants' funds? Therefore, the *qard* concept to be provided by the *takaful* operator seems to be the way out, provided it can be guaranteed.

Being a financial institution, *takaful* operators are bound to certain levels of financial regulation. The two main issues that need attention are the solvency ratio to ensure that they are not over-exposed to risk. Thus, the three pillar strategy of the European Solvency II suggestion as described in Figure 12.13 is a good inspiration for *takaful* operators.

Table 12.4 *Risks Faced by Takaful Funds*

Categories of Risk	*Personal Risk Funds (PRFs)*	Shareholders' Funds
Operational Risks The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. *Shari'ah* noncompliance risk should also incorporate possible causes of loss resulting from noncompliance and failure in the *takaful* operator's fiduciary responsibilities.	Loss of income from the purification of tainted income due to *Sharı'ah* rulings. Losses are due to claims fraud and legal risk (e.g., in court interpretations of policy terms).	Administration and acquisition expenses for developing and maintaining the *takaful* contracts. This relates to the business risks whereby the fund will not have adequate cash flow to meet the operating expenses. Also liable for losses arising from its negligence, misconduct or breach of fiduciary duties in the management of *PRFs* (fiduciary risk).
Liquidity Risks The potential loss to a *takaful* undertaking arising from its inability either to meet its oligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.	Additional costs through raising additional funds at a premium in the market or through the sale of assets which simultaneously affect the overall appropriate provisioning and reserving methodologies of *PRFs*.	Additional costs through raising additional funds at a premium on the market or through the sale of assets which simultaneously affect the overall appropriate capitalisation and reserves.
Provisioning and Reserving Risks The risk of underestimation of the underwriting liabilities and adverse claims experiences.	General *takaful* exposed to losses due to random events such as natural perils, fire, pollution, crime, war, terrorism, and others. Family *takaful* is exposed to losses arising from severity and frequency of claims due to changes in anticipated mortality, morbidity and longevity as well as catastrophic events such as epidemic, major accidents or terrorist attacks.	
Underwriting Management Risks The risks of poor management of accepting risk and claim payouts.	Family *takaful* and general *takaful* are exposed to losses arising from poor selection, pricing and acceptance of risk and inappropriate product design.	
Credit Risks The risk of a counter-party failing to meet its obligations in accordance with agreed terms.	Exposed to profit and capital receivables from invested assets. *Takaful* contributions receivable and *re-takaful* recoveries.	Exposed to risk of non-receipts of profit and capital receivables from invested assets. *Wakalah* fee (due to contributions receivable) and other trade debtors[20]
Market Risks The risk of losses arising from movements in market prices, i.e., fluctuations in values in tradable, marketable or leaseable assets (including *sukuk*) and a deviation of the actual rate of return from the expected rate of return.	The risks relate to the current and future volatility of market values of specific assets (for example, the commodity price of a *salam* asset, the market value of a *sukuk*, the market value of assets purchased to be delivered to a *murabahah* customer over a specific period, the market value of *ijarah* assets) and of foreign exchange rates.	The risks relate to the current and future volatility of market values of specific assets (for example, the commodity price of a *salam* asset, the market value of a *sukuk*, the market value of assets purchased to be delivered to a *murabahah* customer over a specific period, the market value of *ijarah* assets) and of foreign exchange rates.

Source: IFSB Standard of Solvency, Draft Exposure.



Source: Capgemini 2006.

Figure 12.13 Three-Pillar Strategy of European Solvency II

Underwriting

Underwriting is a process that enables a *takaful* operator to choose whether to accept a specific risk or not. The main aim is to provide an equitable and fair risk-sharing scheme amongst participants that are relatively homogenous in nature.

Underwriting is a fundamental aspect of covering risk. It is a process that enables an insurance company or *takaful* operator to choose whether to cover a specific risk or not. Underwriting helps to create a portfolio, the *takaful* operator generates charges, it helps in selecting which risk to take on board and it also ensures *Shari'ah* compliance with regard to the risk taken and also protecting the *takaful* fund. *Takaful* underwriting aims to provide equitable and fair risk-sharing schemes amongst participants that are relatively homogenous in nature.

Muslim scholars have expressed some reservations regarding some risks being covered. For instance, it is argued that if someone suffers from AIDS (i.e., the patient is HIV positive) he cannot be underwritten because his risk profile is high and also due to the high probability that he or she has fallen prey to a disease that could have been caused by illicit sexual intercourse. Islam does not endorse illicit sexual intercourse and covering such risk might pollute the fund. This is a debatable issue because the law of the land may not allow such discrimination. In countries like South Africa, discrimination is not allowed due to Section 9 of the constitution which does not allow unjustified discrimination.

Another case would be the coverage for partners rather than spouses. In the UK for instance, *salam* insurance allowed such a provision due to the law of the land that does not allow discrimination based on sexual orientation. However, Malaysia will not accept underwriting with such a condition. Other scholars have also raised issues with regard to women in the case of murder, arguing that the *diyah* is less. Under modern legislation this will not be allowed, and also the case of *takaful* need not necessarily be based on Islamic criminal law for analogical deduction.

The risks to be underwritten can fall either under family or general *takaful* (this is analogous to the long-term and short-term insurance underwriting respectively). In the case of family *takaful,* the following risks are usually underwritten: death, permanent disability, hospital and surgical cost and surrender.

Family *takaful* usually underwrites risks related to death, total and permanent disability, critical illness, hospital and surgical cost, and so on.

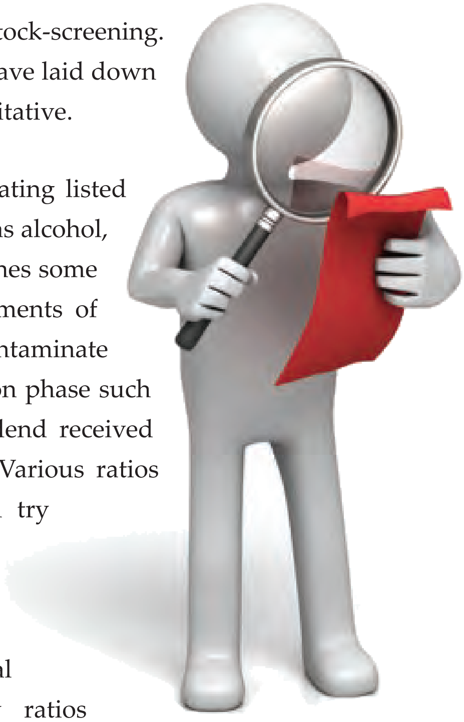
In the case of general *takaful,* there are many risks that are underwritten. However, the two main risks covered are fire and motor. In the case of fire, the factors influencing the underwriting are the construction, occupation of the insured, location and access to it. With regard to motor *takaful,* the factors influencing the underwriting are model of the car, its year of manufacture, age of drivers, location of car, colour and access. The age of a driver can in turn affect high fine which impinges on the underwriting premium to go up.

Consumer Perception

Despite having advantages that make *takaful* a better option in the eyes of consumers, the customers seem to perceive *takaful* to be closely similar to conventional insurance in respect of getting protection, but hardly understand the nature of the contract and relationship among the parties. A segment of them would prefer *takaful* due to religious reasons, but the majority of them still consider the service quality as the most important patronage factor. This factor includes giving adequate explanation on the plan, offering the plan which is really needed, reasonable amount of premium payment, and most importantly, the company's efficiency in processing and paying claims.

Investment Management

The different models of *takaful* influence the investment policy of *takaful* operators. The point remains that investment of the contributions can be broadly categorised into two main streams: those meant for covering individuals and those meant to build up the fund. Not many *halal* avenues exist for investing the contributions. The main ones are stocks, *sukuk* and infrastructure financing.



Currently, there is no international standard for stock-screening. However, what is apparent is that *Shari'ah* scholars have laid down two levels of screening: the qualitative and the quantitative.

The qualitative screening procedure aims at eliminating listed companies with core businesses that are *haram* such as alcohol, pork, and so on. The quantitative procedure establishes some ratios to be observed in order to mitigate the elements of *riba* or other forms of *haram* elements that may contaminate the portfolios. This is often followed by a purification phase such as getting rid of the *haram* element from the dividend received or capital gains and also to pay *zakat* if need be. Various ratios are used by different indices and companies. All try to bring in an element of toleration for some *haram* income that may contaminate the fund. These ratios focus on establishing a tolerance ceiling in terms of percentage for debt over total asset, *haram* income to total income, liquidity ratios and so on.

In Malaysia, the Securities Commission's guidelines can be considered to be an amalgam of both the qualitative and quantitative criteria for the screening of shares. However, their focus has been on the types of industries under which companies are being listed. The importance of companies falling within the ambit of each industry will be considered depending on the extent of importance of that industry for the economy. There are also the different indices having different criteria for the quantitative analysis such as the FTSE Islamic Index compared to the Dow Jones Islamic Market Index. The reason for those differences is mainly because the buying and selling of shares is an area of *fiqh* that demands some sort of *ijtihad* and also due to the volatility of the stock market which often affects the portfolios of shares, depending on the ratios used.

Regarding family *takaful*, one may look into long-term investment or financing such as *sukuk* or even infrastructure financing which yields in the long run. However, this type of investment should be viewed in light of the solvency ratio and other jurisdictional regulatory limitations on investment.

It is observed that the investment in shares is more pronounced among the Gulf Corporation Council (GCC) *takaful* operators. In Malaysia, under the family *takaful* funds, about 45.4% of funds are invested in Islamic securities and equities, 33.2% in investment accounts and Islamic market and 8.5% in government Islamic papers. In the case of investment-linked *takaful* and investment-linked insurance with *Shari'ah*-approved securities, the bulk of investment is in equities.

Regarding investment in *sukuk*, although AAOIFI disapproved non-asset-backed *sukuk*, *takaful* operators will not enjoy such facilities as in the case with equities. In the case of family *takaful* funds, an interesting development for investment is the infrastructure financing which provides long-term return.

Corporate Social Responsibility

Takaful operators are encouraged to be involved in corporate social responsibility (CSR) activities in order to maintain a good corporate reputation which adds to the "reputational capital". It is believed that corporations may become profitable in the long run, since market forces provide financial incentives for such perceived socially responsible behaviour.

In some jurisdictions, *takaful* operators are very committed to CSR activities such as giving scholarships, activities related to environmental issues, giving cash contributions, building homes for the underprivileged, and building canteens and hostels for the community. In Malaysia, some CSR activities and social events done by companies are tax-exempt.

In addition to CSR, an Islamic institution is also expected to pay *zakat*, but there is no such tax exemption for *zakat* payment by institutions. As a result, these companies have to double-pay, i.e., *zakat*, which is imposed by *Shari'ah* on an Islamic entity and tax, which is imposed by the government. This double-pay issue may impede the company's profit and competitiveness. For this reason, some companies, for example Etiqa Takaful (Malaysia) gives contribution via corporate *zakatable* responsibility (CZR) in which such payment is taken from *zakat* proceeds and channelled to social activities involving *zakat* recipients, such as single mothers, orphans, students, the disabled and the extremely poor. With CZR, the company fulfils both obligations prescribed by *Shari'ah* as well as the government. It is, however, important for the department of *Shari'ah* Advisory to monitor the activities so that such events are held within *Shari'ah* limits to ensure its permissibility in the company's operation.

Corporate *zakatable* responsibility (CZR) is a social activity undertaken by certain *takaful* operators in which *zakat* proceeds are channelled to social activities involving qualified *zakat* recipients.

The Way Forward

The promising trajectory of the *takaful* industry is imminent from the projections made. This will most definitely entice other players to join in, such as opening of *takaful* windows, creation of retro-*takaful* in the future, etc. However, the most important factors for successful operations are the transparency of operations, the establishment of *Shari'ah*-compliant products and robust *Shari'ah* supervisory boards that guide product design and ensure *Shari'ah* compliance.

Another concern is the need to produce more Muslim actuaries who understand the products and the markets. Experts in the field have indicated this shortcoming. The development of actuaries focusing on *takaful* is important because they play a role in determining the pricing. The contributions should be invested in appropriate channels to meet both general and family *takaful* claims but the spectrum of financial instruments for investments is limited for *takaful* operators. There is a need for more investment products.

The key challenge for the *takaful* industry is to improve efficiency and to reach critical mass in order to benefit from the economies of scale that are currently the privilege of only a handful of players. It is hoped that these will be met with the expansion of the market and proper regulation.

Summary

1 This chapter introduced the main conceptual framework of the *takaful* industry and the important issues needed for its proper functioning.

2 Historical development and differences between *takaful* and conventional insurance have been highlighted.

3 The models of *takaful* are based primarily on *tabarru'* (donation) which is a way out to mitigate *riba* and *maysir*. However, with regard to *gharar*, a complete elimination is difficult to achieve in the *takaful* industry. But as long as this falls within the ambit of *gharar yasir* (minimum level), it will be accommodated by the *Shari'ah*.

4 The chapter explained that insurance in Islam should be based on the principles of mutuality and co-operation because the Islamic system of insurance embodies the elements of shared responsibility, joint indemnity, common interest, solidarity, and so on.

5 This chapter also touched upon the regulatory issues of *takaful* industry. Some countries such as Bahrain, Pakistan and Malaysia have developed sound regulatory framework for *takaful,* but there is still much to be done in countries like the UK and France, since they have no specific standard for the *takaful* industry.

Key Terms and Concepts

Participants' Investment Account (PIA)
Participants' Risk Account (PRA)
Takaful
Takaful Operator
Underwriting Surplus or Deficit
Corporate Governance
Stakeholders
Takaful Fund
Takaful Undertakings
Mudarabah
Provisions
Tabarru'
Takaful Participants
Wakalah

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Review Questions and Problems

1 Explain the legal and *Shari'ah* position regarding the capacity of *takaful* participants.

2 Elucidate the contracts among *takaful* participants.

3 List the rights and duties of a *takaful* operator in a modified *mudarabah* model.

4 Compare the *wakalah*, *mudarabah* and *waqf* models of *takaful* in terms of operations, investment and surplus distribution. Which model is more effective, cooperative and in line with *maqasid al-shari'ah?*

5 Describe the nature of the relationship between the *takaful* operator and participants.

Problems

Ismail, an independent auditor is engaged to audit the operational aspect of Takaful Ihsan Co. He randomly selects one *takaful* policy, and discovers the following issues:

1 One participant, Ibrahim nominated Iffah, whom he is about to marry.

2 Ibrahim did not state that he is a heavy smoker.

3 Provision that Takaful Ihsan will deduct certain portions of the contributions for *re-takaful* in Selamat Re-Insurance Co.

4 Provision on share of surplus:

(a) If there is any, Takaful Ihsan will give 10% of the surplus to Ibrahim as *hibah*; or

(b) If the surplus is very small, Takaful Ihsan will give it away as charity.

5 No provision on *zakat* payment.

Ismail comes to you to seek your expert opinion on the issues stated above. As a *takaful* consultant, advise Ismail in respect of *Shari'ah* and operational issues for the purpose of *Shari'ah* auditing of Takaful Ihsan.

Part 4

Risk Management Principles and Mechanisms for the Islamic Financial System

Chapter 13

Principles and Best Practices of Risk Management

Preview

This chapter will provide an introduction to the concepts related to risks and principles of risk management. It will also outline the basic approach to risk management from an Islamic perspective and identify issues and challenges related to risk management in Islamic financial institutions. The financial institution's main activity involves current commitment of funds for a period of time to derive future returns, and risk is an integral component of its business. As Islamic finance is relatively new, the risks inherent in the instruments used are not well comprehended. Islamic banks are expected to face two types of risks – risks similar to those faced by conventional financial intermediaries and risks that are unique to them due to their compliance with *Shari'ah* rules and principles. Furthermore, Islamic banks are constrained from using some of the risk mitigation instruments used by their conventional counterparts as these are prohibited under Islamic commercial law. Risk management tools and mechanisms will be discussed in the next chapter.

Though all businesses face uncertainty, financial institutions face special types of risks given the nature of their business activities.

Learning Outcomes

At the end of this chapter, you should be able to:

- Understand the risks facing financial institutions.
- Understand Islamic perspectives on risk and its management.
- Have a sound understanding of the risks facing Islamic financial institutions.
- Understand the key issues and challenges of risk management practices facing Islamic financial institutions.

Introduction to Risk and Uncertainty

Uncertainty is inherent in activities involving the future. While risk can be defined as the "existence of uncertainty about future outcomes", a distinction can be made between its metaphysical and epistemological concepts. The metaphysical property of risk is "a reality that exists in its own right in the world" and the epistemological concept of risk is a "judgement made by a person or the application of some knowledge to uncertainty" (Althaus 2005: 568-69). Risk and uncertainty are central in economic analysis. Frank Knight distinguishes between risk and uncertainty. Risk relates to cases when objective or subjective probabilities can be assigned to potential outcomes allowing quantification. Uncertainty refers to cases of complete ignorance of any potential outcome, making quantification and rational decision-making impossible. The implication is that in the case of risk, the unknown can potentially be controlled by applying available knowledge. In uncertainty, the unknown is random and cannot be predicted or controlled.

Risk relates to cases when objective or subjective probabilities can be assigned to potential outcomes, allowing quantification.

Uncertainty refers to cases of complete ignorance of any potential outcome, making quantification and rational decision-making impossible.

Risk in economics and finance are classified in various ways. One way is to distinguish between business risk and financial risk. Business risk is due to the uncertainty arising from the nature of a firm's business. It relates to factors affecting the product market. Financial risk is the uncertainty arising from possible losses in financial markets due to movements of financial variables (Jorion and Khoury 1996:2). It is usually associated with the risk that obligations and liabilities cannot be met with current assets. The implication of risk of outcomes can be assessed by examining the *likelihood* and *impact* of the risk. The likelihood can be termed in probability terms. The impact can be measured as the total loss or value of assets lost. In the case of subjective risks that cannot be quantified, the categorisation of both likelihood and impact can be high, medium, or low.[1] Given the above, we can form the tolerability index as shown in Figure 13.1. It is apparent from Figure 13.1 that the risks that have high likelihood and impact are the ones that can be the most damaging to any organisation. The goal of the risk management process is to take corrective actions to reduce the impact and likelihood so that the residual risks can be brought within the tolerable loss range. The impact can be reduced by controlling the sources from which they arise and instituting limits to the exposures. For example, credit risk can be reduced by controlling the exposure to such risk by exercising due diligence to reduce the probability of default.

1 A more detailed scale like the 5 × 5 matrix can be used with indices of insignificant/minor/moderate/major/catastrophic for impact and rare/unlikely/possible/likely/almost certain for likelihood.

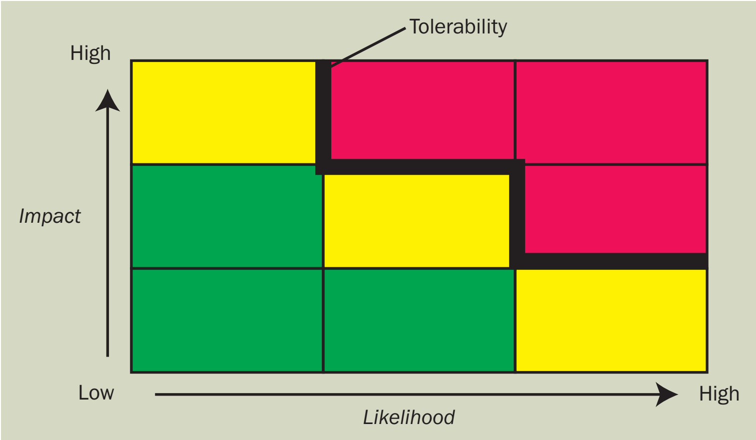
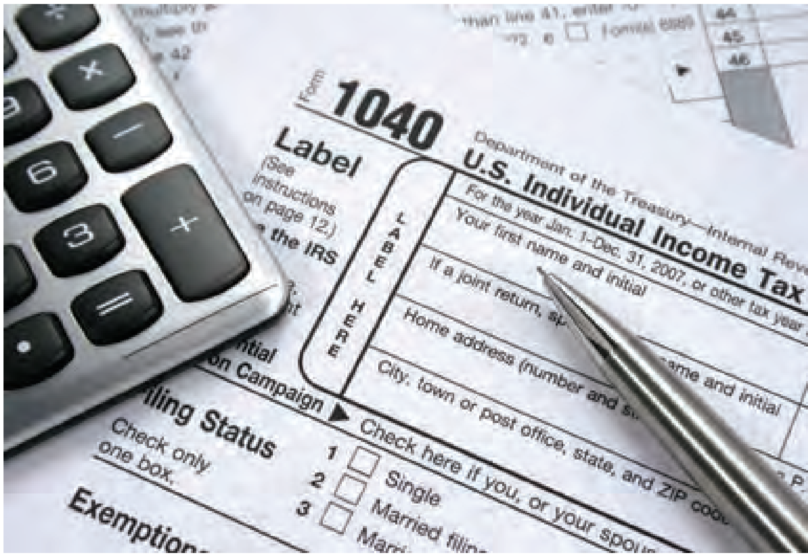


Figure 13.1
Risk Tolerability Matrix



Risk entails both vulnerability and opportunities. There are various costs associated with higher risk (volatility) of cash flows. These include higher expected bankruptcy costs (e.g., payments to lawyers, court costs, etc.), higher expected costs to corporate stakeholders, and higher expected tax payments. Successful firms are not those that reduce risks but those that take advantage of the opportunities offered by risk-taking. The objectives of risk management are first and foremost to reduce the volatility of income, cash flows, a firm's market value, return on equity and cost of borrowing. From the stakeholders' perspective, managing risks would involve firm value maximisation, elimination of costly lower tail outcomes, and maintaining a certain financial risk profile.

Though all businesses face uncertainty, financial institutions face some special types of risks given the nature of business activities. Risk management, according to Cumming and Hirtle (2001: 3), refers to "the overall process that a financial institution follows to define a business strategy, to identify the risks to which it is exposed, to quantify those risks, and to understand and control the nature of risks it faces". Damodaran (2005) distinguishes between risk reduction and risk management. While risk reduction is defensive and is used to protect firms from risk by using hedging, insurance and derivatives, risk management is about using the risk to an organisation's advantage by seeking it out to exploit uncertainty and risks through various proactive policies to create value. Risk reduction relates to utilising financial products to hedge against risk (e.g., using options, futures, insurance). Risk management is strategic and should be part of the corporate culture and strategy.

Risk management refers to "the overall process that a financial institution follows to define a business strategy, to identify the risks to which it is exposed, to quantify those risks, and to understand and control the nature of the risks it faces".

From a risk management perspective, risks facing financial institutions can be classified into three types: risks that can be eliminated, risks that can be transferred to others, and risks that can be managed by the institutions themselves. Financial intermediaries avoid certain risks by simple business practices and will not take up activities that impose risks upon them. The practice of financial institutions is to take up activities in which the risks can be efficiently managed and to shift the risks that can be transferred. The approaches and instruments that can be used for risk management are depicted in Table 13.1.

Table 13.1 Approaches and Instruments of Risk Management

Approaches Instruments	Avoid/Eliminate	Transfer	Absorb/Manage
Set Policy	X		X
Hedge/Sell	X	X	
Diversify	X		X
Insure	X	X	X
Hold Capital			X

Source: Adapted from Schroeck (2002: 40), with changes.

Risk avoidance techniques would include the standardisation of all business-related activities and processes, construction of a diversified portfolio, and implementation of an incentive-compatible scheme with accountability of actions.

Risk avoidance techniques would include the standardisation of all business-related activities and processes, construction of a diversified portfolio, and implementation of an incentive-compatible scheme with accountability of actions. Some risks facing banks can be reduced or eliminated by transferring or selling these in well-defined markets. Risk transferring techniques include, among others, use of derivatives for hedging, selling or buying of financial claims, changing borrowing terms, etc. There are some risks that cannot be either eliminated or transferred and must be absorbed by the banks. These risks are accepted by the financial institutions as they are central to their business and the banks are specialised in dealing with them. Examples of these risks are the credit risk inherent in the banking-book activities and market risks in the trading-book activities of banks.

Once a bank decides that it has a comparative advantage in taking certain risks, it has to determine the role of its risk management in exploiting this advantage. Note, however, that a firm's ability to undertake activities involving risk not only depends on its risk management policy, but also on its capital structure and general financial health. Risk management and capital are in some ways substitutes for each other in the protection against risks in financial exposures. When firms lower their risks by efficient risk management procedures, the requirement for capital is also reduced.

Islamic Perspective on Risk Management

The broad perspective on risk and its management are embodied in the overall goals of Islamic law or *maqasid al-shari'ah*. Chapra (2008a) quotes al-Ghazali in defining *maqasid* as promotion of "the well-being of the people, which lies in safeguarding their faith (*din*), their self (*nafs*), their intellect (*'aql*), their posterity (*nasl*), and their wealth (*mal*)". The principle of *maqasid* would imply taking all the precautions to safeguard present and future wealth. As risk in economics represents the probable loss of wealth, it is not desirable in itself from an Islamic perspective. While risks are not desirable on their own, they must be undertaken to create wealth and value. From an Islamic perspective, economic activities are not judged by their inherent risks, but by whether they add value and/or create wealth.

From an Islamic perspective, economic activities are not judged by their inherent risks, but by whether they add value and/or create wealth.

In line with the above discussion, Hassan (2009) identifies three types of risks from the Islamic perspective. First, is the *essential* risk that is inherent in all business transactions. This business risk is necessary and must be undertaken to reap the associated reward or profit. Two legal maxims associating returns to essential risks form the basis of Islamic economic transactions. The first maxim states "the detriment is as a return for the benefit (*al-ghurm bil ghunm)*" (Majalla Art. 87). This maxim attaches the "entitlement of gain" to the "responsibility of loss". This maxim is usually used to propose the preference for profit-and-loss-sharing (PLS) financing instruments. The second maxim is derived from the Prophetic saying "*al-kharaj bil daman"* stating "the benefit of a thing is a return for the liability for loss from that thing" (Majalla Art. 85). The maxim asserts that the party enjoying the full benefit of an asset or object should bear the risks of ownership. Note that linking returns to risks of ownership does not necessarily relate to PLS contracts. The principle points out the risks related to ownership associated with sale and leasing transactions. For instance, the implication for a sale-based transaction is that the seller must bear all the risks associated with the object of the sale, and in a leasing contract, the lessor should be responsible for the asset leased out.

The second risk is the *prohibited* risk in the form of excessive *gharar*. *Gharar* is usually translated as uncertainty, risk or hazard, but it also implies ignorance, gambling, cheating and fraud. Generally, *gharar* relates to ambiguity and/or ignorance, either regarding the terms of the contract or its object. Thus, a sale can be void due to *gharar*: due to risks of existence and taking possession of the object of sale on the one hand, and uncertainty about the quantity, quality, price or time of payment on the other. Ibn Taymiyyah provides another perspective on forbidden *gharar* by equating it to activities leading to evils and unjustified devouring of people's wealth, as in the case of gambling. Thus, transactions having gambling-like features are forbidden due to excessive *gharar*.

The final form of risk identified by Hassan is the *permissible* risk that does not fall in the above two categories. Examples of these risks can be operational risks, liquidity risks, etc. These risks can either be accepted or avoided.

Al-Suwailem discusses the principles of risk management from an Islamic perspective by linking risk and causality. He asserts that there is a need to distinguish between causes and uncertain outcomes. In uncertain situations, individuals have control over the causal factors, but not the outcome. Citing the Prophetic saying of "tie the camel and then entrust it to God", he asserts that the Islamic approach to risk management would be to understand and control the causes of risks and then leave the final outcome to the will of God.

Al-Suwailem also discusses the ethics of risk management in Islam. He asserts that deeds are judged according to intentions and means are treated in the same manner as ends. Thus, if an action can lead to various outcomes, its value should be judged by the most probable outcome. An economic activity creating value would be one in which the probability of gain would exceed the probability of loss. However, an individual's attitude towards risk is not subject to rigid rules. While some individuals may have the inclination to take more risks than others, engaging in gambling-like activities is discouraged. The latter type of activities would be those in which probability of success is less than the probability of failure or loss.

Siddiqi discusses the approaches to risk management in financial intermediation from an Islamic perspective. He identifies two ways of managing risks in financing: sharing and transferring. While the tendency in conventional finance is to transfer risks (through debt-based financing), he asserts that the approach in Islamic finance should be risk-sharing. Thus, modes such as *musharakah* and *mudarabah* reflect the spirit of Islamic teachings and should be used by Islamic financial institutions (IFIs). He maintains that selling or buying of risks associated with other people's businesses is akin to gambling and is prohibited in Islam.

Since the approach in Islamic finance is risk-sharing, modes such as *musharakah* and *mudarabah* reflect the spirit of Islamic teachings and should be applied by IFIs.

Types of Risk Exposures

Risks can be classified as financial and non financial. Financial risk can be further partitioned into market risk and credit risk. Non financial risks include, among others, operational risk, regulatory risk, and legal risk. Another way of decomposing risk is between systematic and unsystematic components. Systematic risk is associated with the overall market or the economy whereas unsystematic risk is linked to a specific asset or firm. The asset-specific unsystematic risk can be mitigated via a large diversified portfolio. The systematic risks, however, are non-diversifiable and have to be reduced through risk mitigation and transferring techniques.

The objective of financial institutions is to maximise profit and shareholder value by providing different financial services mainly by managing risks. An important element of risk management is to understand the risk/return trade-off. Investors can expect a higher rate of return only by increasing the risks systematically. As the objective of financial institutions is to create value for shareholders, managing the resulting risks created to achieve this becomes an important function of these institutions. The returns need to be positive to compensate the investor for the time the funds are committed, the expected rate of inflation, and the uncertainty of future payments or risk (Reilly and Brown, 1997: 5).

The objective of financial institutions is to maximise profit and shareholder value by providing different financial services, mainly by managing risks.

Risks Faced by Financial Institutions

The balance sheet of a financial institution gives us an indication of the nature of risks that the institution faces. A typical balance sheet of a bank will have the equity and deposits/debt on the liabilities side, and the banking and trading portfolios on the assets side. Schroeck (2002) divides risks faced by a financial institution into two types. First, risks related to the balance sheet or both assets and liabilities. These risks include interest rate, exchange rate, and liquidity. Second, there are transaction risks that relate to the assets side of the balance sheet only. These risks are credit, market, and operational. The nature of some of these risks is discussed below.

Credit Risk (CR)

Credit risk is a risk where the counter-party will fail to meet its obligations on time and in accordance with the agreed terms due to volatility in default rates and credit qualities. This risk can occur in the banking and trading books of the bank. In the banking book, *loan credit risk* arises when the counter-party fails to meet its loan obligations in a timely manner and fully in accordance with the agreed terms. This risk is associated with the quality of assets and the probability of default. Due to this risk, there is uncertainty of net income and market value of equity arising from non-payment and delayed payment of principal and interest.

Similarly, *trading credit risk* arises due to a borrower's inability or unwillingness to discharge contractual obligations in trading contracts. This can result in *settlement risk* where one party to a deal pays money or delivers assets before receiving its own assets or cash, thereby, exposing it to potential loss. Settlement risk in financial institutions particularly arises in foreign-exchange transactions. While a part of the credit risk is diversifiable, it cannot be eliminated completely.

Market Risk (MR)

Market risk is the risk originating from instruments and assets traded in markets. Market risks can result from macro and micro sources. Systematic market risk results from overall movement of prices and macro policies in the economy. The unsystematic market risk arises when the price of the specific asset or instrument changes due to events linked to the instrument or asset. Volatility of prices in various markets causes different kinds of market risks. Market risk can be classified as *equity price risk, interest rate risk, currency risk*, and *commodity price risk*. It can occur in both banking and trading books of banks.

While all of these risks are important, interest rate risk is one of the major risks that banks have to worry about. Interest rate risk is the exposure of a bank's financial condition to movements in interest rates. Interest rate risk can arise from different sources. *Re-pricing risk* arises due to timing differences in the maturity and re-pricing of assets, liabilities and off-balance sheet items. Even with similar re-pricing characteristics, *basis risk* may arise if the adjustment of rates on assets and liabilities are not perfectly correlated. *Yield curve risk* is the uncertainty in income due to changes in the yield curve.

Liquidity Risk (LR)

Liquidity risk relates to a firm's cash flow and the risk that arises due to insufficient liquidity for normal operating requirements, reducing the ability of a bank to meet its liabilities when they are due. This risk may result from either difficulties in obtaining cash at a reasonable cost from borrowings (*funding or financing liquidity risk*) or sale of assets (*trading or asset liquidity risk*). One aspect of asset-liability management in the banking business is to minimise the liquidity risk.

Operational Risk (OR)

Operational risk is not a well-defined concept and may arise from human and technical errors or accidents. It is the risk of direct or indirect loss resulting from "inadequate or failed internal processes, people, and technology or from external events" (Basel Committee Banking Supervision (BCBS), 2001a). While *people risk* may arise due to incompetence and fraud, *technology risk* may result from telecommunications system and programme failure. *Process risk* may occur due to various reasons including errors in model specifications, inaccurate transaction execution, and violation of operational control limits. Due to problems arising from inaccurate processing, record-keeping, system failures, compliance with regulations, etc., there is a possibility that operating costs might be different from what is expected, affecting the net income adversely.

Legal risk can be considered as part of operational risk. Legal risk relates to risks of unenforceability of financial contracts. This relates to statutes, legislation, and regulations that affect the fulfilment of contracts and transactions. This risk can be external in nature (like regulations affecting certain kinds of business activities) or internally related to a bank's management or employees (like fraud, violations of laws and regulations, etc.). *Regulatory risk* arises from changes in the regulatory framework of the country.

Unique Characteristics of Risks in Islamic Finance

Islamic banks face certain risks that are associated with specific business models and Islamic contracts. The unique risks arising from compliance with *Shari'ah* rules and principles need to be addressed by Islamic banks and included in their assessment of risk management systems. To understand the risks that arise in Islamic banks, we examine the risks faced by Islamic banks at two levels. First, the nature of risks faced by Islamic banks are identified in the section below. Secondly, risks arising in individual modes of financing are examined.

Islamic banks need to address the risks arising from compliance with *Shari'ah* rules and principles and include it in their assessment of risk management systems.

Nature of Risks Faced by Islamic Financial Institutions (IFIs)

To understand the risks in Islamic banks, it is important to examine their balance sheet. Iqbal et.al. (1998) distinguished two models of Islamic banks based on the structure of their assets. The first is the two-tier *mudarabah* model that replaces interest by profit-sharing modes on both liability and asset sides of the bank. In particular, all assets in this model are financed by profit-sharing modes of financing (*mudarabah*). This model of Islamic banking will also act as an investment intermediary, rather than only a commercial bank. The second model of Islamic banking is the one-tier *mudarabah* with multiple investment tools. This model has evolved due to the practical and operational problems faced by Islamic banks in using profit-sharing modes of financing on the assets side.[2]

On the assets side, Islamic banks use *murabahah* (cost-plus or mark up sale), instalment sale (medium/long-term *murabahah*), *bay'-muajjal* (price-deferred sale), *istisna'/salam* (object deferred sale or pre-paid sale), *ijarah* (leasing) and profit-sharing modes of financing (*musharakah* and *mudarabah*). On the liabilities side of the balance sheet of Islamic banks, savings and investment deposits take the form of profit-sharing investment accounts (PSIAs). Demand deposits or checking/current accounts in Islamic

2 Iqbal, et.al. (1998) mentioned three models, the third one being the case where Islamic banks work as an agent (*wakil*), managing funds on behalf of clients on a fixed commission basis.

banks take the nature of *qard hasan* that are returned fully on demand. Using the profit-sharing principle to reward depositors is a unique feature of Islamic banks. The returns on PSIAs are state-contingent and neither the principal nor a return is guaranteed. The owners of PSIAs participate in the risks and share in the bank's profit and losses. Investment accounts can be further classified as restricted and unrestricted ($PSIA_r$ and $PSIA_u$ respectively). In the former, the bank can use the funds only in specific assets, while in the latter, the bank has the freedom to use the funds as it deems best. This feature, along with financing instruments, changes the nature of risks that Islamic banks face. The Islamic Financial Services Board (IFSB) (2005a) identifies the various risks faced by institutions offering Islamic financial services as follows.

Credit Risk (CR)

Credit risk is defined as the risk that a counter-party will fail to meet its obligations in accordance with agreed terms.

Credit risk is defined as the risk that a counter-party will fail to meet its obligations in accordance with agreed terms. Credit risk would take the form of settlement/payment risk arising when one party to a deal pays money (e.g., in a *salam* or *istisna'* contract) or delivers assets (e.g., in a *murabahah* or *bay'-muajjal* contract) before receiving its own assets or cash, thereby exposing it to potential loss. As *murabahah* contracts are trading contracts, credit risk arises in the form of counter-party risk due to non-performance of a trading partner. The non-performance can be due to external systematic sources. In the case of profit-sharing modes of financing (like *mudarabah* and *musharakah*), the credit risk will take place as a counter-party risk and will occur when the entrepreneur defaults in his payment of the share of the bank when it is due. This problem may arise for banks in such cases due to the asymmetric information problem whereby they do not have sufficient information on the actual profit of the firm.

Equity Investment Risk (EIR)

Equity investment risk is the "risk arising from entering into a partnership of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares the business risk".

The IFSB identifies equity investment risk as the "risk arising from entering into a partnership of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares the business risk". The risk of loss that can impair capital invested, can arise due to a partner's behaviour or the business activity itself. Thus, it is important to perform due diligence on both the prospective partner and the business prior to the investment decision and to ensure the accurate flow of information on the business after the investments are made.

Market Risk (MR)

Market risk is "the risk of losses in on- and off-balance sheet positions arising from movements in market prices".

Since Islamic finance is either asset-backed or equity-based, market risk becomes an important part of Islamic banking. The IFSB defines market risk as "the risk of losses in on- and off-balance sheet positions arising from movements in market prices". As mentioned above, market risks are systematic risks that arise from macro sources, or unsystematic risks that are asset or instrument-specific. Thus, currency and equity risks would fall under the systematic category, while the commodity or asset the bank is dealing with would fall under specific market risk. The specific market risks include the residual value of a leased asset in an operating *ijarah* contract and the price fluctuations of a commodity in a *salam* contract.

Islamic financial institutions use a benchmark rate to price different financial instruments. For example, in a *murabahah* contract, the mark up is determined by adding the risk premium to the benchmark rate (such as LIBOR). The nature of fixed-income assets is such that the mark up is fixed for the duration of the contract. If the benchmark rate changes, the mark up rates on these fixed income contracts cannot be adjusted. As a result, Islamic banks face risks arising from movements of the market interest/benchmark rates. Mark up risk can appear in profit-sharing modes of financing like *mudarabah* and *musharakah* as the profit-sharing ratio depends on, among others, a benchmark rate like LIBOR.

The *murabahah* price risk and commodity/asset price risk must be clearly distinguished. As pointed out, the basis of the mark up price risk is changes in LIBOR. Furthermore, it arises as a result of the financing not the trading process. In contrast to mark up risk, commodity price risk arises as a result of the bank holding commodities for some reason. For example, an Islamic bank may hold an inventory of commodities for selling or as a result of *salam* financing, or it may have real estate holdings and hold equipment for operating leases. Note that both the mark up risk and commodity/asset price risk can exist in a single contract. For example, under leasing, the equipment itself is exposed to commodity price risk and the overdue rentals are exposed to interest rate risks. Similarly, if the lease contract is a long one and the rental is fixed and not floating, the contract faces an interest rate risk.

Rate of Return Risk (RORR)

The rate of return risk is a type of market risk linked to the balance sheet of IFIs. Changes in the market benchmark rate introduce some risks in the earnings of IFIs. In particular, when the benchmark rate increases, the investment account holders (IAHs) would expect an increase in their rates of return. However, as IFIs use a benchmark rate to price different financial instruments, and the rates of return on fixed-income assets such as *murabahah* contracts cannot be changed, the IFI may not be able to give the IAHs the higher rates of returns. From the Islamic bank's perspective, this introduces a "withdrawal risk" that is linked to the lower rate of return relative to market rates of return.

The rate of return risk is a type of market risk linked to the balance sheet of Islamic financial institutions.

Displaced Commercial Risk (DCR)

The withdrawal risk transfers the risk associated with deposits to equity holders. A variable rate of return on savings/investment deposits introduces uncertainty

Displaced commercial risk arises when, under commercial pressure, banks forgo a part of their profit to pay the depositors to prevent withdrawals due to a lower return.

regarding the real value of deposits. Displaced commercial risk arises when, under commercial pressure, banks forgo a part of their profit to pay the depositors to prevent withdrawals due to a lower return (IFSB 2005). Situations may arise when an Islamic bank operating in full compliance with the *Shari'ah* requirements may not be able to pay competitive rates of return as compared to its peer group of Islamic banks and other competitors. In such situations, depositors may have the incentive to withdraw their funds. In order to prevent withdrawals, IFIs may be under pressure to pay the IAHs a return that is higher than their due returns. Under commercial pressure to pay competitive returns on deposits, banks will need to apportion part of the profit of shareholders to the investment depositors.

Liquidity Risk (LR)

Liquidity risk is the potential loss to IFIs arising from their inability to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.

The IFSB (2005a: 19) defines liquidity risk as "the potential loss to IFIs arising from their inability to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses". As mentioned above, liquidity risk arises from either difficulties in obtaining cash at reasonable cost from borrowings (funding liquidity risk) or sale of assets (asset liquidity risk). The liquidity risk arising from both sources is critical for Islamic banks. As interest-based loans are prohibited by *Shari'ah,* Islamic banks cannot borrow funds to meet liquidity requirement in case the need arises. Furthermore, *Shari'ah* does not allow the sale of debt, other than its face value. Thus, to raise funds by selling debt-based assets is not an option for IFIs.

Operational Risk (OR)

Operational risk is the risk arising from inadequate or failed internal processes, people and systems or from external events.

The IFSB uses the definition of the BCBS in defining operational risk as "risks arising from inadequate or failed internal processes, people, and systems, or from external events". Due to the fact that Islamic banks are relatively new, operational risk in terms of personal risk can be acute in these institutions. Operational risk in this respect particularly arises as the banks may not have enough qualified professionals (capacity and capability) to conduct the Islamic financial operations. Given the different nature of businesses, the computer software available in the market for conventional banks may not be appropriate for Islamic banks. This gives rise to system risks of developing and using informational technologies in Islamic banks.

Legal risks for Islamic banks are also significant and may arise due to various reasons. First, as most countries have adopted either the common law or civil law framework, their legal systems do not have specific laws/statutes that support the unique features of Islamic financial products. For example, whereas Islamic banks' main activities are trading (*murabahah*) and investing in equities (*musharakah* and *mudarabah*), current banking law and regulations in most jurisdictions forbid commercial banks to undertake such activities. Secondly, non-standardisation of contracts makes the whole process of negotiating different aspects of a transaction more difficult and costly. Financial institutions are not protected against risks that they cannot anticipate or may not foresee. Standardised contracts also imply that transactions are easier to administer and monitor after the contract is signed. Finally, the lack of Islamic courts that can enforce Islamic contracts increases the legal risks of using these contracts. In an environment with no Islamic courts, Islamic financial contracts include choice-of-law and dispute settlement clauses.

Fiduciary Risk (FR)

Fiduciary risk can be caused by a breach of contract by the Islamic bank. Demand deposits are *qard hasan* (loans) and investment deposits are *mudarabah* contracts. Given this nature, demand deposits need much more protection than investment deposits, and it is important to prevent transmission of risks from the latter to the former. Thus, a part of the fiduciary duty of the management is to keep the risks arising in assets financed by demand deposits separate from those in investment deposits. The funds provided in the form of *mudarabah*-based investment deposits entail certain fiduciary duties on the part of the bank. The interests of the fund providers must be protected and the funds managed efficiently and in a *Shari'ah*-compliant manner. Not fulfilling the fiduciary duties willfully can cause a serious confidence problem and deposit withdrawals. A lower rate of return than the market can also introduce fiduciary risk when depositors/investors may interpret a low rate of return as breach of investment contract or mismanagement of funds by the bank (AAOIFI 1999).

Fiduciary risk can be caused by a breach of contract by the Islamic bank.

Shari'ah-Compliance Risk (SCR)

As most depositors and investors use IFIs due to their Islamic character, financial institutions must ensure that all their activities conform to the principles and values of Islam. This would require contracts and all necessary supporting documentations, including the legal papers, forms and processes, to be *Shari'ah*-compliant. After the product is launched in the market, there is a need to ensure that the procedures and processes are implemented in accordance with approved *Shari'ah* guidelines. Other operational issues including treatment of interest-based calculations, discounting, early and late payments, defaults, etc., must also follow the guidelines provided by the *Shari'ah* supervisory board.

Reputation Risk (RR)

Islamic financial institutions may face reputation risk, which the IFSB defines as risks arising from "failures of governance, business strategy and process". The reputation of an IFI and its profitability and market position could be at stake if there is negative publicity about its "business practices, particularly relating to *Shari'ah* noncompliance in their products and services" (IFSB 2005: 4). *Shari'ah* noncompliance can be a reason for reputation risk that can trigger bank failure and cause systemic risk and instability.

Reputation risk is risk arising from failures of governance, business strategies and processes.

The same can happen if the perception of stakeholders about the Islamic products becomes negative, causing a serious loss of trust and credibility.[3]

Risks in Islamic Modes of Financing

In this section, we will discuss the risks inherent in the Islamic modes of financing. To do so, we will focus only on financial risks (credit and market risks) on the assets side of the balance sheet. As Islamic financial instruments are either asset-backed or equity-based, market risks become important, along with credit risks. To understand the risks involved in Islamic financial instruments, we will look at the status of a transaction at three stages: the beginning of the transaction, the transaction period itself, and the conclusion of the transaction. Furthermore, transactions may involve transfer of cash or assets/goods that the IFI owns either on the spot or at a future time. As the IFI is engaged in financing and investment, its ultimate goal is to finance trade or invest in assets or equity to earn a return. Thus, the objective of the IFI is to liquidate the financing or investments at the end of the contract period and not hold on to the assets or goods forever.

The ultimate goal of IFIs is to finance trade or invest in assets/equity to earn shares.

To understand how credit and market risks appear in Islamic financial instruments, the types of assets held over different time periods are examined. When the IFI has cash in the current time period, there are no risks involved. If the IFI holds assets or goods on the spot, it needs to dispose of them. In doing so, it is subject to market risk as the price of the assets or good may change. When an IFI is expecting cash from a transaction at the future date, it faces credit risk as the debtor may not pay what is due on time. Similarly, if an asset or good is due at a future date, market risk rises along with credit risk, as the price of the asset may change during that time. The market and credit risks in different transactions are shown in Table 13.2.

Table 13.2 Classification of Risks for Different Asset Types and Possession Time

Asset Type	Possession Time Period	
	Current/Spot	Future
Cash	No Risks (NR)	Credit Risk (CR)
Assets/Goods	Market Risk (MR)	CR/MR

3 Chapra and Ahmed (2002) reported a survey that shows 381 (or 81.4%) from the total number of 468 depositors from Bahrain, Bangladesh and Sudan will move funds to other banks due to non compliance of *Shari'ah* and a total of 328 (70%) would move their funds if they learned that income of the banks come from interest earnings.

Given the above framework, the risks involved at different phases of the transaction for various Islamic modes of financing will be discussed next.

Murabahah

Murabahah is a sale contract that indicates the rate of profit or percentage mark up. The financial institution buys the goods and sells them simultaneously to the client at a mark up. The financial institution must sign separate contracts with the supplier and buyer for the transaction to be valid. Furthermore, before entering the sale contract, the bank (seller) must own and possess the goods. The profit rate (mark up) and other details like quantity and quality of the goods, the terms of payment, etc. should be specified in the contract. The bills of trade resulting from a *murabahah* transaction cannot be traded at a discount but can be transferred at face-value. *Murabahah* sales are usually short-term instruments. The various financial risks involved in different stages of transaction in the case of a *murabahah* transaction are discussed below.

Beginning of Transaction: The IFI buys the asset based on a promise from the buyer. If the promise is not binding, then the IFI may get stuck with the asset and be exposed to market risk as the price of the goods can change when disposing of it. Furthermore, any loss arising from damage of the goods before delivery to the buyer has to be borne by the bank. To eliminate the market risk, IFIs usually make the promise binding on the buyer.[4]

Transaction Period: Once the goods are delivered to the buyer, the payment of the price is due in the future and the IFI faces a credit risk. To reduce this risk, the bank can ask for guarantees and collateral in case the debtor defaults on payments. In case of delinquency, the bank can foreclose on the collateral or go to court but may not increase the outstanding debt.

Conclusion of Transaction: If the payment is made, the IFI gets its dues and there are no further risks.

Salam

Salam is a pre-production product-deferred sale in which the price is paid in advance and the product is to be delivered at a later date. The essence of a *salam*

4 Islamic *Fiqh* Academy Resolution No. 40–41 (2/5 and 3/5) (IRTI & IFA 2002, pp. 86–87).

contract is selling goods in advance. *Salam* is used to finance farmers and traders who get an advance to produce or purchase the goods. The goods being sold need not be available at the time of the contract, but should be available at the time of the delivery. The price has to be paid in full upon signing the contract, but this price can be lower than the spot price. The commodities on which a *salam* sale can be transacted must be ones whose quality and quantity can be specified exactly. For example, wheat of a particular brand can be sold through a *salam* contract, but not precious stones as they vary from one to another. Furthermore, the delivery time should be determined by mutual consultation and clearly specified in the contract. *Salam* creates an in-kind debt, and a security or guarantee can be demanded to ensure payment.

Beginning of Transaction: As the IFI gives cash at the beginning of the transaction, there are no risks involved in the case of a stand-alone *salam*.

Transaction Period: As in-kind debt is created, counter-party risks can occur if the supplier fails to supply the quality of goods as contractually agreed upon or does not deliver on time. In extreme cases, the supplier may not be able to supply the goods at all. Since *salam* is used mainly for agricultural goods, the counter-party risks may arise due to factors beyond the control of the client. For example, the credit quality of the client may be very good, but he or she may not be able to supply contractually agreed quantities due to catastrophic risks such as natural calamities. As a result, the bank may be exposed to market risk if the price of the goods during the period increases considering that the price of the goods has been fixed from the beginning.

Conclusion of Transaction: All *salam* contracts end up in physical deliveries and ownership of commodities by the IFI. If the IFI does not have a ready party to buy the goods, these commodities will require inventories, thus exposing the banks to storage costs. The IFI also faces market risks related to the price of the commodities.

In order to eliminate the market risks at the conclusion of the *salam* transaction, the IFI may opt for a parallel *salam*, whereby it promises to deliver the same goods to another party at a certain price (higher than what it paid) at a date immediately after the original *salam* contract. Note that in order to comply with *Shari'ah* principles, these two contracts have to be separate. While parallel *salam* contracts mitigate the market risk and mobilise funds for the transaction, they introduce market risk related to the credit risk of the original *salam* contract. If the first party fails to deliver the right quantity/quality on time, the IFI is liable to meet its end of the deal with the second party by buying the goods from the market. This may translate into losses equal to the amount needed to purchase the promised quantity for the second transaction less the value of collateral of the first transaction. As the loss is related to the price of the goods, this transaction will also have market risk in case of default by the first party.

Istisna'

Istisna' is a pre-production sale contract used when an item, equipment, building or project needs to be constructed, manufactured, or assembled according to specification. The financial institution makes the item available (by getting it manufactured, constructed, or assembled) and sells it to the client by adding a profit margin. The quality, quantity and price of the good sold should be known fully at the time of the contract. The price of the goods can be paid at the time of the contract, at the time of delivery or any time afterwards in lump-sum or instalments. The seller (bank) of the goods can either manufacture or sub-contract it to others. The latter would be in the form of a parallel *istisna'.* The seller is liable if the good delivered is not in accordance to specifications or has hidden defects. The contract may, however, specify that such claims may be made against the sub-contractor, but the seller must remain guarantor in case the sub-contractor does not conform. *Istisna'* is usually a medium- to long-term contract.

Beginning of Transaction: After the IFI commits to the contract, it has to select sub-contractors who can manufacture/construct the goods or assets.

Transaction Period: As *istisna'* involves manufacturing or construction and payments made in instalments during the transaction period, the IFI faces both market risk and counter-party and/or credit risk. The former can arise if the costs of production increase and the latter if the buyer either declines to accept the asset or defaults on payment.

Conclusion of Transaction: There are no other risks involved if the asset is delivered and the payment is received.

In many cases, the banks may sub-contract the *istisna'* transaction into a parallel *istisna'*. This is done mainly because the IFI is not in the business of manufacturing/building and to mitigate the market risk arising from higher costs of production. Parallel *istisna'*, however, creates other risks such as the failure of the supplier to deliver the asset or to deliver one that is according to specification. This increases the counter-party risk at the conclusion of the contract.

Ijarah

Ijarah (operating lease) constitutes the sale of the usufruct rights of durable goods/assets. The owner of the assets gets lease payments or rents periodically as long as the lessee can use the usufruct. An *ijarah* contract is similar to that of an operating lease in which the ownership of the assets does not get transferred to the lessee. While the lease contract must specify who pays the maintenance costs, the costs arising from accidental damage or total loss are borne by the owner himself. The owner can sell the leased asset to a third party or the lessee. In the case the asset is sold to a third party, the lease contract can also be transferred to the new owner.

Unless the contract explicitly prohibits sub-leasing, the lessee can sub-lease the asset to a third party at a rental rate that may be higher or lower than the rental paid by the lessee.

Beginning of Transaction: If the asset is acquired by the IFI, but the client refuses to lease it (in a non-binding contract), then the IFI faces market risk in disposing of the asset. This will not be the case for a binding lease.

Transaction Period: There is a credit risk in terms of non-payment of rental instalments by the counter-party/lessee.

Conclusion of Transaction: The IFI has to deal with the market risk related to the residual value of the asset.

Ijarah wa Iqtina (hire-purchase) is a leasing contract in which the ownership of the asset is transferred to the lessee at the end of the contract. At the end of the lease period, the asset is transferred to the lessee through a sale contract or given away as a gift. The instalment payment consists of rental payment and part of the capital. *Shari'ah* scholars have objections to the financial lease. They contend that the purchase contract cannot be binding; it must be optional at the beginning of the sale contract. Furthermore, as the price of the asset at the end of the contract will depend on its quality, which is unknown at the beginning of the lease contract, it cannot be fixed in advance and should be market-determined at the time of the sale. Islamic banks have resolved this issue either by giving away the asset at a nominal value or as a gift at the end of the lease period. One implication of a pure financial lease is that it is a sale contract with deferred payments. Thus, the lease payments constitute debt payments, and can be sold or transferred at face value only. *Ijarah* contracts can have tenures of short/medium/long-terms.

Beginning of Transaction: If the asset is acquired by the IFI, but the client refuses to lease it (in a non-binding contract), then the IFI faces market risk in disposing of the asset. This will not be the case in a binding lease.

Transaction Period: There is a credit risk in terms of non-payment of rental instalments by the counter-party/lessee.

Conclusion of Transaction: As the asset is transferred to the lessee, the IFI is no longer exposed to market risk.

Mudarabah

Mudarabah is a form of partnership in which some of the partners contribute only capital (*rabbul mal*) and the other partners (*mudarib*) provide labour. *Mudarabah* is a principal-agent relationship, the financier (*rabbul mal*) is a sleeping partner and cannot interfere in the management of the firm. The *mudarib,* or manager as an agent, manages the project with the objective of earning profits. Profit is shared among the parties at an agreed upon ratio and must be explicitly specified in the *mudarabah* agreement. A variable of escalating share of profit that is dependent on the level of profit achieved is permissible (El Gari 2002). The financier cannot ask for a guarantee of the capital nor claim a fixed amount of profit or percentage of capital. The financier, however, can ask for guarantees for losses arising from negligence and mismanagement of the project by the *mudarib*.

Mudarabah can be restricted or unrestricted (Chapra 2001). Under unrestricted *mudarabah*, the funds are provided to the *mudarib* without conditions related to the type, place, timing, and the people with whom the business will be undertaken. In restricted *mudarabah*, the *rabbul mal* has the right to specify the terms and conditions of the use of capital but cannot intervene in the management of the *mudarabah*. If the conditions of the *mudarabah* are violated, it will constitute failing the fiduciary duties and the manager will be responsible for any losses arising from it. *Mudarabah* contracts usually have short- to medium-term tenures.

Beginning of Transaction: Adverse selection, and a bank's existing competencies in project evaluation and related techniques are limited.

Transaction Period: The counter-party risk arising from the problem of information asymmetry is expected to be high under this mode. The counter-party risk includes misreporting of profit by the manager.

Conclusion of Transaction: The counter-party risk of untruthful reporting of profit exists.

Musharakah

Musharakah is a partnership in which all partners contribute both capital and labour. The main difference with *mudarabah* is that all the partners are entitled to participate in the management of the project. The profit share may be different for different partners depending on their involvement in the project and the capital contributed. Like *mudarabah*, a variable profit share that depends on the level of profits is allowed. The tenure of *musharakah* is usually long-term (three years or more).

Beginning of Transaction: Adverse selection, and a bank's existing competencies in project evaluation and related techniques are limited.

Case Study Risk Perceptions for Different Islamic Modes of Financing

In 2001, Khan and Ahmed conducted a survey on the perceptions of 18 Islamic bankers on credit and risks inherent in various Islamic modes of financing. Table 13.3 shows the results of the survey.

Table 13.3 Risk Perception – Risks in Different Modes of Financing*

	Credit Risk	Market Risk
Murabahah	2.47 (17)	2.75 (12)
Mudarabah	3.38 (13)	3.56 (9)
Musharakah	3.71 (14)	3.67 (9)
Ijarah	2.64 (14)	3.17 (6)
Istisna'	3.13 (8)	2.75 (4)
Salam	3.20 (5)	3.25 (4)

Note: The numbers in parentheses indicate the number of respondents.

*The rank has a scale of 1 to 5, with 1 indicating "Not Serious" and 5 denoting "Critically Serious".

Credit risk appears to be the least in *murabahah* (2.47) and the most in *musharakah* (3.71) followed by *mudarabah* (3.38). It appears that profit-sharing modes of financing are perceived to have higher credit risk by bankers. *Ijarah* ranks second (2.64) after *murabahah* as having the least credit risks. Like the *murabahah* contract, *ijarah* contract gives the banks a relatively certain income and the ownership of the leased asset remains with the bank. *Istisna'* and *salam,* ranked with 3.13 and 3.20 respectively, are relatively more risky. These product-deferred modes of financing are perceived to be riskier than price-deferred sale (*murabahah*). This may arise as the value of the product (and hence the return) at the end of the contract period is uncertain. There are chances that the counter-party may not be able to deliver the goods on time due to different reasons like natural disasters (for commodities in a *salam* contract) and production failure (for products in an *istisna'* contract). Even if the goods are delivered, there can be uncertainty regarding the price of the goods upon delivery affecting the rate of return.

Market risk is ranked highest in terms of severity for profit-sharing modes of financing with the highest for *musharakah* (3.67) followed by *mudarabah* (3.56). *Murabahah* and *istisna'* are considered to have the least market risk (2.75) followed by *ijarah* (3.17). Note that in four of the six modes, the concern about the market risk is ranked higher than that of credit risk.

Transaction Period: The counter-party risk due to moral hazards and information asymmetry problems is expected to be high under this mode. The counter-party risk is in the form of the manager not reporting the actual profit generated.

Conclusion of Transaction: Depending on the asset type, the risk of counter-party and market risk may exist. If the investment is in physical assets (e.g., *musharakah* with an *ijarah* sub-contract or *musharakah* with a *murabahah* sub-contract), then the bank will face asset price risk and/or counter-party risks.

IFSB Guidelines on Risk Management for IFIs

As IFIs face unique risks due to using Islamic financing instruments, they may require some distinctive risk management tools and approaches. To address the risk management issues related to IFIs, the IFSB published *Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services* in 2005. The document presents fifteen principles related to various aspects of risks facing IFIs. While the guidelines on risk management are given in the Appendix, this section highlights the main features of the IFSB Guidelines. After presenting a comprehensive risk management and reporting process, the principles governing management of specific risks in IFIs are outlined.

Comprehensive Risk Management and Reporting Process

The overall risk management process should be comprehensive; embodying all departments and sections of the institution so as to create a risk management culture. Accordingly, the first principle of IFSB (2005a: 4) states:

> "The IFI shall have in place a **comprehensive risk management and reporting process**, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks and, where appropriate, to hold adequate capital against these risks. The process shall take into account appropriate steps to comply with *Shari'ah* rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority."

The main elements of risk management, identified above as risk identification, measurement, monitoring, reporting and control, cannot be effectively implemented unless there is a broader process and system in place. It should be pointed out that the specific risk management process of individual financial institutions depends on the nature of the activities and the size and sophistication of an institution. The IFSB (2005a)

The specific risk management process of individual financial institutions depends on the nature of activities and the size and sophistication of the institution.

suggests that the risk management system should have a "sound process for executing all elements of risk management, adequate system of controls with appropriate checks and balances, ensure the quality and timeliness of risk reporting available to regulatory authorities, and should make appropriate and timely disclosure of information". A comprehensive risk management system should encompass the following three components.

Establishing Appropriate Risk Management System and Environment

This stage deals with the overall objectives and strategy of the bank towards risk and its management policies. The board of directors is responsible for outlining the overall objectives, policies and strategies of risk management for any financial institution. The overall risk objectives should be communicated throughout the institution. Other than approving the overall policies of the bank regarding risk, the board of directors should ensure that the management takes the necessary actions to identify, measure, monitor, and control these risks. The board should periodically be informed and should review the status of the various risks facing the bank.

Senior management is responsible to implement the policies approved by the board through the establishment of a risk management system. To do so, the management needs to establish policies and procedures that would be used by the institution to manage these risks. These include developing a risk management review process, setting appropriate limits on risk-taking, developing adequate systems of risk measurement, ensuring a comprehensive reporting system, and maintaining effective internal controls. Procedures should include appropriate approval processes, limits and mechanisms designed to assure the bank's risk management objectives are achieved. Banks should clearly identify the individuals and/or committees responsible for risk management and define the line of authority and responsibility. Various aspects of creating an appropriate risk management framework and system are shown in Table 13.4.

Table 13.4 Risk Management System and its Processes

Body/Unit	Function	Duties and Role
Board	Set the overall policies	Define overall objectives and ensure its implementation by management.
Management	Set up an institution-wide risk management system.	Identify the risks and implement the objectives and policies of the board.
Risk Management Department/Unit	Identify and measure risks	Set up standards, limits, and rules, guidelines, and procedures related to risks. Publish various risk reports periodically (for both current situations and expected future scenarios).
All Operational Units/Employees	Identify and control the risks	Comply with the standards, limits and rules, guidelines, and procedures related to risk.
Internal Audit	Monitor risk management process	Ensure that risk-related guidelines and policies are followed and implemented at different levels of operations.

Maintaining an Appropriate Risk Measurement System

There are four ways in which the risk management system can be operationalised. They are standards and reports, position limits and rules, investment guidelines or strategies, and incentive contracts and compensation. While the first three aspects of a risk management system are discussed here, the last one is discussed in the next sub-section. In setting the standards, the management identifies and categorises the risks and spells out the tools to control and manage these risks. To assist in identifying the risks, there is a need for standardised financial reporting that provides information on various aspects of a risk, risk exposures and asset quality in terms of inherent risks. The second aspect of the risk management system is to have position limits and rules that indicate the level of risk undertaking. Clear rules and standards of risk undertaking regarding eligible features for investments, limits of exposures to counter-parties, concentration limits, exposure to various types of risks, etc., should be provided. The third element of a risk management system consists of investment guidelines and strategies, the former for operational reasons and the latter for long-term directions. These are meant to give a broader picture of the risk at the portfolio level. Investment guidelines and strategies should be followed to limit the risks involved in different activities. These guidelines should cover the structure of assets in terms of concentration and maturity, asset-liability mismatching, hedging, securitisation and so on.

In setting the standards, the management identifies and categorises the risks and spells out the tools to control and manage these risks.

Banks must have adequate management information systems (MIS) for measuring, monitoring, controlling and reporting different risk exposures on a periodic basis. Steps that need to be taken for risk measurement and monitoring purposes include the establishment of standards for categorisation and review of risks, consistent evaluation and rating of exposures. Periodic standardised risk and audit reports within the institution are also important. The bank can also use external sources to assess risk, such as using either credit ratings or supervisory risk assessment criterion.

Risks undertaken by the banks must be monitored and managed efficiently. Banks should consider doing stress tests to see the effects on the portfolio resulting from different potential plausible events. For example, the bank may examine the effects of a downturn in the industry or economy and market risk events on default rates and liquidity conditions of the bank. Stress testing should be designed to identify the conditions under which a bank's positions would be vulnerable and the possible responses to such situations. The banks should have contingency plans that can be implemented under different scenarios.

Adequate Internal Controls

Banks should have internal controls to ensure the adherence of all relevant policies. An effective system of internal control includes an adequate process for identifying and evaluating different risks and having sufficient information systems to measure and report them. The system would also establish policies and procedures and make

An effective system of internal control includes an adequate process for identifying and evaluating different risks and having sufficient information systems to measure and report them.

sure that adherence to them is continually reviewed. This may include conducting periodic internal audits of different processes and producing regular independent reports and evaluations to identify areas of weakness. It is important, as part of good internal control, to segregate the duties of those who measure, monitor, and control risks.

Finally, an appropriate incentive and accountability structure that is compatible with risk-taking activity forms part of the important elements for reducing overall risks. The incentives given to different risk undertakers should reflect the objectives and the goals of the institutions. A prerequisite of these incentive-based contracts is accurate reporting of the bank's exposures and its internal control system. An efficient incentive-compatible structure would limit individual positions to acceptable levels and encourage decision-makers to manage risks in a manner that is consistent with the bank's goals and objectives.

Table 13.5 highlights a survey finding of an assessment of the overall risk management system in 17 Islamic banks. Each bank was asked about the various aspects of the risk management system and processes described previously. Specifically, there were six questions related to "Establishing an Appropriate Risk Management System and Environment", nine questions on "Maintaining an Appropriate Risk Measurement System" and five questions on "Adequate Internal Controls". The figures reported in Table 13.5 show the sum of affirmative answers as a percentage of the total possible answers in each component.

Table 13.5 Scores on Aspects of Risk Management System for Islamic Banks

Risk Management Components	Score (Total)	Percentage
Establishing Appropriate Risk Management System and Environment	84 (102)	82.4
Maintaining an Appropriate Risk Measurement System	106 (153)	69.3
Adequate Internal Controls	65 (85)	76.5

Source: Khan and Ahmed (2001)

The figures in Table 13.5 indicate that Islamic banks have been able to establish better risk management policies and procedures (82.4%) than measuring, mitigating, and monitoring risks (69.3%), with internal controls somewhere in the middle (76.5%). The relative percentages indicate that IFIs have to improve their measuring, mitigating, and monitoring process as well as have better internal control mechanisms to improve their risk management system.

Managing Specific Risks

The IFSB Guiding Principles provides detailed risk management principles to manage different risks facing IFIs. The principles broadly cover four basic elements of a comprehensive risk management and reporting system: Strategy/Policy, Structure/Process, Measurement/Reporting and Monitoring/Mitigating. The features of these elements for various risks are summarised in Table 13.6 and discussed below.

Table 13.6 IFSB Risk Management Principles for Specific Risks

Risk Type	Strategy/Policy	Structure/Process	Measuring/ Reporting	Monitoring/Mitigating
Credit Risk (CR)	Credit strategy, credit policies.	CR management structure, operational procedures, due diligence process, credit management systems.	Appropriate measuring and reporting methods of risk exposures.	Monitoring system, risk mitigating techniques, remedial action in case of distress, risks in parallel contracts.
Equity Investment Risk (EIR)	Strategy, policies and criteria of investing in equity investments, exit strategies.	Due diligence, investment appraisals.	Appropriate valuation techniques.	Appropriate risk mitigating techniques, capacity to monitor investments and risk transformation.
Market Risk (MR)	Market risk strategy, risk appetite for tradable assets.	Market risk management process, framework for pricing, valuation, and income recognition.	Strong MIS for reporting, quantifying MR exposures, appropriate valuation of assets.	MIS for monitoring and controlling, and holding appropriate capital. Manage risks of restricted IAHs' accounts.
Liquidity Risk (LR)	Strategy for managing LR.	Sound processes and systems for measuring, reporting and monitoring LR, liquidity contingency plan.	Maturity ladders, IAHs' expectations.	Identify liquidity shortfall, identify funding sources and liquidation procedures.
Rate of Return Risk (RORR) *[Displaced Commercial Risk (DCR)]*	RORR management policy strategy for managing IAHs' and shareholders' expectations.	RORR management processes. Establishing profit equalisation reserves and investment risk reserves.	Dependency on current accounts and IAH, gapping method, cash flow forecasting	Balance sheet techniques to exposures. Hold appropriate levels of PER.
Operational Risk (OR) *[Shari'ah-Compliance Risk (SCR) & Fiduciary Risk (FR)]*	Establish framework for OR control environment for *Shari'ah*-compliance policy. Policy of safeguarding fund providers.	Structure/system for implementation of OR control framework. Adequate systems and controls. Mechanisms of safeguarding IAHs.	Periodic reviews evaluating internal controls. *Shari'ah* audit.	Internal and external audit. *Shari'ah* control department and *Shari'ah*-compliance review, income cleansing. Regular disclosure of information.

Credit Risk

Islamic financial institutions should have a clear credit strategy and policy document outlining risk tolerance levels and pricing policies. In a strategy for financing, a bank should identify, among others, the risk appetite of the institution and the list of instruments to be used for financing. A credit risk management operational structure and process must be in place for credit review and risk mitigation. A due diligence review process has to be in place to identify prospective clients and investment opportunities. There have to be appropriate mechanisms to measure and report credit risk exposures arising in different financing instruments. The IFI should also have a risk monitoring system for individual credit exposures to ensure that the credit policies are followed and implemented. Finally, the institution should have *Shari'ah*-compliant credit risk mitigating techniques to minimise risks in various instruments. There should be procedures to handle early settlements and remedies for financial distress or default of a client. In case a bank uses parallel contracts, such as parallel *salam* or *istisna'*, the risks in these transactions need to be understood and mitigated.

Equity Investment Risk

The strategy of an Islamic bank should include the criteria and objectives of investments in profit-sharing instruments. Among others, risk tolerance, holding periods, and expected returns must be specified. An appropriate risk management structure along with policy and procedures to evaluate and manage equity investment risk (EIR) must be in place. An important aspect in equity investments is to have proper valuation methodologies to assess quality of investments and determine the allocations and expected returns. The bank should also have a proper infrastructure and capacity to continuously monitor the performance and evolution of risk of investments. The IFI should have appropriate risk mitigating techniques, procedures and controls in place to address the risks arising at different stages of an investment cycle. The risks associated with moral hazard and manipulation of results has to be addressed in partnership contracts. The exit strategies outlining the criteria for extension, redemption conditions and divesture of under-performing investments have to be clearly established.

Market Risk

As Islamic banks use asset-backed and equity-based financing, the IFI must have a market risk strategy and ensure that it has an appropriate market risk management framework. The strategy will outline the risk appetite of the bank and identify the target activities, markets and the instruments to be used. A guideline governing risk-taking activities and appropriate framework for pricing, valuation, income recognition and underlying market risk identification has to be in place. The bank should have a mechanism to quantify market risk as well as a robust MIS to report, monitor and control the risk exposures. An IFI should manage the risks associated with assets held on behalf of restricted IAHs in the same way as they manage the assets of shareholders and unrestricted IAHs.

Liquidity Risk

The IFI should have a liquidity management strategy and framework to develop and implement processes and systems to measure and monitor liquidity. The policies for liquidity management would entail both quantitative and qualitative factors. While the former would include liquidity aspects of the balance sheet structure (such as funding base concentration and marketable assets) and the availability of external funding sources, the latter relates to skills and abilities of management and relevant departments such as MIS to identify and manage liquidity risk (LR). An important aspect of LR is to forecast the expected withdrawals by IAHs. Systems and processes that can measure, monitor and report cash flows and liquidity exposures should periodically be in place. Banks should use maturity ladders for various time-bands and calculate net-funding requirements to project liquidity needs and shortfalls. The bank should have a liquidity crisis management system and a liquidity contingency plan in place that can tackle liquidity needs in case of emergencies. The bank would identify the funding facilities that can be tapped into in case of liquidity shortfalls. Possible sources include cash flows from banking activities, sale and securitisation of tradable assets, capital infusion by shareholders and *Shari'ah*-compliant funding arrangements with the central bank. Other arrangements that can generate liquidity such as sale and leaseback should also be considered.

Rate of Return Risk

Islamic banks should have appropriate rate of return risk (RORR) management processes and structures in place to identify, measure, report, monitor and control the risks. The banks should have appropriate systems to identify and measure the factors causing RORR. Important determinants of RORR are the various balance sheet positions in general and the proportion of IAHs relative to the total deposits in particular. To mitigate the risk may require cash flow and future earnings forecasting. A policy framework for managing a related risk, the displaced commercial risk, that considers the expectations of shareholders and IAHs should also be in place. Appropriate levels of Profit Equalisation Reserves (PER) and Investment Risk Reserves (IRR) needed to smooth and enhance rates of returns to mitigate RORR should be identified and maintained.[5]

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5 PER is created by appropriating a portion of the gross income before allocating the bank's share and is used to maintain a particular level of return for IAHs and to increase the owners' equity. IRR is deducted from the income of IAHs after allocating the bank's share, in order to cushion future losses on IAHs (IFSB 2005a: 23).

Operational Risk

As operational risk includes various aspects of the operations of a financial institution, the IFSB suggests establishing a "comprehensive and sound framework for developing and implementing a prudent control environment" to manage the risks. This framework must be understood by all the relevant employees and implemented consistently throughout the organisation. Periodic reviews and internal control mechanisms such as using internal and external audits must be used to address operational deficiencies.

The operational review should also manage *Shari'ah*-compliance risk by ensuring that the rules and principles approved by the *Shari'ah* Supervisory Board are adhered to in all activities of the bank. Among others, the compliance of contract documentations and operations with *Shari'ah* principles and guidelines must be assured. The IFI should undertake periodic *Shari'ah*-compliance review to verify that the operations are in line with the resolutions and recommendations of the *Shari'ah* board. A related risk arising from the fiduciary role of banks should be minimised by ensuring that the funds of IAHs are properly managed in accordance with the principles of *Shari'ah*. The fiduciary risk management also requires having a clear policy of managing and safe-guarding the funds of IAHs. This would involve having a transparent process of investing the funds in various asset classes and identifying the revenue and expenses in order to arrive at their profit share.

Issues, Opportunities, and Challenges

Islamic finance is a relatively young and evolving industry. The risks and risk management systems associated with its specificities are not well understood and developed. The previous discussion, which points out the nature of risks faced by Islamic banks in certain circumstances, is different at the organisational and product levels. Managing risks in an IFI would require the suitable risk management strategy and process at the organisational level and also the appropriate risk management tools and instruments. Furthermore, due to the rigidities and deficiencies in the infrastructure institutions beyond the scope of individual IFIs, the risks facing the institutions are either magnified and/or difficult to mitigate. Various issues, opportunities and challenges related to risk management of an IFI at different levels will be discussed next.

Infrastructure and Risks

As Islamic banking is relatively new, an adequate regulatory and legal framework to support the industry is still lacking in many countries. This gives rise to risks at the macro-level such as systemic risk, liquidity risk, *Shari'ah*-compliance risk and reputation risk. Some of the issues and challenges facing IFIs are discussed in this section.

Islamic financial institutions are prone to liquidity risks due to a few reasons. First, there is a *fiqh* restriction on the securitisation of the existing assets of Islamic banks, which are predominantly debt in nature. This limits the ability of the Islamic banks to securitise the debt-based assets compared to that of conventional banks. Second, due to the slow development of innovative financial instruments, Islamic banks are not able to raise funds from the markets very quickly. In other words, there are a dearth of short-term *Shari'ah*-compliant securities or markets for liquidity risk management. In most jurisdictions, there are limited *Shari'ah*-compliant interbank money markets. Third, in some jurisdictions, the existing liquidity risk facilities are based on interest, and therefore, Islamic banks cannot benefit from these emergency liquidity facilities.

Islamic banks can also be exposed to the lack of appropriate legal infrastructure institutions. One of the issues relates to the supporting laws for financing. For example, collateral is one of the most important securities against credit loss. Islamic banks are also allowed to use collateral to secure finance as *rahn* (an asset as a security in a deferred obligation). The industry-wide general quality of collateral, however, depends on a number of institutional characteristics of the environment as well as the products offered by the industry. An improvement in the institutional infrastructures can be instrumental in enhancing the collateral quality and reducing credit risks. For example, a country with a mortgage law in which the real estate being financed can be used as a lien will have lower credit risk as the asset being financed can be used as collateral.

An improvement in the institutional infrastructures can be instrumental in enhancing the collateral quality and reducing credit risks.

The Islamic financial system can become susceptible to instability due to *Shari'ah* noncompliance and reputation risks. Negative perceptions of stakeholders about Islamic products and practices can lead to instability in the short-term and cause loss of trust and credibility in the long-run. Additionally, the possibility of the *Shari'ah* Supervisory Boards (SSB) coming up with conflicting opinions within one jurisdiction can increase the legal risks. The likelihood of conflicting *fatwas* will undermine customer confidence in the industry. There may be a need to resolve the reputation and legal risks in Islamic finance by having a national *Shari'ah* authority that harmonises the *fatwas* and oversees their implementation in IFIs.

Negative perceptions of stakeholders about Islamic products and practices can lead to instability in the short-term and cause loss of trust and credibility in the long-run.

Lack of standardised contracts at the national and international levels makes the whole process of negotiating various aspects of a transaction more difficult and costly. As a result, financial institutions are not protected against risks that they can not anticipate or may not be enforceable in courts. Standardised contracts also imply that transactions are easier to administer and monitor after the contract is signed. Lack of Islamic statutes and courts that can enforce Islamic contracts increases the legal risks of using these contracts.[6] In an environment with no courts that specifically handle matters relating to Islamic finance, Islamic financial contracts include choice-of-law and dispute settlement clauses.

Organisational Level Risks

At the organisational level, the techniques of risk identification and management available to Islamic banks could be of two types. The first type comprises standard techniques that are used in conventional finance and are consistent with the Islamic principles of finance. These techniques would include risk reporting, internal and external audit, GAP analysis, Risk Adjusted Return on Capital (RAROC), internal rating, etc. The second type of technique is unique to IFIs and has to be developed or adapted to satisfy *Shari'ah*-compliance requirements. The latter type of techniques requires understanding the risks, principles and values of Islamic law (*Shari'ah*).

Weaknesses and vulnerabilities exist in the risk management of Islamic banks. Table 13.6 on page 575 identifies the weakness of maintaining an appropriate risk management system. One key risk type that needs to be managed by IFIs is operational risk. Given the novelty of Islamic banks, operational risk in terms of personnel risk can be acute in these institutions. One of the challenges facing IFIs is the lack of qualified professionals (capacity and capability) who can understand and manage risks in Islamic financial operations. Given the different nature of businesses, the computer softwares available in the market for conventional banks may not be appropriate for Islamic banks. Furthermore, the small number of Islamic banks have limited resources to install costly MIS systems that can measure and monitor the risks. This gives rise to system risks of developing and using informational technologies in Islamic banks.

Another challenge that Islamic banks face at the organisational level is managing liquidity risks. As management of liquidity risks is difficult for IFIs due to lack of liquid secondary markets for Islamic securities, extra precaution has to be taken to mitigate potential liquidity problems. For example, funding risk from external sources can be controlled by proper planning of cash flow needs and seeking newer sources of funds to finance cash-shortfalls. The asset liquidity risk due to a lack of liquid assets can be mitigated by the diversification of assets and setting limits on certain illiquid products.

6 Most countries have adopted either the common law or civil law framework, and their legal systems do not have specific laws/statutes that support the unique features of Islamic financial products. For example, whereas Islamic banks' main activities are in trading (*murabahah*) and investing in equities (*musharakah* and *mudarabah*), current banking law and regulations in most jurisdictions forbid commercial banks to undertake such activities.

The following section identifies some problems that may hinder quantitative prudent risk management. First, it is important to have accurate data for a good approximation of the distribution of returns on various assets. Once the loss distribution has been identified, then an estimation of sufficient capital can be set aside to absorb losses. Secondly, economic capital is held to provide comprehensive coverage of losses for the institution as a whole and is an important tool for integrated risk management. The amount of capital held by any bank will depend on the risks associated with the assets. Given the profit-sharing nature of PSIAs in Islamic banks, there are suggestions that the PSIA may be treated as capital (IFSB). There is, however, a need for caution in treating all PSIAs as capital. Fund providers in PSIAs are risk averse and too much downside in their returns can lead to withdrawals that can create systemic risks. Thus, to minimise the withdrawal and systemic risk, none or only a very small portion of PSIAs should be treated as capital. When assets are funded by PSIAs, however, a larger part of the funds can be treated as capital.

Improper estimation of distribution may give rise to a modelling error. Other than mis-estimation of risk due to inaccurate specification of the model to estimate risks, the short-term vision of managers may result in "risk ignorance". There is a possibility that operational risk may arise in the form of the mis-estimation of risk in Islamic finance due to the complexity of risks in different modes of financing. As discussed previously, credit and market risks exist in Islamic financing modes and they change at various phases of the transaction.

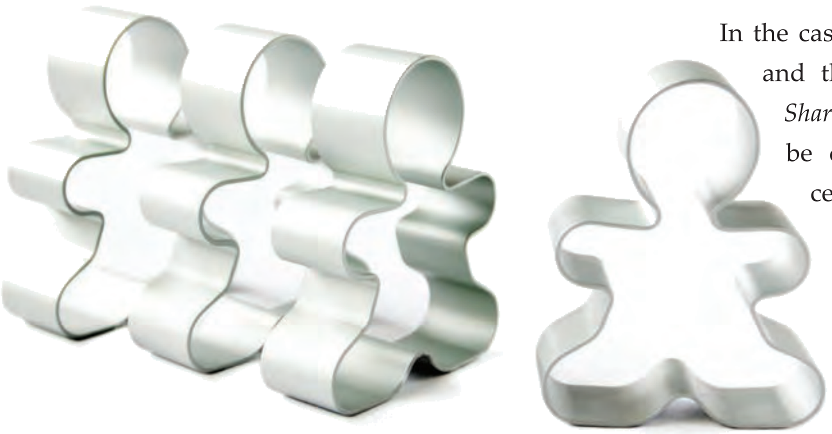
The IFI may be able to estimate the risk distribution accurately but fail to take the necessary steps to mitigate and transfer them using various means and processes. For example, IFIs should hold sufficient loan loss reserves to protect against expected credit losses. The effectiveness of these reserves depends on the credibility of the systems in place within banks to calculate the expected losses. Recent developments in credit risk management techniques have enabled large traditional banks to identify their expected losses accurately. Islamic banks are also required to maintain the mandatory loan loss reserves subject to the regulatory requirements in different jurisdictions. However, as discussed before, the Islamic modes of finance are diverse and heterogeneous as compared to interest-based credit. These may require more rigorous and credible systems for expected loss calculation. Furthermore, for comparability of the risks of different institutions, there is also a need for uniform standards for loss recognition across modes of finance, financial institutions and regulatory jurisdictions. In addition to the mandatory reserves, some Islamic banks have established PER and IRR. These reserves are aimed at providing protection for capital as well as PSIAs against any risk of loss (including default) and to minimise the withdrawal risk.

Instruments and Techniques – Briefly

From an Islamic perspective, the guiding principle of risk management and mitigation at the instruments level is to improve asset quality with the focus on risk-sharing.

As discussed previously, risk management can involve avoidance, transfer, or acceptance of risks. Risk avoidance techniques in IFIs include the standardisation of all business-related activities and processes, construction of a diversified portfolio, and implementation of an incentive-compatible scheme with accountability of actions. The guiding principle of risk management and mitigation at the instruments level from an Islamic perspective should be to improve asset quality with the focus on risk-sharing.

Possibilities of shifting risks to other participants create incentives to take on higher risks. In line with the overall principles of Islamic finance, Chapra points out that using equity modes of financing would induce stringent due diligence and monitoring of assets by financial institutions, which can prevent systemic risks arising from transferring risks.



In the case of IFIs, the nature of the contracts and their mitigation are affected by the *Shari'ah* rules and principles. There can be certain *Shari'ah* objections to using certain instruments and mechanisms of managing risks. For example, guarantees supplement collateral in improving the quality of credit and are extremely important tools to control credit risk in conventional banks. Although some Islamic banks also use commercial guarantees, the general *fiqh* understanding goes against their use (see *Shari'ah* Standard No. 5, AAOIFI 2003). In accordance with *fiqh*, only a third party can provide guarantees as a benevolent act in which case a service charge is allowed for actual expenses but no more. Due to this lack of consensus, therefore, this tool is not effectively used in the Islamic banking industry.

Conventional banks can either transfer some risks to other parties or sell them in well-defined markets. A variety of instruments such as derivatives, selling or buying of financial claims (e.g., debt), changing borrowing terms, etc., are used to transfer and mitigate risks. Most of the conventional derivative instruments used for risk transferring do not conform to *Shari'ah*. Instead of innovating solutions to mitigate risks through risk-sharing and other means, the general trend in Islamic finance has been to replicate conventional derivatives by reverse engineering. As a result, IFIs are developing synthetic derivatives that replicate their conventional counterparts. Risk management tools and mechanisms are explored in greater detail in the next chapter.

Summary

1 Islamic finance is a relatively new industry and although its risks are not well understood, the risk management system of IFIs is evolving.

2 The general trend of Islamic finance has been to drift towards conventional finance. Not only do Islamic banks adopt the organisational format of conventional debt-based banks, they also adopt the Islamic variants of conventional products. The risk management instruments developed by the Islamic financial sector are also replicating those of conventional finance by reverse engineering.

3 The risks facing IFIs are different than those of their conventional counterparts due to the contractual nature of Islamic financial products. The additional risks arise as Islamic products use a combination of several contracts to produce an outcome that is similar to conventional products.

4 This trend is diluting the uniqueness of Islamic finance and blurring the differences of the two systems. There is a need for a fundamental shift of the practice that conforms to the basic rules and principles of *Shari'ah*. The move towards a financial system and instruments that fulfil the goals of the *Shari'ah* would require a move towards innovative financial engineering that introduces practices of risk-sharing rather than risk-transferring.

5 All IFIs should have a comprehensive risk management system to identify, measure, monitor, report and control various risks facing them.

6 The development of secondary markets for liquid *Shari'ah*-compliant securities can help to minimise liquidity risks.

Key Terms and Concepts

Credit Risk
Operational Risk
Fiduciary Risk
Rate of Return Risk
IFSB
Market Risk
Counter-party Risk
Displaced Commercial Risk
Regulatory and Legal Risk
Liquidity Risk
Shari'ah-Compliance Risk
Equity Investment Risk
PSIA

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Review Questions and Problems

1 What is risk and what are the sources of risk in the financial sector?

2 What is the approach to risks and the management of risks from an Islamic perspective?

3 Do *Shari'ah* rules and principles give rise to some unique risks in financing and investment activities? What are the specific risks arising in an IFI?

4 What are the nature of risks in different Islamic modes of financing and investment?

5 What are the IFSB guiding principles for the management of various risks facing IFI?

6 What are the issues and challenges of risk management in Islamic finance?

Appendix: IFSB Guiding Principles of Risk Management

1 General Requirement

Principle 1.0: IFIs shall have in place a **comprehensive risk management and reporting process**, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks and, where appropriate, to hold adequate capital against these risks. The process shall take into account appropriate steps to comply with *Shari'ah* rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.

2 Credit Risk

Principle 2.1: IFIs shall have in place a **strategy** for financing, using various instruments in compliance with *Shari'ah*, whereby it recognises the potential credit exposures that may arise at different stages of the various financing agreements.

Principle 2.2: IFIs shall carry out a **due diligence review** in respect of counter-parties prior to deciding on the choice of an appropriate Islamic financing instrument.

Principle 2.3: IFIs shall have in place appropriate **methodologies for measuring and reporting the credit risk exposures arising** under each Islamic financing instrument.

Principle 2.4: IFIs shall have in place *Shari'ah*-compliant **credit risk mitigating techniques** appropriate for each Islamic financing instrument.

3 Equity Investment Risk

Principle 3.1: IFIs shall have in place appropriate strategies, risk management and reporting processes in respect of the **risk characteristics of equity investments, including *mudarabah* and *musharakah* investments**.

Principle 3.2: IFIs shall ensure that their **valuation methodologies** are appropriate and consistent, and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IFI and the *mudarib* and/or *musharakah* partners.

Principle 3.3: IFIs shall define and establish the **exit strategies** in respect of their equity investment activities, including extension and redemption conditions for *mudarabah* and *musharakah* investments, subject to the approval of the institution's *Shari'ah* Board.

4 Market Risk

Principle 4.1: IFIs shall have in place an appropriate **framework for market risk management** (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

5 Liquidity Risk

Principle 5.1: IFIs shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their **liquidity exposures in respect of each category** of current accounts, unrestricted and restricted investment accounts.

Principle 5.2: IFIs shall assume liquidity risk commensurate with their ability to have sufficient **recourse to *Shari'ah*-compliant funds** to mitigate such risk.

6 Rate of Return Risk

Principle 6.1: IFIs shall establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting the **rates of return on assets in comparison with the expected rates of return for investment account holders (IAHs)**.

Principle 6.2: IFIs shall have in place an appropriate framework for managing **displaced commercial risk**, where applicable.

7 Operational Risk

Principle 7.1: IFIs shall have in place adequate **systems and controls**, including *Shari'ah* Board/Advisor, to ensure compliance with *Shari'ah* rules and principles.

Principle 7.2: IFIs shall have in place appropriate **mechanisms to safeguard the interests of all fund providers**. Where IAH funds are commingled with the IFI's own funds, the IFI shall ensure that the bases for assets, revenue, expenses and profit allocations are established, applied and reported in a manner consistent with the IFI's fiduciary responsibilities.

Chapter 14

Risk Management Tools and Mechanisms

Preview

This chapter is intended to provide an explanation of hedging in Islamic finance and gives an overview of basic derivative contracts. A derivative is a financial instrument whose value depends on the value of other, more basic, variables. There are four basic derivative instruments in conventional finance: forward, futures, option and swap contracts. Islamic derivatives have been created and are now being used in the Islamic financial industry. These derivative products use *Shari'ah*-approved contracts and instruments such as, among others, *wa'd*, *tawarruq*, and commodity *murabahah*. The views of Islamic scholars on forwards, futures, options and swaps will be considered. Islamic financial contracts that have the features of conventional derivatives and structured products will be explained. This chapter also touches on the pricing of Islamic derivatives and Islamic-structured products. The objective of this chapter is to enable the reader to appreciate risk-hedging mechanisms, principles and structures used in Islamic finance today.

When both the farmer and buyer are faced with the possible risk that the price of maize may decrease or increase, respectively, they enter into a forward contract to lock in the price of maize to be paid and delivered in the future.

Learning Outcomes

At the end of this chapter, you should be able to:

- Understand the basic conventional derivative instruments in conventional finance.
- Comprehend and be able to calculate foreign exchange basics of depreciation and appreciation of currency.
- Understand the need for hedging instruments in Islamic finance.
- Know how to structure and apply Islamic derivatives and structured instruments.
- Calculate the pricing of Islamic derivatives.

Introduction

Risk is the possibility that the outcome of an event could result in an adverse result. More specifically in finance, risk refers to the probable loss of income and asset value.

The concept of risk has been explained extensively in the previous chapter. To recapitulate, "risk" is the possibility that the outcome of an event could result in an adverse result. More specifically in finance, risk refers to the probable loss of income and asset value. One way of mitigating risk is through hedging.

Hedging is one way through which a risk can be mitigated.

Hedging is defined as a "transaction that offsets an exposure to fluctuations in financial prices of some other contract or business risk" (Gupta, 2006, p. 599), or "to hedge is a position in a hedging instrument that is put on to reduce the risk resulting from the exposure to a risk factor". (Stulz, 2003, p. 156). Hedging amounts to reducing one's exposure to risk. Hedging and minimising risk in line with the *Shari'ah* is encouraged, as discussed in the previous chapter.

Using hedging instruments not only provides the benefit of avoiding risk but the economic benefit of ensuring certainty and guaranteeing the future. For example, a forward contract does not guarantee profit but guarantees a buyer for a seller and a seller for a buyer at a pre-determined price and quantity. If a manufacturer or farmer were to use a forward contract, it would guarantee the sale of his commodity by locking in the price and quantity of the commodity. By doing this, it would ensure that the manufacturer or farmer could plan for the future. Hedging is thus a necessary and an essential tool.

Hedging can be defined as a transaction that offsets an exposure to fluctuations in the financial prices of some other contract or business risk.

The issue, however, is not whether to hedge but *how* to carry out hedging. According to Al-Suwailem (2006), in Islam, if it involves gambling-like activities, it would be *haram* even though it would achieve hedging. To achieve legitimate hedging without elements of gambling is the ultimate aim of Islamic hedging instruments. This is exactly why Islamic derivatives have been developed in Islamic finance; to hedge against risk without elements of *maysir*.

This chapter begins by defining basic derivative contracts.

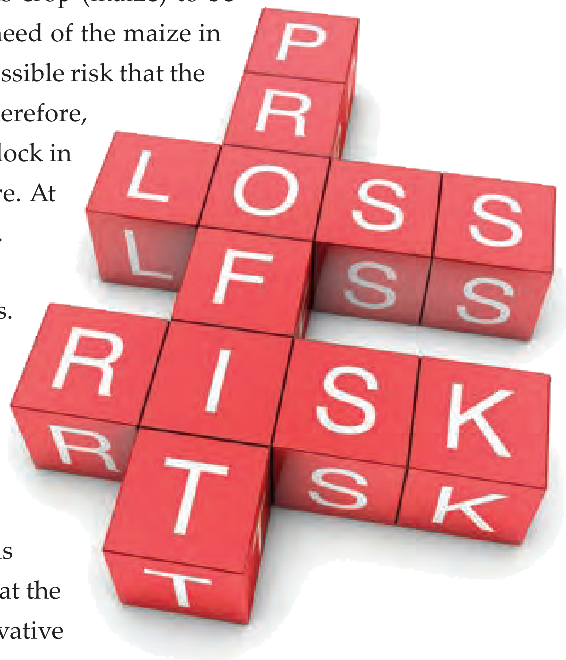
The Basics: Defining Derivatives

From the *Shari'ah* point of view, it is not a question of whether or not we need hedging, but rather, *how* are we going to hedge.

In conventional finance, hedging involves taking an offsetting position in a **derivative** in order to balance any gains and losses to the underlying asset. Hedging attempts to eliminate the volatility associated with the price of an asset by taking offsetting positions contrary to what the customer currently has. A derivative is a financial instrument whose value depends on the value of other, more basic, variables such as grains, crude oil, palm oil, currencies, or indexes. There are four basic derivative instruments in conventional finance: forward, futures, option and swap contracts.

A derivative is a financial instrument whose value depends on the value of other, more basic, variables such as grains, crude oil, palm oil, currencies, or indexes.

A forward contract has been recorded as the first derivative instrument to be used, and it is also the simplest in form. In a forward contract, two parties undertake to complete a transaction at a future date but at a price which is determined today. A good example would be a farmer who anticipates his crop (maize) to be harvested in the near future and a consumer who is in need of the maize in the near future as well. Both parties are faced with the possible risk that the price of maize may decrease or increase respectively. Therefore, to hedge their risk, they enter into a forward contract to lock in the price of maize to be paid and delivered in the future. At this point, there is no exchange of money or commodity.



The forward contract possesses a number of problems. First is the necessity of multiple coincidences; a party interested in the forward contract must find another with diametrically opposing needs. Second, since the forward price is arrived at by negotiation, one of the parties, who is in a better bargaining position than the other, may be able to impose a price on the other. Third is the counter-party risk, i.e., the risk to one of the parties that the other will default. Thus, the need arose for futures, a derivative contract which could solve all these problems.

A futures contract is basically a forward contract which is standardised with respect to contract size, maturity, product quality, place of delivery, and so on. Futures contracts are traded on exchanges that mediate the transactions of all buyers and sellers. Since many buyers and sellers transact through an exchange, the problem of multiple coincidence will be solved. Further, futures prices are considered to be fairer since the prices are arrived at by the interaction of many buyers and sellers, and therefore, a situation of one party imposing a price upon another is avoided. As for counter-party risk, this is solved by the exchange itself being the guarantor for each trade by being the buyer to each seller and the seller to each buyer.

A futures contract is basically a forward contract which is standardised with respect to contract size, maturity, product quality, place of delivery, etc.

The exchange, then, has to minimise the risk it bears, which is the potential default risk. The exchange achieves this by a process known as the margining process and by marking to market. The exchange requires each party to deposit initial deposits, known as initial margins. When losses occur, it will require the party who is losing to pay up as the losses occur. This is known as a margin call. Marking to market means that the gain or loss in each contract position resulting from changes in the price of the futures (or option) contracts at the end of each trading day are added or subtracted from each account balance. Through this marking to market process, the exchange will make margin calls when a party's position is losing. The party whose position is losing will be required to pay up as the losses occur. Another unique feature of futures is the ability of the buyers and sellers to reverse out of their position before delivery or maturity. Therefore, in commodity futures, physical delivery hardly ever takes place compared to forward contracts where delivery may take place.

An option contract entitles the holder the right, but not the obligation, to buy (or sell) the underlying asset at a pre-determined exercise price at, or any time before, maturity.

An option contract entitles the holder the right, but not the obligation, to buy (or sell) the underlying asset at a pre-determined exercise price at, or any time before, maturity. To acquire this right under an option, payment of a premium is required. There are two basic types of options: a call option and a put option. A call option provides the holder the right to buy, while a put option provides the holder the right to sell the underlying asset at a pre-determined price.

There are two basic types of options: a call option, and a put option.

In futures and forwards, unless the holder reverses his position before maturity, there will be an obligation to exercise the contract (pay the pre-determined price or deliver the commodity). However, for options, no such obligation exists at maturity until the option holder decides to exercise the option. In other words, for an option holder, inactivity will just cause the option contract to expire, with the net result that the premium paid will be lost. However, in a futures or forward contract, inactivity will require the holder to pay up or deliver the commodity.

A swap is a contractual agreement in which two parties agree to exchange payments over a period of time, based on a notional amount of the underlying asset.

A swap, on the other hand, is a contractual agreement in which two parties agree to exchange payments over a period of time, based on a notional amount of the underlying asset. The rate at which the payments are exchanged is pre-determined based on either a fixed amount or an amount based on a reference measure. There are several types of financial swaps that are commonly used in the conventional financial system – the interest-rate swap, currency swap, commodity swap and equity swap. The interest-rate swap involves the exchange of a fixed rate payment for a floating rate that is adjusted periodically. The currency swap includes the exchange of interest-rate payments in different currencies. The commodity swap, contrary to its name, does not involve any exchange of commodities. Instead, one party pays the other a fixed price for a commodity, such as crude oil, over a fixed period. At the same time, the other party would pay the first party the market price for the same commodity. The equity swap involves exchanging a stream of payments based on the performance of an underlying quantity of equity shares or an equity-share index.

Next, the concept of exchange rate and foreign exchange basics will be explained. This is necessary to understand why risk management tools are used in the financial world. In Islamic finance, managed risks are related to financial risks, which include currency exchange rate risks.

Foreign Exchange Basics (Nominal Versus Real Exchange Rate)

The foreign exchange (forex) market is an important component of any nation's capital market. Depending on how one looks at it, one could either consider the forex market as a component of the capital market or as a link between domestic capital markets and the global capital markets. Either way, the forex market can be a key source of liquidity for a domestic capital market. Actions of participants in the forex can either increase liquidity in a domestic capital market through capital inflows or drain liquidity through capital outflows.

The proper functioning of a domestic capital market and its well-being can depend, to a large extent, on the equilibrium in the foreign exchange market and the national currency's exchange rate. So, what exactly are the exchange rate and the forex market?

What is an Exchange Rate?

An exchange rate is the price of a foreign currency in terms of a local currency.

An exchange rate can be defined as the price of a foreign currency in terms of a local currency. When we say the Ringgit/US$ exchange rate is RM3.56, what it means is that the price per US$ in terms of Ringgit is RM3.56. It costs 3.56 Ringgit to buy 1 US$. If exchange rates are simply prices, then just as prices change when demand, supply and other factors change, so do exchange rates. For example, if the demand for US$ by Malaysians increases, then, *ceteris paribus*, the US$ will increase in price against the Ringgit. We call such an increase an appreciation. In this case, since the US$ has increased in value against the Ringgit, we say the US$ has appreciated against the Ringgit. If the US$ has gone higher in price in Ringgit terms, it follows that the US$ price of the Ringgit must have reduced. We call this reduction in value a depreciation. Since an exchange rate is a quotation involving a pair of currencies, an appreciation of one must mean a depreciation of the other. However, unless the exchange rate is unitary, that is one-to-one, the percentage appreciation of one currency need not equal the percentage depreciation of the other. To understand this, let us work through the following examples.

Example 1: Determining Percentage Appreciation/Depreciation

- Suppose the spot rate on 2 Jan, 20XX is;

  USD/MYR Exchange Rate = 3.42MYR per USD

- The exchange rate at year end on 31 Dec, 20XX is;

  USD/MYR Exchange Rate = <u>3.20MYR</u> per USD

Given the above spot exchange rates:

1. Which currency has appreciated/depreciated?
2. What is the percentage of appreciation/depreciation?

Based on the above rates, it is clear that the Malaysian Ringgit (MYR) has appreciated against the US Dollar. This is because it costs less in December to buy a USD than it did in January (RM3.20 as opposed to RM3.42). Since the Ringgit price/value of the USD has fallen, we say that the USD has **depreciated** against the MYR.

- MYR has appreciated against USD
- USD has depreciated against MYR.

Example 2: What is the percentage appreciation/depreciation?

Generally, the percentage appreciation and depreciation can be computed as follows:

$$\% \text{ Appreciation} = \left[\frac{e_1 - e_0}{e_0}\right] \times 100 \ldots (1)$$

Where:

e_1 is the exchange rate in the new period

e_0 is the exchange rate in the previous period

$$\% \text{ Depreciation} = \left[\frac{\frac{1}{e_1} - \frac{1}{e_0}}{\frac{1}{e_0}}\right] \times 100 = \left[\frac{e_0 - e_1}{e_1}\right] \times 100 \ldots (2)$$

In Examples 1 and 2, one has to be careful about the terms by which the exchange rate is quoted. Equation 1 would work if the exchange rates are entered as USD value of MYR, however, we are given exchange rates as MYR value of USD. To convert from the stated MYR value of USD to USD value of MYR is a simple process. One simply takes the reciprocal.

Table 14.1 Conversion of Exchange Rate

	MYR Value of USD	USD Value of MYR
e_0	3.42	1/3.42 = 0.2924
e_1	3.20	1/3.20 = 0.3125

Thus, e_0 of 3.42 MYR per USD is equivalent to 0.2924 USD per MYR.

Determining % appreciation of MYR using Equation 1:

$$\left[\frac{e_1 - e_0}{e_0}\right] \times 100 = \left[\frac{0.3125 - 0.2924}{0.2924}\right] \times 100 = 6.87\%$$

Thus, the MYR has appreciated 6.87% against the USD over the one-year period.

% Depreciation of USD using Equation 2:

$$\left[\frac{e_0 - e_1}{e_1}\right] \times 100 = \left[\frac{0.2924 - 0.3125}{0.3125}\right] \times 100 = -6.43\%$$

% Appreciation of MYR = 6.87%

% Depreciation of USD = 6.43%

The exchange rate, therefore is a price and like other prices is influenced by demand and supply conditions. While exchange rates are prices, it is a very important price, in the sense that it has widespread impact on the overall economy. Just as an incorrect price will distort a product's demand/supply equilibrium, a misaligned exchange rate, especially against currencies of key trading partners, could impact a nation's competitiveness. This happens because an exchange rate dictates the terms of trade between any two countries. An "under-valued/under-priced" exchange rate increases a nation's competitiveness whereas an "over-valued" exchange rate reduces competitiveness. The change in competitiveness comes hand-in-hand with other factors. For example, trying to gain competitiveness by deliberately undervaluing a currency may work only temporarily. Over a longer period, such under-valuation causes imported inflation, provide perverse incentives and a myriad of other problems including dysfunctional industrial growth. The long-term consequences could be serious.

Exchange rate is an important price that dictates the terms of trade between any two countries.

Exchange Rate Risk

Having discussed changes in exchange rates, we now turn to the related issue of exchange rate risk. If exchange rates can change, the parties involved in transactions that involve foreign currency would be exposed to exchange rate risk. Exchange rate risk can be defined as the potential change in the value of assets/liabilities or revenues/costs as a result of changes in the exchange rate. To understand how changes in exchange rates can cause changes in revenues, costs and assets or liabilities, let's look at Example 3.

Exchange rate risk refers to a potential change in the value of assets/liabilities of revenues/costs as a result of changes in the exchange rate.

Example 3: Understanding Exchange Rate Risk

1 Changes in Revenue/Receivable due to exchange rate change

A Malaysian exporter of sawn timber has just shipped 500 tonnes of timber to his Japanese customer, the Bento Corporation. The exporter has priced the product at RM30 million and has, therefore invoiced Bento for ¥300 million. This Yen amount was arrived at by using the current spot rate of 10 Yen per MYR. Bento has 90 days to pay the ¥300 million. As in most cross-border transactions, it is typical that at least one party would be faced with an exchange rate exposure, as the Malaysian exporter is, in this case. Bento Corporation of Japan has no currency exposure since it is paying in Yen, which is its home currency. The exposure, therefore is for the Malaysian exporter, who has a foreign currency receivable. This ¥300 million receivables is revenue for the Malaysian company.

Depending on what the spot rate between Yen and MYR is on day 90, the ¥300 million received may have a value different from the expected RM30 million. If the Yen appreciates over the next 90 days, the proceeds in MYR could be higher than RM30 million. If on the other hand, the Yen depreciates, proceeds could be lower. It is this uncertainty and the resulting implied "gain" or "loss" that is termed an exchange rate risk. We examine below the Ringgit (MYR) proceeds for three different spot rates on day 90.

Spot Rate on Day 90

(a) Yen depreciates: 12 Yen per MYR

$$\text{Proceeds in MYR} = \frac{¥300\text{ mil}}{12.0} = \text{RM25 mil}$$

Ringgit (MYR) proceeds = RM25 mil

Thus, implied loss/gain based on expected RM30 mil

= RM25 mil – RM30 mil

= (RM5 mil)

The Malaysian exporter would have suffered an exchange loss of RM5 million.

(b) Yen Stays Constant

$$\text{Proceeds in MYR} = \frac{¥300\text{ mil}}{10}$$

= RM30 mil

Ringgit (MYR) proceeds = RM30 mil

Since the proceeds equal the expected RM30 million, there will be no exchange gain or loss.

(c) Yen appreciates: 8.5 Yen per MYR

Proceeds in MYR = $\frac{¥300 \text{ mil}}{8.5}$

= RM35.29 mil

Ringgit (MYR) proceeds = RM35.29 mil

Implied gain = Actual proceeds – Expected proceeds

= RM35.29mil – RM30 mil

= RM5.29 mil

With the appreciation of the Yen, the Malaysian exporter stands to gain RM5.29 million as a result.

What can we summarise from the above examples?

Receivable/Revenue denominated in Foreign Currency (FC)

FC appreciation against HC (Home Country) = Exchange gain

FC depreciation against HC (Home Country) = Exchange loss

2 **Changes in Costs/Payables due to exchange rate change**

A Malaysian distributor of electrical appliances has just confirmed the import of a range of flat screen HDTVs from Samsung of Korea. Samsung will invoice the amount of Korean Won 980 million for the goods. Payment will be due in 90 days. The current MYR/Won rate is 0.30 MYR per 100 Won.

To examine the impact of a change in the MYR/Won exchange rate on the Malaysian company's Ringgit cost, we examine two scenarios. First, if the Won appreciates against the Ringgit and second, if the Won depreciates against the Ringgit.

Spot Rate on Day 90

(a) Won appreciates: MYR 0.33 per 100 won

Cost in MYR = (980 mil Won × 0.01) × 0.33

= RM3,234,000

Based on the exchange rate on day 0 of 0.30 MYR per 100 Won, the Ringgit cost would have been:

Cost in MYR = (980 mil Won × 0.01) x 0.30

= RM2,940,000

Implied Exchange Loss due to higher Won

= Expected Cost – Actual Cost

= RM2,940,000 – RM3,234,000

= (RM294,000)

(b) Won depreciates: MYR 0.26 per 100 Won

Cost in MYR = (980 mil Won × 0.01) × 0.26

= RM2,548,000

Based on day 0 exchange rate of MYR 0.30 per 100 Won, the Malaysian importer makes an implied gain from the Won's depreciation. The exchange rate gain is:

Expected Cost – Actual Cost = RM2,940,000 – RM2,548,000

= RM392,000

Summarising from the above example, when a cost/payable is in a foreign currency (FC),

FC depreciation against HC (Home Country) = Exchange Gain

FC appreciation against HC (Home Country) = Exchange Loss

The size of the gain or loss would depend on the extent of exchange rate change.

Again, the size of the gain or loss would depend on the extent of exchange rate change.

Table 14.2 Exchange Rate Change and Gains/Losses

FC Denominated	Item	Impact if FC Appreciates Against HC	Impact if FC Depreciates Against HC
Exports	Revenue	Gain	Loss
Imports	Cost	Loss	Gain
Receivable	Asset	Gain	Loss
Payable	Liability	Loss	Gain

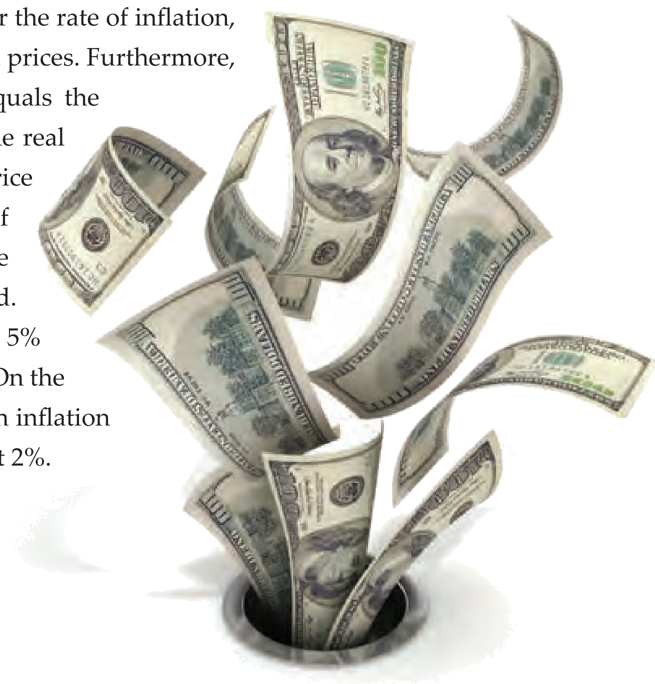
Exchange rate exposure arises the moment one enters into a foreign currency denominated transaction. Depending on one's position in the transaction and the direction of change in the exchange rate, an exchange-rate induced gain or loss is possible. This uncertainty is known as an exchange-rate risk. We will discuss some of the available *Shari'ah*-compliant products for managing such risks in the later sections.

Nominal versus Real Exchange Rates

Just as nominal and real prices can deviate in the presence of inflation, so too can exchange rates. A real price is the nominal price adjusted for inflation. If inflation is zero, then there is no difference between real and nominal prices. When, however, inflation is positive, say 5%, then nominal prices will increase by 5% whereas the real price is unchanged. This relationship can be shown as follows:

$P_{nom.} = P_{real} (1 + \mathit{inflation\ rate})$

$P_{real} = P_{nom} / (1 + \mathit{inflation\ rate})$



As is evident from the above equations, the higher the rate of inflation, the larger the deviation between real and nominal prices. Furthermore, as long as the increase in the nominal price equals the inflation rate, the real price is left unchanged. The real price only changes if the change in the nominal price is not equal to the inflation rate. For example, if the nominal price increases by more than the rate of inflation, then the real price too, has increased. An 8% increase in nominal price when inflation is 5% implies an increase in the real price by about 3%. On the other hand, if nominal prices go up only 6% when inflation is 8%, real prices would have gone down by about 2%.

A multi-period version of the above equations can be written as:

$P^t_{nom} = P_{real} (1 + \mathit{inflation\ rate})^t$

$P_{real} = P^t_{nom} / (1 + \mathit{inflation\ rate})^t$

Where exchange rates are concerned, the same logic applies. This logic is encapsulated within a parity or equilibrium condition within international finance, known as Purchasing Power Parity (PPP). According to PPP, a country with higher relative inflation should see its currency depreciate in relative terms. The percentage depreciation should equal the inflation differential. For example, if Thailand has 3% higher inflation than Malaysia, its currency, the Baht should depreciate 3% against MYR, the Malaysian Ringgit. If the currency depreciation equals the inflation differential, than PPP is said to hold. When PPP holds, *the real exchange rate is unchanged.* So, in the earlier example, when the Thai Baht falls 3% against the MYR because Thailand has 3% higher inflation, the nominal exchange rate has depreciated 3%, but in real terms the exchange rate is unchanged. An important implication of PPP is that, when the real exchange rate is unchanged, there is no change in a country's competitive position. It is only when there is a change in the real exchange rate that a country's competitive position is changed. For example, if the Thai Baht falls 7% against the MYR in the presence of 3% higher inflation in Thailand relative to Malaysia, then the Baht is *under-valued* in real terms against the MYR by about 4%. Such an under-valuation in real terms would make Thai exports more competitive against Malaysian exports in overseas markets. Alternatively, if the nominal depreciation of the Baht is only 1% against the MYR, then going by PPP, the Baht would be *over-valued* by about 2%. It is over-valued because the Baht did not fall as much as it should have. Such an over-valuation in real terms would mean that Thai exports would be less competitive against Malaysian exports.

The key point to keep in mind is that nominal exchange rate changes do not necessarily lead to changes in competitiveness. What really matters are changes in the real exchange rate and not nominal exchange rates.

To manage exchange rate risk, conventional finance uses derivatives as described above — forwards, futures, options and swaps. However, Islamic scholars have objected to these instruments due to a number of reasons.

Next, we turn to the reasons as to why there are objections against derivatives in the *Shari'ah*.

Forwards, Futures, Options, and Swaps from the Islamic Perspective

The main *Shari'ah* grounds based on which contemporary scholars in Islamic finance have objected to derivatives are categorised next. It should be noted that these objections are not universal; scholars disapprove or approve derivatives for various reasons. The main reasons why they have been disapproved are discussed below:

1 In the case of forex derivatives, the rules of *bay' al-sarf* (currency exchange) are contravened and there is *riba*. Currency forward, futures, option and swap contracts involve the exchange of money of different types or genus. When currency exchange is involved, the rules of *sarf* applies.

Exchange of debt for a debt, *bay' al-kali bi al-kali*, is prohibited.

2 A futures sale, being the deferment of both counter values, is a sale of one debt for another, i.e., *bay' al-kali bi al-kali*, which is forbidden. The exchange of a debt for a debt is also known as *bay' al-dayn bi al-dayn.* It has generally been found to be prohibited in Islamic law by Islamic scholars. Imam Ibn Hanbal, founder of the Hanbali school, ruled that common consensus (*ijma' al-nas*) has forbidden the sale of debts for debts or cash. There also exists a *hadith* which reports that Musa ibn Ubayd reported from Abd Allah ibn Umar and Rafi Ibn Khadij simply that the "the Prophet (peace be upon him) prohibited *bay' al-kali bi al-kali*" (compiled by Al-Dara-qutni, Ibn Al-Bazzar and Ibn Abi Shaibah). This general prohibition has been construed to apply to futures; it is concluded that the sale of futures contracts, where

the parties can offset their transactions by selling the "debts" owed to them to other parties before the delivery of the underlying asset, will amount to a sale of a debt, which is prohibited.

Exhibit 14.1 *Shari'ah* Ruling on *Bay' al-Sarf*

The Accounting and Auditing Organization of Islamic Financial Institution's *Shari'ah* Standard 1 on Trading in Currencies, laid down the following *Shari'ah* ruling on trading in currencies:

> 2/1 It is permissible to trade in currencies, provided that it is done in compliance with the following *Shari'ah* rules and precepts:
> (a) Both parties must take possession of the counter values before dispersing, such possession being either actual or constructive.
> (b) The counter values of the same currency must be of equal amount, even if one of them is in paper money and the other is in coin of the same country, like the note of one pound for a coin of one pound.
> (c) The contract shall not contain any conditional option or deferment clause regarding the delivery of one or both counter values.
> (d) The dealing in currencies shall not aim at establishing a monopoly position, nor should it entail any evil consequences to the interest of individuals or societies.
> (e) Currency transactions shall not be carried out on the forward or futures market.

Thus, trading of currencies is required to be done hand-to-hand in equal quantities in the same genus, or with different amounts in different genus, to prevent *riba*. In the case of forwards, futures, options and swaps, where there is deferment of the payment of the currency, there will be a breach of the rules of *sarf*, and thus the incurrence of *riba al-nasi'ah*.

3 Both counter values, the money and goods, in forward, futures and option sales are deferred and often nonexistent at the time of the contract. Hence, a genuine sale does not exist but is merely a sale or exchange of promises. A sale can only be valid in *Shari'ah* if either the price or the delivery is postponed but not both. In Islamically permitted contracts, only one of the counter values of the contract is allowed to be deferred and nonexistent (for example, the *salam* contract). Where both the counter values are deferred and nonexistent at the time of the contract, as is in the case of futures and options, *Shari'ah* objections as to the permissibility of derivatives arise.

Article 197 of The Mejelle, the Ottomon Civil Code, (elaborated between 1869 and 1875 and based on the Hanafi law of *fiqh*), provides that "the thing sold must be in existence", and Article 205 further provides that "the sale of a thing which is not in existence is void".

The scholar Mahmassani has stated that contracts to sell future things, except for the *salam* and *istisna'* contracts, are invalid in *Shari'ah* because such things are nonexistent. In the case of *salam,* only one of the goods is deferred at the time of the sale. This is allowed in *Shari'ah*. However, the non-existence of both counter values of the contract in the case of forwards, futures and options amounts to unwarranted risk-taking and *gharar* that is filled with uncertainties over the prospects of fulfilment.

Exhibit 14.2 OIC Islamic *Fiqh* Academy Resolution on Conventional Forward

This opinion is also held by the Organization of the Islamic Conference (OIC) Islamic *Fiqh* Academy. The Islamic *Fiqh* Academy, at its seventh session in 1412 H (9 to 14 May 1992), issued the following resolution:

> Where the contract provides for the delivery of described and secured merchandise at some future date, and payment of its price on delivery. It also stipulates that it shall end with the actual delivery and receipt of the merchandise. This contract is not permissible because of the deferment of the two elements of the exchange. It may be amended to meet the well-known conditions of "*salam*" (advance payment). If it does so, it shall be permissible.

4 Option sales are a mere right to buy or sell; charging of fees for this is not permissible. In an option contract for the right given to buy (or sell) the underlying asset at a pre-determined exercise price, payment of a premium is required.

An option is a promise and such a promise itself is permissible and is "normally binding on the promisor". However, the fact that an option transaction entails a fee for the promise makes it invalid under *Shari'ah*.

This view is based on the fact that options are rights, not tangible assets, and therefore cannot be the subject matter of a sale and purchase.

Exhibit 14.3 OIC Islamic *Fiqh* Academy Resolution on Option

The OIC Islamic *Fiqh* Academy, at its seventh session in 1412 H (9 to 14 May 1992), issued Resolution No. 63/1/7 stating:

Option contracts as currently applied in the world financial markets are a new type of contract which does not come under any one of the *Shari'ah* nominate contracts. Since the object of the contract is neither a sum of money nor a utility nor a financial right which may be waived, the contract is not permissible in *Shari'ah*.

5 This objection is in relation to exchange-traded derivatives. The majority of buyers and sellers in futures and option transactions reverse out of their position before delivery or maturity. Thus, the trader sells something which he does not possess. This feature of derivative trading, i.e., sale before taking delivery is made or selling something one does not possess, has been subject to intense criticism by Islamic scholars. The rationale behind taking possession is to prevent *gharar.*

Exhibit 14.4 OIC Islamic *Fiqh* Academy Resolution on Exchange Traded Derivatives

The Islamic *Fiqh* Academy, at its seventh session in 1412 H (9 to 14 May 1992), issued Resolution No. 63/1/7, stating:

> The contract provides for the delivery of described and secured merchandise at some future date, and payment of its price on delivery. The contract, however, does not stipulate that it shall end with the actual delivery and receipt of the merchandise, and thus it may be terminated by an opposite contract. This type of contract is the most prevalent in the commodity markets. It is not at all permissible; moreover, it is not permissible to sell merchandise purchased under "*salam*" terms with advance payment unless the merchandise has already been received.

6 Futures, option and swap trading involve speculation and verge on *maysir, qimar* and *gharar.* In exchange-traded derivatives, speculators often bet on the rise or fall in prices of the underlying asset. The zero-sum (gain of one party at the loss of the other) nature of derivatives allows them to be used as a tool for speculation and games of chance. Even in an Islamic framework, speculation per se is not unlawful, but when speculation is akin to gambling, it is prohibited.

Due to all the above objections to conventional derivatives, Islamic derivatives have been created. These are described in the following pages.

Islamic Forex Derivative Instruments

The Islamic derivative instruments developed and used in Islamic banking and finance have been mostly to hedge against risks in exchange rates and profit rates. Under this part of the chapter, Islamic derivatives like instruments used to hedge against exchange rate and profit rate risk are explained and discussed.

Firstly, we start with the Islamic promissory forward contract using the *wa'd*, then the Islamic FX Swap instrument, also using the *wa'd*. Next, the Islamic Cross Currency Swap which uses the commodity *murabahah/tawarruq* structure is described, followed by the Islamic profit rate swap that also uses the commodity *murabahah/tawarruq* structure. Lastly, we discuss the Islamic options using the *wa'd* instrument (this structure is not in universal use).

The use of the *wa'd* instrument has been approved in the trading of currencies by the OIC *Fiqh* Academy, the AAOIFI and the *Shari'ah* Advisory Council of Bank Negara Malaysia.

Exhibit 14.5 *Shariah* Ruling on the Use of Promise in Structuring Islamic Currency Forwards

According to the AAOIFI *Shari'ah* Standard 1: Trading in currencies, 2/9:

> Bilateral Promises in Currency Trading: A bilateral promise is prohibited in currency trading when it is binding upon both parties, even when it is done to treat the risk of decline in a currency's value. **As for a unilateral promise from one party, that is permissible, even if it is binding.**

Also, according to the *Shari'ah* Advisory Council of BNM:

> The Council, in its 49th meeting held on 28 April 2005/19 Rabiulawal 1426, resolved that an Islamic banking institution is allowed to enter into a forward foreign currency transaction, based on unilateral binding promise (binding only on the promisor) and the compensation for breaching of promise could be implemented.
>
> This permissibility is only applicable for currency hedging purposes. Such a transaction may be arranged between the Islamic banking institution and its customers, or between Islamic banking institutions, or between Islamic banking institutions and conventional banking institutions.

The AAOIFI Standard and the *Shari'ah* Advisory Council of BNM, allows a unilateral promise or *wa'd* to be given in a currency exchange. This opinion is also held by the OIC Islamic *Fiqh* Academy in Resolution No. 63/1/7 of 1992 in its seventh session where they recommended the use of *wa'd* as one of the *Shari'ah*-approved instruments to create *Shari'ah*-approved alternatives to currency trading.

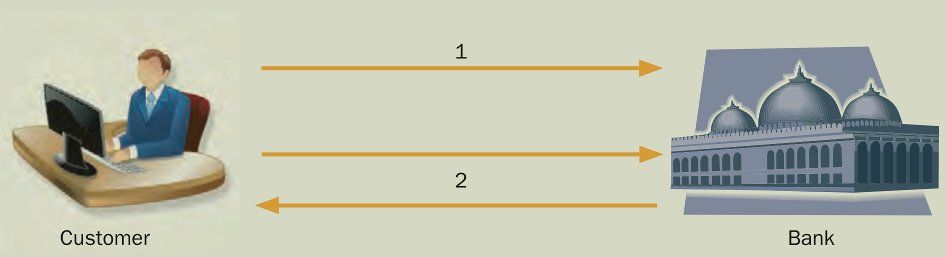
However, bilateral promises are not to be allowed. Here, a distinction has to be made between *al-wa'd*, a unilateral promise by one party; *al-wa'dan*, two independent unilateral promises given by two parties to each other but dependent on two different conditions; and *al-muwa'adah*, where two bilateral promises are made by two parties which are dependent on each other.[1] The first two promises are permissible, however, the last bilateral promise would seem to be prohibited in currency trading. In the Islamic forward structures that are discussed in this chapter, there are only *al-wa'd* and *al-wa'dan* promises and no *al-muwa'adah* (bilateral promises).

Islamic Promissory Forward Contracts

Forward *Wa'd-i* Product

A forex forward *Wa'd-i* product is a unilateral contract involving two parties, where the first party promises with the latter party to buy or sell currency for settlement on a forward value date at the rate and amount agreed today. The party who makes the promise is obliged to honour the contract; however, the other party is not obliged to do the same.

A forex forward *Wa'd-i* product is a unilateral contract involving two parties, where the first party promises with the later party to buy or sell currency for settlement on a forward value date at the rate and amount agreed today.



Source: Modified from interviews with Islamic banks.

Figure 14.1
Forex Forward *Wa'd-i* Product

1 Customer promises on 24 June 2010, to buy USD10 million from an Islamic bank on 24 July 2010 at the exchange rate 3.2700. The customer is bound by the unilateral promise.

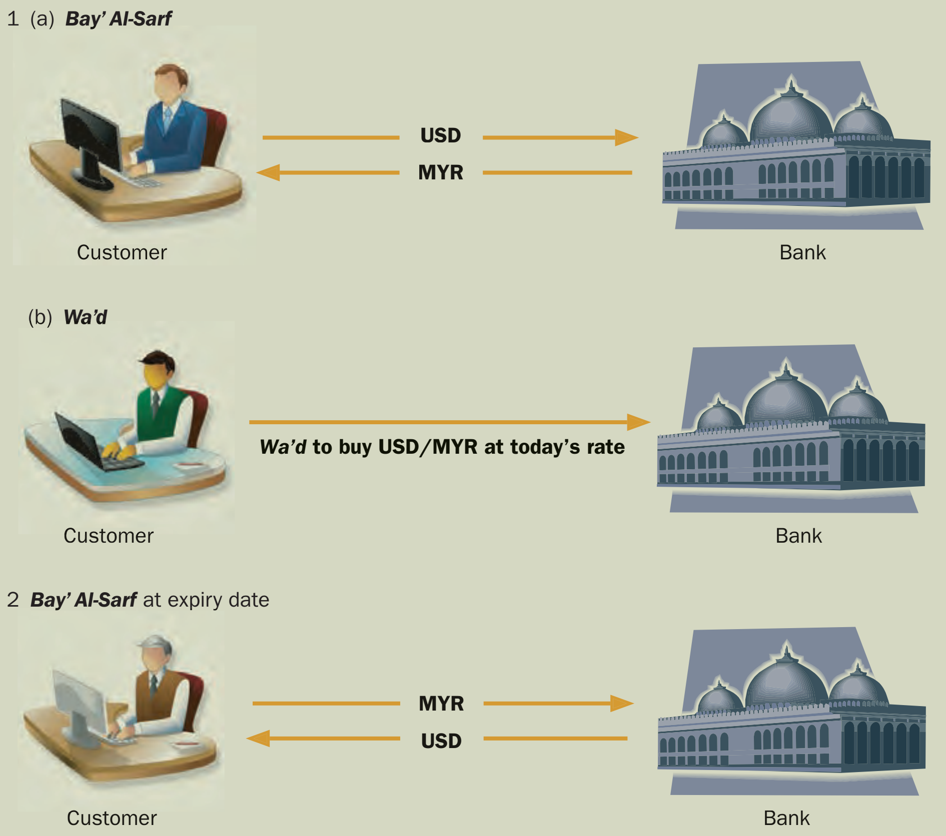
2 On 24 July 2010, the bank will pay USD10 million and receives MYR 32.7 million from customer.

The currency exchange is complete and the customer receives USD10 million at the exchange rate 3.27000 regardless of the market rate.

1 A *wa'dan* are two unilateral promises given by both counterparties but with different conditions and having a different effect whereas *muwa'adah* has the same effect. See Hasan (2008) for further reading.

Islamic Forex Swap

This structure is a forex swap based on the concept of *wa'd*. This arrangement consists of a *bay' al-sarf* at the beginning of the transaction followed by an undertaking *(wa'd)* by the customer to enter into a currency exchange (*bay' al-sarf*) on a future date at today's exchange rate. On the future date, another *bay' al-sarf* takes place at the rate which was promised at the earlier date.



Source: Modified from Dusuki (2009:89).

Figure 14.2
Forex Swap based on *Wa'd*

Islamic Cross Currency Swap

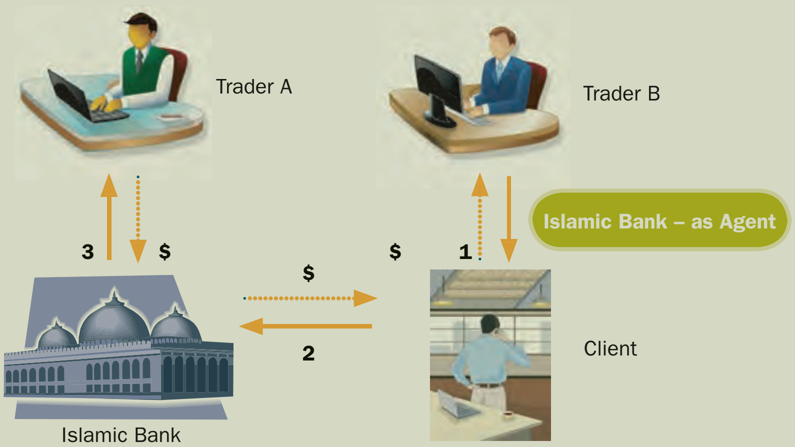
The Islamic Cross Currency Swap (ICCS) is a bilateral agreement between two parties to make regular payments to each other at an agreed interval, but in two different currencies. It is used as a risk management tool to hedge both the foreign currency rate and the profit-rate risk. The bilateral payments can be done in different arrangements: fixed exchange rate (fixed) swapped with floating exchange rate (e.g., based on KLIBOR) (floating), floating-floating, fixed-fixed or floating-fixed. A commodity transaction is used at every settlement date.

The Islamic Cross Currency Swap (ICCS) is a bilateral agreement between two parties to make regular payments to each other at an agreed interval, but in two different currencies.

Example: A client receives 5% quarterly for five years for its US$10 million investment. In other words, the client receives fixed investment returns in USD; however it requires MYR to pay for its liabilities. So, the client swaps this with an Islamic bank for Ringgits, based on KLIBOR. The exchange rate is fixed, thus hedging against forex rates.

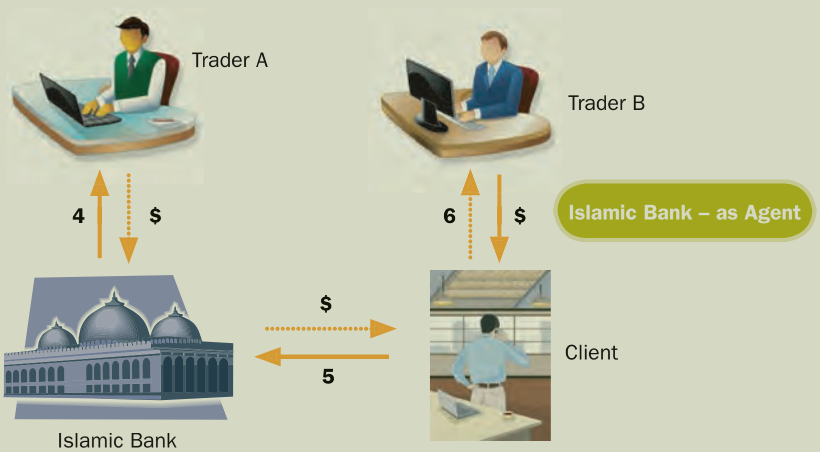
Through the use of commodity *murabahah* or *tawarruq*, the Islamic bank carries out the ICCS in the following manner:

FIRST LEG – Islamic bank buys the commodity and pays the client cost × KLIBOR in MYR



Step 1: Client buys a commodity through an Islamic bank from Trader B for cash.
Step 2: Islamic bank buys the commodity from the client at cost + KLIBOR in MYR (assuming floating is KLIBOR).
Step 3: Islamic bank sells off the commodity at cost.

SECOND LEG: Client buys the commodity and pays the Islamic bank cost + 5% USD.



Step 4: Islamic bank buys a commodity from Trader A for cash.
Step 5: Islamic bank sells the commodity to client at Cost + 5% p.a. USD.
Step 6: Islamic bank assists the client to sell off the commodity at cost.

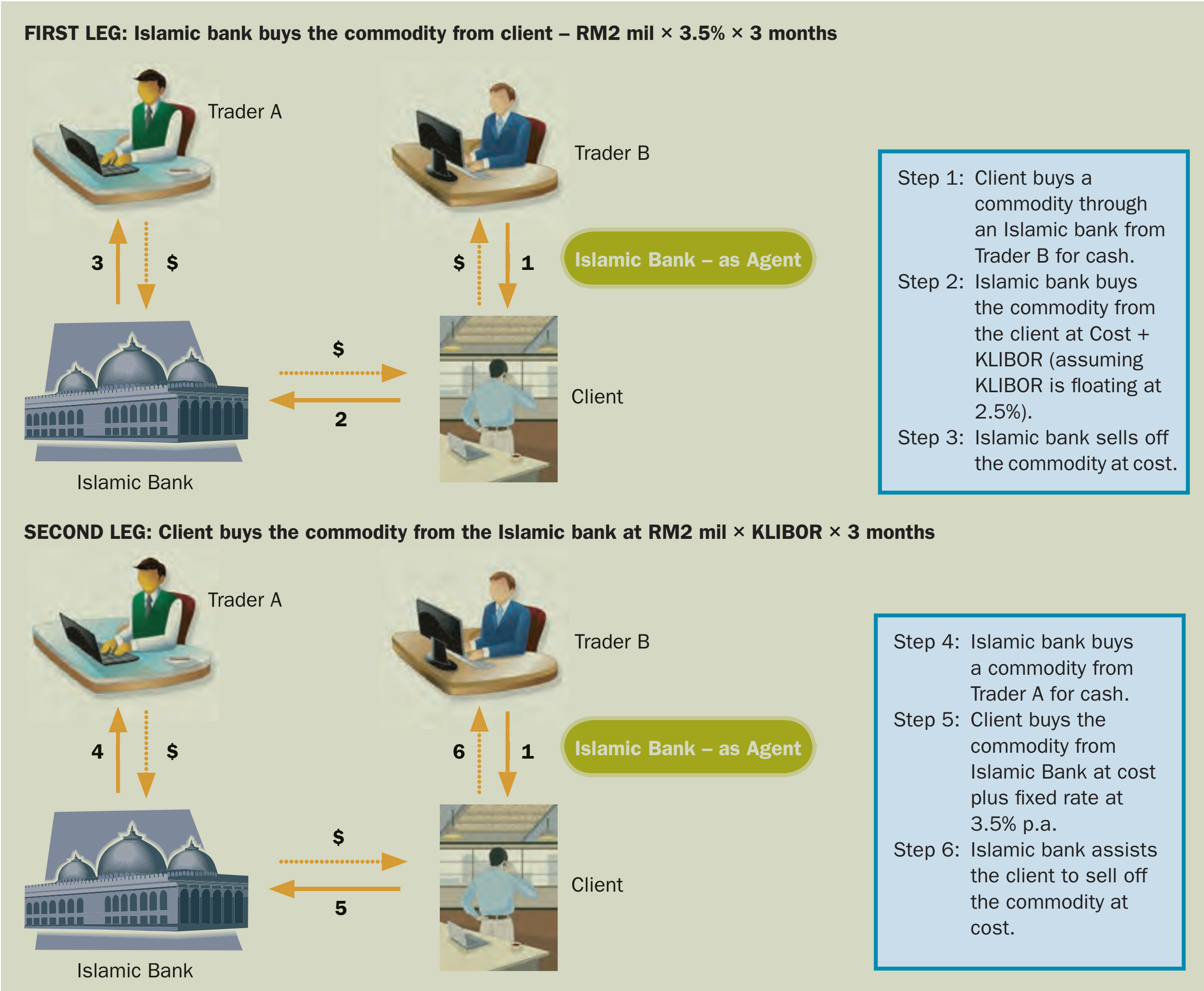
Client pays:
US$10 mil (USD) × 5% (fixed rate) × 92/365 (3 months) = US$126,027.00
Islamic bank pays:
RM34 mil (MYR) × 2.5% (floating - KLIBOR) × 92/365 (3 months) = RM214,244.20
Notional amount exchanged (i.e., the total amount due is exchanged, not just the difference)
Client swaps US$126,027.00 with Islamic Bank's RM214,244.20

Source: Modified from author's interviews with bankers.

Figure 14.3 An example of Islamic Cross Currency Swap

Islamic Profit Rate Swap

The Islamic Profit Rate Swap (IPRS) is a bilateral agreement between two parties to make regular payments to each other at agreed intervals. These instruments are used to hedge against adverse profit-rate movements, usually by exchanging cash flow from fixed to floating (or vice-versa) within the same currency. The commodity transaction



Client pays:
RM2 mil × 3.5% (fixed rate) × 92/365 (3 months) = RM17,643.80
Islamic bank pays:
RM2 mil × 2.5% (KLIBOR) × 92/365 (3 months) = RM12,602.26
Islamic bank to pay the net amount (*muqasah*) to client, an amount of RM17,643.80 – RM12,602.26 = **RM5,041.20**

Source: Modified from author's interviews with bankers.

Figure 14.4 An example of Islamic Profit Rate Swap is used at each settlement date. The amount and the period of time between the regular payments are customisable, according to the client's and bank's needs.

The Islamic Profit Rate Swap (IPRS) is a bilateral agreement between parties to make regular payments to each other at agreed intervals.

As for the structure, the fixed rate is determined at the start of the contract and remains the same until the end of the tenure and agreed reset date. The floating rate is referenced to an index and is determined at every settlement date. The notional amount is usually not exchanged: only the net-off amount (difference) is exchanged at each settlement date (see Figure 14.4).

Example: A client has a RM2 million rental obligation with a two-year remaining tenure. The client is paying a floating rental by paying a KLIBOR flat every quarter and wishes to pay an equivalent of fixed rental.

The Islamic bank agrees to swap the floating rental payments with a fixed rate for the next two years at 3.5% p.a. In other words, the client will give the Islamic bank the rental based on KLIBOR, and the Islamic bank will swap this with the client at a fixed rate of 3.5%.

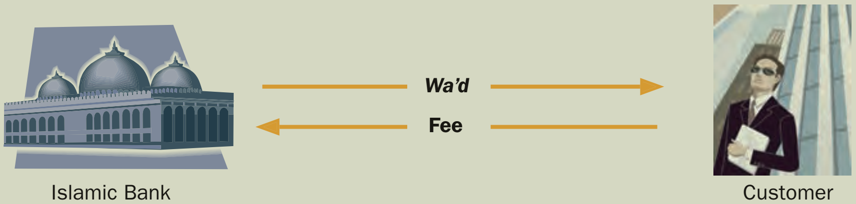
Through the use of commodity *murabahah* or *tawarruq* or *musawamah*,[2] the Islamic bank carries out the IPRS in the following manner:

Islamic Options

Forex *Wa'd*

The forex *wa'd* is a structure very similar to the conventional option. It uses the *wa'd* promise which is binding on one party. On the start date of the transaction, the bank will undertake to the customer to exchange Currency 1 against Currency 2 at a pre-agreed rate on a future date. On the same date, the bank will receive a fee from the customer for its undertaking.

1 Start date:



Source: Modified from author's interviews with bankers.

Figure 14.5
Forex *Wa'd*

2 A sale in which the seller is not obligated to disclose the price paid to create or obtain the goods or services. This defers from *murabahah*, where a buyer knows the cost of the underlying asset.

On the future date, the customer might ask the bank to fulfil its promise or might release the bank from its undertaking. If the customer wants to execute the *wa'd* upon the maturity date, the bank and the customer will exchange the currencies.

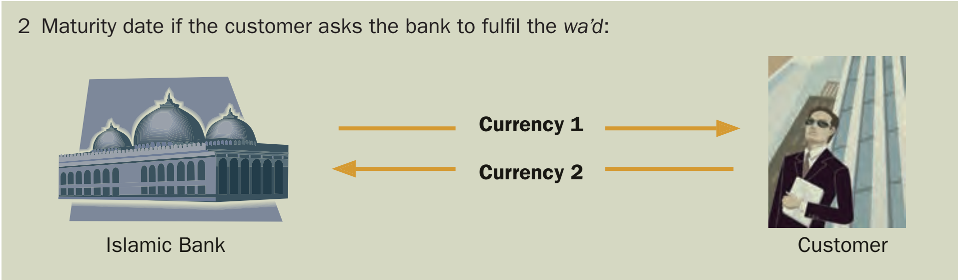


Figure 14.6
Forex *Wa'd*

The customer will want to execute the *wa'd* if the currency rate is favourable to him. The upside of this contract is that the customer can wait and see whether the *wa'd* is more favourable or less favourable then the prevailing market rate. However, the customer is required to pay a fee for the *wa'd*.

Islamic-Structured Products

Islamic-structured products are investment products and not risk-management tools per se. However, they are included in this chapter because they contain underlying Islamic derivatives.

A structured product is not easy to define; this could be because the term "structured product" is a generic term that encompasses a variety of investment products. The Securities Commission of Malaysia (SC) defines "structured product" in its Guidelines on Structured Products under para 1.03 as:

> 1.03 for the purposes of these guidelines:
>
> (a) The term "structured product" means any investment product that falls within the definition of "securities" under the SCA [Securities Commission Act 1993] which provides the holder with an economic, legal or other interest in another asset ("underlying asset") and derives its value by reference to the price or value of the underlying asset;
>
> (b) The term "underlying asset" means any security, index, currency, commodity or other assets or combination of such assets.

A structured product is an investment product that derives its value from an underlying asset.

As can be seen from the above definition, a structured product is firstly an investment product and secondly, it derives its value from an underlying asset. The latter part of the definition of a structured product would be a derivative. Another useful definition of a structured product is found on the Internet at several websites:

> "Structured products are investment instruments specially created to meet specific needs that cannot be met from the standardised financial instruments available in the markets. Structured products can be used as an alternative to a direct investment; as part of the asset allocation process to reduce risk exposure of a portfolio; or to utilise the current market trend."

Islamic structured products use permissible contracts according to Islamic principles to create Islamic-structured products, but the economic effect is the same. Examples of conventional-structured products are Interest Rate-linked Notes, Equity-linked Notes, Forex and Commodity-linked Notes, Hybrid-linked Notes, Bond-linked Notes, and Index-linked Notes.

The majority of Islamic-structured products come in the form of capital-guaranteed equity-linked Islamic-structured notes.

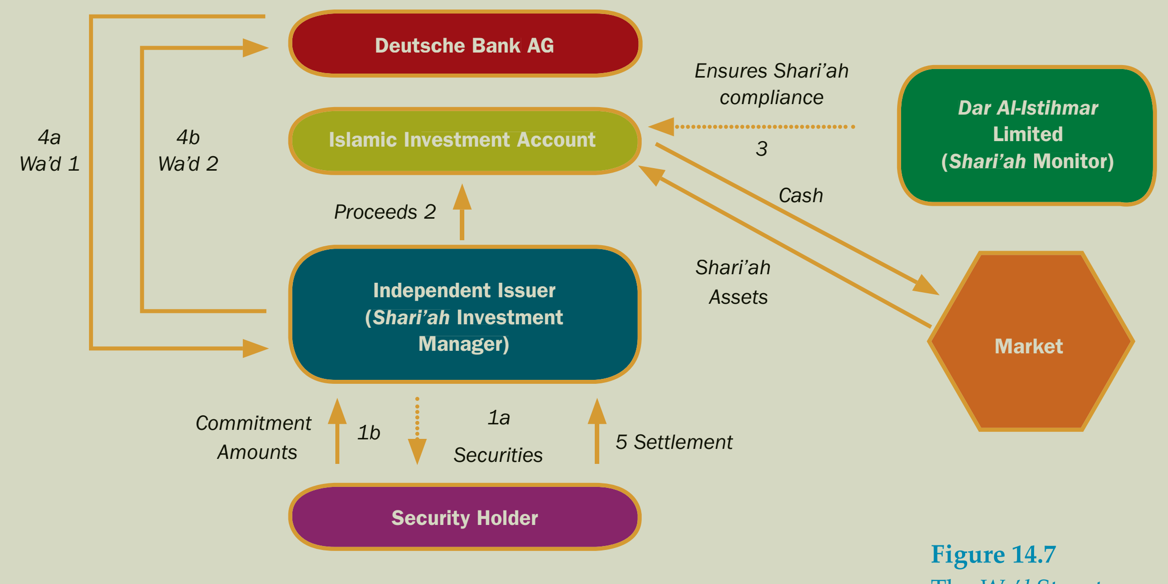
In this chapter, we discuss two structures used in the Islamic financial industry, one based on *wa'd* and the other on *murabahah*. The two structured products are real case examples from Deutsche Bank and Calyon Bank in Dubai. The information is derived from Deutsche Bank, *Understanding the Deutsche Bank* Wa'd *Structure*, and Calyon Bank's fact sheets.

Islamic structured products, while having the same economic effect, use permissible *Shari'ah*-compliant contracts.

Wa'd Based – Deutsche Bank

This structure was developed by Deutsche Bank (DB), as an Islamic investment structure. It allows customers to channel their funds in a *Shari'ah*-compliant way.

The structure is as follows:



Source: Deutsche Bank, *Understanding the Deutsche Bank* Wa'd *Structure*.

Figure 14.7
The *Wa'd* Structure

The explanation below is based on Figure 14.7:

1 The Issuance Process:

(a) Independent Issuer issues the Securities to the Security Holder

(b) Independent Issuer receives the Commitment Amounts ("Par")

2 Independent Issuer will credit the Islamic Investment Account in respect of each structured product with *Shari'ah*-compliant assets (the "Islamic assets", bought from the market, of value equal to the commitment amounts, and shall operate the Islamic Investment Account (holding full legal title to the assets) in its capacity as *Shari'ah* Investment Manager pursuant to an Investment Management Deed Poll, all in accordance with the instructions of the *Shari'ah* Monitor.

3 Independent Issuer will appoint Dar Al Istithmar Ltd as its *Shari'ah* Monitor in accordance with a *Shari'ah* Monitoring Agreement.

4 (a) Deutsche Bank will in accordance with the terms of the Undertaking to Purchase, *Wa'd* 1, unconditionally and irrevocably promise the *Shari'ah* Investment Manager to purchase the Islamic assets in accordance with certain conditions and upon delivery to DB of a Relevant Notice.

(b) The *Shari'ah* Investment Manager enters into a similar Purchase Undertaking, *Wa'd* 2, unconditionally and irrevocably promising DB, in accordance with a different set of conditions, to sell the *Shari'ah* assets at a pre-defined price and upon delivery to the *Shari'ah* Investment Manager of a Relevant Notice.

There are two things to note here, firstly, these two *wa'ds* are subject to different conditions and therefore, only one will ever be exercised. Secondly, in these two unilateral purchase undertaking deeds, the pre-defined purchase price is benchmarked to the performance of a reference asset, thereby offering security holders exposure to the performance of a potentially non-*Shari'ah* underlying.

5 Deutsche Bank, in its capacity as calculation agent, will compute any profit or loss to the security holders in accordance with the terms of the securities and the relevant underlying asset (as set out in the prospectus).

Transaction:

Customer's cash is pooled in a segregated Islamic Investment Account and invested only in *Shari'ah* assets. The *Shari'ah* assets are traded/managed, that is, bought and sold, at benchmarked prices by the *Shari'ah* investment manager.

The ***Purchase Undertaking Deeds*** can take two different forms:

1. ***For non-principal protected products***
   - (a) If the value of the Islamic assets is greater than the performance of the reference asset, DB will issue a notice and purchase the assets at a price benchmarked to the reference asset.
   - (b) If the value of the Islamic assets is less than the performance of the reference asset, the investment manager is able to sell the Islamic assets to DB at a price benchmarked to the reference asset.

2. ***For principle-protected products***
   - (a) If the value of the Islamic assets is greater than the performance of the reference asset, DB will deliver a notice which will enable it to purchase the Islamic assets at the sale price.

     Sale Price = Cost (Commitment Amount or Par) + Profit (Index Performance)[3]
   - (b) If the value of the Islamic assets is less than the performance of the reference asset, DB will receive a notice to purchase the Islamic assets at the sale price and the customers shall receive par plus index performance.

Commodity *Murabahah*-based Structured Product – Calyon Bank

The structured *murabahah* deposit is a series of commodity *murabahah* sales, and offers a return linked to the performance of an underlying asset, according to a pre-agreed formula. It is intended to replicate the economics of a structured deposit. The first *murabahah* deal will pay a fixed profit because the return on the underlying will not be known until the end of the period. Starting from the second *murabahah* until the *n*th *murabahah*, each *murabahah* will pay as a profit the (n – 1)th underlying performance reflecting the return of the previous period.

The structured *murabahah* deposit is a series of commodity *murabahah*, and offers a return linked to the performance of an underlying, according to a pre-agreed formula.

3 Index performance is floored at zero.

In respect of each *murabahah* transaction, the customer will receive:

1 Part of the sale price (profit) on the trade date

2 The balance of the sale price on a deferred basis

The last *murabahah* will be a short *murabahah* (two or three days) where, on a deferred payment date, the customer will receive his initial investment plus the profit on the underlying for the final period.

Transaction:

On the start date, the customer funds the deposit by purchasing commodities and selling them to Calyon on deferred terms, reflecting a fixed return for the first reference period and payable to the customer at the end of the first reference period.

For all subsequent *murabahah*, the customer receives as a profit the performance of the underlying from the previous period.

The profit must be known at the time of the *murabahah* transaction.

The capital is guaranteed upon maturity only. If the customer decides to terminate the investment before maturity, a loss could be incurred.

Next, we discuss the principles on pricing Islamic derivative instruments and Islamic-structured products.

Pricing of Islamic Derivatives and Islamic-Structured Products

In attempting to price Islamic derivatives instruments, one would run into several challenges. Opacity is perhaps the main hurdle. Since almost all available Islamic derivatives are over-the-counter (OTC) instruments and customised, they are essentially structured products. As all structured products are different from one another, we cannot use generalised pricing techniques. Furthermore, in the case of Islamic derivatives, *Shari'ah* compliance, more than anything else, is often the key objective, as users may not be too concerned about pricing efficiency. In addition, Islamic financial institutions often view pricing to be a proprietary issue. In many cases, pricing may also be on a willing buyer/willing seller basis.

Given a lack of transparency and the customised nature of these products, we will describe how one could use the underlying valuation principles in pricing these instruments. Accordingly, in the discussion that follows, we describe common valuation techniques and show how they could be applied in pricing Islamic derivatives instruments.

The basic logic of pricing an asset in finance can be described as follows:

1 The value of the financial asset/instruments is equal to the present value of cash flows generated from the asset.

2 Where they are offsetting cash flows, the value will depend on the net cash flow, i.e., all positive cash-flows add to value whereas negative ones reduce value.

3 Where there are multiple cash-flows, each cash flow should be valued individually and aggregated to arrive at the overall value of the asset/instrument.

4 Where a component cash flow is based on a contingent claims analysis (CCA) which uses probabilities, it can be used to determine "expected" cash flows.

5 Where an asset has one or more embedded options, the options must be identified and valued individually.

6 Where an asset is based on another underlying asset, its value is derived by valuing cash flows generated by the underlying asset.

We will discuss three Islamic-structured products to illustrate how some of the above principles would be applied. First, a basic *sukuk ijarah*. Secondly, a *sukuk ijarah* with warrants attached (a warrant is nothing but a long-dated call option), and thirdly, a *wa'd*-based currency swap.

Valuing a Basic *Sukuk Ijarah*

In a typical *sukuk ijarah*, a customer would receive two types of inflows in exchange for an initial outlay. The value or price of such a basic *sukuk* would be the present value of cash flows that one can receive from investing in the *sukuk*. The present value (PV) is simply the aggregate discounted value of each future cash flow. The discount rate would not be the interest rate commonly used in conventional finance but an opportunity cost applicable to the customer. This opportunity cost could be risk adjusted, in the sense that a higher opportunity cost of funds would be applied to *sukuk* issued by entities perceived to have higher risk.

Using the appropriate discount rate, one would first find the present value of the periodic lease payments. The aggregate of this is then added to the present value of the single proceed from the sale of the underlying asset to the *mudarib*. If the sale price is pre-determined, then one merely finds the present value of the amount given the opportunity cost and the time (in years) when the cash flow will occur. If, however, the sale price is not pre-determined, then an estimate of the expected sale price has to be made. There are several ways to handle this estimate. One way would be to assign several possible sale prices and then assign probabilities to each potential price. The weighted average of this value is then taken to be the "expected" sale price. For example, suppose there are five possible sale prices with the following probabilities.

Table 14.3 Sale Prices and Probabilities

Scenario	Potential Sale Price	Probability
1	RM120 million	0.10
2	RM110 million	0.20
3	RM100 million	0.40
4	RM85 million	0.20
5	RM60 million	0.10

The certain equivalent value or expected sale price would be:

Expected Sale Price = $\Sigma(P_t SP_i)$

Where:

P_i = probability of the event/scenario happening.

SP_i = Sale price of asset under the scenario.

$$\begin{aligned}\text{Expected Sale Price} &= \Sigma(0.10 \times \text{RM } 120 \text{ mil}) + (0.20 \times \text{RM } 110 \text{ mil}) + \\ &\quad (0.40 \times \text{RM } 100 \text{ mil}) + (0.20 \times \text{RM } 85 \text{ mil}) + (0.10 \times \text{RM } 60 \text{ mil}) \\ &= \text{RM } 97 \text{ mil}\end{aligned}$$

In this case, the probability weighted average of RM97 million is the expected sale price. The price of the basic *sukuk al-ijarah* will be the sum total of the following two items:

1 Total PV of periodic payments received

+

2 PV of expected sale price of underlying asset at maturity

Pricing of a *Sukuk Ijarah* with Warrants/ Embedded Options

Of late, we have seen the issuance of several "exotic" *sukuk* that have embedded options within them. The Khazanah Exchangeable *Sukuk* and the 1997 KFC Holdings *Sukuk* had warrants attached. Both these *sukuk* were akin to convertible "bonds" in that *sukuk* holders could convert or exchange the *sukuk* with equities. In the case of Khazanah's 2006 issuance, the *sukuk* were Telekom shares owned by Khazanah.

As for the 1997 KFC Holdings issuance, the *sukuk* came with warrants attached. These warrants, exercisable at maturity, converted into stocks of KFC Holdings at pre-determined prices.

The attachment of a warrant to the *sukuk,* as in the KFC Holdings issuance, increased the value of the *sukuk* by the amount of the value of the warrant. In determining the price of such a *sukuk*, one would have to determine the value of the call and add the call's value to that of the basic *sukuk*. The value of the call can be determined by way of the Black Scholes Option Pricing Model (BSOPM).

Valuing the Embedded Call Option

This warrant is a call option since it provides a right but not the obligation to buy the stock at a pre-determined price. The BSOPM is essentially an equation that provides a closed-form solution. It is used to value European style calls (or Puts). A European style option is one where the option can only be exercised upon maturity and not before. In valuing a call using BSOPM, one needs to input the following five parameters. These are:

The warrant is a call option since it provides a right but not the obligation to buy the stock at a pre-determined price.

1 The current stock price = S_0

2 Estimated volatility of the underlying asset = σ

3 Time to maturity of the call (warrant) as a percentage of a year = t

4 The risk-free interest rate = rf

5 The exercise price of the call = k

The BSOPM can be written as:

$$C = S_0 N\,(d_1) - K^{e\text{-}rt} N\,(d_2)$$

N (d_1) and N (d_2) are probability values derived from a cumulative density function.

$$(1 - N\,(d_1) = Nd_2)$$

In using the BSOPM to value the warrant attached to a *sukuk*, we do the following two modifications:

1 We replace the risk-free interest rate, which is the three-month KLIRR (Kuala Lumpur Interbank Rate of Return).

2 If exercise of the warrant results in new shares being issued, then an adjustment has to be made for the dilution factor.

Finally, as the BSOPM equation above shows, the call is valued on a per share basis. Since warrants typically can be exercised into more than one share, an additional adjustment has to be made. For example, if the warrant can be converted into 1,000 shares, then the call value arrived at using BSOPM should be multiplied by 1,000 to arrive at the value of the warrant. Suppose by using BSOPM, we get a call value of RM0.34. This is value on a per share basis. If the warrant has a conversion ratio of say 1,000 shares, then the value of the embedded option represented by the warrant will be worth RM340.00 (i.e., RM0.34 x 1,000).

Since the presence of the embedded options enables the *sukuk* holder to potentially profit from the appreciation of the underlying shares and since the ringgit value of the potential profit has been valued at RM340 using the BSOPM, we need to add the RM340 to the present value of the other cash flows derived from the *sukuk*. For example, if the *sukuk ijarah* has periodic *ijarah* payments, then the total value of the *sukuk* equals:

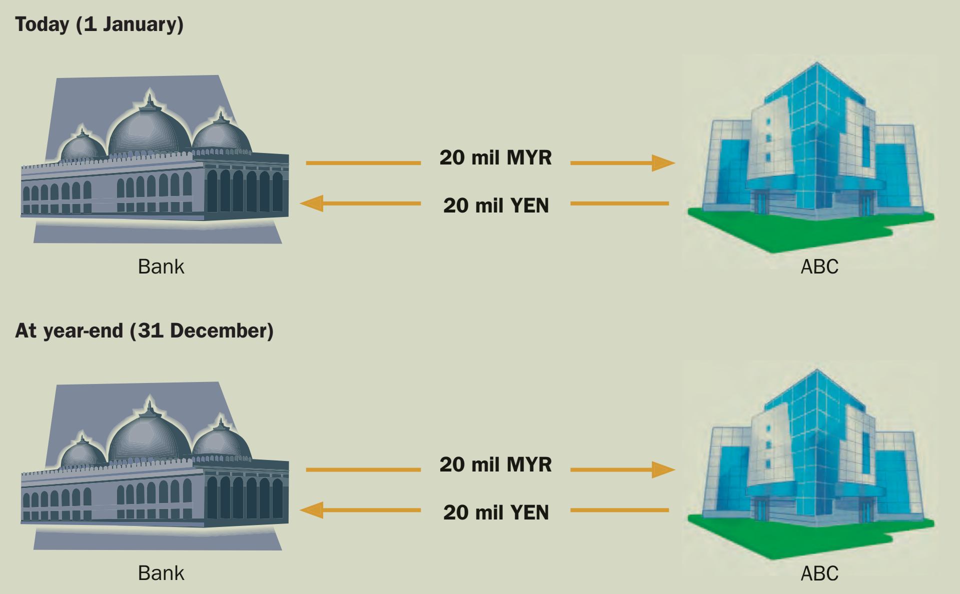
1. PV of Periodic *Ijarah* Payments

   +

2. RM340 (value of embedded option)

Valuing *Wa'd*-Based Currency Swaps

Many Islamic Banks offer *wa'd*-based currency swaps to business entities that need to manage their exchange rate exposure. The exchange rate exposure refers to risk that arises from fluctuations in exchange rates. In a typical currency swap, the parties would exchange one currency for another with a promise (*wa'd*) to reverse the exchange at a future date. For example, in a one-year currency swap between a business entity (ABC) and an Islamic bank, the swap would be as follows:



Source: Modified from author's interviews with bankers.

Figure 14.8 Valuing *Wa'd*-Based Currency Swaps

Notice that the same amounts are reversed at year-end. This effectively eliminates exchange rate risk. Notice also that the year-end cash flows are essentially the same as that of a forward contract. In a forward contract, there are no cash flows at the initial period, only a promise. To determine the correct value and therefore the appropriate compensation to the bank, we can use the logic of forward contracts. A forward contract is priced by adjusting the underlying asset's spot price for the net cost of carry. The net cost of carry refers to the net of all costs that will be incurred in purchasing the asset today at the spot price and "carrying"/holding on to it, so as to be able to deliver it upon maturity. In a typical commodity forward, there are usually three costs that go into the net carry computation. These are:

1 The opportunity cost of receiving the price upon maturity rather than now.

2 The costs incurred in storing the asset appropriately, incurring spoilage/shrinkage and other handling costs.

3 The benefit if any (convenience) received from holding the physical commodity. Since this benefit accrues to the holder, it is deducted from the other costs.

In the case of a currency forward, of course there are no storage costs nor are there convenience yields. The only relevant cost is the opportunity. In the case of the swap, since two currencies are being exchanged simultaneously and will be reversed in exact amounts, the difference in the opportunity costs of each is what matters in pricing.

Typically, in pricing a *wa'd*-based currency forward/swap contract there are four parameters that would be relevant in pricing. These are:

1 The difference in opportunity costs (interest rates) between the two currencies.

2 The expected rate of appreciation/depreciation of each currency relative to the other. The one who receives the currency expected to appreciate should compensate since the currency he provides would by definition be expected to depreciate. Generally, the quoted forward should capture this expectation.

3 The relative bid-ask prices of the two currencies, and

4 The perceived counter-party risk. If the counter-party has poor credit risk, the Islamic bank would want to compensate itself by charging a premium.

Having explained the pricing of Islamic derivative instruments and Islamic-structured products, we next move on to the issues, opportunities and challenges of Islamic derivatives.

Issues, Opportunities and Challenges

ISDA/IIFM *Tahawut* (Hedging) Master Agreement provides a template and framework for the expansion of derivatives activities in the Middle East, South Asia and other regions throughout the world.

There are definitely new developments in the field of hedging through Islamic derivatives that require mention before issues and challenges are raised. On 1 March 2010, the International Swaps and Derivatives Association (ISDA) and International Islamic Financial Market (IIFM) jointly issued the *Shari'ah*-compliant master agreement for OTC derivatives called the ISDA/IIFM *Tahawut* (Hedging) Master Agreement. This new *tahawut* master agreement provides a template and framework for the expansion of derivatives activity in the Middle East, South Asia and many regions throughout the world. Since the vast majority of Islamic-derivative contracts are currently privately negotiated or concluded OTC, this is definitely a welcome development. The *tahawut* master agreement has been developed from the 2002 ISDA Master Agreement under the guidance and approval of the IIFM *Shari'ah* Advisory Panel. The *tahawut* master agreement is expected to be used as a reference for market participants where they or their customers need to hedge risks in line with *Shari'ah* principles.

As for exchange-traded derivatives in Malaysia, there have been some inroads into their development. For example, the *Shari'ah* Advisory Council of the SC has resolved that futures contracts on crude palm oil are permissible and that the mechanism for stock index futures contracts does not contradict *Shari'ah* principles. It also ruled that stock index trading is allowed as long as it is *Shari'ah*-compliant. The *Shari'ah* Advisory Council of Malaysia has also approved another derivative instrument: the single stock futures[4] (SSF). As long as the underlying stocks of the SSFs are *Shari'ah*–compliant, SSFs are considered permissible. The other jurisdiction in the Islamic financial world that is also developing its derivatives market is Iran. In June 2008, the Iranian Islamic capital market launched the futures contract for gold bullion. They have, since then, also introduced other futures contracts which have as their underlying gold coin, wired copper and copper cathode, respectively. The Iranian Islamic capital market plans to extend the Islamic futures market for other underlyings such as stocks, petrochemical assets and agricultural assets (Pireh, 2010).

This move to allow exchange-traded derivatives in Islamic finance should be seen positively. The problem with privately negotiated derivatives is that they are opaque and terms may not be standardised. By trading on an exchange, all aspects of the contract, i.e., price, duration, quality and quantity, are known and standardised. There is transparency and monitoring, and regulation is possible. As long as steps are taken to ensure strict regulation and monitoring by a regulatory body to develop exchange-traded Islamic derivatives, this move should be encouraged.

A challenge facing Islamic derivatives is that there appears to be no consensus nor a definite opinion on the acceptability of derivative instruments in Islamic finance. Whether these instruments are permissible depends on which scholar is asked for a ruling. Even where scholars have found derivatives to be objectionable, their reasons for objection differ. Due to these objections, their use is shrouded in uncertainty.

There is no consensus and definite opinion on the permissibility of derivative instruments in Islamic finance.

More transparency and clarity are required with the usage of Islamic derivatives. It is easy to criticise the structures; however, reality proves that currency risks are real and can cost businesses huge losses. If Islamic derivatives are not created, and if they are dismissed as being nothing more than duplication of conventional counterparts, how can businesses compete in the real world and hedge against losses?

Furthermore, there are opportunities for further research in risk-shifting or risk-sharing. The solution for hedging currency risk at the moment is through Islamic derivatives. However, research has to be done in the field for the underlying cause for the need of Islamic derivatives. By introducing Islamic derivatives, the symptoms of the problems, i.e., fluctuations in currency exchange and profit rate, are being treated.

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4 An SSF is a futures contract with an underlying of one particular stock, usually in batches of 100. There is no transmission of share rights or dividends. Five SSFs were deemed *Shari'ah*-compliant, namely AirAsia, IOI Corporation, Maxis Communications, Scomi Group and Telekom Malaysia.

Case Study Islamic Hedging Instrument

Under this last section, an Islamic hedging instrument is described. This product, though not used universally, is a good example of embedded Islamic options. This case study is taken from Bacha (2007: 327).

The *Istijrar* Contract

The *istijrar,* introduced in Pakistan, has embedded options that could be triggered if the underlying asset's price exceeds certain bounds. The contract is complex in that it constitutes a combination of options, average prices and *murabahah* or cost-plus financing. The *istijrar* involves two parties, a buyer, which could be a company seeking financing to purchase the underlying asset, and a financial institution.

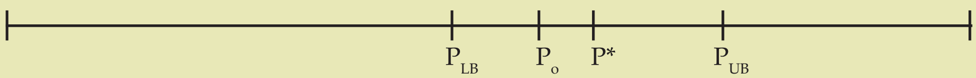
A typical *istijrar* transaction could be as follows: a company seeking short-term working capital to finance the purchase of a commodity (like an essential raw material) approaches a bank. The bank purchases the commodity at the current price (P_o), and resells it to the company for payment to be made at a mutually agreed upon date in the future – for example in three months. The price at which the settlement occurs upon maturity is contingent on the underlying asset's price movement from t_0 to t_{90}, where t_0 is the day the contract was initiated and t_{90} is the 90th day, which would be the day the transaction matures.

Unlike a *murabahah* contract where the settlement price would simply be a pre-determined price, where $P^* = P_o (1+r)$, with "r" being the bank's required return/earning, the price at which the *istijrar* is settled upon maturity date could either be P* *or* an average price ($\overline{P}$) of the commodity between the period t_0 and t_{90}. As to which of the two prices will be used for settlement, this will depend on how prices have behaved and which party chooses to "fix" the settlement price. The embedded option is the right to choose to fix the price at which settlement will occur at any time before the contract matures. At the initiation of the contract, t_o, both parties agree on the following two items:

(i) the pre-determined *murabahah* price; P* and

(ii) the upper and lower bound around the P_o (bank's purchase price at t_o).

For better elucidation, the different prices are shown below in a continuum. Prices increase as one goes to the right.



where P_o = The price that the bank pays to purchase underlying commodity.
P^* = *Murabahah* price; $P^* = P_o (1+r)$.
P_{LB} = The lower bound price.
P_{UB} = The upper bound price.

The settlement price (P_s) at t_{90} would be;

(i) $P_s = \overline{P}$, if the underlying asset price remained within the bounds, or

(ii) $P_s = P^*$, if the underlying asset exceeds the bounds and one of the parties chooses to exercise its option and use P* as the price at which to settle upon maturity.

For either party to exercise its option and thereby fix the settlement price at P*, the spot price during the term of the contract must have exceeded the bounds at any time. As to which party would exercise, would of course depend on the direction of the spot price movement. For example, if the spot price at anytime breaks through the upper bound, the buyer would get worried. But whether he will exercise or not, would depend on his expectations of the spot price over the remaining period of the contract. If he believes that the price is likely to keep increasing, thereby causing $\overline{P}$ at which settlement will occur to be greater than P*, it will be in his interest to "exercise" by fixing the settlement price now at P*. Essentially, he would notify the bank that he is exercising his option and that the settlement would be P*. Should spot prices be falling such that the lower bound is broken, the seller, in this case the bank, would have the option to fix the settlement price at P*.

The settlement price is determined as follows:

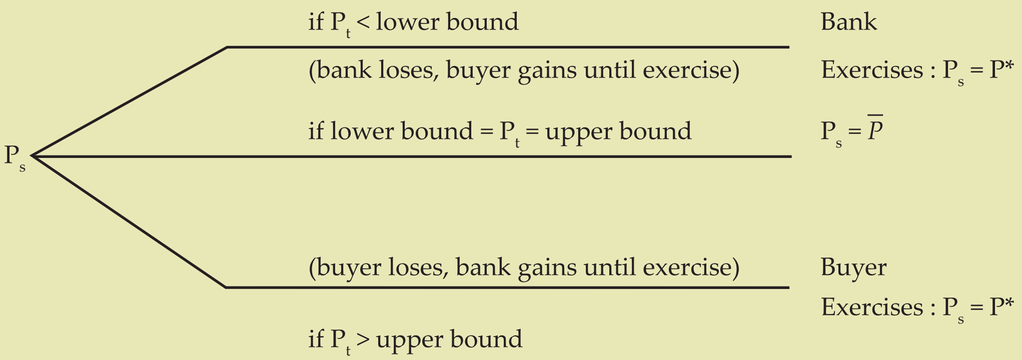


Figure 14.9 *Istijrar*

where P_s = Settlement price upon maturity.
$\overline{P}$ = Average price; Pt_0 to $Pt_{90.}$
P_t = Spot price of underlying commodity on day t.
P* = The pre-determined, cost-plus or *murabahah* price.

What the *istijrar* contract attempts to do is to allow for the impact of price changes but to cap the benefits that accrue as a result. By definition, since price changes are allowed only within a band, the advantage to one party and the disadvantage to the other is capped. The maximum potential gain or loss is limited. Such a contract fulfils the need to avoid a fixed return on a riskless asset which would be considered *riba* and also avoids *gharar* in that both parties know upfront, P* and the range of other possible prices (by definition between the upper and lower bounds).

Source: Bacha (2007: 327).

If the industry really wants to deal with the problem, more research and resources must go into researching solutions to treat the source and not the symptoms.

The risks are real and can affect businesses adversely. Hence, there is a dire need for hedging instruments. However, further research is needed on the topic.

Currently, there is a definite need for hedging instruments as the risks are real and can affect businesses adversely. If Islamic banking and finance cannot provide for the needs of the industry, then the industry will seek conventional financing solutions. The lesser evils should always be pursued, and thus Islamic banking and finance has to provide solutions for hedging. For a start, Islamic derivative contracts are being used to hedge against currency and exchange rate risks.

Summary

1 Even though Islam encourages risk management, there are objections to conventional derivatives for various reasons such as *riba, maysir* and *gharar*.

2 Islamic finance has engineered Islamic derivatives based on Islamic instruments such as *wa'd, tawarruq* and commodity *murabahah.*

3 Islamic derivatives achieve similar outcomes to their conventional counterparts.

4 The Islamic derivatives discussed in this chapter include the Islamic promissory forward contract, the Islamic forex swap, the Islamic cross-currency swap, the Islamic profit-rate swap and the Islamic options.

Key Terms and Concepts

Derivative	Hedging	Forward
Futures	Options	Swap
Exchange Rate	Exchange Rate Risk	Islamic Promissory Forward Contract
Islamic Forex Swap	Islamic Cross Currency Swap	Islamic Profit Rate Swap
Islamic Options	Structured Products	*Wa'd*
Risk	*Tawarruq*	*Sukuk*
Ijarah		

Further Readings

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Review Questions and Problems

1 Compare and contrast the *istijrar* contract (see Case Study on page 34) with its closest conventional contract. What are the main similarities/differences?

2 Evaluate conventional derivative instruments and their trading methods in light of the *Shari'ah* requirements. What are some of the concerns that Islamic scholars and jurists have with regard to derivatives?

3 The need to avoid *gharar* is a key requirement in Islamic finance. Define *gharar* and briefly evaluate modern day futures contracts from the viewpoint of *gharar*.

4 Mr Ali, who is a chief strategist at Islamic Asset Management Sdn Bhd, has just completed his analysis of forecast profit rate movements. He is convinced that profit rates are going to rise sharply in the near future. He wants to position his company to take advantage of this outlook.

(a) State three derivatives that Mr Ali can use to position his company given his outlook.

(b) For each of the above, clearly describe the strategy that Mr Ali should take.

5 Explain the differences between an Islamic forex swap and an Islamic cross-currency swap.

6 Does Islamic finance encourage risk taking?

7 Datin Kamariah is a successful businesswoman who owns a booming business of importing foreign KUGGI bags from London. Her financial advisor has warned her of an impending drop in the value of the sterling pound. Datin Kamariah is worried about potential losses to her business. She approaches an Islamic bank for solutions. Advise Datin Kamariah on the following:

(a) Whether hedging is allowed in Islam.

(b) Suitable Islamic derivative instruments that might be used in Datin Kamariah's situation.

8 How do Islamic derivatives overcome the objections by scholars in Islamic finance against conventional derivatives?

9 What is the primary reason that Islamic derivatives have been created and used in Islamic finance? Explain.

10 Explain the terms "appreciation" and "depreciation". How do you calculate the percentage of appreciation/depreciation of a currency?

11 The spot rate of currencies USD/MYR on 1 January, 2012 is RM3.25 per USD. The spot rate of currencies USD/MYR on 31 March, 2011 is RM3.38 per USD. Given the spot rates above, answer the following:

(a) Which currency has appreciated/depreciated?

(b) What is the percentage of appreciation/depreciation?

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12 Explain the basic principles of pricing in finance.

Part 5

Regulation, Supervision and Governance of the Islamic Financial System

Chapter 15

Regulations and Supervision of Islamic Financial Institutions

Preview

This chapter highlights the rationale that underlies the need for a specific regulatory framework for Islamic finance. It emphasises the importance of having a reliable regulatory framework and explains the unavoidable correlation between having such a framework and the sustainability and development of the Islamic financial services industry in every jurisdiction. It presents an overview of the regulatory framework applicable to Islamic financial services at the national and international levels. It also discusses various regulatory issues and challenges facing the regulatory authorities. Besides that, potential solutions to the lingering challenges are proffered.

In addition, this chapter highlights the impact that differences between conventional financial institutions and Islamic financial institutions (IFIs) have on the regulations that govern them and the governance mechanisms that they adopt. Besides this, the chapter adduces reasons for the current variations in the legal and regulatory practices governing IFIs across countries.

Malaysia has developed a comprehensive Islamic financial system that includes the banking and *takaful* industry, other specialised financial institutions and the Islamic money and capital markets.

Learning Outcomes

At the end of this chapter, you should be able to:

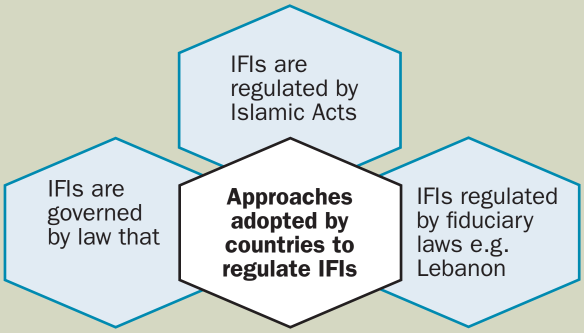
- Understand the importance of a regulatory framework in the development of Islamic finance.
- Establish how the current diversity in regulatory framework affects the efficiency and effectiveness of safeguarding the overall soundness of the Islamic financial system.
- Rationalise the need for certain modifications and adjustments in the current financial regulatory framework in order to address the specificities of IFIs.
- Comprehend how the regulatory framework continues to develop and change in accordance with the dynamics and sophistication of the market.
- Understand country-specific differences in the regulation of IFIs and why such regulation exists.

Overview of the Regulations of Islamic Finance Institutions

Among the features that distinguish the Islamic financial system from the conventional system are the regulations that govern them as well as the governance mechanisms that they adopt. While conventional institutions have been established and governed by secular, man-made laws and regulations (whether under the civil law or common law system), IFIs, while still expected to conform to the same existing man-made laws and regulations as their conventional counterparts, must also adhere to the divine rules and principles in the form of a body of laws known as the *Shari'ah*.

As IFIs in their modern form are indeed a recent phenomenon that started only about four decades ago, it is understandable that the legal and regulatory practices governing IFIs remain varied across countries. Since the early 1970s, the growth of the Islamic financial services industry has been quite robust. The growth is observed in tandem with the rapid political, social and economic development of many Muslim countries as they have gained independence from their colonial masters. While most countries that operate IFIs adopted the dual-financial system (Islamic finance operating in parallel to conventional finance), a few others, such as Iran and Sudan, adopted a single, full-fledged Islamic financial system. The decision by each country to adopt either a single or dual financial system is pre-dominantly influenced by their respective socio-political histories and realities, rather than by economic factors. Since public sentiments are often very central to the socio-political developments of every country, it could be an over-riding reason behind certain public policies. Hence, the merits or demerits of a single or dual financial system cannot simply be generalised but must be appraised on a case-by-case basis.

In countries like Saudi Arabia and Egypt, no specific Islamic banking laws are enacted to govern the specificities of IFIs. Thus, they operate under the same laws governing conventional banks. In contrast, countries with a single, full-fledged Islamic banking system, such as Sudan and Iran, have adopted Islamic accounting standards, established requirements for *Shari'ah* Supervisory Boards, and put in place supervisory frameworks specific for IFIs. According to a survey carried out by Nik Thani & Othman (2008), at least thirty countries have either enacted specific Islamic banking laws or incorporated express provisions for Islamic banking activities in their existing banking laws. However, these laws vary in scope, and some appear to replicate for IFIs the regulatory and supervisory framework applied for conventional banks.This is done without fully taking into account the unique characteristics of Islamic banking. For example, even the approach in defining the relationship between the regulating authorities and IFIs concerning the respect of the right of establishment and methods of operation varies across countries (Figure 15.1).



Source: IBS Intelligent, April 2010.

Figure 15.1
Approaches to the Regulation of IFIs

The table below summarises the differences in regulatory practices in other jurisdictions.

Table 15.1 Diversity in the Legal and Regulatory Arrangements

Legal System	Countries		Legal and Regulatory Arrangements		
	Muslim population		***Banking System***	***Legislative Framework***	***Presence of Shari'ah Body***
Civil Law	Majority	Algeria, Republic of Djibouti, Indonesia, Egypt, Jordan, Kyrgyz Republic, Kazakhstan, Lebanon, Palestine, Syria, Tunisia, Turkey.	Dual.	Indonesia, Kyrgyz Republic, Kazakhstan, Lebanon, Syria and Turkey have enacted specific legislation for IFIs. Others have incorporated sections for Islamic activities under existing banking law.	A common regulatory requirement at the IFIs level, but only Indonesia has a central *Shari'ah* body.
	Minority	Philippines, Thailand, Switzerland, USA.	Conventional – IFIs have a very small presence.	Philippines and Thailand have enacted specific legislation for IFIs. Others regulate IFIs under existing banking law.	Not regulated, therefore not common.
Common Law	Majority	Bangladesh, Brunei, Gambia, Malaysia, Maldives.	Dual.	Brunei, Gambia and Malaysia have enacted specific legislation for IFIs. Others have incorporated sections for Islamic activities under existing banking law.	A common regulatory requirement at the IFIs level, but only Brunei and Malaysia have a central *Shari'ah* body.
	Minority	Hong Kong, Mauritius, Singapore, Sri Lanka, UK	Conventional – IFIs have a very small presence.	These countries have either incorporated sections for Islamic activities or issued guidelines related to them under existing banking law.	Not regulated, but a common practice.
Shari'ah	Majority	Gulf Cooperation Council (GCC) countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE.	Dual system for all, except Oman which has no IFI.	Kuwait and UAE have enacted specific legislation for IFIs; Bahrain has a specific rule book for them. Qatar and Saudi Arabia regulate Islamic activities under existing banking law.	A common regulatory requirement at the IFIs level, but none has a central *Shari'ah* authority.
	Majority	Iran and Sudan	Single, full-fledged Islamic.	The legislative framework enacted is specific for IFIs.	A common regulatory requirement at the IFIs level; Sudan has a central *Shari'ah* authority.
	Majority	Pakistan and Yemen	Dual.	Yemen has enacted specific legislation for IFIs; Pakistan regulates Islamic activities under existing banking law.	A common regulatory requirement at the IFIs level; Pakistan has a central *Shari'ah* authority.

Source: Compiled and adapted from different sources including Chapra & Khan, 2000, Zaher & Hassan, 2001, Grais & Pelligrini, 2006, and Nik Thani & Othman, 2008.

Various international organisations have been established to set standards that would strengthen and eventually harmonise prudential regulations as they apply to IFIs. In the context of the conception of an adequate regulatory environment, several institutions were created. These include the Islamic Financial Services Board (IFSB), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and International Islamic Financial Markets (IIFM). The roles of these international standard-setting bodies will be discussed later in this chapter.

As a conclusion, prudential framework should be designed to enhance confidence and ensure stability in the Islamic financial services industry. Such a framework is necessary to enhance the confidence of the various stakeholders in the industry. However, at present, the framework is still at a developing stage. Without collective efforts to improve the prudential framework, it would be challenging to gain the confidence of stakeholders and promote stability, solidity and future expansion of the industry. In addition, these measures must be supported by the IFIs.

Rationale for the Regulation of Islamic Finance

There are various theories suggesting the rationale for the regulation of Islamic finance.

Arguments For

Chapra-Khan Theory

Chapra & Khan (2000) suggested four reasons for the need of regulation of IFIs. They include systemic objectives, the protection of depositors, compliance with *Shari'ah*, and the integration of Islamic finance in the international financial system.

Systemic Considerations

A key systemic consideration is the risk of "contagion" whereby if one financial institution fails, the sustainability of others is also threatened. Regulation is also needed to maintain an efficient payment system and mitigate the risks of disruption of payments. Regulators also often have to manage a delicate balance between promoting economic development (which may require a more aggressive risk-taking environment) and ensuring the stability of the financial system (which may require a more conservative approach towards risk-taking).

Protecting the Interest of Depositors and Investment Account Holders (IAHs) of IFIs

In many jurisdictions, the existing regulations do not recognise the distinct contractual rights and risks profiles that distinguish normal depositors from IAHs. As such, there is a need to adopt a cross-sectoral approach to Islamic finance regulations whereby the banking regulators' usual emphasis on depositor protection has to be balanced with the securities regulators' approach to investor protection, particularly for IAHs. While current account holders in IFIs are capital-guaranteed and therefore protected like any conventional depositors, IAHs contractually are supposed to bear their own risks. Therefore, since they may not enjoy any capital guarantee, they should have rights for additional investor protection. Such a protection might be through a more representative governance system and a more transparent disclosure regime. This may also be aligned to the need to safeguard efficient use of public resources and adequate integrity in fiduciary contracts.

It is reasonable for IAHs as investors to expect transparency from the IFIs in terms of the features of the contract they enter into and appropriate recourse if the contract is breached. In this respect, regulations promoting the integrity of fiduciary contracts would be consistent with the theory of Islamic finance. Considering that, for example, restricted investment accounts use a "two-tier *mudarabah*" (profit-sharing) model that does not envisage any reserve requirement, IAHs may not always be fully aware of the risks they face in relation to their investment. This is because, without proper disclosure, IAHs may assume they are protected in the same way as depositors are in a conventional bank. IFIs also face competitive pressures to protect their investment base by providing sufficient security assurance and returns the same as, if not better than, those of conventional institutions. Therefore, they need regulations that can help level the playing field in their favour.

Investment account holders may not always be fully aware of the risks they face in relation to their investment because they assume they are protected in the same way as depositors in a conventional bank.

Ensuring Compliance with *Shari'ah*

To illustrate the importance of *Shari'ah*-compliant risk, IFIs are prohibited from recognising as profits any income derived from transactions that do not comply with *Shari'ah* tenets. Such tainted income has to be screened and channelled to charity.

In countries where historically the legal systems were inherited from former colonial powers and *Shari'ah* rules and principles subscribed by IFIs and Muslims are not aligned to co-exist harmoniously, many legal issues may appear whenever a dispute arises from an Islamic financial contract.

As aforementioned, the level of interfaces between common, civil and religious laws vary across jurisdictions, mainly due to socio-political history. In countries having legal systems inherited from former colonial powers, which are not harmoniously aligned with the *Shari'ah* rules and principles subscribed to by IFIs and Muslims, many legal issues may appear whenever a dispute arises from an Islamic financial contract. Questions of credibility may be posed to financial regulators in terms of their capacity to ensure that Islamic financial intermediation activities comply with the *Shari'ah* or to conventional courts in terms of their competence in resolving Islamic finance disputes. In jurisdictions where the legal system manages to harmoniously accommodate man-made laws with the divine *Shari'ah* rules and principles, the public would have stronger confidence in the role of financial regulators and the courts. In recent years, the establishment of a *Shari'ah* supervisory body that can provide assurance that the strategic direction, formulation of policies and conduct of financial transactions of IFIs are in compliance with the *Shari'ah* rules and principles has become an important element for instilling public confidence.

Supporting the Integration of IFIs in the International Financial System

Today, Islamic finance has evolved into a viable and competitive component of the international financial system. Following the global financial crisis, discussions have increasingly turned to the prospects of the potential role and relevance of Islamic finance in contributing to global financial stability and overall economic growth.

It is expected that globalisation, especially in the form of IFI participation in the financing of international trade and international payments, would expedite the integration of IFIs into the international financial system.

However, the increasing exposure of IFIs to the international financial system (and vice-versa) may bring along its own challenges.

Drage's Theory

According to Dowd (1996), experience suggests that financial systems are prone to periods of instability. In recent decades, bank failures around the world have been common, large and expensive. Some argue that this event suggests a case for more effective regulation and supervision. Drage et al. (1998) argued that the 1997 Asian banking crisis was, in part, a product of "the poorly regulated and often distorted financial sectors in these countries".

Drage et al. (1998) argued that the 1997 Asian banking crisis have in part, been a product of "the poorly regulated and often distorted financial sectors in these countries".

Although IFIs generally seem to have fared better than their conventional counterparts in surviving the recent global financial crisis, there is a strong perception that in many countries IFIs are still under-regulated. This is evident in a survey conducted by Deloitte Islamic Financial Knowledge Centre in 2010. Such perception may hamper the acceptance of Islamic finance as a welcomed and integral component of the global financial system.

Llewellyn's Theory

Llewellyn (1999) asserts that there are seven components of the economic rationale for regulation and supervision in banking and financial services. These are:

1. Potential systemic problems associated with externalities (a particular form of market failure).
2. The correction of other market imperfections and failures.
3. The need for monitoring of financial firms and the economies of scale that exist in this activity.
4. The need for consumer confidence, which also has a positive externality.
5. The potential for gridlock, with associated adverse selection and moral hazard problems.
6. Moral hazard associated with the revealed preference of governments to create safety net arrangements: lender of last resort, deposit insurance, and compensation schemes.
7. Consumer demand for regulation in order to gain a degree of assurance and lower transaction costs.

In this respect, it is paramount for public authorities to make conscious policy decisions in applying, among others, these seven economic rationales in setting the prudential framework for IFIs. This is rather like the free market approach, which may ride on irrational socio-political flavours and public sentiments.

Arguments Against

Dowd, Benston and Kaufman, and Kane Theories

Although the financial services industry is generally a highly regulated industry, it is interesting to note that some academic liberals (such as Dowd, 1996; Benston, 1998; Benston & Kaufman, 1996; and Kane, 1997) are sceptical of the benefits of regulation. This group, among others, argues that there are no market failures and imperfections. If they do exist, they are not sufficiently serious to warrant regulation. Regulation may not in practice solve these failures, or if it does, it can do so only by imposing costs that exceed the costs of the original problem. Serious moral hazards may arise when regulation is imposed and regulation imposes a wide range of costs which are ultimately, paid by consumers.

The global financial crisis of 2007–2009 illustrates the shortcoming of the "light tough" regulation that Dowd et. al. supported. This has led to the introduction of a tougher regulatory regime by the Basel Committee for Banking Supervision under Basel III.

The development of legal and regulatory framework for Islamic financial industry should be premised on the principle of neutrality in ensuring a "no worse off" treatment *vis-à-vis* conventional finance in terms of taxation, laws and regulations to catalyse its healthy growth.

At this juncture, a point is in order. Most countries, where IFIs operate, adopt a dual-system. Sequel to this, the central banks in such countries need to always be mindful of the potential regulatory arbitrage which causes competitive distortions that undermine an environment of level playing field between conventional finance and Islamic finance. The development of legal and regulatory framework for Islamic financial industry should be premised on the principle of neutrality in ensuring a "no worse off" treatment *vis-à-vis* conventional finance in terms of taxation, laws and regulations to catalyse its healthy growth.

The Unique Characteristics of the Regulation of Islamic Finance

Islamic Banking

When regulating the Islamic finance industry, the unique characteristics and risks entailed in Islamic banking and its products and services need to be carefully examined and considered. This is to ensure that the risks are managed effectively. *Shari'ah*-compliance risk, equity investment risk and displaced commercial risk are a few examples of risks peculiar to Islamic finance.

At present, some countries have adopted the Basel standards in their regulatory and supervisory framework for their Islamic banking industry. However, these standards do not adequately address the requirements of Islamic banking operations and transactions, resulting in gaps in the standards. Therefore, these gaps should be taken into account with respect to the capital treatment and associated risk for the different types of Islamic financial contracts to truly reflect their features and characteristics.

While certain products in Islamic finance, such as the restricted investment accounts aforementioned, by their nature may not attract capital, the IFIs need to have a more rigorous process in managing the risks inherent in funds placed under this arrangement. In this regard, the risk management standard needs to specifically address this concern. The IFIs can expect to be better regulated and supervised following the adoption of the standards issued by the IFSB. The IFSB will also have a prominent role in facilitating the streamlining of the standards covering cross-border supervision issues including the home-host supervisor issue.

Islamic Financial Institutions need to have a more rigorous process in managing the risks inherent in funds placed under this arrangement.

Another issue is the setting of prudent and appropriate minimum capital adequacy requirements for the IFIs. The proposed framework that incorporates such requirements needs to reflect the risks that the IFIs undertake. The profit-sharing investment accounts, for example, create a class of depositors that should more accurately be construed as investors and ranked *pari passu* with shareholders. Similarly, risk weights assigned to individual asset components need to reflect the nature of inherent risks in those assets. In other words, account holder-IFI relationship is not as straightforward as a debtor-creditor relationship in conventional banking but rather involves other equity-like risk factors arising from the investor-entrepreneur relationship that is inherent in some products and services offered by the IFIs.

It goes without saying that efficient risk management framework is an essential element for well-functioning IFIs. The absence of strong risk management systems will deprive the IFI's effective ways of hedging risks and this may undermine its potential contribution to the economy. It is also important to allocate sufficient resources in risk identification, measurement and development of risk management techniques. This would evoke a thorough understanding of *Shari'ah* law with strong knowledge of modern risk management techniques to facilitate the development of innovative risk mitigation and hedging instruments that are compliant with *Shari'ah* principles.

Islamic Capital Markets

The Islamic Capital Market (ICM) could be classified into equity and debt capital markets. The regulation differs for both, as each market offers different instruments and caters for different types of players.

In view of the *Shari'ah* prohibition against dealing with *riba*, gambling and trading of impure commodities such as alcohol and pork, investors and fund managers in ICM cannot freely buy and sell shares without undertaking a *Shari'ah*-screening process from time to time in order to ensure that their investment portfolios comply with *Shari'ah*.

A number of securities regulators and stock exchanges have established and/or facilitated the *Shari'ah*-screening processes for ICM investment portfolios. The screening process involves qualitative and quantitative parameters such as source of income, business activities and financial structures. A screening process in a comparative manner is shown in Table 15.2.

Table 15.2 Comparative Table of Screening Processes

Dow Jones Islamic Market Index	Standard & Poor Islamic Index	FTSE Islamic Index
Non-permissible activities		
Pork production	Pork production	Pork production
Non-*halal* food	Non-*halal* food	Non-*halal* food
Alcohol	Alcohol	Alcohol
Interest-based institutions	Interest-based institutions	Interest-based institutions
Gambling Institutions	Gambling Institutions	Gambling Institutions
Receivables		
Account receivables to total asset ratio < 45%	Account receivables to market value of equity < 49%	Account receivables to total asset < 45%
Leverage		
Total debt to 12-month moving average market capitalisation < 33%	Total debt to market value of equity < 33%	Total debt to total asset < 33%

Source: Bank Negara Malaysia.

The Securities Commission of Malaysia is the only securities regulator that has its own *Shari'ah* Advisory Council.

In Malaysia, the Securities Commission (SC) assumes a vital and leading role for formulating screening guidelines which are applied to all listed companies to determine their *halal* status. The SC is the only securities regulator that has its own *Shari'ah* Advisory Council (SAC). The council comprises renowned *Shari'ah* scholars mandated by law to advise the SC on ICM issues, including the *Shari'ah*-screening process. Reports are issued bi-annually to inform investors on the latest list of *Shari'ah*-compliant stocks. This sets the regulation of ICM distinct from that of the conventional setup whereby rules in relation to the permissibility of a stock are not applicable.

Table 15.3 Screening Processes

***Shari'ah*-compliant Securities on Bursa Malaysia**			
Number of *Shari'ah*-compliant securities – May 2009			847
% to total listed securities			88%
Latest market capitalisation – May 2010			**(RM billion)**
Shari'ah-compliant			666.34
Total market			1044.35
Percentage of *Shari'ah*-compliant securities to total market			63.8%
Equity market indices	**30 June 2009**	**30 June 2010**	**% change**
KL Composite Index (KLCI)	1075.24	1314.02	22.21%
FBM EMAS *Shari'ah*	7445.71	8764.17	17.71%
FBM Hijrah *Shari'ah*	8133.37	9275.39	14.04%
DJIM Malaysia Titan 25	654.86	745.78	13.88%

Non-compliant activities
1 Financial services.
2 Gambling.
3 Manufacturing of non-*halal* products, conventional insurance.
4 Entertainment.
5 Manufacture of sale or tobacco-based products or related products.
6 Stockbroking or share trading in *Shari'ah* non-approved securities.
7 Other activities deemed non-permissible.

Non-compliant side income
1 Interest income from conventional fixed deposits/interest bearing instruments.
2 Dividends received from investment in *Shari'ah* non-compliant securities.

Screening Process	
5%	Clearly prohibited activities, *riba*, gambling, liquor, pork.
10%	Activities that are widespread and difficult to avoid.
20%	Lease from *Shari'ah* non-compliant tenant.
25%	Generally permissible activities which are tainted by non-compliant elements e.g., hotel, resort, share trading.

* The SAC of SC releases the updated *Shari'ah*-compliant securities list each year in May and November.

Source: ICM Bulletin 2Q 2010; Securities Commission's website.

Rationale for Capital Regulation

The objective of capital regulation is to promote financial system stability and to fortify the banks against possible shocks, both internal and external to the system. Besides that, capital regulation is of paramount importance as, during the event of insolvency, depositors (especially the retail depositors) may suffer losses on their savings and IAHs may suffer losses on their investments (which of course are not capital-protected).

Capital acts as an important buffer (albeit not the only one) especially during adverse times. Banks with strong capital could mitigate against possible bank failure when they are required to perform provisioning exercise.

Capital acts as an important buffer (albeit not the only one), especially during adverse times. Banks with strong capital could mitigate the possibility of bank failure when they are required to perform provisioning exercise. The inability to stem the depletion of equity capital would result in a bank failure, which may lead to a potential systemic effect on the industry and possibly a slowdown in the economy.

Capital Adequacy Framework for IFIs

Under the new Basel III, which was announced in December 2010, banks will have to hold top-quality capital — known as "core Tier 1 capital", consisting of equity or retained earnings worth at least 4.5% of assets. They will also have to build a new, separate "capital conservation buffer" of common equity; this will comprise 2.5% of assets, bringing the total top-quality capital requirement to 7%. If they draw down the buffer, they will face curbs on the bonuses and dividends which they can pay out. Banks are also required to build a separate "counter-cyclical buffer" of between zero and 2.5% when the credit markets are booming. A summary of the capital requirements for banks under Basel III is illustrated in Table 15.4.

Table 15.4 Basel III Capital Requirements

Calibration of the Capital Framework Capital Requirement and Buffers (all numbers in percent)			
	Common Equity (after deductions)	Tier 1 Capital	Total Capital
Minimum	4.5	6.0	8.0
Conversion Buffer	2.5		
Minimum Plus Conversion Buffer	7.0	8.5	10.5
Counter-cyclical Buffer Range*	0 – 2.5		

**Common Equity or other fully loss-absorbing capital.*
Source: Bank for International Settlements' website.

While the Basel III requirements were never tailored towards addressing specific risks related to Islamic finance activities, it is interesting to note that the IFSB Capital Adequacy Standard (IFSB-2) that was issued in 2005 and based on Basel II, have already incorporated features similar to "capital conservation" and "counter-cyclical" buffers in response to IFIs' own fund mobilisation and preservation practices. In particular, the investment risk reserve (IRR) and profit-equalisation reserve (PER) mentioned in IFSB-2 actually serve as capital conservation and counter-cyclical buffers, respectively, especially for unrestricted IAHs; although the rationale behind PER and IRR was different. (The main concern was the displaced commercial risk arising from competitive pressure on IFIs in mobilising and preserving funds from its customers.)

IFSB-2 was structured in a matrix format to address the quantification of capital adequacy of IFIs against risk exposures, including market, credit and operational risks, arising from the specificities of the Islamic financial contracts, which are usually asset-based, lease-based or profit-sharing. For example, asset-based instruments such as *murabahah* or *ijarah* may result in the exposure to price risk from holding physical assets upon acquisition and may transform to credit risk due to counter-party default. As such, the assets are risk-weighted according to transformation of risks associated with the underlying asset at the various stages of the contracts.

IFSB-2 was structured in a matrix format to address the quantification of capital adequacy of IFIs against risk exposures, including market, credit and operational risks, arising from the specificities of the Islamic financial contracts which are usually asset-based, lease-based or profit-sharing.

As another example, in a profit-sharing/*mudarabah* contract, IAHs are not guaranteed whether in terms of profits or capital. As such, they have to bear their own losses unless it is due to negligence or misconduct of the IFIs. Although it appears as if IFIs do not need to provide capital for such products, in reality, they would need to rely on risk mitigants such as PER and IRR to cater for the displaced commercial risk.

As IFIs continue to grow and expand, new innovations will take place both in terms of Islamic financial instruments and risk management methodology. In this respect, it is reasonable to expect IFSB-2 to also undergo changes and refinement in the future, just as the Basel framework has.

Regulatory and Supervisory Authorities for Islamic Finance

It is an established fact that in most countries a central bank, being the authority responsible for policies that affect a country's supply of money and credit, regulates and supervises the financial institutions, including IFIs. In reality, however, different authorities have different mandates. These mandates largely determine whether a central bank can play an active or passive role in the development of the Islamic financial services industry of its country.

In recent years, it has been well recognised that the three main roles of a central bank are to ensure:

1 Price stability or stability in the value of money (this is also understood as maintaining a sustained low rate of inflation).

2 A stable real economy. This is often interpreted as high employment and high and sustainable economic growth, as the monetary policy adopted by the central bank is expected to smooth the business cycle and offset shocks to the economy.

3 Financial stability. This encompasses an efficient and smoothly running payment system and the prevention of financial crises.

However, in this section, we shall learn about the different mandates given to authorities that regulate and supervise IFIs, and their experiences in developing the Islamic financial services industry in their respective countries. The following section provides an analysis of the experience of the regulatory and supervisory authorities in Malaysia. These authorities have successfully developed the country as a leading international Islamic financial hub. This discussion on such authorities will be complemented with an analysis of the regulatory and supervisory experience in other jurisdictions. This will constitute the subject of "Experience in Other Jurisdictions" discussed in the subsequent pages.

Malaysia's Experience

Central Bank

In Malaysia, the role of the central bank is entrusted to Bank Negara Malaysia (BNM), which was established on 26 January 1959 under the Central Bank of Malaysia Act 1958 (CBA 1958) to act as the Malaysian banking and financial institutions supervisor. CBA 1958 had since been repealed by the Central Bank of Malaysia Act 2009 (CBA 2009) which became effective on 25 November 2009.

Role in Development of Islamic Finance

Over the years, the roles and responsibilities of BNM have evolved and expanded. Today, BNM focuses on three pillars, namely monetary stability, financial stability and the payments system. In addition, importance is given to its developmental role in relation to economic management, institutional building and the development of the financial system.

Exhibit 15.1 Principal Objectives and Functions of BNM

The principal objectives and functions of BNM as stipulated in Section 5 of CBA 2009 are:

1. To promote monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy.
2. To formulate and conduct monetary policy in Malaysia.
3. To issue currency and keep reserves safeguarding the value of the currency.
4. To regulate and supervise financial institutions which are subject to the laws enforced by the Bank.
5. To provide oversight over money and foreign exchange markets.
6. To promote the reliable, efficient and smooth operation of national payment and settlement systems and to ensure that the national payment and settlement systems policy is directed towards Malaysia's advantage.
7. To promote a sound, progressive and inclusive financial system.
8. To promote an exchange rate regime consistent with the fundamentals of the economy.
9. To act as the financial advisor, banker and financial agent of the Government.

Malaysia has now developed a comprehensive Islamic financial system that includes the banking and *takaful* industry, other specialised financial institutions and the Islamic money and capital markets. The supporting financial infrastructure includes a robust regulatory and supervisory framework reinforced by the legal and *Shari'ah* framework, the payment and settlement systems, and the development of the pool of expertise and talent to support the industry.

BNM has a strong track-record in creating a comprehensive enabling environment for the financial system that is resilient and robust to withstand financial shocks and contribute to the overall stability of the financial system. Under the Financial Sector Master Plan (2001-2010), the development of the Malaysian Islamic financial system has been given specific focus:

1 **The Islamic Banking System:** This forms the backbone of the Islamic financial system. It plays an important role in mobilising deposits and providing financing to facilitate growth.

2 **The Islamic Interbank Money Market:** This is another important component in the Islamic financial system. It provides IFIs with short-term finance and paves the way for interbank investment which makes it possible for the surplus banks to feed the deficit banks, thereby, enhancing stability in the system. Under the *mudarabah* interbank investment (MII) mechanism for instance, Islamic banking institutions are able to raise funds and meet their short-term funding requirements based on a profit-sharing arrangement.

3 **The Islamic Capital Market:** This is a market for sourcing long-term funds. It comprises the debt, equity and capital markets.

4 **The Islamic Debt Market:** This is the market where funds are raised to finance long-term infrastructure and development projects through the issuance of Islamic private debt securities. The Islamic capital market reduces over-dependence on the Islamic banking system for long-term financing. This market (debt market) allows Islamic banking institutions to diversify part of the risks emanating from asset and liability mismatches.

5 **The Islamic Equity Market:** This is a market where Islamic institutional investors participate in capital raising exercises to finance business expansion of corporations.

6 **The *Takaful* Industry:** This is another important component in adding significant synergies to the overall Islamic financial system. *Takaful* operators in particular and *takaful* business in general, contribute to mitigate part of the risks of the banking system resulting from financial transactions. Therefore, the presence of the *takaful* industry strengthens the resilience of the Islamic financial system.

Legal, Regulatory and Supervisory Infrastructure

To enable BNM to meet its objectives, it is vested with comprehensive legal powers under the CBA 2009. Among the important provisions that were introduced under the CBA 2009 are:

1 The acknowledgement that Malaysia will have two financial systems i.e., the Islamic financial system and the conventional financial system.

2 The enhanced mandate of the National *Shari'ah* Advisory Council (NSAC). The purpose is to promote consistency in Islamic financial legislation and to raise the status of the NSAC as the highest *Shari'ah* authority in the country when it comes to Islamic finance. In line with such objectives, the CBA 2009 stipulates that the courts and arbitrators shall refer to the NSAC on matters pertaining to *Shari'ah* and that SAC decisions shall be binding on them.

3 The commitment of BNM to promote and position Malaysia as an international Islamic financial centre.

Although BNM has a more limited role in regulating the securities market compared to the SC, it has contributed in terms of capacity-building, among other aspects, through the administration of guidelines relating to issuance of corporate bonds. At present, BNM continues to play its role of regulating and supervising the financial institutions and also has the power to approve issues of securities by financial institutions licenced under the Banking and Financial Institutions Act 1989 (BAFIA). Moreover, it is also vested with the power to control shareholding in licenced financial institutions.

Central Bank of Malaysia Act 2009
(Came into force on 24 November 2009)

1. Islamic Financial System

Section 27: The financial system shall consist of the conventional and Islamic financial system.

2. *Shari'ah* Advisory Council as the highest authority

Section 56(1): The court or arbitrator shall take into account published rulings of BNM's *Shari'ah* Advisory Council (SAC) and refer to any *shari'ah* questions to the SAC for its ruling. **Section 57: IFIs** rulings of SAC shall be binding on IFIs, courts or arbitrators and these rulings are final.

3. Malaysia International Islamic Financial Centre (MIFC)

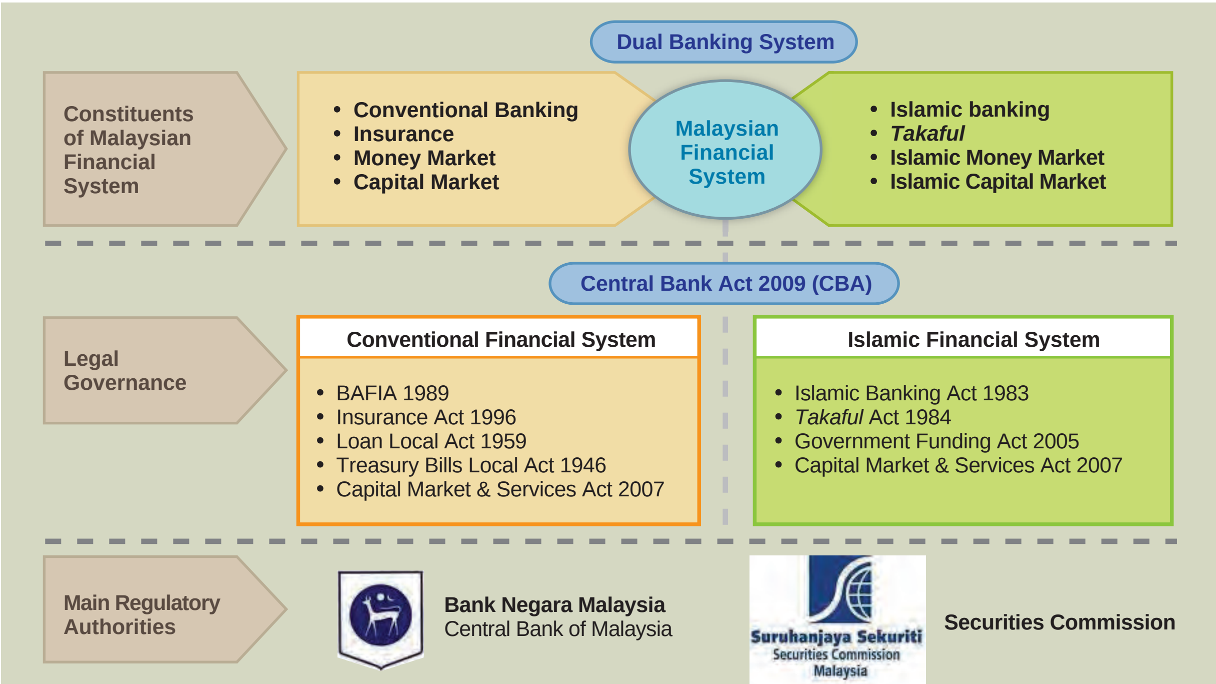
Section 68(1): BNM has the role to develop Malaysia as an international financial centre.

Rationale of the New CBA
- To provide the Central Bank with the necessary power to carry out its mandate.
- Provide greater clarity in terms of mandates.
- To ensure autonomy in achievement of mandates.
- To address financial and monetary stability.

Role of Legal Fraternity
- Provide legal services to facilitate Islamic finance transactions.
- Enhance understanding of the general public on Islamic finance matters.
- Champion legal issues in Islamic finance towards higher standards.

Source: Bank Negara Malaysia.

Figure 15.2 New Provisions Introduced in CBA 2009



Source: Bank Negara Malaysia.

Figure 15.3 Malaysia and Its Dual Financial System

Strengthening Synergies Between Financial Centres

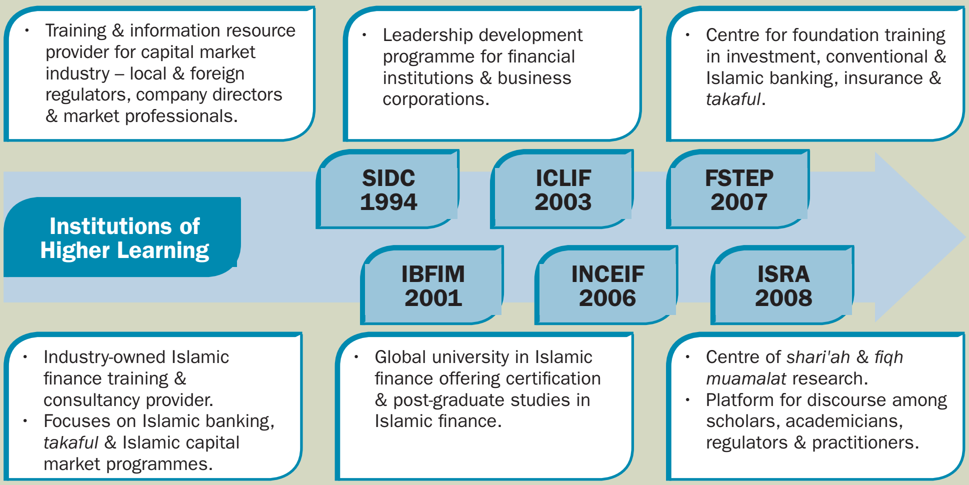
BNM is also responsible for increasing the integration of Islamic finance into the international financial system by accelerating the development of Islamic financial markets and increasing liberalisation efforts. The development in the Islamic financial markets has contributed to the availability of a wide spectrum of Islamic financial instruments that has ranged from instruments to manage liquidity to structures for the financing of mega investments. A higher level of foreign participation in the Malaysian Islamic financial market has resulted in the increase in cross-border flows in the international Islamic financial system, thereby enhancing international financial linkages between Malaysia's financial system and others. Liberalisation policies have also brought in greater foreign institutional presence in the Malaysian Islamic financial system, resulting in increased diversity of players and further strengthening of the international financial linkages.

In 2009, the first foreign currency *sukuk* of US$1.5 billion was successfully issued by Petroliam Nasional Berhad with a significant over-subscription by investors from Europe, the Middle East and Asia.

As an illustration, in 2003, the Islamic financial system in Malaysia was liberalised to allow for increased foreign presence. In 2007, the *sukuk* market was liberalised to allow the raising of funds by eligible corporations from any part of the world in any currency. In 2009, the first foreign currency *sukuk* of US$1.5 billion was successfully issued by Petroliam Nasional Berhad with a significant over-subscription by investors from Europe, the Middle East and Asia.

Human Capital Development

A further area of international collaboration is towards promoting value-added investment in human capital building as a long-term solution to sustainable growth of the Islamic financial services industry. The establishment of talent development and research institutions in Islamic finance is becoming increasingly widespread in several



Source: Bank Negara Malaysia.

Figure 15.4 Malaysia´s Comprehensive Human Capital Infrastructure jurisdictions with several cross-border strategic alliances being entered into. The International Centre for Education in Islamic Finance (INCEIF) in Malaysia was set up by BNM with programmes for practitioners and post-graduate studies to ensure the continuous supply of talent in Islamic finance. The current enrolments in INCEIF comprise students from more than 60 countries including, among others, students from the UK, Canada, France, Japan and Korea as well as the Middle East.

Shari'ah Governance

As the previously localised Islamic finance industry becomes more globalised, innovations and new solutions are needed to resolve the contemporary issues faced by Islamic finance players. By virtue of the new CBA 2009 that elevates the NSAC to a special stature with unique quasi-judicial powers, BNM has given the strongest recognition to the role of *Shari'ah* governance and *Shari'ah* scholars in developing the Islamic finance industry. It has also responded to the calls for a greater convergence in the theoretical understanding and practical considerations especially in the area of *Shari'ah* knowledge and expertise. This has been enhanced by the establishment of a platform for active engagement and intellectual dialogue among global *Shari'ah* scholars, practitioners, regulators and academicians through the International *Shari'ah* Research Academy for Islamic Finance (ISRA). As the global economy becomes more inter-connected and inter-dependent, the process of greater convergence of financial standards and mutual recognition of products is also facilitating the international integration of Islamic finance across different jurisdictions.

Lender of Last Resort

The institutional arrangements for the resolution of troubled IFIs are also important. In most countries, IFIs face certain challenges in their day-to-day management of cash. This arises from the lack of a comprehensive Islamic interbank market with highly-rated short-term tradable instruments. Without access to such a market, it is difficult for these institutions to manage their short-term liquidity needs in an efficient and effective manner. This would in turn require them to maintain a larger amount of liquidity compared to their conventional counterparts.

In Malaysia, such markets exist and have been instrumental in facilitating liquidity management. However, BNM is pushing for the development of a broader range of Islamic financial market instruments. Among the instruments BNM envisages to develop in this market include those with equity ownership features, Islamic asset-backed securities, the inclusion of permissible forms of credit enhancements as well as *Shari'ah*-compliant risk mitigating instruments. These instruments would help create sufficient availability of liquidity to support the intermediation of funds in the Islamic financial system.

Bank Negara Malaysia proactively ensures that it has sufficient Islamic financial instruments at its disposal to manage the liquidity conditions in the Islamic financial system. It has also put in place a mandated resolution mechanism to provide for expedient, effective and cost efficient resolution of IFIs. A mechanism for the co-operation between regulators within and across jurisdictions is underway for a resolution to contain potential systemic risks beyond the national boundaries.

Securities Commission's Role

What is needed is a regulator with the expertise to monitor financial innovations, such as the growth of the shadow banking system; to diagnose likely weaknesses in the financial system; and to pursue policies that can head off likely systemic problems.

It has been argued that the fewer the regulators with supervisory responsibilities, the more consolidated the structure. The more regulators with supervisory responsibilities, the more fragmented the structure. We have seen it with the US Securities and Exchange Commission (SEC) in the recent global crisis; the legally oriented, rule-enforcing regulator is ill-equipped to cope with a systemic crisis caused by a financial system that has outgrown the existing set of rules. What is needed is a regulator with the expertise to monitor financial innovations, such as the growth of the shadow banking system, to diagnose likely weaknesses in the financial system, and to pursue policies that can head off likely systemic problems.

Some opinions state that central banks should regulate capital markets as they have daily trading relationships with market participants as part of their core function of implementing monetary policy and are well-placed to monitor market events and flag looming problems in the financial system. No other public institution has comparable insight and access to the broad flows in the financial system. It is also the central bank's mandate to maintain macroeconomic stability, which is well-matched to its role of ensuring the stability of the financial system. Macroeconomic downturns are often tightly connected to the financial system, and similar analyses, drawing on the disciplines of macroeconomics and financial economics, can provide guidance for both types of oversight. As a result, macroeconomic policy and systemic regulation are tailor-made for each other.

Another benefit of having the central bank as the regulatory body for the financial system is because the central bank is the lender of last resort. It has a balance sheet that it can use as a tool to meet systemic financial crises. As the lender of last resort, it will be called on to provide emergency funding in times of crisis. Too often during the current crisis, central banks have been drawn in at the last minute to provide funding to institutions about which they had no first-hand knowledge. For example, Northern

Rock in the UK was supervised by the Financial Services Authority (FSA), and Bear Stearns in the US was supervised by the SEC. No amount of information-sharing can substitute for the first-hand information gathered from direct on-site examinations.

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The downside of a single regulatory structure is, however, the lack of focus of its mandate. The concerns relate to a central bank overreaching itself in the resolution stage of a crisis when it greatly extends its balance sheet to lend to private institutions.

Malaysia's Experience on Securities Commission

The Securities Commission (SC) was established on 1 March 1993 under the Securities Commission Act (SCA) 1993 with the mandate to promote and maintain fair, efficient, secure and transparent securities and futures markets and to facilitate the orderly development of an innovative and competitive capital market. The SC is a self-funding statutory body with investigative and enforcement powers in the areas within its jurisdictions through the SCA 1993, Capital Markets and Services Act 2007, and Securities Industry (Central Depositories) Act 1991. Reporting to the Minister of Finance, the SC is entrusted with the responsibility of regulating and systematically developing Malaysia's capital markets.

Exhibit 15.2 The Securities Commission's Regulatory Functions

1. Supervising and monitoring the activities of exchange holding companies, exchanges, clearing houses and central depositories.
2. Registering authority for prospectuses of corporations other than unlisted recreational clubs.
3. Approving authority for corporate bond issues.
4. Regulating all matters relating to securities and futures contracts by, *inter alia,* ensuring reasonable measures taken in maintaining the confidence of investors in the securities and futures markets through protection for such investors.
5. Regulating the take-over and mergers of companies.
6. Regulating all matters relating to unit trust schemes.
7. Licencing and supervising all licenced persons.
8. Encouraging self-regulation among the professional associations or market bodies in the securities and futures industries.
9. Ensuring and promoting proper conduct of market institutions and licenced persons by, *inter alia*, suppressing illegal, dishonourable and improper practices in dealings and tradings in securities and futures contracts.

The SC regulates the offerings and issues of securities by public companies, and debentures by private companies. It also regulates the listing of such securities on Bursa Malaysia, as well as matters relating to take-overs and mergers of companies, and unit trust schemes. It is the sole approving and registering authority for prospectuses of all securities. The SC has direct responsibility for supervising and monitoring the activities of market institutions, including the exchanges and clearing houses, and regulating all persons licenced under the Capital Market and Services Act (CMSA) 2007.

The CMSA 2007, among others, gives mandate to the SC "to encourage and promote the development of the securities and futures markets in Malaysia". This mandate empowers the SC to provide a more focused approach in developing the ICM industry in Malaysia. Apart from its regulatory functions over capital market institutions, intermediaries and activities, the SC has undertaken effective steps towards providing the infrastructure for the development of ICM. A dedicated department responsible for ICM was established with the purpose of conceptualising and proposing initiatives for the development of the ICM.

The SC joined the International Organisation of Securities Commissions (IOSCO) in 1993 and has since remained an active member of various committees and task forces of IOSCO. The SC was invited to sit on the drafting committee for IOSCO's Objectives and Principles of Securities Regulation. The SC was also invited to sit on the Implementation Task Force which, in October 2003, released the Methodology for Assessing the Implementation of the IOSCO Objectives and Principles of Securities Regulation.

At the 33rd IOSCO Annual Conference in Paris, France in May 2008, the SC chairman was elected as the vice-chairman of the Emerging Markets Committee (EMC). The EMC is one of the key committees within IOSCO responsible for discussing regulatory issues and challenges that are relevant to emerging market jurisdictions. This is with a view to developing international guidance and best practices to regulate the capital market.

The SC also chairs the EMC's Working Group on the Regulation of Secondary Markets, a position it has held since 1994. This group is responsible for a number of significant publications addressing secondary market issues of particular relevance to emerging markets, including:

> The Securities Commissions also chairs the EMC's Working Group on the Regulation of Secondary Markets, a position it has held since 1994.

1. *Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets*, November 1999.
2. *The Development of Corporate Bond Markets in Emerging Market Countries*, May 2002.
3. *Exchange Demutualisation in Emerging Markets*, April 2005.
4. *Factors Influencing Liquidity in Emerging Markets*, December 2007.

In the past, the SC also chaired the EMC from 1996 to 1999, and the Asia-Pacific Regional Committee (APRC) from 2000 to 2005.

Experience in Other Jurisdictions

Central Bank of Bahrain

In recent years, Bahrain has rapidly become a global leader in Islamic finance, playing host to the largest concentration of IFIs in the Middle East. Presently, there are twenty-six Islamic banks and nineteen Islamic insurance companies (*takaful*) operating in the Kingdom. In addition, Bahrain is amongst those at the forefront in the market for Islamic securities (*sukuk*), including short-term government *sukuk* as well as leasing securities. The Central Bank of Bahrain (CBB) has played a leading role in the introduction of these innovative products.

The CBB was originally established as the Bahrain Monetary Agency in 1973 and changed its name following the promulgation of the Central Bank of Bahrain and Financial Institutions Law in 2006. The CBB is the single regulatory body in Bahrain responsible for licencing, supervision, and regulation of the financial sector, comprising banking, insurance and the capital market. IFIs in Bahrain are liable to the same rules of accounting, auditing, transparency and professional regulations that apply to their conventional counterparts. The CBB has devised an industry-specific regulatory framework that is transparent and conforms to international best practices.

The Central Bank of Bahrain is the single regulatory body in Bahrain responsible for licencing, supervision, and regulation of the financial sector, comprising banking, insurance and the capital market.

The CBB also regulates the Bahrain Stock Exchange ("BSE") and acts as the Listing Authority for companies and financial instruments listed on the BSE. It is also responsible for regulating conduct in Bahrain's capital markets.

Exhibit 15.3 The Central Bank of Bahrain's Objectives

Article 3 of the law defines the CBB's objectives as follows:

1 Set and implement monetary, credit and other financial sector policies for the Kingdom of Bahrain.
2 Provide effective central banking services to the government and financial sector of the Kingdom.
3 Develop the financial sector and enhance confidence therein.
4 Protect the interests of depositors and customers of financial institutions, and enhance the Kingdom's credibility as an international financial centre.

Article 4 of the same law specifies various specific duties and powers of the CBB. They include the issuance of the national currency; the licencing, regulation and supervision of persons undertaking regulated financial services; the provision of banking services to the government; and managing the Kingdom's gold and foreign currency reserves.

The CBB publishes its regulatory requirements applicable to all Islamic full commercial Banks (FCBs), offshore banking units (OBUs) and investment banks (IBs) in the form of a Rulebook. The CBB Rulebook is divided into separate volumes, each focusing on a particular category of licencee or industry sector. Volume 2, which contains the Prudential Information and Regulatory Framework for Islamic banks (PIRI), is relevant to IFIs.

The CBB and BNM have worked together to establish a number of multilateral institutions related to Islamic finance, including the IFSB, IIFM and International Islamic Rating Agency (IIRA).

With a view to strengthening the global Islamic financial services industry, enhancing the ability of IFIs to trade in the international markets, and improving business volumes, a Memorandum of Understanding (MOU) was signed in July 2003 between CBB (then known as BMA) and the London Metal Exchange (LME). The agreement came as a result of a common recognition by BMA and LME of the tremendous potential in demand for products that conform to the *Shari'ah*. Under the terms of the agreement, LME will help BMA to develop contracts and documents that can be used by IFIs for conducting transactions in metals also traded on the LME. Standardisation of such contracts and documents will help trading by IFIs, which manage assets in excess of US$230 billion, of which approximately 80% is invested in commodities. LME authorities gave assurance to co-operate to help ensure that transactions based around LME metals meet the standards required under *Shari'ah*.

Qatar Central Bank

The Qatar Central Bank (QCB), established in August 1993 was formerly known as the Qatar Monetary Agency (and before that as Qatar Dubai Currency Board). It has the objectives of ensuring:

1. Stability of the Qatari Riyal exchange rate and its free convertibility to other currencies.
2. Stability of domestic price levels.
3. Financial stability.
4. Other macroeconomic objectives without interfering with the above objectives.

Throughout its history, the QCB has increasingly worked in association with other, larger central banks to achieve a stable currency for the country, most recently and notably, with the Monetary Authority of Singapore.

As indicated above, the two core purposes of the QCB in contributing towards a healthy economy are ensuring monetary stability and financial stability. Monetary stability means stable prices and confidence in the currency, which the QCB seeks to meet using the monetary policy tools, whereas its role of ensuring financial stability means it engages in the detection and reduction of threats to the financial system. The QCB monitoring system detects the threats, which may be reduced by improving the infrastructure and conducting financial and other operations comprising, for instance and in exceptional cases, acting as lender of last resort. Throughout its history, the QCB has increasingly worked in association with other, larger central banks to achieve a stable currency for the country, most recently and notably, with the Monetary Authority of Singapore.

Exhibit 15.4 Main Functions of the Qatar Central Bank

The main functions of the QCB are:

1. Manage and conduct operations related to exchange rate policy.
2. Conduct and implement monetary policy and evaluate its conduct.
3. Exercise the privilege of the issuance, and circulation of domestic currency, and adopt and take necessary security measures to prevent counterfeiting.
4. Supervise and control the activities of financial institutions, i.e., banks, exchange houses, investment companies, financial companies, and representative offices.
5. Conduct domestic public debt operations.
6. Contribute to policies of financial stability.
7. Act as a bank for all banks operating in the state of Qatar under the umbrella of the Qatar Financial Centre (QFC).
8. Manage QCB's reserves in foreign assets.
9. Organise and manage bank clearing operations and payments system.
10. Conduct studies and research related to domestic and world economic developments.
11. Extend advice and consultations to the government related to financial and economic issues.
12. Promote the banking sector in Qatar.
13. Promote efficiency and development of the financial markets.
14. Any other function that falls within its jurisdiction.

Apart from the regulatory and supervisory roles played by QCB, it also plays a major role in maintaining financial stability through its contribution to price stability, and maintaining low levels of inflation. QCB also constantly ensures an efficient and smooth payment system, compiles data for the financial sector and the economy for prudential surveillance purposes, and constructs and monitors financial soundness indicators on a regular basis.

Qatar Financial Markets Authority

The Qatar Financial Markets Authority (QFMA) officially started its activity on 1 September 2007. The strategic vision driving the QFMA establishment includes:

1. Developing an appropriate regulatory environment to support the tremendous growth of the Qatari Capital Markets.
2. Providing a safe investment environment for investors and a sound business environment for securities professionals.

The financial system consists of markets and institutions actively engaged in the channelling of investable funds from surplus fund units (SFUs) to deficit fund units (DFUs).

Exhibit 15.5 Objectives of the Qatar Financial Markets Authority

The QFMA was established with the following objectives:

1 Develop an adequate market structure and regulation to ensure the fostering of investor confidence in the Qatari Capital Markets.
2 Create and strengthen market institutions.
3 Strengthen the capital market's integrity by conducting proper market surveillance and adequate supervision framework.
4 Meet international standards for laws, regulations and operations.
5 Streamline market processes and reduce systemic risks.
6 Improve investor awareness and protection.

Central Bank of the United Arab Emirates

The Central Bank of the United Arab Emirates (CBUAE) was formed in 1980 and replaced the Currency Board which had been set up in 1973. The establishment of the CBUAE was to bring about control and discipline to the banking sector in the United Arab Emirates (UAE) and provide greater control of national and foreign banks operating within the country, in addition to regulating various financial institutions. The CBUAE is primarily responsible for overseeing banks in the UAE, except in the Dubai International Financial Centre (DIFC), where the regulatory authority is the Dubai Financial Services Authority (DFSA).

The principal governmental and regulatory policy that governs the banking sector is Federal Law No. 10 of 1980, which is the backbone of the conventional banking sector, whereas Federal Law No. 6 of 1985 was promulgated to legalise Islamic banking in the UAE. It was the first Islamic banking law in the GCC. Article 5 of Law No. 6 of 1985 provides that the Higher *Shari'ah* Authority should be established and approved through a cabinet decision, but it has never materialised. Instead, it was Article 6 of the same law which was implemented, whereby each Islamic bank, financial institution and investment company should establish its own *Shari'ah* Supervisory Authority to ensure that its transactions and practices conform to Islamic law. The provision of the law is rather prescriptive as it also requires that IFIs insert the establishment of the *Shari'ah* Supervisory Authority in their respective articles and memorandum of association and that the Authority consists of at least three members.

Dubai Financial Services Authority

The Dubai government established the Dubai International Financial Centre (DIFC), a financial centre in free zones governed by its own laws and regulations which are based on English common law as applied to finance. The laws that govern the zone are regulated by Dubai Financial Services Authority (DFSA). The DFSA's regulatory mandate is similar to the FSA of the UK whereby it covers asset management, banking and credit services, securities, collective investment funds, custody and trust services, commodities futures trading, Islamic finance, insurance, an international equities exchange and an international commodities derivatives exchange.

The DFSA administers Regulatory Law 2004, which is the cornerstone legislation of the regulatory regime. Under the Law, DFSA has the power to enforce the law and rules that apply to all regulated participants within the DIFC. The DFSA was in the privileged position of developing a regulatory regime on a blank slate and devised its integrated risk-based regime with both conventional and Islamic firms. In respect of the regulation of Islamic finance, the underpinning law is the Law Regulating Islamic Financial Business. Under this law, a financial firm is allowed to operate as a wholly-Islamic firm or as an Islamic "window" within a conventional set-up.

The DFSA has recently drawn up comprehensive rulebooks to govern Islamic financial activities including the capital treatment of various Islamic contracts. The DFSA has taken steps to create an enabling regulatory framework by creating international regulatory parameters within a conducive environment, not only in line with the cross-sectoral features of Islamic finance but also to the pace of innovation in the industry. Furthermore, the DFSA also applies the internationally accepted standards and principles in Islamic finance as issued by the AAOIFI and IFSB.

The Dubai Financial Services Authority has taken steps to create an enabling regulatory framework by creating international regulatory parameters within a conducive environment, not only in line with the cross-sectoral features of Islamic finance but also to the pace of innovation in the industry.

Mindful of the differences of opinion in *Shari'ah* interpretations, the DFSA has implemented a "*Shari'ah* systems" approach to regulation. Islamic firms operating in the DIFC must implement systems and controls to ensure that the firm operates in compliance with *Shari'ah*. This includes the appointment of a *Shari'ah* Supervisory Board (SSB) of at least three competent scholars in accordance with guidance provided. Hence, the firm must have the systems in place to disseminate SSB's rulings, to conduct regular *Shari'ah* reviews and also to carry out an internal audit.

Central Bank of Kuwait

The regulatory framework of Islamic banking in Kuwait complements the current banking and financial legislation. The Central Bank of Kuwait (CBK) has contributed to the efforts leading to the shaping of Islamic banking legislation as it has been involved in the regulation of Islamic finance since the early 1990s when several Islamic investment companies were established under its supervision. Moreover, the CBK has sought a

Case Study Pakistan

Pakistan has a protracted history of Islamic banking with the initial attempt to Islamise banking system in 1980s, leading to sweeping changes in the Banking Companies Ordinance, 1962 (BCO'62) and associated laws and regulations to accommodate non-interest-based banking transactions. Some specific developments around this period are noteworthy:

1 In 1979, two government-owned mutual funds in Pakistan, the National Investment Trust (NIT) and Investment Corporation of Pakistan (ICP), started to eliminate interest from their operations by eschewing investment of their funds in interest-bearing securities. On 1 October, 1980, the investor scheme of ICP was substituted by a new scheme based on profit-and-loss-sharing (PLS).

2 The state-run House Building Finance Corporation (HBFC) also eliminated interest from its operations from 1 July, 1979.

3 In June 1980, Pakistan's legal framework was amended to permit issuance of a new, interest-free instrument of corporate financing called Participation Term Certificate (PTC).

4 New laws, namely, the Modaraba Companies and Modarabas Ordinance, 1980 along with the Modaraba Companies and Modaraba Rules, 1981 was promulgated to introduce *mudarabah* as a two-tier fund structure for undertaking *Shari'ah*-compliant businesses.

5 The Banking and Financial Services Ordinance, 1984 amended seven laws, and the Banking Tribunals Ordinance, 1984 provided a new system of recovery of non-interest-based modes of financing.

6 From 1 January 1981, separate interest-free counters started operations in all the nationalised commercial banks to mobilise deposits on a PLS basis. Concurrently, banks were prohibited from specified interest-based transactions, which resulted in the development of Islamic modes of financing.

7 Finally, the State Bank of Pakistan (SBP) issued the Banking Control Department Circular No. 13 of 1984 that called for the elimination of *riba* from the banking system and on 1 January, 1985, all financing of Federal and Provincial governments, public sector corporations and public or private joint-stock companies was directed to carry out operations only through interest-free modes.

8 From 1 July, 1985, all commercial banking in Pak Rupees was made interest-free.

Resultantly, the percentage of PLS deposits out of total deposits rose from 9.2% at the end of 1981 to 61.6% by the end of 1985. These measures resulted in a country-wide roll out of Islamic banking. However, the premature and sudden conversion of the banking system to an Islamic system coupled with the lack of preparedness and understanding among financial institutions and the public posed difficulties in implementation. The Federal *Shari'ah* Court challenged some emerging products and processes and declared them un-Islamic. The *Shari'ah* Appellate Bench of the Supreme Court upheld the decision of the Federal *Shari'ah* Court and offered guidelines to address the issues involved, setting a timeline for implementation. This decision was later set aside in a review petition filed by the United Bank.

Some key lessons emerged from Pakistan's experience of the 1980s:

(i) Regulation

It is important to ensure that all regulations are in place to support the growth of Islamic finance.

(ii) Absence of a *Shari'ah* Committee

The development and product growth is not supported by robust *Shari'ah* compliance. The markets and customers must have confidence in *Shari'ah* compliance by the Islamic finance industry to ensure the sanctity of the system. As such, having a *Shari'ah* committee at the bank's level is instrumental as it acts as the first line of defence against *Shari'ah* risk.

(iii) Infrastructure

The markets and customers must have confidence in *Shari'ah* compliance by the Islamic finance industry to ensure sanctity of the system.

Drawing from the valuable experiences and lessons learned, the SBP has embarked into a financial strategy by introducing Islamic Banking Policy (IBP) in 2001. Under IBP, the SBP is promoting a dual financial system where the development of Islamic banking is parallel to the conventional finance industry. Islamic banking licences were issued to stand-alone Islamic banks. Al-Meezan Investment Bank was the first Islamic Bank to be awarded the Islamic banking licence. In addition, the SBP also allowed conventional banks to set up Islamic banking subsidiaries or dedicated Islamic banking branches to speed up the growth and development of Islamic banking.

In 2003, the SBP established a dedicated department (Islamic banking department) within its structure. It was envisaged that with the establishment of a dedicated department, it could promote and jolt the development of Islamic banking at a faster pace. The SBP has set a target for the Islamic banking market share to reach 12% by 2012.

The Islamic banking department will also be responsible to streamline the regulation of Islamic finance (without compromising *Shari'ah* values) to be on par with international best practices. The move will enhance the regulatory and *Shari'ah* compliance aspect, and hence strengthen the resilience of the Islamic banking system.

The initiative was also aimed at building a broad-based financial system to enable all segments of society, including the underserved region, poor and vulnerable groups, to gain access to financial services and play their due role in the overall economic development. The successful implementation of the strategy will facilitate the achievement of the outlined objectives and, hence contribute towards optimum utilisation of the potential that Islamic finance enjoys, i.e., blend economic and social objectives and address the ethical aspects of financing effectively.

Source: Adapted from the speech of Dr Shamshad Akhtar (Governor of State Bank of Pakistan), 2007.

legislative framework to establish prudent regulatory and supervisory policies and procedures for Islamic finance in general and Islamic banking in particular. The CBK Law (Act No. 32 of 1968) was amended in 2003 (Act No. 30 of 2003) to include a section with fifteen articles on Islamic banking. The CBK law is prepared in such a way as to provide it with the required flexibility and adaptability:

First: It takes into account that Islamic banking units may engage in the activities of either commercial or investment banks, or both types of activities combined within the concept of "universal banking".

Second: It is specifically adapted to the nature and type of current Islamic banking operations, such as those involving temporary acquisition of real estate assets for financing purposes.

Third: It allows the CBK to develop financial instruments that comply with the provisions of the *Shari'ah*.

Fourth: To ensure that the activities of Islamic banks are conducted according to the provisions of the *Shari'ah*, it entrusts this task to independent bodies, i.e., in the form of *Shari'ah* boards, within the Islamic banking units.

The CBK law further sets the requirement for the IFIs in Kuwait to establish an SSB upon registration. In case of conflict of opinions among members of the SBB concerning a *Shari'ah* rule, the board of directors of the Islamic bank may transfer the matter to the *Fatwa* Board in the Ministry of *Awqaf* and Islamic Affairs, as they are the highest authority in *Shari'ah* matters.

This legislation enabled the CBK to bring Islamic banking, which had not been regulated for the previous 16 years, into its supervisory fold. It also allowed more Islamic banks to be established. To date, Kuwait has six Islamic banks and 54 Islamic investment companies (which are non-deposit-taking financial institutions). Additionally, a Kuwaiti conventional bank is in the process of converting its operations into a full-fledged Islamic bank.

The supervision over Islamic banks pursues the same objectives as supervision over conventional banks, namely promotion of a proper depository environment, maintenance of an efficient payment and settlement systems, provision of appropriate banking services by Islamic banks to their clients, and support for general economic policies. These objectives could be attained through the adoption of proper policies and measures, mainly in the areas of capital adequacy adjusted to market risk, bank liquidity and credit and investment concentrations. Furthermore, the supervisory framework developed by the CBK takes into consideration international best practices for effective supervision of conventional banking with adaptations to suit the Islamic banking business. For example, credit concentration ratios for a single customer do not generally differ in conventional and Islamic banks, while capital adequacy ratios have to be adapted to take into account the different asset-liability structures in conventional and Islamic banks.

Bank of England

The Bank of England (BOE) is the central bank of the UK. Sometimes known as the "Old Lady" of Threadneedle Street, the BOE was founded in 1694, nationalised on 1 March 1946 and regained independence in 1997. Standing at the centre of the UK's financial system, the BOE is committed to promoting and maintaining monetary and financial stability as its contribution to a healthy economy.

The BOE performs all the functions of a central bank. The most important of these is maintaining price stability and supporting the economic policies of the British Government, thus promoting economic growth. The BOE works together with Her Majesty's Treasury (i.e., the government department responsible for financial and economic policies), the Financial Services Authority (FSA) and several other institutions to secure both monetary and financial stability. The 1997 Memorandum of Understanding describes the terms under which the BOE, the Treasury and the FSA are collectively expected to work for the achievement of the common aim of increased financial stability. However, the new Conservative-Liberal Democrats coalition government has announced proposals to hand control of financial regulation back to the BOE.

> The Bank of England works together with Her Majesty's Treasury (i.e., the government department responsible for financial and economic policies), the Financial Services Authority (FSA) and several other institutions to secure both monetary and financial stability.

In regulating IFIs in the UK, both the BOE and the FSA were involved in the establishment of the first *Shari'ah*-compliant retail bank in Europe, the Islamic Bank of Britain, in 2004. The BOE gives full support in giving Muslims and others interested in alternative investment products based on faith principles access to such products — provided they do not clash with the general principles of UK banking law and provisions. This coincided with the financial and social inclusion policies of the Labour government of Tony Blair and his then Chancellor, Gordon Brown.

Most importantly, the BOE established the Islamic Finance Advisory Group (IFAG) under the leadership of Andrew Buxton, the former CEO of Barclays Bank and the then adviser to Barclays. The IFAG, with the help of entities such as Norton Rose, which did much of the work pro bono, did all the research and explanatory reports that paved the way for much of the recent legislation, especially in dealing with tax neutrality for Islamic products such as *sukuk*, *murabahah* and home-financing products, such as those dealing with the abolition of double stamp duty and risk weighting for Islamic mortgages.

Today, the UK has twenty-two banks that offer Islamic financial products, including five that are fully *Shari'ah*-compliant; twenty *sukuk* issues raising US$11 billion listed on London Stock Exchange; seven *Shari'ah*-compliant exchange-traded funds (ETFs); twenty law firms supplying services in Islamic finance; advisory services provided by the Big Four professional service firms; and several institutions offering educational and training products in Islamic finance.

Today, the UK has twenty-two banks that offer Islamic financial products, including five that are fully *Shari'ah*-compliant; twenty *sukuk* issues raising US$11 billion listed on London Stock Exchange; seven *Shari'ah*-compliant exchange-traded funds (ETFs); twenty law firms supplying services in Islamic finance; advisory services provided by the Big Four professional service firms; and several institutions offering educational and training products in Islamic finance. London has particularly become the premier centre for commodity *murabahah* transactions through contracts traded on the LME. Similarly, efforts elsewhere are underway to create an attractive environmental and regulatory framework for the promotion, distribution and trading of *Shari'ah*-compliant products in secondary markets.

Financial Services Authority of the UK

The FSA of the UK is an independent non-governmental, quasi-judicial body and a company limited by guarantee that regulates the financial services industry in the UK, given statutory powers by the Financial Services and Markets Act 2000 (FSMA) under which corporate bodies, partnerships, individuals and unincorporated associations are permitted by the FSA to carry on financial activities which are subject to regulation.

The FSA's policy towards IFIs, and indeed any new or innovative financial services company, can be summed up simply as "no obstacles, no special favours" as the FSA is keen to promote a level playing field between conventional and Islamic financial service providers. The FSMA provides for a non-discriminatory regime when authorising financial institutions, i.e., all banks have to meet the Threshold Conditions, which are essentially:

- Sound management;
- Adequate financial resources; and
- Effective systems and controls.

Within this framework, there is some room for flexibility. In the case of Islamic banks, the FSA has applied the same principles which means that their special characteristics could be accommodated by having close dialogue and careful preparation.

In the UK, if the customer deposits a sum of money in a bank, the customer's claim on the bank is fixed at the nominal amount.

The FSA has encouraged growth by providing an open and flexible regulatory environment, which accommodates both Islamic and non-Islamic financial institutions. The most important issue in Islamic banking was the definition of a deposit. In the UK, if the customer deposits a sum of money in a bank, the customer's claim on the bank is fixed at the nominal amount. Under the Islamic banking system, Islamic banks operate with a PLS formula. As such, it is possible for a customer to be entitled to an amount quite less than that deposited because *Shari'ah* law requires the customer to accept the risk of a loss in order to have entitlement of a return. The solution arrived at, says that legally, the depositors are entitled to full repayment but if they prefer to be repaid under the Islamic risk-sharing formula, this is also acceptable. This allows customers to choose not to accept full repayment if their religious convictions dictate otherwise. By settling this, and other issues, the FSA has not only enabled the start-up of Islamic banks in Britain, but has also enabled already established banks, including some of the traditional high street banks to offer *Shari'ah*-compliant products.

The FSA has been able to deal with particular issues related to Islamic finance within the scope of its existing regulatory framework. For example, retail consumers taking out *ijarah* mortgages now get the same protection as conventional mortgage customers since the introduction of new regulations in April 2007. In this regard, the FSA has set out a consultation paper on how it would in practice regulate home purchase plans (HPPs). This is to ensure that the promotion of these products should meet the same standards, are clear and not misleading, as per the FSA requirements in the promotion of non-Islamic mortgages or any financial services.

Furthermore, the FSA does not explicitly regulate the *Shari'ah* compliance of Islamic financial products, but requires transparency and accountability through explanation of the products and their associated risks. The factsheet on HPPs issued in March 2007 is a good example, setting out the key messages for consumers, giving a step-by-step guide to each product and the associated risks and benefits. In this way, the FSA can provide a platform to raise public awareness but it will clearly rely on support from other institutions, organisations, private and official bodies which are involved in this sector.

The structures of Islamic products have created some challenges over their regulatory definitions in the UK. *Sukuk* have been no exception to this as they may have significantly different underlying structures compared to conventional bonds. The AAOIFI has identified at least fourteen possible structures for *sukuk* and more are being developed. It is, therefore evident that it may not be possible to find one overarching regulatory definition for all types of *sukuk*. In October 2009, the FSA and Her Majesty's Treasury published legislative framework for the regulation of alternative finance investment bonds (AFIBs), or *sukuk*.

In respect of the special position of the SSB within IFIs, the FSA has taken the position not to assess the suitability of the scholars consulted by IFIs. The FSA only wants to see that the basis on which an IFI claims to be *Shari'ah*-compliant is communicated appropriately to the consumer. More generally, the FSA supports moves to develop common *Shari'ah* standards by organisations such as the IFSB and the AAOIFI.

Exhibit 15.6 Statutory Instrument Order

A new Statutory Instrument Order was passed in February 2010 to:

1 Provide regulatory definition of AFIBs.
2 Exempt AFIBs from the onerous requirements of collective investment scheme regulations.
3 Have similar regulatory treatment as conventional bonds.
4 Reduce legal costs and remove unnecessary obstacles to the issuance.

Under the new plans to abolish the FSA by 2012 as announced by the Chancellor of the Exchequer, George Osborne, in June 2010, the FSA's responsibilities will be divided between a number of new agencies and the BOE. The Consumer Protection and Markets Authority will be responsible for policing the city and the banking system. A new Prudential Regulatory Authority will carry out the prudential regulation of financial firms, including banks, investment banks, building societies and insurance companies. All other responsibilities will be assumed by the BOE, which will establish a Financial Policy Committee.

International Standard-Setting Organisations

International standard-setting bodies do not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended, to have legal force.

Internationally accepted standards and best practices form major reference points for any regulatory and supervisory framework established by regulatory and supervisory authorities. By design, international standard-setting bodies do not possess any formal supranational supervisory authority, and their conclusions do not, and were never intended to, have legal force. Rather, they formulate broad supervisory standards and guidelines and recommend statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements — statutory or otherwise — which are best suited to their own national systems. This way, the international standard-setting bodies encourage convergence towards common approaches and common standards without attempting detailed harmonisation of member countries' supervisory techniques.

An extensive due process is adopted by international standard-setting bodies in order to develop reasonably sound documents to be adopted by individual regulatory and supervisory authorities, and to seek broad industry endorsement for their initiatives. This includes establishing well-represented working groups and conducting public consultations before any document is finalised as the international standard.

The Basel Committee for Banking Supervision (BCBS)

The BCBS, established by the Central Bank Governors of the Group of Ten (G-10) countries at the end of 1974, provides a forum for regular co-operation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues and approaches and techniques, with a view to promoting common understanding.

The BCBS is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on Cross-Border Banking Supervision. Following the 2007-2009 global financial crisis, the membership of the BCBS has been expanded to the G-20 countries.

The International Organisation of Securities Commissions (IOSCO)

The International Organisation of Securities Commissions (IOSCOs) is recognised as the world's most important international co-operative forum for securities regulatory agencies. The organisation's wide membership regulates more than 90% of the world's securities markets. As the leading international policy forum for securities regulators, the IOSCO plays a key role in setting international standards for securities regulation, identifying issues affecting global markets, and making recommendations in meeting those challenges.

In 2002, the IOSCO established an Islamic Capital Market Task Force, which was chaired by the then chairman of the SC of Malaysia. The Task Force published the *Islamic Capital Market Fact Finding Report* in 2004, which examined the extent of development and regulatory issues relating to the global Islamic capital market. In 2008, an IOSCO Working Group led by the FSA of the UK published a follow-up report entitled *IOSCO Islamic Finance Report: Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulations for Islamic Securities Products*.

International Association of Insurance Supervisors (IAIS)

Established in 1994, the IAIS represents insurance regulators and supervisors of some 190 jurisdictions in nearly 140 countries. Collectively, in terms of global market share of its members, it constitutes 97% of the world's insurance premiums. It also has more than 120 observers.

Its objectives are to:

1. Cooperate towards improved supervision of the insurance industry on a domestic as well as international level in order to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders.
2. Promote the development of well-regulated insurance markets.
3. Contribute towards global financial stability.

The IAIS issues global insurance principles, standards and guidance papers. It also provides training and support on issues related to insurance supervision, and organises meetings and seminars for insurance supervisors.

Islamic Financial Services Board (IFSB)

The IFSB serves as an international standard-setting body consisting of regulatory and supervisory agencies. It is mainly interested in ensuring the soundness and stability of the Islamic financial services industry, broadly defined to include banks, capital markets and insurance. It was officially inaugurated on 3 November, 2002, and started operations on 10 March, 2003. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry by introducing new, or adapting existing international standards consistent with *Shari'ah* principles, and recommending them for adoption. As of April 2010, the IFSB has 191 members, including 50 regulatory and supervisory authorities; six multilateral inter-governmental organisations, including the International Monetary Fund, World Bank, Bank for International Settlements, Islamic Development Bank (IDB), Asian Development Bank; and 135 market players and professional firms from 40 countries.

The Islamic Financial Services Board promotes the development of a prudent and transparent Islamic financial services industry by introducing new, or adapting existing international standards consistent with *Shari'ah* principles, and recommending them for adoption.

Since the IFSB largely complements the work of the BCBS and IOSCO, it is important to understand its position within Islamic finance architecture. Firstly, the standard-setting work of the IFSB takes into account the need to cater for the specificities of the Islamic financial services industry while complementing existing internationally accepted standards and best practices. Secondly, compliance with a common set of internationally recognised prudential standards would help harmonise the regulatory and supervisory framework for the Islamic financial services industry, which may vary greatly across jurisdictions according to national circumstances and practices due to differing interpretations and the way policies are structured. Thirdly, global acceptance of, and compliance with, uniform prudential standards and best practices may help create a level playing field for IFIs among themselves in many regulatory and supervisory aspects before eventually ensuring parity *vis-à-vis* their conventional counterparts.

In this respect, the IFSB has issued a prudential and governance framework for the Islamic financial services industry in the form of Standards, Guiding Principles and Technical Notes, which cover areas involving banking, insurance (*takaful*) and capital markets for the Islamic financial services industry. The IFSB standards also contribute to the harmonisation in the development of Islamic finance across different jurisdictions.

Table 15.5 Published Documents by IFSB

	No.	Full Title	Issuance Date
1	IFSB-1	Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services.	Dec 2005
2	IFSB-2	Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services.	Dec 2005
3	IFSB-3	Guiding Principles on Corporate Governance for Institutions Offering only Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Mutual Funds).	Dec 2006
4	IFSB-4	Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Mutual Funds)	Dec 2007
5	IFSB-5	Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Mutual Funds).	Dec 2007
6	IFSB-6	Guiding Principles on Governance for Islamic Collective Investment Scheme.	Dec 2008
7	IFSB-7	Special Issues in Capital Adequacy Requirements: *Sukuk* Securitisations and Real Estate Investment.	Dec 2008
8	IFSB-8	Guiding Principles on Governance of Islamic Insurance (*Takaful*) Operations.	Feb 2010
9	IFSB-9	Guiding Principles on Conduct of Business for Institutions Offering Islamic Financial Services.	Feb 2010
10	IFSB-10	Guiding Principles on *Shari'ah* Governance System.	Feb 2010
11	IFSB-11	Solvency Requirement for Islamic Insurance (*Takaful*) Operations.	Dec 2010
12	GN-1	Guidance Note in Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on *Shari'ah*-compliant Financial Instruments.	Mar 2008
13	GN-2	Guidance Note of the Regulatory Capital Treatment of Commodity – Trading Transaction as Liquidity Management Instrument in Institutions Offering Islamic Financial Services.	Oct 2010
14	GN-3	Guidance Note on Rating for Islamic Insurance (*Takaful*) Operations.	Oct 2010
15	TN-1	Compilation Guide on Prudential & Structural Islamic Finance Indicators: Guidance on the Compilation and Dissemination of Prudential & Structural Islamic Finance Indicators for Banking and Near-Banking institutions Offering Islamic Financial Services.	Mar 2007
16	TN-2	Technical Note on Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services: The Development of Islamic Money Market.	Mar 2008

Source: IFSB website.

The way they were developed, IFSB-1 to IFSB-5, as well as IFSB-7, are all aimed at complementing the different pillars established by the BCBS under Basel II by catering for the specificities of IFIs that run primarily commercial banking operations. IFSB-3, IFSB-6 and IFSB-9 are benchmarked against governance and market conduct standards established by IOSCO and the IAIS. By using existing internationally recognised standards as the benchmark, the IFSB avoids re-inventing the wheel as adaptation of useful international prudential practices can still be done with minimal adjustments that take into consideration only the specificities of IFIs.

In 2008, the Task Force on Islamic Finance and Global Financial Stability was formed by the IDB and the IFSB, together with industry leaders and international expertise. The essence was to further examine the building blocks of the Islamic financial infrastructure that need to be put in place to ensure financial stability. The Task Force published a report in April 2010 which identified seven building blocks that are fundamental in ensuring the continued development of a robust and resilient Islamic financial system, effective preservation of financial stability and contribution to growth and development.

Other Infrastructure Institutions

As mentioned previously, the IFSB is an international standard-setting body for the Islamic financial services industry that can consider the BCBS, the IOSCO and the IAIS as its conventional counterparts. While an organisation helmed by regulatory and supervisory authorities is certainly important for the development of international prudential standards for Islamic finance, market-based and market-driven organisations also have a role to play.

Of particular importance is AAOIFI, which primarily has a role in developing accounting and auditing standards for IFIs. Such an organisation could compare itself with the International Accounting Standards Board (IASB) or the International Auditing and Assurance Standards Board (IAASB) in terms of serving the public interest by setting high-quality accounting, auditing and assurance standards. By doing so, they facilitate the convergence of international and national best practices in such areas. This strengthens public confidence and induces quality and consistency of practice among the IFIs throughout the world.

Similarly, a market-based organisation such as the **International Islamic Financial Market** (IIFM) can perhaps benchmark itself against the International Swaps and Derivatives Association (ISDA) by pioneering efforts to identify and reduce the sources of risk in the Islamic financial and money market instruments through developing a standard master agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of Islamic financial contracts; securing recognition of the risk-reducing effects of Islamic financial and money market instruments; promoting sound risk management practices; and advancing the understanding and treatment of Islamic products and services from the public policy and regulatory capital perspectives.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

The rules, restrictions and requirements adopted for business and investment in Islamic finance must adhere to the principles of *Shari'ah* in order to be considered acceptable. AAOIFI is an Islamic international autonomous not-for-profit organisation that prepares accounting, auditing, governance, ethics and *Shari'ah* standards for IFIs, participants and the overall industry. The AAOIFI sets compliance standards for institutions that wish to gain access to the Islamic finance market and ensures that participants conform to the regulations set out in Islamic finance. The founding signatories were the IDB (Saudi Arabia), Al Baraka Banking Group (Bahrain), Dar Al Mal Al Islami (Switzerland), Al Rajhi Banking and Investment Corporation (Saudi Arabia), KFH (Kuwait) and Bukhari Capital (Malaysia) who were signatories to the agreement establishing the organisation in 1989. On 27 March 1991, AAOIFI was registered in Bahrain.

AAOIFI is an Islamic international autonomous not-for-profit organisation that prepares accounting, auditing, governance, ethics and *Shari'ah* standards for IFIs, participants and the overall industry.

As an independent international organisation, AAOIFI is supported by institutional members (200 members from 45 countries, so far) including central banks, IFIs and other participants from the international Islamic banking and finance industry worldwide.

Exhibit 15.7 Objectives of AAOIFI

The objectives of the AAOIFI are as follows:

1 To develop accounting, auditing and governance thoughts relevant to the activities of IFIs, with consideration of international standards and practices which comply with *Shari'ah*.

2 To disseminate accounting, auditing and governance thoughts relevant to the activities of IFIs and its applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research and other means.

3 To prepare, promulgate and interpret accounting and auditing standards for IFIs.

4 To review and amend accounting and auditing standards for IFIs.

AAOIFI carries out the objectives highlighted in Exhibit 15.7 above for two purposes. The gist is to enhance the confidence of users of the financial statements of IFIs in the information produced about these institutions. Secondly, it aims to encourage these users to invest or deposit their funds in IFIs and to use their services.

In its efforts to enhance the industry's human resource base and governance structures, AAOIFI now offers professional qualification programmes.

International Islamic Financial Market (IIFM)

IIFM was established in 2001 by the collective efforts of the central banks and monetary agencies of Bahrain, Brunei, Indonesia, Malaysia, Sudan and the IDB as an infrastructure institution. Its mandate is to take part in the establishment, development, self-regulation and promotion of the Islamic capital and money market. IIFM's primary focus lies in the advancement and standardisation of Islamic financial instrument structures, contracts, product development and infrastructure, and the issuance of guidelines and recommendations for the enhancement of Islamic capital market and money market globally. In addition, development of the global primary and secondary Islamic capital, short-term financial market and the creation of a market for Islamic financial instruments is a key area of the IIFM.

The IIFM's industry-building initiatives include:

1 Framework for Islamic hedging which could lead to product development.

2 Master Agreement for Islamic treasury *murabahah* contracts.

3 Framework for *sukuk* and other Islamic instruments, secondary market trading documentation and products.

4 Primary and secondary market guidelines, best practices, recommendation and standard documentation.

5 Infrastructure improvement including systems and procedures.

International Islamic Liquidity Management Corporation (IILM)

The global Islamic finance industry witnessed a major breakthrough in its current development with the establishment of the IILM on 25 October 2010 in Kuala Lumpur. Eleven central banks and two multilateral organisations signed the Articles of Agreement for its establishment to become the founding shareholders of the IILM (IFSB, 2010).

As indicated earlier in this article, the availability of *Shari'ah*-compliant instruments for efficient liquidity management by institutions offering Islamic financial services (IIFS) in many jurisdictions is either not present or very limited. Such instruments, even if they are available, are also not sufficiently liquid, carry large transaction costs, or may not be sufficiently flexible during a crisis. The industry also faces insufficient and irregular supply of tradable and sovereign instruments that can be held for their liquidity purposes.

As the share of Islamic finance in national and global financial systems expands, these limitations on the systemic liquidity infrastructure for Islamic finance can aggravate systemic risk. In addition, they can impede further the development and global competitiveness of Islamic finance. The recent financial crisis has also highlighted the critical importance of maintaining a robust systemic liquidity infrastructure for strengthening resilience and limiting contagion. Hence, the lack of adequate liquidity infrastructure for IIFS is a pressing issue that must be addressed to enhance the soundness and stability of the IIFS.

The main objective of the IILM is therefore to facilitate cross-border liquidity management amongst IIFS by making available a variety of instruments of acceptable features and characteristics. This is achieved through the use of IILM instruments by IIFS as instruments for liquidity management and as eligible collateral for interbank transactions, and/or central bank financing, or through the trading of IILM instruments amongst IIFS (either within the same country or cross-border) in the secondary market. It will also leverage on the credibility and goodwill of its shareholders which would enhance the possibility of the instruments issued by the IILM to achieve a high rating.

It is envisaged that the instruments issued by the IILM be of broad range, utilising various *Shari'ah*-compliant structures, to enable as many IIFS of different jurisdictions as well as conventional institutions to participate. To facilitate cross-border liquidity management amongst IIFS, the instruments shall also be tradable and be regularly issued in sufficient volume (the instruments should be issued periodically in accordance with a pre-planned schedule), and in amounts commensurate with the liquidity management needs of IIFS in participating countries.

As the IILM is intended to facilitate cross-border liquidity management, its instruments shall be denominated in major reserve currencies. This is to ensure access to a large pool of global investors and broaden the range of its holders, thereby enhancing the prospects for active secondary trading. Given the currency denomination of foreign asset holdings of central banks and IIFS, the initial instruments will likely be denominated in major currencies like the euro and US dollar.

Deposit Insurance

Deposit insurance has been internationally recognised as an important component of a country's financial safety net. It has been implemented in some 100 countries around the world. However, very few countries with Islamic economies have a complete Islamic deposit insurance system. Malaysia and Sudan are among the few countries in the world with a complete Islamic deposit insurance system.

Islamic deposit insurance, established in accordance with *Shari'ah* rules and principles, is a system that protects depositors against the loss of their insured Islamic deposits placed with IFIs in the unlikely event of an institution being unable to meet its financial obligations.

Malaysia Deposit Insurance Corporation (MDIC)

The establishment of MDIC in 2005 under the Malaysia Deposit Insurance Corporation Act 2005 was one of the key elements in building the foundation for an effective consumer protection framework as outlined in Malaysia's 10-year Financial Sector Master Plan (FSMP) to promote financial system stability.

Table 15.6 Benefits of MDIC

Benefits of MDIC	
To Depositors	**To the Financial System**
• Deposit insurance protection is automatic. • MDIC protects depositors holding deposits with banks. • There is no charge to depositors for deposit insurance protection. • Should a bank fail, MDIC will promptly reimburse depositors on their deposits.	• MDIC promotes public confidence in the Malaysian financial system by protecting depositors against the loss of their deposits. • MDIC reinforces and complements the existing regulatory and supervisory framework by providing incentives for sound risk management in the financial system. • MDIC minimises costs to the financial system by finding the lowest cost solutions to resolve troubled banks. • MDIC contributes to the stability of the financial system by dealing with bank failures expeditiously and reimbursing depositors promptly.
Under the Act, MDIC's mandates are set out as: 1 To administer a deposit insurance system. 2 To provide insurance against the loss of part or all of the deposits of a financial institution. 3 To provide incentives for sound risk management in the financial system. 4 To promote and contribute to the stability of the Malaysian financial system.	

Source: MDIC website.

With the mandates outlined in Table 15.6, MDIC's main functions, *inter alia*, are to assess and collect premiums or fees from banks, manage the Deposit Insurance Fund, undertake resolution of non-viable banks, reimburse depositors should a bank become insolvent, and comply with *Shari'ah* principles in respect of Islamic deposits and funds. It also conducts on-going public awareness and education initiatives.

The Malaysia Deposit Insurance Corporation runs a dual deposit insurance system and administers two separate and distinct deposit insurance systems under a single organisation making Islamic banking as competitive *vis-à-vis* conventional banking.

The Malaysia Deposit Insurance Corporation runs a dual deposit insurance system and administers two separate and distinct deposit insurance systems under a single organisation, making Islamic banking as competitive *vis-à-vis* conventional banking. MDIC was given statutory powers to ensure a prompt, effective and least-cost resolution to safeguard the stability of the Islamic financial system. This entails, among others, the regulatory powers and mandate to ensure expedient resolution of financial institutions in distress. Certain countries have their deposit insurance scheme sponsored by the banks and not the government.

The Islamic deposit insurance mechanism being implemented by MDIC meets the *Shari'ah* requirements through the application of *kafalah bil ujr* (guarantee with fee). MDIC acts as a third party guarantor and IFIs are the guaranteed party. As consideration for the guarantee, IFIs pay a fee to MDIC in the form of annual premiums.

Other principles adhered to in developing Islamic deposit insurance include the separation principle in terms of management of funds, premium assessment and payout, and equitable principles in terms of equivalent coverage limit. Equivalent coverage for both conventional and Islamic deposits aims to avoid creating competitive distortions within the financial system. Separate differential premium systems for Islamic and conventional banking, given the separate risk and management assessment between the two, helps promote incentives for sound risk management.

• Funded by contribution (premium) collected from Islamic banks. • Pooled contribution (funds) managed separately. • Invests in *Shari'ah*-compliant instruments.	• Islamic deposit covered separately from conventional • All coverage limits similar to conventional. • Up to RM250,000 per depositor per member institution (covers 99% of total depositors).	• Separate deposit premium assessment system for Islamic and conventional. • Separate supervisory assessment for Islamic and conventional banking institutions (including windows).	• Separate payment in event of failure. Islamic deposit insurance funds used only for Islamic banks. • Deficit contribution – can raise funds from government based on *Shari'ah* principles.

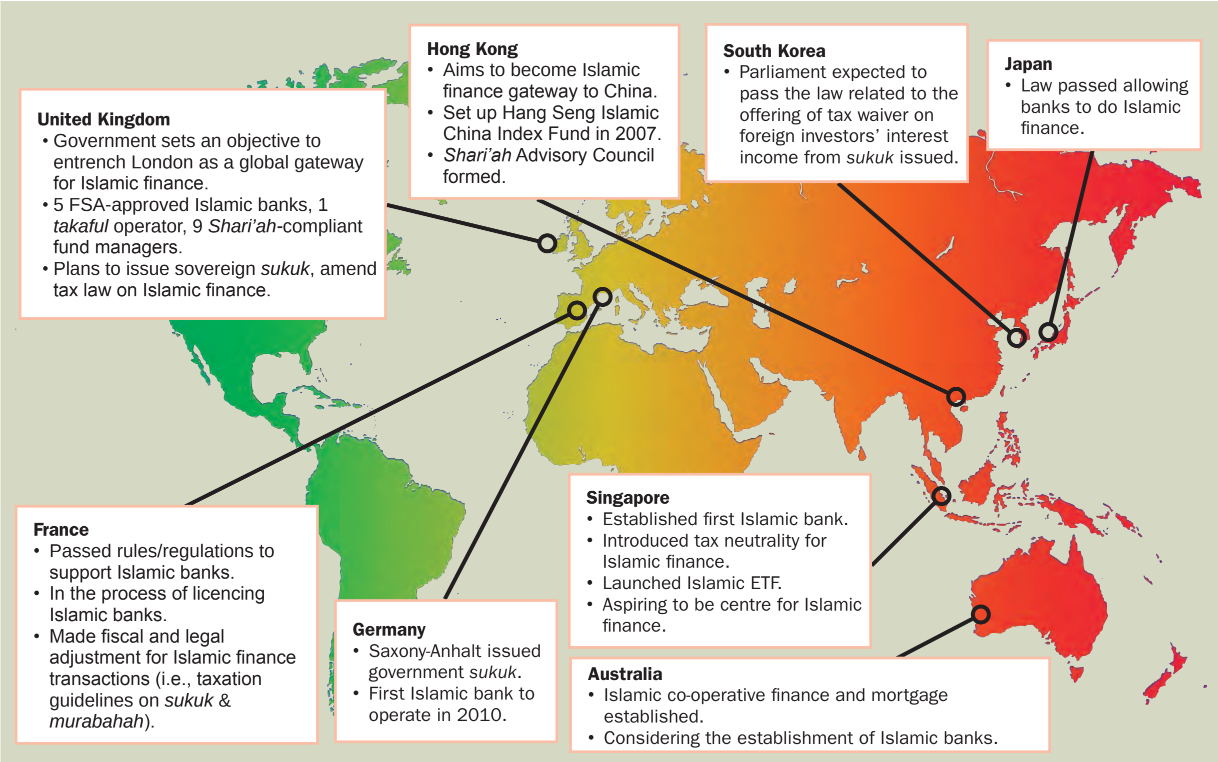
Source: Deposit Insurance System in Malaysia, MDIC.

Figure 15.5 Separate and Equitable Principles of MDIC

Issues, Opportunities and Challenges

Opportunities

Islamic finance is becoming an integral feature in the mainstream global economy. There are a number of encouraging signs of the development of Islamic finance. Now, financial centres such as London, Japan, Hong Kong and Singapore are starting to make aggressive efforts to become Islamic financial hubs. Increasing numbers of advanced economies such as France, Japan and Korea have started to jump onto the Islamic finance bandwagon by initiating amendments to their laws to permit Islamic finance transactions.



Source: Bank Negara Malaysia.

Figure 15.6 Growing Prominence of the Global Islamic Finance Industry

Challenges

There are at least three fundamental issues that increase the challenges for regulatory and supervisory authority in introducing the appropriate framework for Islamic finance:

Lack of a Prudential Database

In the case of conventional banks, they have been operating all over the world for decades and their business practices are well-documented, their financial statements are subject to intense analysis, and stakeholders are well-informed about the industry. The strong culture of documentation, disclosure and transparency among conventional banks has enabled the regulatory and supervisory authorities to develop a comprehensive prudential database for the industry.

This is certainly not the case in the Islamic financial services industry, which lags behind in almost all of those aspects. For example, save for a few major leading IFIs that are of international reputation with regional or global operations, most IFIs have poor or limited financial disclosures. The report issued by Deloitte Islamic Finance Knowledge Centre in September 2010 highlights the widespread perception among industry leaders that current levels of transparency in Islamic finance practices vary substantially between IFIs. This depends on the jurisdiction where they operate and the organisational structure of the IFI as to whether it is a window, subsidiary, a universal institution or full-fledged Islamic bank.

The report issued by Deloitte Islamic Finance Knowledge Centre in September 2010 highlights the widespread perception among industry leaders that current levels of transparency in Islamic finance practices vary substantially between IFIs.

Most stakeholders of IFIs and the public generally have a very limited knowledge about the specificities of Islamic finance. The academic community is only gradually recognising Islamic finance as a discipline for serious study and research. Accounting practices, legal requirements and regulatory procedures still vary considerably among jurisdictions.

This complex environment has created a challenge for the regulators in collecting and developing a reliable, comparable and accurate prudential database on the Islamic finance industry. They certainly need to deepen their understanding and awareness of Islamic finance in order to ensure sound regulatory frameworks and provide a financial infrastructure that is conducive to efficient financial intermediation. As the industry continues to grow, the regulators must also base their policy decisions on reliable, comparable and accurate prudential database.

Cost of Haphazard Policy Decisions and Lack of a Level Playing-Field

The international standards for prudential framework in Islamic finance have only been developed in the last few years. As such, there generally exists a lack of thorough understanding of the complexities of IFIs' operations. This is because these institutions are still subjected to different approaches to regulation and supervision in various jurisdictions within which they operate. In some countries, the supervisors have developed specific guidelines for IFIs, while in others they have opted to generally apply to these institutions the same prudential policies as those they apply in supervising conventional banks. Such differences in the approaches to supervising and regulating the IFIs have raised concerns that compliance with multiple supervisory and regulatory regimes would impose additional costs on IFIs. This would impede the industry's growth, and consequently, its aspiration to be integrated into the mainstream global financial system, thereby hindering it from realising its full potential.

Human Capital Development

In 2009, the International Islamic University Malaysia estimated that the number of professionals required by the Islamic financial services industry would reach two million by 2020. However, the report issued by Deloitte Islamic Finance Knowledge Centre in September 2010 highlights that only 4% of Islamic finance leaders agree that IFIs are properly staffed; 15% disagree that IFIs are properly staffed; while the

The International Islamic University Malaysia estimates that the number of professionals required by the Islamic financial services industry would reach two million by 2020.

remainder, 81%, feels that IFIs are staffed with competent workers to a certain extent. This reflects how the inadequate development of qualified talents in Islamic finance poses a huge challenge for the industry.

Although various reports such as the *10-Year Framework and Strategies for the Islamic Financial Services Industry*, jointly published by the IDB and IFSB in 2006, special reports on Islamic finance by Moody's in 2009 and Standard & Poor's in 2010, have all highlighted the need for more capacity building to address the human capital needs of the Islamic financial services industry, it is expected that this area will remain a major challenge for years to come.

It must be noted that the human capital pool with expertise in regulations and supervision of IFIs requires specialised training from market players. Therefore, more coherent and conscious efforts towards talent development need to be undertaken, especially by the relevant authorities.

Summary

1 Conventional financial institutions are established and governed by secular, man-made laws and regulations (whether under the civil law or common law system), whereas IFIs (while still expected to do conform to man-made laws and regulations as do their conventional counterparts) must also adhere to divine rules and principles (the *Shari'ah*).

2 IFIs in their modern form are indeed a recent phenomenon. As such, the legal and regulatory practices governing IFIs remain varied across countries, depending on their respective socio-political histories and realities. While most countries that operate IFIs have adopted the dual financial system, a few others have adopted a single, full-fledged Islamic financial system.

3 Several theorists have suggested the regulation of IFIs. In response, jurisdictions have either enacted specific Islamic banking laws or incorporated express provisions for Islamic banking activities in their existing banking laws. Such regulatory frameworks vary in terms of their scope. Some appear to replicate the regulatory and supervisory framework applied for conventional banks onto IFIs.

4 In regulating the Islamic finance industry, the unique characteristics and risks entailed in Islamic banking and its products and services need to be carefully examined and considered. As evident in its operation, *Shari'ah*-compliance risk, equity investment risk and displaced commercial risk are a few examples of risks peculiar to Islamic finance.

5 In view of the existence of *Shari'ah* non-compliant activities, investors and fund managers in ICM cannot freely buy and sell shares without undertaking a *Shari'ah*-screening process from time to time in order to ensure that their investment portfolios comply with the *Shari'ah*. Such a screening process involves qualitative and quantitative parameters such as source of income, business activities and financial structures.

6 International standard-setting bodies (like the BCBS, IFSB and AAOIFI, among others) do not possess any formal international supervisory authority. Thus, their conclusions do not, and were never intended to, have legal force. Rather, they formulate broad supervisory standards and guidelines and recommend statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements which are best suited to their own national systems.

7 While the fact cannot be denied that regulatory bodies in different IFIs jurisdictions have introduced policies to man and stabilise the sector, there exist lingering issues. Lack of a prudential database, the low level of human capital development, the cost of haphazard policy decisions and lack of a level playing-field constitute fundamental issues that raise challenges for regulatory and supervisory authorities in introducing the appropriate framework for Islamic finance.

Key Terms and Concepts

Regulation
Supervision
Prudential Standards
Capital Requirements
Takaful Industry
ISRA
AAOIFI
Central Bank
Islamic Finance
Dual Banking System
Islamic Capital Market
Islamic Equity Market
IFSB
IIFM
Risk Management
Screening Process
Capital Adequacy
Regulatory Authorities
INCEIF
Islamic Interbank Money Market

Further Readings

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Review Questions and Problems

1 What are the attributes that distinguish the Islamic financial institutions from their conventional counterparts? Discuss why and how the governance mechanisms that they adopt differ from each other.

2 What are the rationales for having a specific regulatory framework for Islamic finance? Discuss your answer by citing evidence on some relevant problems in the market which necessarily warrant the need.

3 In the current regulation of IFIs, the relevant laws in different countries vary in terms of their scope of coverage. Explain, with reference to the practice in different jurisdictions, the different existing approaches to the regulation of IFIs.

4 What are the regulatory issues and challenges presently confronted by the regulatory authorities of IFIs? Suggest possible solutions to some of their existing challenges.

5 What are the theories that provide theoretical foundations for the relevance of regulatory authority in a financial system? Discuss the various theories that either support or oppose regulation for the financial system.

6 While international standard-setting bodies share the unique attribute of encouraging convergence towards common approaches across jurisdictions, they differ in their functionalities and scope of standards. Mention any two of such bodies and discuss how their functions and the scope of their standards differ.

7 What is meant by "*Shari'ah*-screening process"? What are the set of factors that necessitate it in the Islamic capital market? Explain the possible reasons for variations in the relevant ratios across the domain of different regulatory authorities.

Chapter 16

Corporate and *Shari'ah* Governance in Islamic Financial Institutions

Preview

Corporate and *Shari'ah* governance are considered the most significant topics in Islamic finance. Sound corporate governance, especially within an Islamic paradigm is very imperative as it tends to encourage honesty, integrity, transparency, accountability and responsibility amongst all stakeholders in an organisation. Meanwhile, *Shari'ah* governance is the very essence of Islamic finance in building and maintaining the confidence of the shareholders and stakeholders, i.e., all transactions, practices and activities are in compliance with *Shari'ah* principles. Realising the importance of this subject within the context of Islamic financial institutions (IFIs), this chapter attempts to provide necessary information on corporate and *Shari'ah* governance by discussing its theory and practices. Since the coverage of this topic is relatively wide, this chapter will only examine the key elements of corporate and *Shari'ah* governance practised in IFIs.

All the theoretical approaches on corporate governance basically conclude that Islam presents distinctive values and special characteristics of corporate governance which aims to uphold and maintain the principles of social justice to the shareholders as well as to the stakeholders.

Learning Outcomes

At the end of the chapter, you should be able to:

- Understand theoretical and practical key basic principles of corporate and *Shari'ah* governance.
- Understand the diverse practices and the different models of corporate and *Shari'ah* governance.
- Describe the mechanisms of corporate and *Shari'ah* governance in IFIs including the functions of each organ of governance.
- Understand the framework of the available guidelines and governance standards on corporate and *Shari'ah* governance such as the AAOIFI Governance Standards and the IFSB Guiding Principles on *Shari'ah* Governance System.
- Analyse any issues pertinent to corporate and *Shari'ah* governance.
- Critically examine and provide solutions on any issues of corporate and *Shari'ah* governance.

Corporate Governance

Corporate governance in banking has been analysed extensively in the context of conventional banking markets. Western concepts of corporate governance from either the Anglo-American model that promotes the shareholder-value system or the Franco-German model that upholds the stakeholder-value system has been the subject of continuing debate for many years. By contrast, little has been written on corporate governance from the Islamic perspective.

The discourse on corporate governance from the Islamic perspective is relatively new and, until now, there is no universally accepted model of corporate governance in Islam. The available literature offers different and diverse views on the foundational dimension and theoretical approach of corporate and *Shari'ah* governance. All of these theoretical approaches basically conclude that Islam presents distinctive values and special characteristics of corporate governance with an aim to uphold and maintain the principles of social justice not only to the shareholders of a firm but to all stakeholders.

Conceptual Definition of Corporate Governance from the Islamic Perspective

The concept of corporate governance in Islam refers to a set of organisational arrangements on how a corporation is directed, managed, governed and controlled.

The concept of corporate governance in Islam refers to a set of organisational arrangements on how a corporation is directed, managed, governed and controlled. This provides the governance structure through which all stakeholders' interests are protected, the company's objective is achieved and the principles of *Shari'ah* are complied with. This is, to a certain extent, consistent with the definition of the Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance, which explains it as:

> "A set of relationship between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the company goals are set and the means of attaining those objectives and monitoring performance are determined." (OECD, 2004, p.11).[1]

1 Part One (I)(A) further underlines fundamental principle of corporate governance, i.e., "to promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities." (OECD, 2004: 17).

This definition denotes that the central aim of corporate governance is to ensure transparency, fairness and accountability which are parallel to the principles in Islam.

In the context of Islamic financial institutions (IFIs), the definition of corporate governance can be found in the Islamic Financial Services (IFSB) Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (excluding Islamic Insurance (*Takaful*) Institutions and Islamic Mutual Funds) (IFSB-3).[2] The IFSB-3 defines corporate governance:

> "As a set of relationships between a company's management, its board of directors (BOD), its shareholders and other stakeholders which provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined."

The IFSB-3 further explains corporate governance in the context of IFIs to encompass:

> "A set of organisational arrangements whereby the actions of the management of institutions offering Islamic financial services are aligned, as far as possible, with the interests of its stakeholders; provision of proper incentives for the organs of governance such as the BOD, *Shari'ah* Supervisory Board and management to pursue objectives that are in the interests of stakeholders and facilitate effective monitoring, thereby encouraging IIFS to use resources more efficiently; and comply with Islamic *Shari'ah* rules and principles (IFSB, 2006, p. 33).

The IFSB-3 definition provides a clear explanation of the actual meaning and framework of corporate governance in IFIs. The definition consists of all the elements of the mainstream corporate governance framework with an additional feature of the *Shari'ah* requirement. The first limb of the definition explains the general functional objective of corporate governance as a set of relationships between the stakeholders. The second limb of the IFSB-3 then incorporates the requirement of compliance with *Shari'ah* rules and principles thus clarifying the actual conceptual framework of corporate governance in IFIs. Referring back to the definition of *Shari'ah* and its framework in business organisations, it is observed that major *Shari'ah* issues involved in the context of corporate governance fall under the purview of *fiqh mu'amalat*.

Major *Shari'ah* issues involved in the context of corporate governance falls under the purview of *fiqh mu'amalat*.

2 See also IFSB-6, Guiding Principles on Governance for Collective Investment Schemes (IFSB, 2009a) and IFSB-8, Guiding Principles on Governance for *Takaful* (Islamic Insurance) Undertakings (IFSB, 2009b).

The Role of Corporate Governance in Islamic Financial Institutions (IFIs)

The role of corporate governance in IFIs shares some similarities with the general concept of corporate governance in other types of corporations. The best explanation of the objective of corporate governance can be simplified as: promoting corporate fairness, transparency and accountability. Good corporate governance is crucial in order to protect the rights and interest of all stakeholders. This is the main reason why there has been a growing interest in the topic of corporate governance, particularly in financial institutions (Macey, 2003). In the context of corporate governance in IFIs, its framework goes beyond the relationship between the shareholders, BOD, management and stakeholders as it includes maintaining the relationship with God. In this aspect, IFIs require an additional framework of *Shari'ah* in its character to safeguard and maintain not only the relationship with God but to include correlation with humankind as well as the environment.

The framework of corporate governance in IFIs goes beyond the relationship between the shareholders, board of directors, management and stakeholders as it includes maintaining the relationship with God.

Grais and Pellegrini, (2006) state that there are two broad sets of corporate governance roles which are exclusive to IFIs. Firstly, there is a need to reassure stakeholders that their activities fully comply with *Shari'ah* principles. Secondly, the stakeholders also need to be assured that IFIs maintain and improve growth and are able to prove efficiency, stability and trustworthiness. The role of corporate governance hence includes harmonising these two functions so as to meet the requirements of *Shari'ah* and satisfy the aim of a profit-generating corporation.

Corporate governance in IFIs is also crucial as a means to address numerous types of risk, especially governance risk. Failure to institute appropriate corporate governance measures to mitigate risk may lead to corporate collapse, such as in the case of Ihlas Finance in Turkey, Islamic Bank of South Africa and Islamic Investment Companies of Egypt, and huge commercial losses as in the case of Dubai Islamic Bank and Bank Islam Malaysia Berhad. Iqbal and Mirakhor (2007, pp. 227–50) define governance risk as:

> "The risk arising from failure in governing the institution, negligence in conducting business and meeting contractual obligations, and from a weak internal and external environment."

They further classified governance risk into operational risk, fiduciary risk, transparency risk, *Shari'ah* risk and reputation risk (Iqbal & Mirakhor, 2007). Since the complexity and some exclusive characteristics of risks in IFIs differ from their conventional counterparts, a sound and efficient corporate governance system must be in place to mitigate those kinds of risks.

As an Islamic corporation, an IFI has to avoid involvement with all kinds of *Shari'ah* prohibitions such as *riba* (interest), *gharar* (uncertainty), speculation and *maysir* (gambling). It also has to observe the principle of Islamic morality. In this respect, corporate governance in Islam is a dire necessity to IFIs not only to foster and gain confidence of the stakeholders, but also of the general public, that all its products, operations and activities adhere to *Shari'ah* rules and principles.

IFIs must avoid involvement with all kinds of *Shari'ah* prohibitions such as *riba*, (interest), *gharar* (uncertainty), speculation and *maysir* (gambling) as well as to observe the principle of Islamic morality.

The Development of Corporate Governance in Islamic Financial Institutions

When Islamic banks were established in the 1970s in the form of corporations and conventional banks which opened Islamic windows and branches, numerous issues arose as to the mechanism of control for IFIs in carrying their business without impeding the interest and rights of all stakeholders. With the failure of several IFIs such as Ihlas Finance House in Turkey, the need for a good and efficient governance system was considered crucial.

With this in mind, a few international infrastructure institutions were established with the purpose of supporting the Islamic financial sector. These include the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM), the International Islamic Rating Agency (IIRA), the International Islamic Centre for Reconciliation and Commercial Arbitration (IICRA), the General Council of Islamic Banks and Financial Institutions and the Islamic Development Bank Group (IDB). The first two institutions were specifically established, *inter alia,* to strengthen the corporate governance of IFIs. The remaining institutions provide the support infrastructure for the implementation of Islamic finance.[3] On top of that, Hawkamah, the Institute of Corporate Governance of the Dubai International Financial Centre, has also made initiatives to develop corporate governance for IFIs in the Middle East and North African region.

Foundational Dimension of Corporate Governance

Corporate governance in Islam is founded on the epistemological aspect of *Tawhid* and the associated *Shari'ah* rules and principles. The former refers to the

3 The AAOIFI has issued governance standards in *Shari'ah* Supervisory Board: Appointment, Composition and Report, *Shari'ah* Review, Internal *Shari'ah* Review and Audit and Governance Committee for IFIs while the IFSB has released the Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Mutual Funds) in December 2006.

Corporate governance in Islam is founded on the epistemological aspect of *Tawhid* and the embedded *Shari'ah* rules and principles where the former refers to the principle of consultation (*shura*), in which all stakeholders share the same goal of *Tawhid* or the oneness of Allah (s.w.t.).

recognition of Allah's unique rights and the responsibility of all stakeholders before Him. The latter concerns adopting a stakeholder-oriented value system. In addition, the foundational axioms of Islamic economics, formulated based on the *Qur'an* and *Sunnah*, also provide a philosophical foundation for corporate governance in Islam. At this point, it is worth discussing the foundational base and the main arguments of the Islamic corporate governance model as identified in the literature.

Tawhidi Epistemology and *Shuratic* Process

Although there is consensus amongst Islamic economists and Muslim jurists on the concept of *Tawhid* as one of the philosophical pillars of Islamic economics, little is written on the *Tawhid* epistemological aspect on the issue of corporate governance. Choudhury and Hoque (2004 and 2006), however, did attempt to link Islamic epistemology of *Tawhid* in Islamic corporate governance.[4]

As the foundation of Islamic faith is *Tawhid*, the basis for corporate governance framework also emanates from this concept. Allah (s.w.t.) says in the *Qur'an:*

> *Those who remember Allah standing, sitting, and lying down on their sides, and think deeply about the creation of the heavens and the earth, (saying): "Our Lord! You have not created this without purpose, glory to You! Give us salvation from the torment of the Fire.* (*Al-Qur'an*, 3:191)

Allah's praise of the believers who remember Him standing, sitting, lying down and who contemplate the wonders of creation indicates the *Tawhid* paradigm. Another verse of the *Qur'an* (51:56) further points out the *Tawhid* dimension in Islam. Allah (s.w.t.) says, "*And I created not the Jinn and mankind except that they should worship Me*". Both these verses indirectly provide a fundamental principle of governance in that everything created by Allah (s.w.t.) has a purpose and human beings are created to be the vicegerent of God.

As Allah (s.w.t.) knows everything and all mankind is accountable and answerable to Him, the principle of *Tawhid*, therefore, defines a firm's obligation and objectives to include a large group of stakeholders than the shareholders alone. Furthermore, it also denotes the concept of accountability or *taklif*, indicating that everyone is accountable to God for his own deeds. As such, the principle of *taklif*, that is derived from the supreme concept of *Tawhid* shall be the foundation of corporate governance in Islam.

4 Choudhury & Malik (1992) discuss the principle of *Tawhid* as the episteme of corporate governance and human solidarity in Islamic political economy. Episteme *means the total set of relations that unite at a given period, the discursive practices that give rise to epistemological figures, science and possibly formalised system* (Dreyfuss & Rabinow, 1983: 18)

Inspired by the paradigm of *Tawhid* that acknowledges stakeholders as vicegerents, firms and corporate organisation have a fiduciary duty to uphold the principle of distributive justice via the *shuratic* process. There are numerous references in both the *Qur'an* and the *Sunnah* that oblige every single human being to practise the principle of *shura* (consultation) in every aspect of their lives. Allah (s.w.t.) says in the *Qur'an* (3:159): "*So pass over (their faults), and ask for (God's) forgiveness; and consult them in affairs (of the moment); then, when you have taken a decision, put thy trust in God*". Based on this divine message in explaining how important the concept of *shura* is, Chapra (1992) mentions that the practice of *shura* is not an option but, rather, an obligation.

In the context of corporate governance, *shura* provides the widest possible participation of the stakeholders in the affairs of the corporation, either directly or via representatives. The constituents of a *shura's* group of participants, namely the shareholders, the management, the BOD and the employees, play a crucial role in ensuring that all activities not only meet all the firm's objectives but are also in line with *Shari'ah* principles. In this aspect, each organ of governance has its own unique function. The management and the BOD act as active participants and conscious stakeholders in the process of decision making and policy framework. The decisions are made by considering the interest of all direct and indirect stakeholders, rather than maximising shareholders' wealth alone. The other stakeholders, such as the community, on the other hand, play their roles in providing mutual cooperation and stimulating the social well-being of the corporation.

Stakeholders-Oriented Approach

Chapra & Ahmad (2002) emphasise the notion of equitably protecting the rights of all stakeholders irrespective of whether they hold equity or not. This seems to support the model proposed by Iqbal & Mirakhor (2004), who consider the corporate governance model in an Islamic economic system to be a stakeholder-centred model in which the governance style and structures protect the interest and rights of all stakeholders rather than the shareholders per se. Iqbal & Mirakhor's main arguments are based on two fundamental concepts of Islamic law, namely, the principle of property rights and the commitment to explicit and implicit contractual agreements that govern the economic and social behaviour of individuals, society and state. These two principles provide strong justification for the notion of classifying Islamic corporate governance as a stakeholder-oriented model. In addition, Nienhaus (2006), states that Islamic corporate governance should be based on value and promote the principle of fairness and justice with respect to all stakeholders.

The corporate governance model in an Islamic economic system is a stakeholder-centred model in which the governance style and structures protect the interests and rights of all stakeholders rather than the shareholders per se.

The principle of property rights in Islam provides a comprehensive framework to identify, recognise, respect and protect the interest and rights of every individual, community and corporation. The majority of jurists agree that usufruct (*manafi'*) and rights (*huquq*) are considered as property and must be protected and

safeguarded. At this point, Islam guarantees the protection of property rights, be it in the form of *manafi'* or *huquq*, and these include rights of ownership, acquisition, usage and disposition. In terms of the right of ownership, Islam declares that Allah (s.w.t.) is the sole owner of property and human beings are just trustees and custodians who are required to use and manage the properties in accordance with the *Shari'ah*, as property is given as *amanah* (trust) to individuals. There are numerous verses of the *Qur'an* referring to the principle of property rights, for instance: "*Believe in Allah and His Messenger and spend out of that in which He has made you successors"* (*Al-Qur'an*, 57:7). The implied meaning of this verse lays down the foundational principle and the effect of property ownership where mankind is only regarded as a trustee of God. Ahmad (2003, p. 195) affirms that property rights in Islam guarantee individuals as well as corporations "the right to own private property and economic resources, to make a profit, to expand jobs, to boost investment and to increase prosperity" (Azid, et al, 2007, p. 7).

The contractual framework is also very unique in Islam. In the *Qur'an, Surah al-Maidah*, Allah (s.w.t.) clearly reminds Muslims of the principle of fulfilling each of their contractual obligations when He says: "*O you who believe, fulfil contracts*" (*Al-Qur'an*, 5:1). This verse presents a basic foundation on the principle of contract that all individuals, corporations, society and the state are bound by their contracts which define the rights and obligations of the parties. In relation to the issue of corporate governance, each stakeholder has a duty to perform his contractual obligations in accordance with the terms stipulated in the contract. This contractual framework enhances the scope of a firm's stakeholders, as it is not necessary to refer to the shareholders alone but also involves those who have an active and non-active participation in the decision-making process. As such, all parties who are directly or indirectly affected by the firm's business are considered as the rightful stakeholders. In this regard, each stakeholder has his or her own function: the shareholders have a duty to provide business capital, the management to manage and run the business, the employees to perform their respective duties and the regulators to ensure enforceability of the contracts.

Corporate governance based on the stakeholders' model comprises two fundamental concepts of *Shari'ah* principles of property rights and contractual frameworks. The definition of stakeholders does not necessarily refer to the shareholders per se or to those who have an active participation in the decision-making process but it includes non-investors or non-owner stakeholders, i.e., any party who has direct or indirect participation in the corporation. Iqbal & Mirakhor (2004) formulated two tests to determine if any individual qualifies as a stakeholder. Firstly, whether the individual or group has any explicit or implicit contractual obligation, and secondly, whether an individual's property rights are at risk due to the business exposure of the corporation.

Comparative Overview on Corporate Governance from Western and Islamic Perspectives

The design of the corporate governance model in Islam has its own unique features and presents distinctive characteristics in comparison with the Western concept of corporate governance, particularly the Anglo-Saxon and the European models. This section summarises the differences of these three models and classifies them into four aspects, namely the episteme, the corporate objective, the nature of management, the management board and the capital-related ownership structure. The following comparison is based on the general characteristics of the Anglo-Saxon and the European models. Undeniably, both models are evolving and their features may change into other forms and may even converge.

The design of corporate governance model in Islam has its own unique features and presents distinctive characteristics in comparison with the Western concept of corporate governance, particularly the Anglo-Saxon and the European models.

Table 16.1 The Diversities of the Anglo-Saxon, the European and the Islamic Models of Corporate Governance

Aspects	The Anglo-Saxon Model	The European Model	The Islamic Model
Episteme	Rationalism and Rationality.	Rationalism and Rationality.	*Tawhid.*
Objective			
Rights and Interest	To protect the interest and rights of the shareholders.	The right of community in relation to the corporation.	To protect the interest and rights of all stakeholders but subject to the rules of the *Shari'ah*.
Corporate goal	Shareholders control managers for the purpose of shareholders' profit.	Society controls the corporation for the purpose of social welfare.	*Shari'ah* objective or *maqasid al-Shari'ah.*
Nature of Management	Management dominated.	Controlling shareholder dominated.	Concept of vicegerency, *shura* and interactive, integrated and evolutionary process.
Management Boards	One-tier board.	Two-tier boards: executive and supervisory hold separate responsibilities.	*Shari'ah* board as the ultimate governance.
Capital and Ownership Structure	Widely dispersed ownership; dividends prioritised.	Banks and other corporations are major shareholders; dividends less prioritised.	Shareholders and depositors or investment account holders.

Islam rejects rationality and rationalism as the sole episteme of corporate governance and replaces it with the episteme of *Tawhid.*

The above simplified version of the differences between Islamic and conventional concept of corporate governance provides an overview of the different theoretical frameworks of corporate governance. In the aspect of epistemological method, Islam rejects rationality and rationalism as the sole episteme of corporate governance and replaces it with the episteme of *Tawhid.* While the Anglo-Saxon model prioritises the shareholders' value alone and the European model protects all the stakeholders' interest and rights, the corporate governance objective in Islam balances the corporate goal of maximising the profit with the duty to uphold the principles of social justice and *maqasid al-shari'ah,* and this entails the notion of protecting the interests and rights of all stakeholders within the *Shari'ah* rules.

The nature of the management of the corporate governance model is premised on two fundamental principles of *shura*, and the apex level of management is the *Shari'ah* board that is responsible for supervising and overseeing overall corporate activities so as to comply with *Shari'ah* principles. In contrast to the Western concept, the nature of the ownership structure in corporate governance considers the shareholders and the investment account holders (IAHs) as the rightful owners rather than the shareholders alone. The distinct features and characteristics of corporate governance combine the elements of *Tawhid, shura*, and *Shari'ah* rules with Islamic morality and maintain the private goal without ignoring the duty of social welfare.

Corporate Governance Framework in Islamic Financial Institutions

Corporate governance is of equal concern to both the conventional and Islamic financial services sectors. At this point, the key principles of corporate governance in the OECD Principles of Corporate Governance shall also be applicable to IFIs. These include the elements of separation of ownership and control, transparency and market discipline, balancing the stakeholders' interests and information asymmetries. Nevertheless, the uniqueness of Islamic corporate governance can be found in its two features, i.e., the faith-based approach that requires all business transactions to comply with *Shari'ah* principles and at the same time recognition and acknowledgement of the profit-motive and maximisation of shareholders' wealth (Akhtar, 2007). These two distinct elements enlighten the conceptual framework of corporate governance in Islam. The section titled "International Standard-Setting Agency", which you will come across later, briefly explains the corporate governance framework from an Islamic perspective in the context of IFIs by describing the roles, functions and relationships of the BOD, the management, the shareholders, the depositors and, more importantly, the *Shari'ah* board as it represents fundamental components of *Shari'ah* governance.

One of the versions of the Islamic corporate governance framework is outlined by Abdul Rahman (1998) who presents a framework that integrates *Shari'ah* and Islamic moral precepts. He emphasises the institutions of *shura, hisbah* and religious audit as the major components of a corporate governance framework. The institution of *shura*, which consists of management, BOD, shareholders, employees, customers and other interested parties, may ensure the effectiveness of any corporate decision making. The institution of *hisbah*[5], on the other hand, plays the role of monitoring the corporations on both regulatory and moral aspects. The religious auditors or *Shari'ah* boards issue legal rulings and provide advice for ex-ante auditing and supervise and monitor ex-post auditing.

A more comprehensive framework of Islamic corporate governance is presented by Choudhury & Hoque (2004). They clearly locate the governance structure and the appropriate level of each institution, its roles and functions, aims and objectives and the governing laws of the corporation. Nienhaus (2007) also offers another illustration of the Islamic corporate governance framework; he insists on the aspects of the regulatory framework of Islamic law as well as general banking law and regulations. Banaga, et al. (1994) conceptualise an integrated framework of incorporating corporate culture and control mechanisms within an Islamic setting.

With respect to the above, corporate governance of IFIs requires additional measures of governance compared to its conventional counterpart. As the only guiding principles available so far for corporate governance in IFIs, the IFSB-3 attempts to provide guidelines and key principles to facilitate IFIs with appropriate governance structures and processes. The IFSB-3 generally covers the overall framework of corporate governance in Islam with the stakeholders-oriented approach as a model basis. This can be illustrated in Part 1 and Part 3 of IFSB-3; the former insists on the importance of ethics and the latter requires each IFI to have an appropriate mechanism of compliance with *Shari'ah* rules and principles (IFSB, 2006).

In order to understand and appreciate the corporate governance framework in IFIs, it is essential to examine the roles and duties of several of its key participants, i.e., the shareholders and depositors, the BOD, the management and the *Shari'ah* board. The BOD, managers, shareholders and depositors remain as the four internal

5 During the early Abbasids (750 CE), the institution of *hisbah* or an office of local administration was established to ensure compliance with the requirements of *Shari'ah*. The very basic functions of *muhtasib* or the office holder of *hisbah* were to promote good and discourage evil and these include duties to inspect correct weights and measures in business dealings, fair trading transactions, checking business frauds and irregularities, auditing illegal contracts, keeping the market free and preventing hoarding of necessities (Abdul Rahim, 1998, pp. 63–64). Klein, (2006) provides comprehensive examination on theoretical and manual *hisbah* literature. The literature mentions several *hisbah* duties and they include music-related offenses, public display of wine offences, offences inside the home, overseeing cemeteries and wailing practices, instruction of children and mosque-related tasks.

The *Shari'ah* board, religious auditors and depositors, particularly investment account holders, are unique features and solely exclusive to the institution of corporate governance in IFIs.

institutional centers of power of the corporation. The regulatory authorities and the non-management parties are considered as the external institutions. There are features which are unique and solely exclusive to the institution of corporate governance in IFIs, namely, the *Shari'ah* board, religious auditors and depositors, particularly IAHs. Table 16.2 illustrates the key participants of corporate governance in IFIs.

Table 16.2 Key Participants of Corporate Governance in IFIs

Key Participants	Interest	Functional Roles
Regulatory Authority	Economic stability.	Sets regulatory framework for sound and proper corporate governance.
Supervisory Authority	Compliance with the laws and regulation.	To supervise and monitor the effectiveness of corporate governance and to check compliance with regulations.
Shareholders	Wealth maximisation, satisfactory earnings per share, dividends, above average return on investment and excellent continuous growth.	Appoint fit and proper boards, management, auditors and *Shari'ah* board.
IAH	Repayment of deposits at maturity on the agreed terms, protection of their interests and profit.	To monitor the investment performance.
Shari'ah Board	Compliance with *Shari'ah* and fulfilling *maqasid al-shari'ah*.	To ensure *Shari'ah* compliance and protect the rights and interest of depositors and other stakeholders.
BOD	Monetary and non-monetary compensation, high integrity, an efficiently and effectively managed company, and outstanding corporate reputation and brand.	To set the IFI's direction and policies.
Management	Monetary and non-monetary compensation, and commitment to claims of the contract.	To implement policies set by the BOD.

The legal and regulatory authorities as an external organ of governance play a key role in corporate governance by defining the regulatory and legal environment to facilitate a sound corporate governance framework. The regulatory authorities have responsibilities to provide appropriate guidelines for the financial system and develop internal control, risk management procedures, standard of transparency and to monitor the overall IFI's operations. To complement this function, the supervisory authorities have a duty to supervise and monitor the effectiveness of the corporate governance system and check compliance with regulation.

The election and appointment of the *Shari'ah* board members by the shareholders demonstrates the uniqueness of IFIs. The AAOIFI Governance Standards state that the appointment of a *Shari'ah* board shall be made by the shareholders during the general assembly.

With regard to the internal institution of governance, shareholders have a responsibility to appoint a fit and proper BOD, management auditors and *Shari'ah* board. Unlike conventional banks, the functions of shareholders in IFIs extend to the appointment of a *Shari'ah* board. Usually, the BOD nominates the *Shari'ah* board members and the shareholders approve them at the annual general meeting (AGM). The AAOIFI Governance Standards state that the appointment of a *Shari'ah* board shall be made by the shareholders in the general assembly. This demonstrates the uniqueness of IFIs in that the shareholders play a role to elect and appoint the *Shari'ah* board members. This position is essential to indicate that the *Shari'ah* board is independent of the BOD and carries out its advisory and supervisory functions without fear or favour.

The scope of corporate governance has been enlarged for IFIs to include not only protecting the shareholders but also the depositors. This is because, in Islamic banking the depositors are exposed to a much higher risk than in conventional banks. The modus operandi of the deposit in Islamic banks, particularly investment accounts, implies participation in the financial results of the employment of funds (Nienhaus, 2007).

The BOD plays a strong function in specifying the strategic objectives, guiding principles, code of conduct and standard of appropriate behaviour of the employees (Chapra, 2002). This is affirmed by Cadbury (2002) who explains the main functions of the BOD to include defining the firm's objectives, to outline strategies and plans for that purpose, to establish the firm's policies, to appoint the management, particularly the chief executive officer, to monitor and assess the performance of the management team and to assess their own performance. Corporate governance requires the BOD to not only be professionally competent in the matter of risks, business strategies and banking business, they must also have the additional qualification to understand and appreciate *maqasid al-shari'ah* as well as having at least a basic understanding of *Shari'ah* rules and principles. The motivation of managing the corporation is not solely for the purpose of maximisation of the shareholders' wealth but rather to promote the welfare of all stakeholders. At this point, Principles 13–17 of the IFSB-3 state that the BOD shall be responsible for steering the establishment of a governance policy framework (IFSB, 2006). These principles require the BOD to not only be concerned about the profit-driven business strategy of the firm but also to consider the interests and rights of all stakeholders such as depositors, employees and consumers.

Maqasid al-shari'ah means protection of the welfare of the people, which lies in safeguarding their faith, life, intellect, posterity and wealth.

Unlike the BOD, the management has a fiduciary duty to implement the policies and strategies set by the BOD. The management is an agent or *wakil* of the BOD and owes fiduciary duties to perform its duties. As an agent, the management acts as a trustee not only to the BOD but to the shareholders and other stakeholders. It is therefore important that the management be honest and frugal at all times and in all matters. It is also essential for the management to be truly aware of the principle of *maqasid al-shari'ah* and other Islamic principles so as to ensure that all stakeholders' interest are protected while performing their duties. The IFSB-3 considers the management as a crucial entity to ensure that the direction and all business transactions meet the *Shari'ah* requirements and align with the interest of all stakeholders because it involves the day-to-day activities of IFIs (IFSB, 2006).

The most essential component of Islamic corporate governance is the *Shari'ah* board, which is an institution that can only be found in the organisational structure of an Islamic corporation.

The most essential component of Islamic corporate governance is the *Shari'ah* board. A *Shari'ah* board is an institution that can only be found in the organisational structure of an Islamic corporation. Principle 13 of the IFSB-3 requires that each IFI set up a *Shari'ah* board comprising at least three members to oversee and monitor the implementation of the governance policy framework by working together with the management and the Audit Committee (IFSB, 2006). The functions of a *Shari'ah* board are two-fold, i.e., advisory and supervisory, and these include advising the IFI in its operation, analysing and evaluating *Shari'ah* aspects of any banking and financing activities, and monitoring and supervising the extent of *Shari'ah* compliance.

A unique feature of Islamic corporate governance model adds value to the existing governance structure as it emphasises the element of faith, ethics and *Shari'ah* principles.

As a whole, corporate governance in Islam adds additional value to the existing governance structure as it emphasises the element of faith, ethics and *Shari'ah* principles. A unique feature of the Islamic corporate governance model requires another layer of governance structure in order to accomplish all of those elements. In this regard, IFIs need a specific organisational arrangement known as "*Shari'ah* governance" as part of their corporate governance framework. This will be explained in more detail in the next section.

Corporate Social Responsibility in IFIs

Another aspect that deserves due attention pertaining to corporate governance in IFIs is social responsibility. Corporate social responsibility (CSR) outlines the ideal standard of behaviour of a firm from a socially oriented perspective.[6] The later section titled "*Shari'ah* Governance Issues" briefly discusses the theoretical framework of CSR in Islam and highlights its key elements and the way it is practiced in IFIs. The discussion also examines the existing studies on CSR in IFIs and attempts to enlighten several fundamental issues.

The term CSR has been broadly used to refer to a firm's social obligations discharged on a voluntary basis. The definition of CSR by the European Commission (EC) is: "A concept whereby companies integrate social and environmental concern in their business operation and in their interaction with their stakeholder on a voluntary basis" (EC, 2001, p. 6). Unlike the definition by the EC which is very narrow, the definition of CSR by the World Business Council for Sustainable Development (WBCSD) extends the framework by not limiting it to voluntary forms of CSR. The WBCSD defines CSR

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6 Dusuki and Dar, (2005) highlight four main factors that lead to the emergence and initiative of CSR namely growing market pressure, regulatory pressure, power of communication and competitive advantage. These inherent factors also influence the IFIs to be more socially responsible and in fact, as Islamic institutions, social responsibility is considered as a collective religious obligation.

as "the commitment of businesses to contribute to sustainable economic development, working with employees, their families and local community and society at large to improve their quality of life" (WBCSD, 2002, p. 6).

In the context of IFIs, AAOIFI has issued specific standards of CSR known as Governance Standards No. 7: Corporate Social Responsibility, Conduct and Disclosure for IFIs. The AAOIFI refers to CSR as "all activities carried out by IFIs to fulfil their religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries, as individuals and institutions" (AAOIFI, 2010). The AAOIFI definition further enhances the scope and foundation of CSR compared to the WBCSD and the EC. Corporate social responsibility is considered not only part of IFIs' contribution to socioeconomic development but is also regarded as religious obligations and ethical considerations inspired by the teachings of the *Qur'an* and the *Sunnah*.

The AAOIFI refers to CSR as "all activities carried out by IFIs to fulfil its religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries, as individuals and institutions".

The basis of CSR in modern business organisations is founded on several Western theoretical foundations; these include Classical View Theory, Social Contract Theory, Instrumental Theory, Legitimacy Theory and Stakeholder Theory. This section offers another theoretical foundation of CSR, namely, Islamic Theory of CSR, formulated based on the underlying principles of the *Qur'an* and *Sunnah*. Khan (2007) asserts that there should be a distinctive Islamic corporate objective as opposed to the narrow profit and utility maximisation-based conventional objectives whereby IFIs should also aim to maximise the social welfare function. This can be materialised by being involved in community banking, responsible and ethical finance, and CSR initiatives (Asutay, 2007). Table 16.3 summarises the distinct characteristics and theoretical frameworks of all of these theories of CSR.

Table 16.3 demonstrates the diverse characteristics of theories on CSR from Western and Islamic perspectives. The Western theories of CSR are founded on the secular approach, which emphasises physical reality and human rationality. The central motivation of CSR hence is materialistic rather than ethical. On the other hand, Islamic theory considers CSR as part of the collective religious obligations inspired by the *taqwa* dimension derived from the principle of *Tawhid*. The *taqwa* dimension is an important factor in motivating the individual to voluntarily contribute to socially responsible activities. At this point, the theoretical foundation of CSR in Islam is based on the holistic approach by combining moral and ethical principles, *Shari'ah* and belief. Implementing CSR is one of the ways to achieve *taqwa* and fulfill one's duty as vicegerent of Allah to achieve "*falah*" or success in the world and the hereafter.

Islamic theory considers CSR as part of the collective religious obligations inspired by the *taqwa* dimension derived from the principle of *tawhid*.

Taqwa means God-fearing or God-consciousness which essentially means harmonising and integrating material well-being with moral-spiritual values that determines the fate of Muslims in the world and hereafter.

With regard to the scope of CSR, Dusuki & Dar (2005) illustrate four main areas of CSR, namely the environmental dimension, the human resource dimension, the philanthropic dimension and the human rights dimension. Islam strongly emphasises the duty of preserving all of these four dimensions. In advocating the implementation of CSR in IFIs, Farook (2007) suggests the scope of CSR in mandatory and voluntary

Table 16.3 Theories of Corporate Social Responsibility

Theory	Characteristics	Literatures	Theoretical Foundation
Classical view	Social responsibility of business is to increase its profit.	Friedman, (1996)	• Secular approach • Physical reality and human rationale • Materialistic rather than ethical
Social contract	Business is part of society.	Moir, (2001)	
Instrumental	Social responsibility is part of the business strategy for reasons of good image, public relations ploy, firm's competitive advantage.	Burke and Logsdon, (1996); Fombrum, Gardberg et al. (2000); Quester and Thompson (2001); Windsor, (2001); Lantos, (2001 and 2002); Johnson, (2003); Husted, (2003); Greenfield, (2004); Garriga and Melé, (2004)	
Legitimacy	CSR is a response to the environmental pressures involving social, political and economic forces.	Deegan, (2000); Suchman, (1995); Tomer, (1994)	
Stakeholder	CSR is founded on the stakeholders' value-oriented system.	Maignan and Ferrell, (2004); Clarkson, (1995); Donaldson and Preston, (1995); Gibson, (2000); Weiss, (2003)	
Institutional	Role of social pressure in determining company's behaviour.	Rahaman, et al, (2004); Ingram and Simons, (1995)	
Islamic	CSR is part of the collective religious obligation inspired by the *taqwa* dimension (God-consciousness).	Iqbal and Mirakhor, (2004); Dusuki, (2008); Farook, (2007, 2009); Aribi, (2009).	• Belief, moral and religious initiative • Holistic approach, namely moral, ethical and *Shari'ah*

Source: Aribi, (2009), Dusuki, (2008) & Farook, (2007).

forms; the former refers to screening of investments, eschewing earnings prohibited by *Shari'ah*, responsible dealing with clients, fair and equal treatment of employees, and *zakat*; while the latter refers to benevolent loans, concern about environmental issues, screening clients, industry-wise investment quotas, social-impact-based investment quotas, environmental-impact-based investment quotas, excellence in customer services, extending funding to micro and small-sized businesses, social savings and investments, employee welfare, charitable activities and *waqf* management.

The list of the scope of CSR is not exhaustive, and its framework can be in many forms as long as they comply with *Shari'ah* principles and Islamic ethical values.

While there is a solid and cogent theoretical foundation for CSR in Islam, the reality falls short. There is a lack of initiatives by IFIs to implement CSR as part of their corporate social objectives. Asutay (2008) maintains that Islamic finance has failed to realise the very reason of its existence in providing socioeconomic development for the majority of the Muslim world. A study by Farook (2009) pertaining to social responsibility trends in 29 IFIs from 19 countries nevertheless indicates significant improvement of IFIs on CSR initiatives. The report reveals that IFIs have taken numerous and significant social measures towards social responsibility in various aspects such as charitable activities, social welfare and development, the environment, concentration on screening, customer service and responsible dealing and employee welfare. Despite the positive trend of CSR in IFIs, there is still room for improvement and enhancement as the public is generally unaware or have a lack of information when it comes to IFIs' CSR inititatives.

Corporate Governance Issues

Concept of Corporation

Although the concept of partnership in the form of *musharakah* or *mudarabah* is well known since the early days of Islam, there is less discussion on the concept of a corporation. In fact, Kuran (2005) writes that "the corporation" was absent from the Middle East until the 19th century.

Vogel & Hayes (2006) mention that classical Islamic law discusses the concept of partnership but not the modern corporation with an artificial personality. Nevertheless, such contention is not truly accurate, as Muslim jurists have already accepted a concept of corporation known as *shakhsiyah i'tibariyah* (legal entity) based on the principles of *qiyas* (analogy) and *istihsan* (equity) or *masalih al-mursalah* (public interest) (Chapra, 2008; Ghazali et al, 2005). In fact, the existence of the public treasury (*bayt al-mal*) and *waqf* implies the recognition of the concept of corporation with a separate legal entity. Although there was no corporation during the time of Prophet Muhammad (p.b.u.h.), such concepts already existed in the form of limited partnership or *sharikah al-'inan* whereby the shareholders may sell their shares in the market and their liability is limited. In addition, the structure of a joint-stock-company is a variation of the concept of *mudarabah* in that the latter acknowledges the notion of separation of ownership and control (Abdul Rahman, 1998).

With regard to the principle of limited liability applied to companies and corporate bodies, Usmani (2007) views that this concept is not alien to *Shari'ah*. Although he agrees that the concept of limited liability as understood in modern practice is a new

The existence of public treasury (*bayt al-mal*) and *waqf* implies the recognition of the concept of corporation with a separate legal entity.

The concept of artificial personality or *shahsiyah i'tibariyah* has been discussed by Muslim jurists since the 6th century but only in the 19th century was the concept materialised through the establishment of the first Muslim-owned corporation.

Sharikah al-'inan is a form of limited partnership where two or more persons participate in a firm with an agreed amount of capital and all profit or loss will be shared by the shareholders in certain specified proportions.

concept and absent in traditional *fiqh* literature, it is nevertheless found in various principles laid down in Islamic jurisprudence, such as in the concept of *waqf* and *bayt al-mal*, the principle of joint-stock in partnership as advocated by the *fiqh* of Shafi'i, the principle of *khultah al-shuyu'* (mixture of shares) in the levy of *zakat*, principles of inheritance under debt, and analogy of the limited liability of the master of a slave (Usmani, 2007). This view is supported by many prominent Muslim scholars such as Abdul Qadir Audah & Mustafa Zarqa (Sanusi, 2009) as well as Hasanuzzaman (1989). All of these principles infer and deduce the validity of the limited liability concept in Islam.

Nyazee (2006) states that earlier Muslim jurists were fully aware of the concept of corporate personality but they rejected it, preferring the system they were already dealing with. He further mentioned that most modern Muslim scholars claimed that this concept was known to Islamic law and only some of the scholars were doubtful on this position. In terms of an appropriate model of corporation, he proposes that the Islamic corporation be based on the principle of *wakalah* with some features of *shirkah al-inan* (Nyazee, 1998). Dien (2001), in his commentaries on Nyazee (1998), states that the concept of corporate legal personality can be found in the institution of *bayt al-mal* (Muslim Treasury) or *waqf* and the system of *'aqila* whereby the former refers to private corporation and the latter refers to public corporation.

The concept of artificial personality or a corpus with a separate legal entity is clearly acceptable in Islam where in the event of disputes, Islamic financial institutions can sue and be sued in the court of law.

Based on the above arguments, it is submitted that the concept of artificial personality or a corpus with a separate legal entity is clearly acceptable in Islam where in the event of disputes, IFIs can sue and be sued in the court of law. The concept of the corporation in business organisation is very essential as it provides certain distinct core characteristics, namely, a separate legal personality, limited liability of the shareholders, divisibility and transferability of ownership, centralised management under a board structure, the absence of *delectus personae* amongst the shareholders, and shared ownership by holders of capital (Kraakman et al, 2004).[7]

7 Lewis (2005: 6–9) distinguishes the characteristics of corporation from partnership into three areas. From a legal perspective, it concerns a distinct legal personality by the law, while the economic point of view considers it as a mechanism to reduce the transaction and cost of negotiating the individual transaction. The accounting view of the corporation contemplates the ability of the firm as a collection of resources of business activities and information on those assets is kept, maintained, documented and reported for the benefit of the stakeholders.

The Rights of Investment Account Holders

The principles of property rights and contractual obligation provide a basis for the stakeholder-oriented model of corporate governance in Islam. This raises an issue on the rights and interests of Investment Account Holders (IAHs) as part of the shareholders in IFIs as well as priority between the actual shareholders and the IAHs. Since the IAH has no governance rights and representative in the governance structure of IFIs, there is a major concern that shareholders may dominantly control the management and BODs to protect their interest rather those of the IAHs. In view of the stakeholder-oriented model of corporate governance, IFIs are expected to equally protect the rights of both the shareholders and the IAHs.

The IAHs in IFIs participate in the profit and loss since their investments are not explicitly or implicitly insured or guaranteed as in the case of conventional financial institutions. In spite of this, the IAHs are not directly exposed to the risk of Islamic banking business as they are not involved in the management and have no voting right in the shareholders' meeting. The IAHs are exposed indirectly to the risks incurred in two situations. First, the deposit insurance system does not insure demand deposit beyond a certain limit of the losses suffered by the banks. Secondly, capital and reserves plus investment deposit may not be sufficient to cover the losses (Chapra, 2002). This position demands extra precaution in terms of good governance in order to gain confidence of the depositors and at the same time protect the rights and interests of the main shareholders.[8]

Grais & Iqbal (2008) highlight other issues concerning IAHs, particularly in the aspect of the Profit Equalisation Reserve and Investment Risk Reserve, in that the IAHs do not have governance rights to influence the use of such reserve funds. In fact, some IFIs require them to explicitly waive any rights related with these reserves. The IFSB-3 recommends several key principles in protecting the rights and interests of the IAHs. For instance, Principle 2.1 requires IFIs to acknowledge the right of the IAHs to monitor the performance of their investments and associated risks, while Principle 2.2 encourages them to adopt a sound and transparent investment strategy (IFSB, 2006, pp. 6–10). In the absence of a right to participate in governance, the *Shari'ah* board, regulatory and supervisory authorities are expected to protect their rights and interests (Greuning & Iqbal, 2008).

The above situations clearly indicate that despite inherent values and ethics in Islamic finance as inspired by its philosophical foundation, IFIs are not immune from corporate difficulties. Islamic financial institutions experience corporate

8 In this circumstance, the *Shari'ah* board and the regulator are responsible for protecting the interest and rights of IAHs by ensuring that adequate and efficient monitoring mechanisms are in place (El Hawary, et al, 2004, p. 16).

Case Study 1

Although Islamic finance is conceived to be inherently stable, in reality, it is actually not immune from failure or crisis as it is part of the global financial system. There are several instances of corporate failures and difficulties in IFIs due to poor corporate governance. Table 16.4 summarises and highlights the corporate governance issues that contributed to corporate difficulties and the closure of some IFIs.

Table 16.4

IFIs	Corporate Governance Issues
Ihlas Finance, Turkey	Ihlas Finance in Turkey was closed on 10 February 2001 due to financial distress and weak corporate governance. Ali (2007) reported that the closure of Ihlas Finance was mainly attributed to the failure of corporate governance and internal checks and balances. It was found that the bank was run without a proper system of internal control, the management did not prepare for any changing circumstances of regulations, and the scope of regulations was unclear.
Islamic Bank, South Africa (IBSA)	The IBSA was closed in November 1997 with debts of between R50–R70 million due to lack of supervision from a regulatory authority, bad management, weak risk management, and numerous loans to insiders (Okeahalam, 1998, pp. 37–38). It is sad to mention that the IBSA was unable to compensate all of the depositors who were mostly Muslims who specifically had saved their money to perform their pilgrimage in Mecca.
Islamic Investment Companies of Egypt (IICE)	The closure of the IICE in 1988 was due to weak corporate governance, irresponsible management, and improper regulatory frameworks as well as engaging in *Shari'ah* noncompliant activities (Zuhaida, 1990). Over one million small investors lost their investments when the IICE and other investment companies collapsed. The IICE was an investment company that offered services free from interest.
Dubai Islamic Bank (DIB)	This refers to the fraud case in DIB involving US$501 million. Seven individuals were charged, including two Dubai Islamic Bank former executives (Morris, 2009). This was the biggest case in the Dubai Court of First Instance, in terms of the amount of financial irregularities (Za'za, 2009).
Bank Islam Malaysia Berhad (BIMB)	The BIMB declared losses, totalling RM457 million in 2005 mainly due to the provisioning of RM774 million as a result of bad financing and investments incurred by its Labuan branch (Parker, 2005). The composition of the board was not appropriate as there were no board members who were familiar with the banking sector as well as no sound and proper credit and debt collection (Parker, 2005).

difficulties because of poor corporate governance implementation. Ihlas Finance (the first domestic IFI in Turkey) was closed during its crisis on 10 February, 2001. In the case of Ihlas Finance, management failures, control failures and regulatory failures were the main factors of its closure. It was found that the majority of the BOD did not have the requisite experience, were ignorant of financial and economic facts and the workings of the company and had conflicts of interest due to their dual role as clients and members. The management was also found to be unprepared for changing regulations and indulged in fraudulent practices.

The IBSA, IICE, DIB and BIMB also faced similar difficulties due to weak corporate governance, weak internal control, poor management and insider trading. These practices led IBSA and IICE to experience financial distress, which finally caused both institutions to close. While IBSA and IICE were closed, the DIB and BIMB faced corporate difficulties and bore significant losses. In the case of BIMB, it was found that the BODs were not competent as there were no board members who were familiar with the banking industry. This position clearly indicates that a sound corporate governance framework is of equal concern to all types of business organisations, including IFIs.

Shari'ah Governance

The philosophical foundation of corporate governance in Islam requires an additional layer of governance for the purpose of *Shari'ah* compliance. With this aspiration, corporate governance in IFIs needs a set of institutional arrangements to oversee the *Shari'ah* compliance aspect of their business and operations. In the absence of a specific model of corporate governance in Islamic literature, the *Shari'ah* governance system was introduced to complement the existing corporate governance framework in IFIs. The *Shari'ah* governance system is exclusive and unique to the corporate governance framework in IFIs and distinguishes them from their conventional counterparts.

As one of the most essential components of corporate governance in IFIs, the institution of the *Shari'ah* board plays essential roles in the aspects of *Shari'ah* supervision, monitoring, auditing and issuing legal rulings.

The institution of the *Shari'ah* board plays an essential role in the aspect of *Shari'ah* supervision, monitoring, auditing and issuing legal rulings.

In parallel with the tremendous growth of the Islamic finance sector worldwide and the complexity of the duties and responsibilities of the *Shari'ah* board towards different stakeholders, it is strongly indicated that there must be a sound and proper *Shari'ah* governance system. The *Shari'ah* governance system enhances and strengthens the function of the *Shari'ah* board and its related institution for the purpose of *Shari'ah* compliance. With the aim of providing an overview of the *Shari'ah* governance system, this section is divided into eight subsections, which include conceptual framework, instrumental functions and objectives of *Shari'ah* governance system, institutionalisation of the *Shari'ah* board, models of a *Shari'ah* board, international standard-setting agencies and *Shari'ah* governance regulatory approach and process.

Conceptual Framework of *Shari'ah* Governance System

Until the issuance of the IFSB Guiding Principles on *Shari'ah* Governance System in Institutions Offering Islamic Financial Services (IFSB-10), there was no formal and proper definition of the *Shari'ah* governance system.

The IFSB-10 defines the *Shari'ah* governance system as "a set of institutional and organisational arrangements through which IFIs ensure that there is an effective independent oversight of *Shari'ah* compliance over the issuance of relevant *Shari'ah* pronouncements, dissemination of information and an internal *Shari'ah* compliance review" (IFSB, 2009, p. 2). To understand further, this definition can be divided into three essential components:

1 A set of institutional and organisational arrangements – This refers to the *Shari'ah* board and its related institutions such as internal audit department and *Shari'ah* division.

2 An effective independent oversight of *Shari'ah* compliance – This indicates the aims and objectives of the *Shari'ah* governance system to provide an efficient mechanism for the purpose of *Shari'ah* compliance.

3 *Shari'ah* pronouncements, dissemination of information and an internal *Shari'ah* compliance review – This involves the overall *Shari'ah* governance processes that covers both ex-ante and ex-post aspects of the *Shari'ah* compliance framework.

The *Shari'ah* board is an independent body entrusted with the duty of directing, reviewing and supervising the activities of the IFIs for the purpose of *Shari'ah* compliance and issuing legal rulings pertaining to Islamic banking and finance.

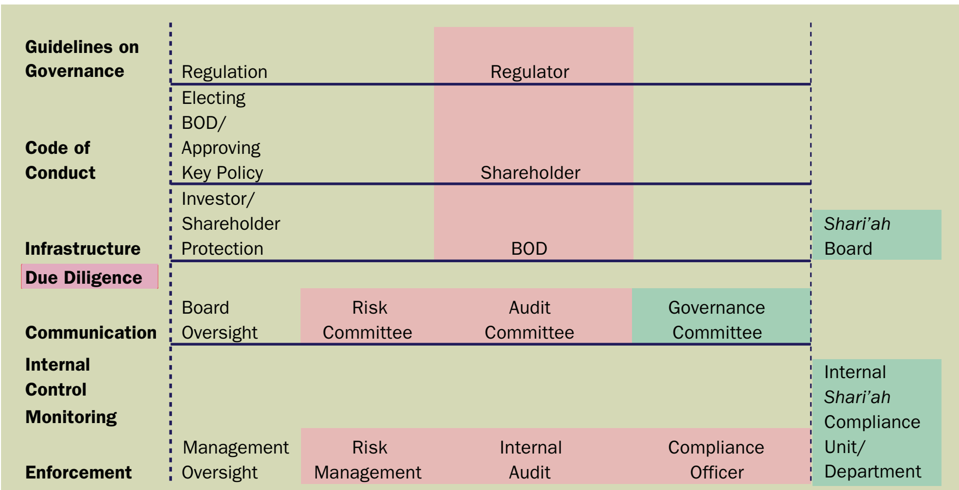
This definition implies that the institution of the *Shari'ah* board is crucial to the *Shari'ah* governance system as an authoritative body ensuring *Shari'ah* compliance. The AAOIFI Governance Standards No. 1 defines a *Shari'ah* board as "an independent body entrusted with the duty of directing, reviewing and supervising the activities of IFIs for the purpose of *Shari'ah* compliance, and issuing legal rulings pertaining to Islamic banking and finance". A similar definition is given by the IFSB-10 where it refers to "a body comprised of a panel of *Shari'ah* scholars who provide *Shari'ah* expertise and act as special advisors to the institutions". In carrying out this duty, the *Shari'ah* board needs a clear framework and structure to ensure its effectiveness, particularly in the matters of its independence, the binding force of its rulings, its objectivity and full mandate. On this basis, any formal or informal arrangement as to how the *Shari'ah* board is directed, managed, governed and controlled for the purpose of *Shari'ah* compliance is also part of the *Shari'ah* governance system.

Shari'ah governance is a unique kind of governance in financial architecture as it is concerned with the religious aspects of the overall activities of IFIs. To illustrate the rationale of the *Shari'ah* governance system in the existing corporate governance framework, Table 16.5 provides an illustration as to how *Shari'ah* governance complements the existing corporate governance framework in IFIs.

Table 16.5 Institutional Arrangement in *Shari'ah* Governance System (IFSB, 2009)

Functions	Typical Financial Institutions	Exclusive to IFIs
Governance	Board of Directors	*Shari'ah* Board
Control	Internal Auditor/External Auditor	Internal *Shari'ah* Review Unit/External *Shari'ah* Review Unit
Compliance	Regulatory and Financial Compliance officers, unit or department	Internal *Shari'ah* Compliance Unit

Table 16.5 indicates that IFIs and typical financial institutions share a common institutional arrangement for their corporate governance framework, particularly in the aspects of governance, control and compliance. The only element that differentiates corporate governance in IFIs is the institutional arrangement for their *Shari'ah* governance mechanism. Islamic financial institutions require another set of organisational arrangement in the form of the *Shari'ah* board, internal or external *Shari'ah* review unit and internal *Shari'ah* compliance unit to meet the religious requirement of *Shari'ah* compliance in all aspects of their business transactions and operations. In terms of governance, the *Shari'ah* governance system adds an additional layer of governance to the existing corporate governance structure. Figure 16.1 demonstrates the unique corporate governance structure in IFIs where the *Shari'ah* board and internal or external *Shari'ah* review unit are the additional institutions that oversee *Shari'ah* compliance aspects.



Source: Stanley, (2008: Modified).

Figure 16.1 Corporate Governance Structure in IFIs

With regard to the scope of *Shari'ah* governance framework, it covers ex-ante and ex-post aspects of *Shari'ah* compliance, where the former refers to issuance of *Shari'ah* rulings and dissemination of *Shari'ah*-related information while the latter refers to periodic and annual internal *Shari'ah* review process. Figure 16.2 illustrates the scope of *Shari'ah* governance system in two phases, i.e., ex-ante and ex-post.

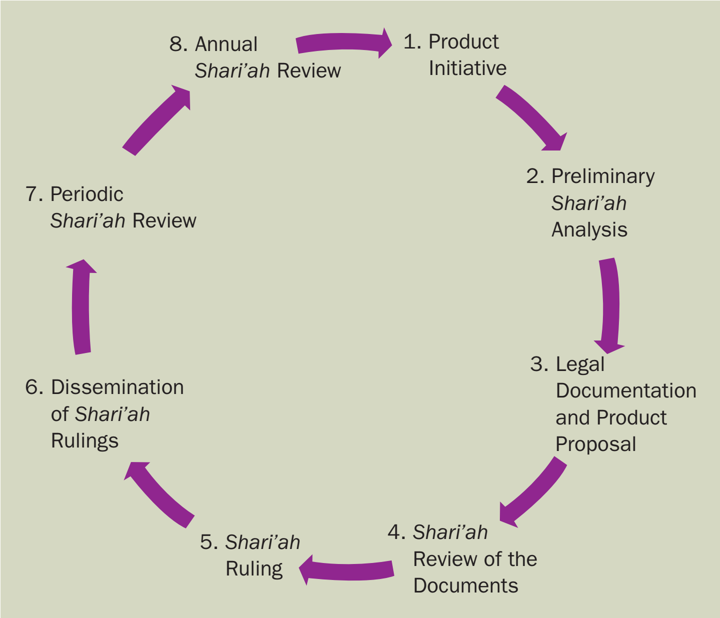


Figure 16.2 Scope of *Shari'ah* Governance Framework (Dar, 2009: Modified)

The scope of *Shari'ah* governance framework in IFIs involves a systematic process and requires involvement of numerous organs of governance. Phase 1 (processes 1 to 6) in Figure 16.2 illustrates the ex-ante *Shari'ah* compliance aspect which includes product proposal, legal documentation, *Shari'ah* review and procurement and dissemination of *Shari'ah* rulings. In Phase 2 (processes 7 to 8), the diagram demonstrates the ex-post process, which involves periodic and annual *Shari'ah* review. The *Shari'ah* board plays a central role in ensuring the legitimacy of the products with *Shari'ah* principles; this can only be achieved by having sound *Shari'ah* coordination cum an efficient internal *Shari'ah* review unit. A *Shari'ah* coordinator acts as a liaison officer or coordinator for the *Shari'ah* governance process from product initiative to annual *Shari'ah* review.

Functions of a *Shari'ah* Governance System

The objectives of a *Shari'ah* governance system lies at the very core of its existence, which is for the sake of *Shari'ah* compliance as aspired by its philosophical foundation.

The objective of a *Shari'ah* governance system lies at the very core of its existence, i.e., for the sake of *Shari'ah* compliance as aspired by its philosophical foundation. It involves numerous processes and procedures which incur cost and the involvement of various organs of governance in IFIs.

The *Shari'ah* governance system is meant to address a specific type of risk exclusive to IFIs; the *Shari'ah* noncompliance risk. The IFSB-3 defines *Shari'ah* noncompliance risk as "the risk that arises from IFIs' failure to comply with the *Shari'ah* rules and principles determined by the *Shari'ah* board or the relevant body in the jurisdiction in which the IFIs operate" (IFSB, 2006, p. 26). Delorenzo (2007) considers *Shari'ah* compliance risk such as the risk of *fatwa* rejection and differences of opinion to be a form of operational and regulatory risk. Iqbal & Mirakhor (2007) classify *Shari'ah* risk into two types: the risk that is due to non-standard practices of Islamic financial products and the risk that is due to noncompliance with the *Shari'ah*.

The significance of *Shari'ah* noncompliance risk to the Islamic finance industry can be illustrated in the case of declining *sukuk* issuances due to the statement made by the Chairman of the AAOIFI *Shari'ah* board, the Organization of the Islamic Conference (OIC) *Fiqh* Academy's declaration on the impermissibility of *tawarruq*, and the Malaysian High Court's judgement on the issue of *bay' bithaman ajil* (BBA). All of these major cases indicate the very significance of the *Shari'ah* governance system as a risk management tool to mitigate *Shari'ah* noncompliance risk. While other kinds of risks such as credit risk, equity investment risk, market risk, liquidity risk, rate of return risk are quantifiable, *Shari'ah* risk, on the other hand, is difficult to manage. Furthermore, there is no specific risk management model to address the *Shari'ah* noncompliance risk which is prevalent to IFIs. The IFSB Guiding Principles on Risk Management (IFSB-1) specifically classifies the *Shari'ah* risk as part of the operational risks which can be managed through a sound and proper *Shari'ah* governance system (IFSB, 2002). The *Shari'ah* governance system would help IFIs to mitigate *Shari'ah* noncompliance risk that may incur unimaginable potential of loss and negate an IFI's credibility.

Institutionalisation of *Shari'ah* Board

Although *Shari'ah* governance is relatively new to any discourse on *fiqh mu'amalat*, the notion of market regulation and enforcement through an institutionalisation approach has already been implemented since pre-modern Muslim societies in the form of the institution known as *hisbah*.[9] *Hisbah* was institutionalised for the purpose of supervising public morals: markets were regulated and monitored by its executor

9 The literature on *hisbah* can be divided into theoretical manuals such as *Public Duties in Islam: The Institutions of the Hisbah* by Ibn Taymiyyah and *Al Ahkam Al Sultaniya* by Al Mawardi and prescriptive-legal literature (*hisbah* manuals) such as manuals of Ibnu Bassam, manuals of Ibnu Ukhuwa (Klein, 2006: 42–43). Ibn Taymiyyah discussed in great detail the institution of *hisbah* pertaining to its duties, rights and obligations upon specific socioeconomic activities as well as market regulation (See Ibn Taymiyyah, 1985).

(the *muhtasib*).[10] Traditionally, the functions of *hisbah* included duty related to violations of public morality such as music-related offences, the public display of wine, wailing at funerals. On top of that, the jurisdiction of *hisbah* also covered matters inside private domains such as offences inside homes and the instruction of children (Klein, 2006). The most important function of *hisbah* in the context of economic welfare of the people was the supervision of market affairs. This included control of scale and prices, protection of measures and standards of weight, accurate value of coins used in the market and prevention of fraud (Wittmann, 2006).

In view of some similarities between the institution of *hisbah* and *Shari'ah* governance, particularly in their objectives and functions to promote good and prevent evil within the boundaries of *Shari'ah*, the institutionalisation of a *Shari'ah* board can be considered a new concept of the *muhtasib* in modern Muslim societies. Unlike the traditional concept of *hisbah*, which is more towards market supervision, the institution of the *Shari'ah* board operates within the internal governance of IFIs by providing advisory and supervisory services as a *Shari'ah* assurance. The adoption of this modified and new form of *hisbah* model is very important to ensure all activities, transactions and operations of IFIs meet the principles of the *Shari'ah* and Islamic morals. The *Shari'ah* board is an ideal institution to play some of the functions of the *muhtasib* as the internal institution of *hisbah* within the context of IFIs.

The institutionalisation of a *Shari'ah* board can be considered as the new concept of the *muhtasib* in modern Muslim societies, in view of some similarities between the institution of *hisbah* with *Shari'ah* governance in promoting good and preventing evil within the boundaries of *Shari'ah*.

At this juncture, it is worth exploring the brief historical development of the institution of the *Shari'ah* board and the *Shari'ah* governance system in IFIs.

The *Shari'ah* board was institutionalised in 1976 when the Faisal Islamic Bank of Egypt was established. It was the first to have a formal *Shari'ah* board consisting of selected *Shari'ah* scholars in Egypt (Kahf, 2004). This practice was then followed by the Jordan Islamic Bank and the Faisal Islamic Bank of Sudan in 1978, the Kuwait Finance House in 1979, Bank Islam Malaysia Berhad in 1983 and the Dubai Islamic Bank in 1999. At the beginning, the Islamic Development Bank (IDB) in Jeddah had no formal *Shari'ah* supervisory board or an appointed *Shari'ah* council, but it had already started establishing relationships with several *Shari'ah* scholars by inviting them for consultation and seeking *fatwa*s on specific issues (Kahf, 2004). The IDB then also established its own internal *Shari'ah* board, which was appointed by the IDB board of executive directors.[11]

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10 The *muhtasib* is the executor who discharged the principles of religious obligation of the individual believer "to command right, when its omission becomes apparent and to forbid wrong, when its realisation becomes imminent" (Wittmann, 2006: 109).

11 The IDB established its own *Shari'ah* board in 2002. Before this, the IDB referred its *Shari'ah* matters to the Islamic *Fiqh* Academy of for deliberation (Bakar, 2002, p. 79).

In the meantime, the OIC countries acknowledged the authority of the Council of the Islamic *Fiqh* Academy based in Jeddah to issue *fatwa* rulings including matters relating to Islamic banking and finance.[12] Currently, the majority of IFIs, including some of the respective central banks, have established their own *Shari'ah* boards or alternatively hired *Shari'ah* advisory firms for *Shari'ah*-related services.

Role of a *Shari'ah* Board

The role of a *Shari'ah* board varies from one board to another, and it depends upon the nature, extent and degree of *Shari'ah* compliance. Inspired by its foundational dimension as discussed above, the *Shari'ah* board has fiduciary duties towards all stakeholders of IFIs. It is also contended that the duty to protect the rights and interests of the account holders, especially IAHs comes under the purview of a *Shari'ah* board since they do not have any rights of participation in IFIs. Moreover, the integrity of IFIs greatly depends on the status of their *Shari'ah* compliance, the impact of products, professional competence and behaviour towards the observance of *Shari'ah* norms (Ayub, 2007). In this aspect, the *Shari'ah* board plays a fundamental role in ensuring and enhancing the credibility of IFIs[13] as well as having the authority to issue *fatwas* via collective *ijtihad*.

A *Shari'ah* board plays a role as a control mechanism that monitors the IFIs' business transactions for the purpose of *Shari'ah* compliance including *zakat* obligation.

As a general observation, a *Shari'ah* board plays a role as a control mechanism to monitor the IFIs' business transactions for the purpose of *Shari'ah* compliance including assuring *zakat* payment (Briston and El-Ashker, 1986). This is affirmed by Dawud (1996) who mentions that the *Shari'ah* boards' objective is to guide IFIs in the setting of policies and regulations according to the *Shari'ah*, in approving their financial transactions from a legal side and in preparing their contracts for future transactions according to Islamic law. In addition, Aboumouamer (1989) describes the role of the *Shari'ah* board as being proactive rather than reactive. He mentions that the *Shari'ah* board has fiduciary duties to force the management of IFIs to disclose and dispense revenue from any unlawful transaction to charity as well as to conduct an audit on *zakat* funds. Banaga et al. (1994), on the other hand, outline the *Shari'ah* board's responsibilities from an auditor's perspective to include answering enquiries, issuing legal opinions, and reviewing and revising all business transactions and operations to be in compliance with *Shari'ah* principles. Abdallah (1994) seems to agree with the

12 The Council of Islamic *Fiqh* Academy is a subsidiary body of the OIC, created by the Third Islamic Summit Conference held in Makkah al-Mukarramah in January 1981.

13 Iqbal (2002, p. 47) mentions that one of the factors of the failure of Kleinwort Benson, the first investment bank to introduce an Islamic unit trust in 1986 was due to investors' reservation about the absence of a *Shari'ah* board. This indicates how important the establishment of *Shari'ah* boards in IFIs is for the sake of gaining confidence from investors and general public as well as to ensure *Shari'ah* compliance.

contention that the *Shari'ah* board must be proactive rather than reactive. He holds the view that the *Shari'ah* board should set up the accounting policies to ensure that the formula used in allocating profit between shareholders and account holders is fair, should ensure that, all revenues are generated from lawful transactions and that *zakat* funds are properly calculated, and should influence the IFIs to perform their social responsibilities towards the community and other stakeholders.

Unlike Aboumouamer (1989), Dawud (1996), Banaga, et. al, (1994), Abdallah (1994), and Briston & El-Ashker (1986), none of whom are *Shari'ah* scholars, it is worth referring to the views of *Shari'ah* scholars' on the functions of the *Shari'ah* board. Sheikh Yusuf Talal De Lorenzo, one of the prominent *Shari'ah* advisors, describes the functions of a *Shari'ah* board in an IFI to include assisting the IFI in the product pre-certification stage such as product development and structuring, certifying products by means of *fatwa* and ensuring *Shari'ah* compliance throughout the financial products' lifecycle (Delorenzo, 2007). In another paper, Delorenzo (2006) explains the functions of the *Shari'ah* board in the context of Islamic mutual funds, which include consumer advocacy, portfolio purification with regard to screening stocks, and portfolio monitoring of management, fees, funds, documentation, industry, product development and *zakat.* Based on all of these descriptions from a spectrum of literature, the ideal functions of the *Shari'ah* board can be summarised as overseeing the ex-ante and ex-post aspects of business transactions, activities and operations of IFIs for the purpose of *Shari'ah* compliance.

Shari'ah advisory firm refers to an organisation which offers *Shari'ah* services either in the aspect of supervisory or consultative functions such as the Institute of Islamic Banking and Insurance (IIBI), the International Institute of Islamic Finance, Incorporated (IIIF), the Islamic Banking and Finance Institute of Malaysia (IBFIM), Yasaar Limited (YL), the Minhaj *Shari'ah* Financial Advisory (MSFA), the Failaka International (FI) and the BMB Islamic (BMBI). In terms of ownership, the current practice shows that *Shari'ah* advisory firms are either owned by independent parties (IIBI), IFIs (BMBI, IBFIM) or legal firms and even by *Shari'ah* scholars themselves (FI, YL, IIIF and MSFA). The initial study found that more than 17 *Shari'ah* advisory firms are available in the market and this figure is expected to increase in line with the market demand of *Shari'ah* advisory services from various entities.

Despite numerous descriptions of the roles of *Shari'ah* boards in the existing literature, they fail to differentiate the diverse functions of various models of *Shari'ah* advisory services. Even though the majority of *Shari'ah* boards share common objectives and responsibilities, it is very important to identify and understand their different functions. For this reason, the roles of the *Shari'ah* board can be categorised in terms of the macro and the micro levels.

1 Macro Level

The *Shari'ah* board at the macro level refers to the international and national set-up of a *Shari'ah* board's institution. International *Shari'ah* boards normally refer to independent *Shari'ah* bodies, e.g., AAOIFI and IDB, which were established by the mutual cooperation of several Muslims countries.

Currently, there are five jurisdictions that have *Shari'ah* boards at the central bank or regulatory authority level, namely Malaysia, Indonesia, Brunei, Pakistan and Sudan. *Shari'ah* boards at this level play significant roles in the harmonisation and standardisation of *fatwas* and act as the highest *Shari'ah* authority of IFIs. For instance, the *Shari'ah* Advisory Council (SAC) of Bank Negara Malaysia (BNM) is the highest authority for the ascertainment of Islamic law for the purposes of Islamic banking business, *takaful* business, Islamic financial business or any other business which is based on Islamic principles and is supervised and regulated by BNM.

2 *Micro Level*

Having the *Shari'ah* board at the micro level is the most prevalent practice of IFIs, either in the form of internal *Shari'ah* boards in IFIs or as *Shari'ah* advisory firms. Generally, IFIs are required to establish their *Shari'ah* boards as stipulated in their articles of association. The objective of the establishment of a *Shari'ah* board, as stated in the article of association, determines the nature of its governance structure. The *Shari'ah* board at the micro level performs a range of responsibilities; these include participating in product development and structuring activities, reviewing and approving matters related to the *Shari'ah*, issuance of *fatwa*, *Shari'ah* auditing, issuance of an annual certification of *Shari'ah* compliance (McMillen, 2006), ensuring the *Shari'ah* compliance of IFIs' investments in shares, equities, *sukuk* and other business avenues (Ayub, 2007), and the computation of *zakat*.

In the case of Malaysia, Section 20 of the BNM/GPS 1 provides clear duties and responsibilities of the *Shari'ah* board; these include: to advise the SAC on *Shari'ah* matters in the IFI's business operation, to endorse *Shari'ah* compliance manuals, to endorse and validate relevant documentation, to assist related parties on *Shari'ah* matters for advice upon request, to advise on matters to be referred to the SAC, to provide written *Shari'ah* opinions, to assist the SAC on references for advice and to advise on matters pertaining to *zakat* (BNM, 2004). In addition, the AAOIFI Governance Standard for IFIs 2005, No. 1, entitled *The Shari'ah Supervisory Board: Appointment, Composition and Report*, states that the *Shari'ah* board is entrusted with the duty of directing, reviewing and supervising the activities of IFIs to ensure that they are in compliance with *Shari'ah* principles.

Based on the above explanation, the roles of the *Shari'ah* board normally involve three main areas, i.e., the issuance of *fatwa* via collective *ijtihad*, supervision (*raqabah*) and review (*mutabaah*).

International Standard-Setting Agencies

The existing standard-setting agencies such as the Organization of Economic Co-operation and Development (OECD), the International Organization of Securities Commission (IOSCO) and the Basel Committee on Banking Supervision (BCBS) have issued numerous guidelines on governance and risk management for financial institutions. The OECD has issued Guidelines on Corporate Governance, the IOSCO on Capital Market and the BCBS on Basel Committee I, II and III. Nevertheless, these standard guidelines fail to address specific issues of Islamic finance. As the nature and financing model of Islamic finance are different from its conventional counterparts, the need for an independent standard-setting agency specifically for Islamic finance was crucial and, hence, upon the initiative of several IFIs and regulatory authorities, AAOIFI and the IFSB were established in 1992 and 2004 respectively. AAOIFI has issued five governance standards while the IFSB has issued three Prudential Standards and one guiding principles on governance in IFIs. The difference between the IFSB Prudential Standards and the AAOIFI Governance Standards is that the IFSB approach is more addressed to regulators while AAOIFI, to individual IFIs.

The need for an independent standard-setting agency specifically for Islamic finance was really crucial and with the initiatives of several IFIs and regulatory authorities, the AAOIFI and IFSB were established.

AAOIFI Governance Standard

The AAOIFI has issued 81 accounting standards and statements, which include 25 accounting standards, six auditing standards, seven governance standards, 41 *Shari'ah* standards and two codes of ethics. Due to the absence of any corporate governance framework for IFIs in the late 1990s, the AAOIFI has taken the initiative to provide basic guidelines for a *Shari'ah* governance framework in its governance standards No. 1–5. It is important to note that none of these five standards can be read in isolation as they complement each other.

1 *Governance Standard for IFIs No. 1:* Shari'ah *Supervisory Board: Appointment, Composition and Report*

Governance Standard No. 1 was adopted by the Accounting and Auditing Standard Board (AASB) in its meeting No. 13 held on 15–16 June 1997. It consists of eight parts, namely, introduction, definition, appointment, composition, selection and dismissal of *Shari'ah* supervisory board, basic elements of report, publication of the report, publication of *Shari'ah fatwas*, rulings and guidelines, and the effective date. Section 2 represents the most important provision of the Governance Standard No. 1. It has three elements which define the term *Shari'ah* supervisory board. Firstly, the *Shari'ah* board is an independent body of jurists specialised in *fiqh mu'amalat*. This section allows the appointment of *those* who are not specialised in *fiqh mu'amalat* but are nevertheless experts in the field of Islamic finance as *Shari'ah* board members. Secondly, it elaborates the role of a *Shari'ah* board to ensure compliance with *Shari'ah* principles by having the authority to direct, review and supervise the activities of IFIs. Thirdly, it affirms the binding authority of the *Shari'ah* board upon the IFIs.

Sections 3–6 mention the process of appointment and remuneration of *Shari'ah* board members. With the motive to ensure the independence of the *Shari'ah* board, the AAOIFI prefers the appointment as well as dismissal to be made by the shareholders in the AGM upon recommendation of the BOD. The term of appointment must be agreed upon by the *Shari'ah* board and needs to be recorded. In terms of remuneration, the BOD, with authorisation of the shareholders, has the authority to fix an appropriate remuneration for the *Shari'ah* board. The AAOIFI requires the *Shari'ah* board to comprise a minimum of three members. The directors or significant shareholders of the IFI cannot be appointed as *Shari'ah* board members even if they possess the requisite qualifications. Sections 9–26 specify the format of the *Shari'ah* report which must be published in the annual report of the IFI.

2 *Governance Standard for IFIs No. 2:* Shari'ah *Review*

Governance Standard No. 2 was adopted by the AASB in its meeting No. 15 held on 21–22 June 1998. It consists of eight parts with 18 sections. Section 3 explains *Shari'ah* review as an examination of the extent of *Shari'ah* compliance of IFIs. While this section further confirms the *Shari'ah* board's authority to access all necessary information for the *Shari'ah* review, Section 5 puts the responsibility for compliance upon the management. The *Shari'ah* board is only responsible for forming and expressing opinions on the extent of *Shari'ah* compliance. Sections 7–13 detail the *Shari'ah* review procedures which involve planning, designing, executing, preparation and review. The *Shari'ah* review will be read at the AGM and issued to the management.

3 *Governance Standard for IFIs No. 3: Internal* Shari'ah *Review*

Governance Standard No. 3 was adopted by the AASB in its meeting No. 17 held on 13–14 June 1999. It consists of 11 parts and 30 sections which complement the Governance Standard No. 2. Standard No. 3 aims at establishing standards and guidance on the internal *Shari'ah* review. As the management of IFIs is responsible for the extent of *Shari'ah* compliance, it is incumbent upon them to have the proper mechanisms of internal *Shari'ah* review. While AAOIFI requires IFIs to carry out the internal *Shari'ah* review, it does not specify the requirement of establishing a separate internal *Shari'ah* audit department. The internal *Shari'ah* review can be carried out by either an independent department or part of the internal audit division.

AAOIFI insists that the internal *Shari'ah* review must be conducted independently and comply with the Code of Ethics for Accountants and Auditors of IFIs. The management and the BOD shall give full and continual support to the internal *Shari'ah* reviewers. In this aspect, the head of internal *Shari'ah* reviewers shall be accountable to the BOD. Since the nature of internal *Shari'ah* review is different from the normal auditing process, the internal *Shari'ah* reviewer must be proficient and have appropriate academic background and necessary training relevant to *Shari'ah* review, particularly proficiency in *Shari'ah* and *fiqh mu'amalat*. The reporting structure requires the head of the internal *Shari'ah* review to discuss the findings with the management and the final report must be addressed to the BOD and copies be delivered to the *Shari'ah* board and management. In the event of disputes between management and internal *Shari'ah* reviewers, they shall be referred to the *Shari'ah* board for determination.

4 *Governance Standard for IFIs No. 4: Audit and Governance Committee*

Governance Standard No. 4 was adopted by the AASB in its meeting No. 21 held on May 2001. In order to complement the corporate governance framework in IFIs, the AAOIFI strongly recommended the establishment of an Audit and Governance Committee (AGC) at the board level. The AGC would consist of a minimum of three members appointed by the BOD from its non-executive and independent board members who are knowledgeable about the affairs of the institution, applicable regulations and laws, including *Shari'ah* rules and principles.

On top of the *Shari'ah* board and the BOD, the AGC plays the specific functions of preserving the integrity of the financial reporting process, safeguarding the interests of stakeholders, providing additional assurance on the reliability of information and acting as an independent link between the management and other stakeholders (Section 3).

5 *Governance Standard for IFIs No. 5: Independence of the* Shari'ah *Board*

Governance Standard No. 5 was adopted by the AASB in its meeting No. 29 held from 7–8 June 2005. It aimed at providing guidelines for the mechanisms to resolve issues of independence. There are nine sections with appendices providing examples of possible issues of independence impairment. The independence of the *Shari'ah* board is of the essence in enhancing public confidence on the aspects of *Shari'ah* compliance. Section 3 restricts the *Shari'ah* board from subordinating their judgements on *Shari'ah* supervision to third parties. The *Shari'ah* board cannot comprise employees of the same IFI who are involved in managerial decisions and operational responsibilities. Upon assessment, the *Shari'ah* board is required to conduct continued assessment with the IFIs and do all things necessary to resolve any issues of independence impairment.

The IFSB Prudential Standards

The IFSB is another standard-setting agency with an exclusive aim to support the Islamic finance industry in terms of regulation, guidelines, training, research, database, standard practices, and promoting greater uniformity. The IFSB does not have its own *Shari'ah* board as it plays a different role from internal and external *Shari'ah* boards. It does not issue any *fatwas* or rulings pertaining to Islamic banking and finance. The objectives of the IFSB include establishing various standards and recommending them for adoption, providing supervisory and regulatory guidelines, encouraging cooperation among member jurisdictions, facilitating training and development, undertaking research and establishing databases of participants in the Islamic finance industry (IFSB, 2008).

The IFSB has issued seven prudential standards for IFIs, two for capital adequacy requirements, one for risk management and four for governance, disclosure and supervisory review process. In the meantime, the IFSB has issued three guidelines for IFIs, the Guiding Principles on Governance for *Takaful* Operations, the Conduct of Business for Institutions offering Islamic Financial Services and Guiding Principles on the *Shari'ah* Governance System. It is worth mentioning that the IFSB has already initiated the prudential standards addressing *Shari'ah* governance issues indirectly within its four prudential standards on governance, disclosure and supervisory process and specifically in the IFSB-10. Therefore, all the IFSB prudential standards must be read together as they complement each other.

The IFSB is a standard-setting agency with the aim to support the Islamic finance industry in terms of regulation, guidelines, training, research, database, standard practices and the promotion of greater uniformity.

The need for a *Shari'ah* governance mechanism has already been addressed in IFSB-1 and IFSB-5. Both standards insist that IFIs establish appropriate policy and institutional arrangements to manage operational risk, specifically *Shari'ah*-compliant risks, as well as to specify a mechanism for the supervisory review process. In addition, IFSB-3, IFSB-6 and IFSB-8, respectively, specify the governance standards for IFIs, Islamic Collective Schemes and *Takaful*. All of these earlier guidelines address only the general framework of corporate governance without specifying the *Shari'ah* governance matter exclusively. The IFSB then initiated IFSB-10, which specifically addresses the issues of the *Shari'ah* governance system in IFIs (IFSB, 2008). The basic premise of IFSB-10 is to promote best practices of *Shari'ah* governance by having a high standard of guidelines. The IFSB-10 focuses on four main elements of governance, which are illustrated in Table 16.6.

The IFSB has initiated the prudential standards addressing *Shari'ah* governance issues indirectly within its four prudential standards on governance, disclosure and supervisory process.

Table 16.6 Key Elements and Principles of the IFSB-10

Key Element	Principle	Operational Framework
Competence	Fit and proper criteria.	Ex-ante: Screening process. Ex-post: Review and assessment.
	Professional training.	
	Formal assessment.	
Independence	Adequate capability to exercise objective judgement.	Ex-ante: Appointment, disclosure and full mandate. Ex-post: Review and assessment.
	Complete, adequate and timely information.	
Confidentiality	Strictly observes confidentiality.	Ex-ante: Undertaking secrecy. Ex-post: Review and assessment.
Consistency	Fully understand that the legal and regulatory framework strictly observes the said framework.	There must be consistency in all ex-ante and ex-post *Shari'ah* governance processes.

The *Shari'ah* governance framework of the IFSB-10 tends to cover the overall aspect of *Shari'ah* compliance processes by invoking the very important elements necessary for an effective *Shari'ah* governance system. Nevertheless, there are some inconsistencies between IFSB-10 and the AAOIFI Governance Standards No. 1–5 that need to be resolved. Since some jurisdictions such as Bahrain, UAE and Qatar have already adopted the AAOIFI Governance standards while the others remain silent, IFSB-10 may be irrelevant to these jurisdictions. At this point, it is the duty of regulatory authorities to determine the adoption of the IFSB-10, as this guiding principle on *Shari'ah* governance system is highly commendable.

Shari'ah Governance Process

The *Shari'ah* governance process represents the instrumental functions of the *Shari'ah* board as part of the institution of corporate governance of IFIs.

The most important element of *Shari'ah* governance is its process. The *Shari'ah* governance process represents the instrumental functions of the *Shari'ah* board as part of the institution of corporate governance of IFIs. This section provides a brief explanation on the *Shari'ah* governance process, which includes attributes of the *Shari'ah* board with respect to its appointment, composition and qualifications, the *Shari'ah* compliance process, *Shari'ah* coordination, *Shari'ah* compliance review and *Shari'ah* report.

Appointment

In contemporary practice, the members of a *Shari'ah* board are appointed by the shareholders or the BOD with the approval of the shareholders at the AGM. In actual practice, numerous IFIs appoint members of their *Shari'ah* board through their BODs, as in the case of Malaysia and Pakistan. Section 8 of the BNM/GPS1 places the power of appointment in the hands of the BOD upon recommendation of its nomination committee and by obtaining prior written approval of BNM. In Pakistan, the appointment of the *Shari'ah* board is approved by the BOD in the case of domestic IFIs. In case of foreign banks having Islamic banking subsidiaries, the appointment shall be made by the management (State Bank of Pakistan, 2008).

The practice is different in the case of the appointment of *Shari'ah* board members at the central bank level, where the power is vested in the government, as in the case of the *Shari'ah* board of the central banks of Sudan, Malaysia and the UAE. In Malaysia, the *Shari'ah* board of the BNM is appointed by the Yang di-Pertuan Agong (King), on the recommendation of the finance minister pursuant to the Central Bank of Malaysia Act 2009. In the case of the UAE, the *Shari'ah* board of the Central Bank of UAE has the authority to approve and endorse the appointment of the *Shari'ah* board at the respective banks by virtue of Section 5, Federal Law No. (6), 1985. On this basis, it can be said that there is no standard practice on the method of appointment of *Shari'ah* boards.

Composition

The *Shari'ah* board comprises *Shari'ah* scholars who are experts in *fiqh mu'amalat* and *usul al-fiqh.* In terms of the composition of the *Shari'ah* board, it varies from one IFI to another. *Shari'ah* boards at the international and national levels usually comprise leading international and regional scholars, whereas *Shari'ah* boards of the domestic IFIs consist of regional and local scholars.

By and large, most IFIs appoint between three and six members for the *Shari'ah* board. The AAOIFI *Shari'ah* board comprises not more than 20 members who are appointed by the Board of Trustees for a four-year term from among *Shari'ah* scholars. The AAOIFI governance standard requires at least three members at the IFI level. This is followed by a few countries such as Bahrain, Dubai, Jordan, UAE and Malaysia. For instance, Section 16 of the BNM/GPS1 puts a condition of a minimum of three members and further requires the IFIs to set up a *Shari'ah* secretariat to ensure the effective function of the *Shari'ah*. *Shari'ah* governance in Indonesia puts a requirement of a minimum of two persons and a maximum of not more than half the numbers of the BODs of the respective IFIs. *Shari'ah* board of the State Bank of Pakistan (SBP) comprises two *Shari'ah* scholars and three experts in the area of banking, accounting and the legal framework. At the individual IFI level, there must be at least one *Shari'ah* advisor.

Internationalist scholars refer to *Shari'ah* board members as those who most often sit in the *Shari'ah* boards of the investment fund and international organisations such as the AAOIFI and the IDB, and have expertise and experience in sophisticated financial transactions in various jurisdictions around the world.

Qualification

It is contended that the ideal qualification of the board members are those who are experts in *Shari'ah* and law, specifically in the area of *fiqh mu'alamat* and *usul al-fiqh*. The reason behind this is that the *Shari'ah* board mostly deals with issues relating to commercial law. This is in parallel with Section 12 of the BNM/GPS1, which requires the *Shari'ah* board members to have at least, either qualification or possess necessary knowledge, expertise or experience, in Islamic jurisprudence or Islamic commercial law. Paragraph 2 of the Guidelines on Islamic Private Debt Securities (1 July 2000) issued by the Securities Commission of Malaysia requires that the appointment of the *Shari'ah* advisors in relation to the approval of the structure of Islamic bonds must be of good reputation, be well-versed in *fiqh mu'amalat* and *usul al-fiqh,* and have at least three years' experience in Islamic financial transactions. In addition, Section 28 of the Regulations of Faisal Islamic Bank of Sudan requires the *Shari'ah* board members to be scholars of the *Shari'ah* or comparative law. Similar provisions can be found in Section 3 of the Guideline of the Supreme *Shari'ah* Supervisory Board, Bank of Sudan (Al-Darir, 2001).

The AAOIFI governance standards and IFSB-10 allow the appointment of a person who has no expertise in *fiqh mu'amalat* to be a *Shari'ah* board member to strengthen the ability of the *Shari'ah* board to scrutinise and understand banking business and its operation.

Nevertheless, the AAOIFI Governance Standards and IFSB-10 allow the appointment of a person who has no expertise in *fiqh mu'amalat* to be a *Shari'ah* board member to strengthen the ability of the *Shari'ah* board to scrutinise and understand banking business and its operation. This position is followed by several countries such as Pakistan and Malaysia. The *Shari'ah* board members of the SBP and BNM comprise experts from various fields, and they include *Shari'ah* scholars, chartered accountants, lawyers, judges and central bankers. The SBP has gone even further by putting very strict conditions on *Shari'ah* board members' qualifications. In terms of educational qualification, any board member must have a degree from a recognised *Waffaqul Madaris* with a minimum of second class Bachelor's degree in Economics or degree in *Takhassus Fil Fiqh* and sufficient understanding of banking and finance or a post-graduate degree in Islamic Jurisprudence or *usuluddin* or LLM (*Shari'ah*) from any recognised university and with exposure to banking and finance. From the aspect of experience and exposure, all members must have at least three years' experience of giving *Shari'ah* rulings or at least five years' experience in research and development in Islamic banking and finance. The SBP also insists on the capability of mastering or having reasonable knowledge of Arabic and English languages (State Bank of Pakistan, 2008a). All of these requirements indicate the essence of the *Shari'ah* board's competency in setting higher standards of practice of *Shari'ah* governance in IFIs.

Shari'ah Compliance Process

There are no specific standard guidelines for the *Shari'ah* board on the aspects of management, product approval, ex-ante and post-ante auditing. It is the *Shari'ah* secretariat or department that will coordinate and handle *Shari'ah* matters.

Every IFI has its own procedure for the *Shari'ah* board's practices. Currently, there are no specific standard guidelines for the *Shari'ah* board on the aspects of management, product approval, ex-ante and post-ante auditing. The practice is that there will be a *Shari'ah* secretariat or department to coordinate and handle *Shari'ah* matters. The officer in the *Shari'ah* department mostly handles clerical and office work pertaining to *Shari'ah* board matters such as compiling and handling documents which need to be presented during the *Shari'ah* board meetings.

Shari'ah boards normally meet on a weekly or monthly basis, depending on the needs of the individual IFI. Research conducted by Aboumouamer (1996) reveals that out of 41 *Shari'ah* boards, 10 (24.4%) have weekly meetings, three (7.3%) have monthly meetings, 20 (48.8%) have quarterly meetings and one (2.4%) has semi-annual meetings. The meetings vary from one *Shari'ah* board to another, and some may be attended by the chief executive officer, management, bank officer, legal officer, lawyer, and representatives from the IFI branches. The range of the attendees, however, depends on the *Shari'ah* issues involved.

During a *Shari'ah* board meeting, members discuss various *Shari'ah* issues including the concept and structure of new and existing products, documentations, operations and investment portfolios. The *Shari'ah* board members will receive all relevant documents from the respective IFI at least a week before the date of the meeting with a purpose of giving sufficient time for them to read and study the documents. Meetings are chaired by the chairman of the *Shari'ah* board, and decisions of the *Shari'ah* board are usually unanimous. Some of the *Shari'ah* boards allow deliberation to be made at least by a simple majority, and this happens mostly in the case of *sukuk* issuances by an international IFI (Ayub, 2007). Certain *Shari'ah* boards' practices require one of its members to be the administrative member. The administrative board member acts as a selection committee who has the authority to exercise discretion whether to convene a discussion on a specific issue or not (McMillen, 2006). Another practice grants power to the *Shari'ah* officer to decide on the matter. The determination of the *Shari'ah* board in the meeting will then be distributed to the relevant parties in the IFIs for reference, and they are bound to follow all of its decisions.

Shari'ah Coordination

Shari'ah coordination is vital to the *Shari'ah* governance system. The *Shari'ah* coordinator acts as a secretary or liaison officer who coordinates the *Shari'ah* governance process, including interaction with the *Shari'ah* board, the internal or external review unit and other organs of governance.

Shari'ah Compliance Review

Unlike conventional banks, IFIs are required to undertake *Shari'ah* review and internal *Shari'ah* review processes for the purpose of ensuring that all transactions are in conformity with *Shari'ah* principles. In a *Shari'ah* review, the *Shari'ah* board examines the extent of *Shari'ah* compliance of the IFI's products, activities and business transactions. The internal *Shari'ah* review process refers to the examination of the extent of *Shari'ah* compliance by an independent internal *Shari'ah* audit or part of the internal audit based on the *Shari'ah* rulings, guidelines and instructions issued by the *Shari'ah* board. The *Shari'ah* board is normally assisted by this internal audit unit to review the *Shari'ah* compliance aspects of the IFIs.

The AAOIFI governance standards have laid down several procedures for *Shari'ah* review; these include planning review procedures, executing review procedures, preparation and review of the working paper as well as procedures in documenting conclusions and preparation of the *Shari'ah* review report (AAOIFI, 2005). In actual practice, there is no standard format of *Shari'ah* review procedures or of the *Shari'ah* compliance report. The IFSB survey shows that more than 90% out of 69 IFIs undertook a *Shari'ah* compliance review (IFSB, 2008). The chief objective of a *Shari'ah* review is to ensure that the management of the IFI is discharging its responsibilities of complying with *Shari'ah* rules and principles as interpreted and decided by the *Shari'ah* board. The scope of a *Shari'ah* review is different from a normal auditing task as it specifically concerns the *Shari'ah* aspect and is guided by Islamic principles.

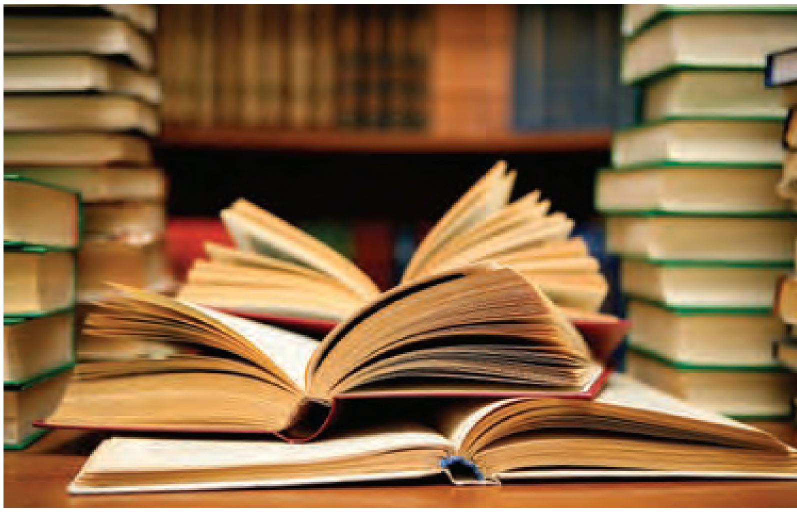
A *Shari'ah* review addresses *Shari'ah* compliance matters of products offered, and this process needs a sound *Shari'ah* internal control system. The *Shari'ah* review process requires the internal auditor to review every stage of the *Shari'ah* governance process, which includes conception of products, product design, product documentation, product testing, product implementation and product review. The *Shari'ah* review practice nevertheless indicates that the majority of IFIs are not involved in the review of the products and the systems (IFSB, 2008). In most IFIs, the *Shari'ah* review is carried out by the internal auditors either as part of their regular internal audit or as a separate unit of *Shari'ah* audit. Some IFIs have also adopted external review. The IFSB reports that 41% of IFIs adopted external review and 89% internal review (IFSB, 2008).

Shari'ah Report

Accountability is the fundamental concept of governance in *Shari'ah*, and hence requires IFIs to provide true disclosure and accurate necessary information.

Shari'ah governance favours fairness, true disclosure and transparency. The fundamental concept of governance in *Shari'ah* is accountability, which requires IFIs to make true disclosure and provide accurate necessary information. This is in line with the spirit of the *Qur'an* where Allah (s.w.t.) says "*O You who believe! When you deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing and let a scribe write down faithfully as between the parties*"

(*Al-Quran*, 2:282). This verse mandates and strongly encourages that any business dealing or transaction should be recorded and written down in a proper way. In the context of *Shari'ah* governance, it refers to the duty of the *Shari'ah* board to produce a *Shari'ah* report either periodically or annually.



The *Shari'ah* board is expected to prepare and issue a report on its activities, information on duties and services, *Shari'ah* pronouncements and declarations of *Shari'ah* compliance. As a general practice, the *Shari'ah* report will be submitted to the BOD. Some IFIs submit the *Shari'ah* report to the BOD and go even further to get endorsement of the shareholders. The practice shows that only 49% presented the *Shari'ah* report to shareholders for approval and 48% to the audit committee (IFSB, 2008). This position perhaps reflects the mode of appointment of the *Shari'ah* board either through the BOD or the AGM.

The content of the annual report of the *Shari'ah* board generally contains information on the duties and services rendered to the respective IFIs, such as *fatwa* issuance, the *Shari'ah* board's activities and its declaration on *Shari'ah* compliance (Banaga, et al, 1994). Haniffa & Hudaib's (2007) view is that the *Shari'ah* report should contain more than that; this includes names, pictures and remuneration of the *Shari'ah* board, number of meetings held, disclosure as to the defects in the products offered and recommendations to rectify the defects including actions taken by management, basis of examination of the documents, declaration of *Shari'ah* compliance and signatures of all *Shari'ah* board members.

In Malaysia, IFIs are required to submit the *Shari'ah* report in accordance with the format specified in the BNM/GP8-i. With the purpose of standardising the report, the BNM/GP8-i specifies the format and content of the *Shari'ah* report that puts minimum requirement of *Shari'ah* governance disclosure.

This practice indicates that most of the *Shari'ah* reports are concerned with product compliance rather than emphasising the efficiency of the internal *Shari'ah* control system (IFSB, 2008). The Draft Guideline for *Shari'ah* Compliance in Islamic Banking Institutions of Pakistan puts specific requirements on the *Shari'ah* report. These include the examination of all transactions, relevant documentation and procedures to observe whether the IFI has complied with *Shari'ah* rules and principles. It goes further to scrutinise whether the allocation of funds, profit-sharing ratios, profits and charging of losses are in accordance with *Shari'ah*, and to ensure that any earnings that have been realised from illegitimate sources have been credited to a charity account (State Bank of Pakistan, 2008). Furthermore, the AAOIFI Governance Standard requires individual IFIs to provide their *Shari'ah* report according to specific format guidelines.

In practice, the format and contents of the *Shari'ah* reports are different; some *Shari'ah* boards do not even submit their annual reports to the AGM. A survey conducted by Grais & Pellegrini (2006) found that four out of 13 institutions offering Islamic

financial services failed to issue *Shari'ah* reports. Another research carried out by Maali, et al. (2003) discovered that from a sample of 29 banks out of 88 IFIs identified (59 banks failed to respond), only 21 banks (72%) provided the report to the *Shari'ah* board. The *Shari'ah* report is important because it serves as an endorsement of the IFI's compliance with *Shari'ah* principles. It is considered as a crucial means by which the general public and interested parties can find information as to what extent services and products of the IFIs meet *Shari'ah* requirements. For this reason, the *Shari'ah* board shall issue the *Shari'ah* report annually in accordance with the specific format laid down by the AAOIFI Governance Standard.

Section 2 of the AAOIFI Governance Standard No. 5 defines independence as "an attitude of mind which does not allow the view points and conclusions of its possessor to become reliant on or subordinate to the influences and pressures of conflicting interests. It is achieved through organisational status and objectivity". Meanwhile, the IFSB-10 explains the independence of the *Shari'ah* board as the ability to exercise sound judgement after fair consideration of all relevant information and views without influence from management or inappropriate outside interests.

There are two types of independence, i.e., practitioner independence and professional independence whereby the former is important to maintain proper attitude of planning, performance, and report in conducting audit and the latter to avoid any appearance which reduces the independence of the auditors (Mautz and Sharaf, 1961). The *Shari'ah* governance system is more concerned towards professional independence as it involves public perception and stakeholders' confidence in the IFIs.

Shari'ah Governance Issues

Independence of *Shari'ah* Board

The debate on the issue of *Shari'ah* board independence has been going on for a long time. One of the reasons is that *Shari'ah* board members receive remuneration from the IFIs and there exists a potential conflict of interest in the incentive to legitimise unlawful or dubious operations in order to remain on the *Shari'ah* board (Rammal, 2006). Even though such an assumption is not truly accurate as the *Shari'ah* board members are expected to be guided by moral belief and religious values (Karim, 1990), there is still a need for a proper framework in the form of policy or regulation because the credibility of IFIs depends on the perceived independence of the *Shari'ah* board. In fact, with the tremendous growth of the Islamic finance industry, the number of conflicting *fatwas* is likely to increase. In this regard, it is imperative to examine the method of appointment of the *Shari'ah* board.

The International Association of Islamic Banks (IAIB) document by El-Nagar (1980) mentions that in order to ensure freedom and independence, *Shari'ah* board members must not be working as personnel in the bank and must not be subject to the authority of the BOD (Rammal, 2006). In addition, the AAOIFI standard provides that shareholders have the authority to appoint members of the *Shari'ah* board at the AGM and not the BOD. This is practised in Kuwait where Article 93 of the CBK (Central Bank of Kuwait) Law requires all IFIs to establish an independent *Shari'ah* board which shall be appointed during the bank's AGM. This is to ensure the independence of the *Shari'ah* board because the management does not have the power to appoint or dismiss any member of the board; that authority is vested in the shareholders during the AGM. In the case of an appointment made by the shareholders during the AGM with recommendation by the BOD, the *Shari'ah* board is allowed to attend the BOD meetings to discuss the religious aspects of their decisions (Abu Ghudda & Abdul Sattar, 2001). According to a survey by Aboumouamer (1996), based on a sample of 41 *Shari'ah* board members, most of them felt that the board's authority was derived from the shareholders (75%) and their relationships with the management and directors were related only to coordination and advisory roles. Another research carried out by the International Institute of Islamic Thought in 1996 seems to demonstrate a different scenario; it found that almost 80% of the appointments of the *Shari'ah* boards were done by the BODs, and a survey by Hasan in the same year also discovered that only 39% were made by shareholders during the AGM (Bakar, 2002). These three surveys establish that the practice of the appointment of the *Shari'ah* board is in actual fact different amongst the IFIs and contrary to the assumption that the board's independence can only be guaranteed if the appointment is made by shareholders during the AGM.

The notion that the independence of the *Shari'ah* board can be assured by having its members appointed by the shareholders during the AGM is not truly convincing. Even if the appointment is made during the AGM, the BOD may still influence the shareholders in the process of selecting the *Shari'ah* board members. In lieu of this, it is worth mentioning suggestions by Grais & Pellegrini (2006) who offer three possible approaches to resolve the issue of *Shari'ah* board independence. The approaches focus on the issue of power and authority. They call for a clear definition of the responsibilities and powers of the board in the articles of association, granting it sufficient powers and proper organisational status regarding audit responsibilities and providing it adequate authority, like that enjoyed by the independent directors in the audit committee.

Competency and Conflict of Interest

According to a survey on Islamic banking practices in terms of the qualifications of the *Shari'ah* board members, 76.6% of the members have training and qualifications, 8.6% were well-versed in both *Shari'ah* and commercial law and only 11.4% have expertise in *Shari'ah*, law and economics (Bakar, 2002). This position may affect the effectiveness of the *Shari'ah* board's roles, particularly in providing solid and concrete *Shari'ah* rulings as they must have necessary professional knowledge and training besides expertise in *Shari'ah*.

Principle 1.2 of the IFSB-10 requires the *Shari'ah* board to have clear terms of reference regarding its mandate and responsibility, well-defined operating procedures and lines of reporting and good understanding of, and familiarity with, professional ethics and conduct.

Case Study 2

The absence of restrictions on multiple appointments of *Shari'ah* board members may also contribute to a shortage of qualified *Shari'ah* scholars. According to a survey titled *Shari'ah* Network in GCC – A Network Analytic Perspective conducted by Funds@Work, it found that from 94 scholars who sat on the board of 467 IFIs, only 20 of them were heavily utilised; the 20 held 339 board positions, which equals an average of 17 board positions per scholar.

Unal (2009) listed the world's top ten *Shari'ah* scholars; it reported that Sheikh Nizam Muhammad Saleh Yaqubi held 77 memberships worldwide; followed by Sheikh Abdul Sattar Abu Ghuddah, 72; Sheikh Muhammad Ali Elgari, 65; Sheikh Abdullah Sulaiman Al Manea and Sheikh Abdul Aziz Khalifa Al Qassar, both 37; Sheikh Mohamd Daud Bakar, 36; Sheikh Hussain Hamid Hassan, 29; Sheikh Essa Zaki Essa, 23; Sheikh Ajeel Jasim Al Nashmi, 24; and Sheikh Ali Mohyuldin Al Qarradaghi, 24. These ten *Shari'ah* scholars represent 58.21% out of 956 *Shari'ah* board positions in 271 organisations in 22 countries.

This position may seriously negate public confidence in the *Shari'ah* board's credibility, and there is even an allegation of *Shari'ah* arbitrage practised by some *Shari'ah* scholars.[14] The reason for the lack of experts, i.e., experienced and competent *Shari'ah* scholars should not be the everlasting justification of employing the same scholars in numerous *Shari'ah* boards.

For many years, numerous *Shari'ah* scholars have enjoyed the right to sit on different *Shari'ah* boards without any sort of restrictions, such as in the case of Saudi Arabia, Kuwait, Bahrain, the UAE and Qatar. In fact, existing practices in many countries show that there is no restriction on the number of IFIs that members of the *Shari'ah* board can advise. This situation creates a negative perception of the *Shari'ah* board as it raises the issue of conflict of interest, confidentiality, and efficiency: how much time can one person devote to the affairs of 20 or more institutions?

It is a necessity to have legal provisions that state clearly the restrictions of sitting in more than one *Shari'ah* board of IFIs at any particular time to avoid any issues or perception of conflict of interest.

In order to avoid any issues or perception of conflict of interest, it is necessary to have legal provision that clearly restricts sitting on the *Shari'ah* board of more than one IFI at any particular time. For instance, Section 19 of the BNM/GPS1 provides that IFIs are not allowed to appoint any person currently sitting on the *Shari'ah* board of

14 El Gamal (2006, p. 175) explains *Shari'ah* arbitrage as an act of "identifying a captive market, with religious injunctions that forbid a given set of financial products and services, and synthesising those products and services from variations on those pre-modern nominate contract". *Shari'ah* arbitrage increases transaction costs in which justifying high related fees and excessive profit rate are charged by IFIs.

another IFI of the same industry. Besides avoiding any element of conflict of interest, this requirement is also important in guaranteeing secrecy and confidential matters and serves to stimulate further *Shari'ah* research by allowing more potential *Shari'ah* scholars to be directly involved in the Islamic financial sector. This policy also ensures full-time availability of the *Shari'ah* board to guide and monitor Islamic banks more effectively. In parallel with the rapid expansion of the Islamic finance industry and the increasing numbers of *Shari'ah* boards, the issues of competency of *Shari'ah* advisors and conflict of interest may be solved by having a legal framework pertaining to their qualifications and restrictions on their service in multiple IFIs.

Disclosure, Transparency and Consistency

The crucial elements of the *Shari'ah* governance system are disclosure and transparency.[15] Transparency is of utmost importance for IFIs so as to comply with *Shari'ah* as the *Qur'an* specifically forbids concealing evidence. Allah (s.w.t.) says *"And if you are on a journey and cannot find a scribe, then a security deposit [should be] taken. And if one of you entrusts another, then let him who is entrusted discharge his trust [faithfully] and let him fear Allah, his Lord. And do not conceal testimony, for whoever conceals it – his heart is indeed sinful, and Allah is Knowing of what you do." (Al-Qur'an,* 2:283). According to the IFSB, IFIs must ensure that the reporting of their financial and non financial information meets the requirements laid down by internationally recognised accounting codes in compliance with *Shari'ah* principles applicable to the Islamic financial services industry as recognised by the supervisory authorities of the relevant country (IFSB, 2006). The disclosure of all information relating to *Shari'ah* advisory services would promote confidence of the public and stakeholders in the credibility of IFIs. The various *Shari'ah* governance practices demonstrate that disclosure of information is very minimal; even information on the *Shari'ah* resolutions are hardly available for public viewing.

> Transparency is of utmost importance for IFIs so as to comply with *Shari'ah* as the *Qur'an* specifically forbids concealing evidence.

> The disclosure of all information relating to *Shari'ah* advisory services would promote confidence of the public and stakeholders in the credibility of IFIs.

A survey conducted by Grais and Pellegrini (2006) and Maali, et al. (2003) indicates shortcomings and weaknesses of the current disclosure of information practice, particularly the *Shari'ah* report. Numerous IFIs still neglect the requirement of a *Shari'ah* report even though it is very important as an endorsement of compliance with *Shari'ah* principles and is considered a crucial means by which the general public and interested parties find information as to what the extent services and products of the IFIs meet *Shari'ah* requirements. The ideal *Shari'ah* governance system must then be able to address the issue of disclosure and transparency.

15 Iqbal and Mirakhor (2007, p. 291) refer to disclosure as "the process and methodology of providing information and making policy decisions known through timely dissemination and openness" and transparency as "the principle of creating an environment where information on existing conditions, decisions and actions is made accessible, visible and understandable by all market participants".

In view of the diversity in practices of Islamic finance in different jurisdictions, the likelihood of conflicting *fatwas* is relatively high. This may undermine the stakeholders' confidence in the industry. The IFSB survey indicates a low percentage of differences of *Shari'ah* resolutions have been resolved. Bahrain, Bangladesh, Indonesia and Sudan indicate less than 20%, UAE, slightly more than 20% and Malaysia, 40% (IFSB, 2008). This crucial finding denotes that most of the issues of *Shari'ah* differences have not been reconciled in many countries. The diversity of the interpretation of *Shari'ah* may also affect the determination of certain rulings on a particular issue, where one IFI would accept a new product as being *Shari'ah*-compliant while others would decide it to be non-compliant (Mcmillen, 2006).

> The diversity of interpretation of *Shari'ah* may also affect the determination of certain rulings on a particular issue, where one IFI would accept a new product as being *Shari'ah*-compliant while others would decide it to be noncompliant.

To tackle this issue, there are a few possible approaches; these include establishing a *Shari'ah* board at the national level, providing legal provision on the final authority of the *Shari'ah* board's rulings, allowing interdisciplinary experts to be appointed as *Shari'ah* board members, and issuing universal *Shari'ah* prudential standards. In the case of conflict of opinions amongst members of the *Shari'ah* boards in Kuwait, the BODs of the designated IFIs may transfer the matter to the "*Fatwa* Board" in the Ministry of Awqaf and Islamic Affairs and the *Fatwa* Board shall be the final authority on the matter (Article 93 of the CBK Law 32/1968). Similarly in Malaysia, the Central Bank of Malaysia Act 2009 grants power to the SAC as the sole *Shari'ah* authority, which shall be referred to by the court or arbitrator in disputes involving *Shari'ah* issues in Islamic banking, finance and *takaful* cases.

Case Study 3

The General Council for Islamic Banks and Financial Institutions (CIBAFI) reported that out of 6,000 *fatwas* issued by different IFIs with over 100 *Shari'ah* scholars, only 10% were not consistent across IFIs (Iqbal & Mirakhor, 2007). Although this figure tends to show that consistency is at an acceptable level, it is expected that more inconsistencies are likely to manifest in the future when the Islamic finance industry further expands.

Legal Status of the *Shari'ah* Pronouncement

One of the debatable issues on *Shari'ah* governance is the status of *Shari'ah* rulings; i.e., are they binding on IFIs, the courts or any other related institutions? To illustrate this important issue, we refer to a survey conducted on the perception of *Shari'ah* rulings; only 56.6% of the IFIs consider the *Shari'ah* rulings to be binding, 20% see them as merely advisory and 22.4% gave no response (Dawud, 1996). The result of this survey indicates that there are loopholes and shortcomings in the *Shari'ah* governance framework, particularly in positioning the *Shari'ah* board's decision as binding and mandatory. Ironically, the IFSB survey on *Shari'ah* boards across jurisdictions demonstrates that although 60% of the respondents agreed that the national *Shari'ah* authority should be the highest authority in Islamic finance, few jurisdictions have affirmed this practice (IFSB, 2008).

With reference to the existing *Shari'ah* governance framework in some countries, they have already provided a clear legal provision on the superiority of the *Shari'ah* board's decisions. This is in parallel with the AAOIFI Governance Standard, which stresses that *fatwas* issued by the *Shari'ah* board shall be binding and fully enforceable (AAOIFI, 2005).

In Malaysia, the Central Bank of Malaysia Act 2009 clearly states that *Shari'ah* rulings are binding for both courts and arbitration. Similarly, in the case of the UAE, Article 5 of the Federal Law No. (6) 1985 provides for the establishment of a "higher *Shari'ah* authority", which shall be accorded the final authority in *Shari'ah* matters in Islamic banking and finance. All decisions made by the higher *Shari'ah* authority shall be binding and mandatory upon all IFIs in the UAE. While the legal frameworks of Malaysia and the UAE have provided a clear position on rulings made by the *Shari'ah* board, the situation is different in other jurisdictions, such as the UK, Saudi Arabia, Kuwait, Qatar and Bahrain, as the status of *Shari'ah* pronouncements is still ambiguous.

In this respect, there must be a practical solution to resolve the issue by examining and studying the UAE's and Malaysia's legal environment and structure.[16] Proactive efforts and continual endeavours should be carried out in placing *Shari'ah* as the supreme law by ensuring that the *Shari'ah* boards' decisions are binding and mandatory upon the IFIs, the arbitrators and the courts of justice.

Proactive efforts and continuous endeavours should be carried out in placing *Shari'ah* as the supreme law by ensuring that the *Shari'ah* boards' decisions are binding and mandatory upon the IFIs, the arbitrators and the courts of justice.

The cases in Table 16.8 illustrate the significance of *Shari'ah* noncompliance risk due to weak *Shari'ah* governance practice and framework.

16 It is worth noting the recommendations of the Council of the Islamic *Fiqh* Academy for the purpose of *Shari'ah* enforcement in its Fifth Meeting in Kuwait in 1988. The Council provides five recommendations to solve the problem of enforcing the *Shari'ah* rules, namely, to continuously conduct thorough and comprehensive research relating to the issue of *Shari'ah* enforcement, to ensure coordination between the Council and other academic institutions entrusted with the enforcement of *Shari'ah* rules, to collect bills relating to Islamic law from Islamic countries and to benefit from them, to urge for the reform of education programmes and various means of communication in order to mobilise them towards the enforcement of *Shari'ah* and to widen the training grounds of research in order to prepare human resources for the application of *Shari'ah* (IFA and IRTI, 2000, pp. 96–97).

Case Study 4

The *Shari'ah* governance system is a control mechanism to address a specific type of risk exclusive to IFIs, namely *Shari'ah* noncompliance risk. These include *fatwa* rejection and differences, risks due to non-standard practices of Islamic financial products, and the risks due to noncompliance with *Shari'ah*. Failure to provide a comprehensive and appropriate *Shari'ah* governance system may potentially expose the IFIs to significant *Shari'ah* noncompliance risk. The importance of having an appropriate *Shari'ah* governance system can be simply illustrated by referring to the disputes involving Investment Dar v Blom Development Bank, the judgement on the BBA financing facility, the closure of Kleinwort Benson, the controversial rulings on *tawarruq*, the statement that 85% of *sukuk* are *Shariah* noncompliant and Bank of Credit and Commerce International's (BCCI's) misuse of Islamic funds. This is summarised in Table 16.7.

Table 16.7 Corporate Difficulties of IFIs due to *Shari'ah* Governance Issues

Case	*Shari'ah* Governance Issues
The Investment Dar Company KSCC v Blom Developments Bank Sal (2009) EWHC 3545 (Ch).	In this case, Investment Dar refused to pay the expected profit and to return the principal amount of *wakalah*-based deposit in the amount of US$10 million. Investment Dar claimed that the *wakalah*-based deposit did not comply with *Shari'ah* and therefore should be considered void. This case is a timely reminder to IFIs about the essence of a *Shari'ah*-compliant product via the mechanism of *Shari'ah* governance.
Judgement on BBA.[17]	The High Court decreed that the profit derived from a BBA facility is unlawful and rendered the transaction null and void. This decision will notably affect IFIs in Malaysia since the judgement obviously declared that defaulters in BBA facility were only liable for the original facility amount and not the selling price.
Kleinwort Benson.	Iqbal (2002) mentions that one of the factors of the failure of Kleinwort Benson, the first investment bank to introduce an Islamic unit trust in 1986 was due to investors' reservations about the absence of a *Shari'ah* board. This indicates the importance of establishing *Shari'ah* boards in IFIs for the sake of gaining the confidence of investors and the general public as well as to ensure *Shari'ah* compliance.
The OIC *Fiqh* Academy declaration on impermissibility of *tawarruq*.	The Islamic *Fiqh* Academy of the OIC issued the final resolution on *tawarruq* at the 19th meeting in Sharjah, UAE on 26–30 April 2009 which confirmed its impermissibility.
Sales of *sukuk* dropped 50% in 2008 and prices fell at an average of 1.51% (Kettel, 2008). According to Bloomberg, sales of global *sukuk* had dropped to US$856 million in 2008 (Sobri, 2008).	Despite other factors that affect *sukuk* issuance worldwide, undeniably, the statement by Sheikh Muhammad Taqi Usmani that 85% of *sukuk* in the Gulf are *Shari'ah* non-compliant has affected, in some way, the public's confidence in the legitimacy and Islamicity of *sukuk*.
BCCI used funds from *Shari'ah* non-compliant transactions and activities.	Due to a weak supervision on *Shari'ah* governance, it was found that BCCI misplaced funds obtained from Islamic banks into a *Shari'ah* non-compliant portfolio (Grais and Pellegrini, 2006).

The need to have an effective *Shari'ah* governance to strengthen the credibility of IFIs is crucial. Such *Shari'ah* governance framework must be able to address various issues pertinent to the foregoing discussion. In this regard, the need for standard guidelines to promote best practices of *Shari'ah* governance is very necessary. The AAOIFI Governance Standards and the IFSB Guiding Principles are very important for the purpose of standardising *Shari'ah* practices to ensure that the Islamic finance industry will be on par with a global *Shari'ah* standard. The standards are expected to effectively resolve many issues, particularly in the aspect of the *Shari'ah* governance process.

17 See *Tinta Press Sdn Bhd v BIMB* (1987) 1 MLJ 474; 1 CLJ 474, *Bank Islam Malaysia Berhad v Adnan Omar* [1994] 3 CLJ 735; [1994] 3 AMR 44, *Dato' Nik Mahmud Bin Daud v Bank Islam Malaysia Berhad* [1996] 4 MLJ 295, *Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporation Sdn Bhd* (2003) 2 MLJ 408; 1 CLJ 625, *Bank Islam Malaysia Bhd v Pasaraya Peladang Sdn Bhd* [2004] 7 MLJ 355, *Arab Malaysian Merchant Bank Berhad v Silver Concept Sdn Bhd* [2005] 5 MLJ 210, *Malayan Banking Bhd v Marilyn Ho Siok Lin* [2006] 7 MLJ 249; 3 CLJ 796, *Affin Bank Bhd v Zulkifli Abdullah* (2006) 1 CLJ 447, *Malayan Banking Bhd v Ya'kup bin Oje & Anor* [2007] 6 MLJ 389, *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)* [2008] 5 MLJ 631 and Arab-Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd [2008] 6 MLJ 295.

Summary

1 It is worth mentioning that this chapter does not intend to discuss in detail every single issue of corporate and *Shari'ah* governance in IFIs. The design of the corporate governance model in Islam has its own unique features and presents distinctive characteristics in comparison with the Western concept of the Anglo-Saxon and the European models. This chapter summarises the diversities of these three models and classifies them into four aspects, namely, the episteme, the corporate objective, the nature of management and the management board and the capital-related ownership structure. As a whole, the basis of the corporate governance model in Islam refers to its epistemological *Tawhid* and *shuratic* processes that denote the elements of a stakeholder-oriented approach.

2 As part of the corporate governance framework in IFIs, *Shari'ah* governance adds value to the existing corporate governance framework. It inculcates transparency, trust and credibility based upon underlying faith (*aqidah*), the laws of the *Shari'ah* and ethics (*akhlaq*) (Nathan & Ribieri, 2007). The institution of the *Shari'ah* board plays a central role as the chief organ of governance for the purpose of *Shari'ah* compliance. The need to have effective *Shari'ah* governance is essential to the credibility of IFIs. Failure to provide efficient *Shari'ah* governance would inevitably lead to serious disruptions in the market, which would have dire consequences for the Islamic finance industry. Such a *Shari'ah* governance framework must be able to address the various issues pertinent to the foregoing discussion.

3 The AAOIFI Governance Standards and the IFSB Guiding Principles are very important for the purpose of ensuring standardisation of *Shari'ah* practices. The standards and guidelines are expected to effectively resolve many issues, particularly in the aspect of the *Shari'ah* governance process. Referring to the diverse perceptions and acceptance of the AAOIFI and the IFSB standards by IFIs around the world, there must be strong mechanisms in place to ensure their universal adoption; one of them is through having a proper legal framework. For this purpose, thorough and intensive studies need to be conducted to examine, analyse and scrutinise the possible adaptation of the AAOIFI and IFSB standards in various markets and environments.

Key Terms and Concepts

Falah
Hisbah
Muhtasib
Shari'ah-compliant
Tawhid
Corporate Governance
Ijtihad
Shari'ah Board
Shari'ah Governance
Due Diligence
Limited Liability
Shari'ah Advisor
Shari'ah Scholar

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Review Questions and Problems

1 Explain the meaning of corporate and *Shari'ah* governance in IFIs.

2 What are the differences between the Western and Islamic perspectives on corporate governance?

3 How are the interests of investment account holders treated in IFIs?

4 What are the roles and functions of the *Shari'ah* board?

5 What are the criteria that should be used when appointing *Shari'ah* board members?

6 What are the advantages and disadvantages of central banks and other regulatory bodies having their own *Shari'ah* boards?

Chapter 17

The Legal Framework for Islamic Finance

Preview

This chapter discusses the different approaches to the legal framework in Islamic finance including its evolution, key legal systems, concepts and areas. It provides an overview of the legal frameworks applicable to Islamic financial services in different jurisdictions and their underlying rationale. Furthermore, it highlights the legal systems around the world, which carry different sets of laws and rules where, Islamic finance operates. This chapter also elaborates the legal issues and challenges facing the industry.

In addition, the chapter stresses the role of the legal framework that lies in safeguarding the public's interest in the Islamic finance sector, which includes empowering the relevant authorities with appropriate mandates and powers, disciplining Islamic financial institutions through enforcement and sanctions, as well as administering justice through effective dispute resolution. The complexity and richness of legal concepts such as "jurisdictions", "jurisprudence", "evidence", "precedents", "procedures" and "binding decisions", which all have an impact on the enforcement of Islamic financial contracts and the law itself, are elaborated.

In any jurisdiction where Islamic finance is present, some form of "law" is always applicable but the effectiveness of such law depends upon the seamless interaction between the different laws and the subjects of the law, namely people and institutions.

Learning Outcomes

At the end of this chapter, you should be able to:

- Understand what a legal framework is and differentiate it from a legal system.
- Distinguish the various divisions in law, namely substantive law and procedural law, which influence the behaviour and practice of Islamic financial services.
- Comprehend the development of the legal framework for Islamic finance in different countries.
- Identify the various factors that influence the development of various legal frameworks governing the Islamic financial system.
- Appreciate the various challenges in developing an effective and comprehensive legal framework to govern the function of, and operation in, Islamic finance.

Conceptual Meaning of a Legal Framework

Every independent country in the world is recognised for its sovereignty, and therefore is free to decide what legal system, legal institutions and laws to establish or adopt. In this section, we will first learn the conceptual meaning of "legal framework". We then learn the various legal systems that exist around the world and how these characterise the features of the legal framework for Islamic finance in the respective countries. We will also study the rationale and justifications behind the adoption of certain approaches by some countries in developing their domestic legal framework for the Islamic finance industry. Therefore, this chapter will consist of the following:

- Meaning of legal framework
- World legal systems
- Approaches of legal systems
- Legal issues and challenges in Islamic finance
- Common clauses in financial contracts

It is important to note that for the greater part of Islamic history, which transcends over 1,400 years, classical Islamic jurisprudence was developed mainly by scholars and jurists through scholarly work and court records. In the early part of Islamic history, the state never proactively codified Islamic jurisprudence into a written law, whether in the form of statutes, codes or regulations. Ironically, the first written constitution in the world, *As-Sahifah Al-Madinah* (the Charter of Madinah) exemplifies how the Holy Prophet Muhammad (peace be upon him) himself promulgated a law, in arguably, a codified manner.

A truly coherent attempt to codify Islamic jurisprudence was undertaken in the 19th century with the publication of *Majallah Al-Ahkam Al-'Adliyyah*[1] during the Ottoman Empire. However, after the demise of this empire, many Islamic states were colonised by Western powers which introduced their own legal systems, primarily either the French Civil Law System or the English Common Law System which largely still exists until today. As we can see later in this chapter, although each system is similar in having the essential components of a state, which are the legislature, the executive and the judiciary, they differ in certain aspects such as the sources of law, the substantive

1 It is a Code of Islamic Civil Law containing rules of *Shari'ah* under the Hanafi Madhhab in matters pertaining to Islamic *mu'amalat*. It was prepared by a committee of Ottoman Hanafi scholars from 1869 to 1888 and was published between 1870 and 1877. It was codified as law in the Ottoman Empire.

law itself and to a certain extent, the procedural law, such as the adjudication process in the courts (either adversarial or inquisitorial). These differences in the legal systems of jurisdictions will determine their approaches in determining the legal frameworks to be adopted for Islamic finance.

Hence, it can be said that the historical development of the legal framework for contemporary Islamic finance is as young and nascent as the industry itself, leaving plenty of room for much needed scholarly works on the legal framework for Islamic finance. It goes without saying that the industry is also very much dependent on lawmakers to have the appropriate vision and political will in formulating the best enabling legal environment for Islamic finance.

In any jurisdiction where Islamic finance operates, some form of "law" exists and would be applicable, but the effectiveness of such law regarding Islamic finance would depend upon the seamless interaction between different laws and the subjects of the law, namely people and institutions. A "legal framework" basically refers to this interaction.

By way of analogy, in order to cook a nice meal, we need the right ingredients and a recipe. Hence, to create a sound and vibrant Islamic finance industry, we need "law" as ingredients and an effective "legal framework" as the recipe. The final output would only be satisfactory if the cook has the correct ingredients and knows how to use the recipe.

Before we discuss the approaches that have been adopted by various jurisdictions in determining their legal framework for Islamic finance, it is necessary to discuss first, as a background, the different characteristics of major legal systems of the world and later, how these determine the outcome in framing the legal framework for Islamic finance.

Legal Systems in which Islamic Finance Operates

A legal system means a system that is used to interpret and enforce the law. It is a system of law adopted by a jurisdiction, such as a common law system or a civil law system, within which a few legal frameworks operate for a specific area of law, such as legal framework for land or real property administration, legal framework for commerce and trade, legal framework for regulation and supervision of banking and finance and so on. It is widely acknowledged that the three main legal systems applied around the world today are the civil law systems, common law systems, and the *Shari'ah* (Islamic law) systems – note that the plural use of "systems" here is deliberate, as in reality,

A legal system is a system that is used to interpret and enforce the law.

each of the systems have further distinctions and divergence in the frameworks and practices between one country and another.

There used to be a fourth, namely the socialist legal systems, which obviously were prevalent in socialist/communist countries, but with the collapse of socialism/communism since the 1990s, such legal systems are no longer considered dominant.

Civil Law Systems

Also known by other names such as **Roman law**, **Continental law** or **Napoleonic law**, the civil law systems refer to a system whereby laws are legislated by parliament or some other form of representative government and codified (i.e., brought together). They are distinguished from common law mainly because they come from parliaments, not from court cases. Indeed, in the civil code systems, the courts do not usually have as much freedom to interpret laws. In the original Napoleonic courts, judges were specifically banned from interpreting statute laws. The underlying principle of civil code systems is that the laws applied to citizens are made by citizens through their political representatives. Judges are there to administer laws, not make them.

The three main world legal systems are the civil law, common law and the *Shari'ah*.

Laws are "codified", which means laws of a similar nature are bundled together to create a rational system across a common area. Advanced societies try to ensure that all laws have consistent principles and interact with each other in a logical way without conflict between laws. In complex societies, codified laws are vast and detailed. Critics say this means they are hard to change but proponents argue they give certainty and predictability.

Civil code systems are mainly "inquisitorial" rather than adversarial – this means courts are there to track down the truth, not to be a forum where two sides battle to demonstrate to a judge or jury who is right and who is wrong. Judges in civil code trials are usually more active in questioning witnesses, challenging evidence and in some cases, even directing investigations. This is quite different from common law trials where the judge is supposed to be impartial.

Common Law Systems

This system is developed from a set of traditional laws first brought together in England around the 12th century. The name derives from the fact that it was one set of laws "common" to the whole kingdom, rather than different sets of laws used by individual communities or tribes.

One of the distinguishing features of common law is, it is developed through usage rather than being imposed by codified legislation as with the civil code system.

Legislation means laws, sometimes also called *statutes*, that are made by a representative body such as a parliament. *Codification* is when individual laws of a similar nature are bundled together under one new, overarching law.

Common law was developed based on the outcomes of individual court cases. Each court case provides a basis for judging the next case of a similar nature. Over the centuries and after millions of court cases, this process led to a body of laws which cover most aspects of society and are based on the principles shared by society in general.

There are several core principles which guide common law, though they are not necessarily unique to it. These include:

Common law is the legal system practice in England and many other English speaking countries, especially those that were former British colonies, including Brunei, Malaysia and India.

1 The concept of "binding precedent", where a decision of the higher courts on the same matter binds the lower courts unless overridden by the higher court or by a specific legislation. Hence, the courts not only have to determine the facts in a case but they also have to argue all the relevant legal precedents set by previous courts making decisions on similar matters. Both the prosecution and the defence lawyers present not only evidence of the events but also evidence on how these previous cases were resolved. Judges and juries too, are expected to consider not only the facts of the current case but also the arguments of previous cases. For this reason, judgement in common law cases are often long and involved. This is so that future lawyers, juries and judges can see how a verdict was reached when considering their own cases. Traditionally, these lengthy and intricate judgements were printed in "law reports" or journals.

The core principles of common law are:

- Binding precedent
- Adversarial
- Case law

2 It is adversarial, which means that parties involved in any dispute have the chance to present their arguments equally before a neutral umpire for a decision. Depending on the court, these neutral umpires can be judges, juries, magistrates or chairs of tribunals, in some cases a combination of these. The judge, or jury, is expected to hear all the evidence presented by each side, together with legal arguments, and make a decision on who has the strongest case. If one side does not like the outcome, they may ask the court for "leave to appeal" to a higher court, where the main points of the case are argued again in front of a new judge or a group of judges sitting as a **bench**. This adversarial system can go all the way to the highest court in the land if the matter is important enough or involves significant constitutional matters. The highest court's decision is usually final, unless new evidence resurfaces in later years which convinces them to reopen the case.

3 Case law coexists with statute law and, in most cases, a constitution. Following the "case law" aforementioned, judges interpret the constitution and statutes (i.e., parliament-made laws) where they are unclear. Of course, the constitution of a country is the paramount law and judges are not able to change its basic provisions. But even with the constitution, they can interpret how it is applied in real life. In strong democracies, judges have a role in interpreting laws as they interact with each other. For example, a court may decide that the legislation passed by a parliament is unlawful because it clashes with more important constitutional rights. Such cases are usually eventually determined by the highest court in the nation or state, such as a high court or a supreme court. If these courts decide a statute is unconstitutional, parliament will normally amend it, otherwise it cannot be successfully applied. The ability for judges to interpret statute law against a background of common law means the legislation does not have to state every possible circumstance. It can state the general principles and set limits (for example on the maximum amount an offender can be fined) and leave the rest for the courts to determine in line with other statute laws and common law precedents. Opponents of common law say this gives too much power to judges, whereas its supporters see this ability to interpret legal statutes in real-life situations as a major strength. As in many things to do with common law, or any law for that matter, the quality of judges and other people in the legal system such as lawyers and the police, determine how successfully the system will work.

Shari'ah (Islamic Law) Systems

The *Shari'ah* is a set of norms, values and laws on the way of life. It is based on the *Qur'an* and *Sunnah*.

As discussed in Chapter 5, the *Shari'ah* is based on the *Qur'an* and the *Sunnah*, supplemented by interpretations over the centuries by Muslim scholars and jurists. It provides rules on how practising Muslims should live their lives. *Shari'ah* literally means "path to a watering place". Technically, it means a path to tread for guidance in this world, commands, prohibitions and values prescribed by Allah (subhanahu wa ta'ala) for His servants either through the *Qur'an* or the *Sunnah* [the teachings of the Prophet Muhammad (p.b.u.h.)]. Normally, *Shari'ah* is described as the "Islamic law". But the boundaries of *Shari'ah* extend beyond the limited horizons of law. *Shari'ah* is a set of norms, values and laws that make up the Islamic way of life. *Shari'ah* is universal, complete and applicable in all times unlike the common law and civil code law that are still evolving.

With the introduction of modern concepts such as central banking, commercial and investment banking, and securitisation, the imminence of the legal importation into the *Shari'ah* system and vice-versa cannot be over emphasised.

The Spread of Different Legal Systems

Figure 17.1 below illustrates the general spread of legal systems around the world.

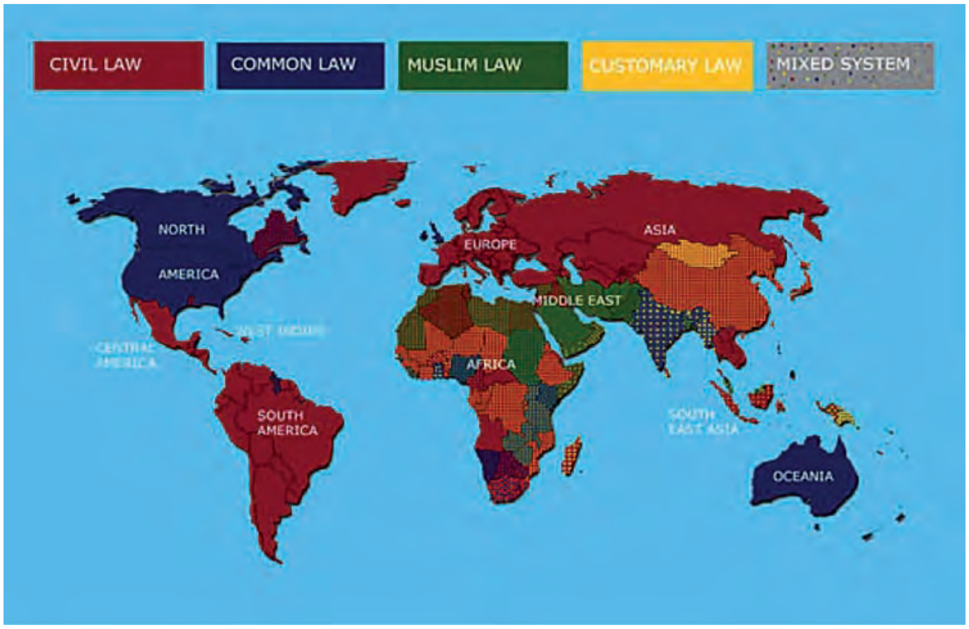


Figure 17.1 World Legal Systems

Source: JuriGlobe (http://www.juriglobe.ca/eng/index.php).

English Common Law is the most common legal system in the world, not only because it applies to the largest slice of the world's population but also because it is used in 27% of the 320 legal jurisdictions in the world. The use of English Common Law is widespread because it was dispersed across the globe during the growth of the British Empire. Since then, the British former colonies have decided to continue using the English Common Law system and it still remains the legal system for increasingly important economies such as Australia, India, Hong Kong and Singapore. The UK law firms are some of the largest in the world, and many international contracts (including Islamic financial contracts) are drafted using English law. In fact, several disputes arising from Islamic commercial and financial contracts have already been heard and decided in English courts (see for e.g., the section titled "Status and Enforceability of *Shari'ah* Pronouncements").

Wood further observes that Napoleonic law, which is used in countries such as Brazil as well as France, applies to the largest share of the world's land mass (34%). As aforementioned, the French Civil Law system is originally based on the codification of the French law under Napoleon, which was spread by the French Empire and by emulation. Egypt is one example of a country that kept the Napoleonic law after it was occupied by the French following the Napoleonic Wars. Some countries, particularly in Latin America, adopted Napoleonic law because the code was the most advanced contemporary model to borrow from at the time they were looking to formalise a legal system. The Napoleonic law covers 23% of the world's population, and these jurisdictions further represent 23% of the world's Gross Domestic Product (GDP).[2] Another civil law system widely adopted is the Roman-Germanic Legal System, which comprises 10% of jurisdictions and covers 11% of the world's population. These jurisdictions represent 19% of the world's GDP. Some countries chose to adopt the Roman-Germanic law because they thought it was a superior system in comparison to other legal groups, and also because as a codified system, it is easy for another country to copy.

The mixed Civil/Common Law group encompasses countries which operate under a hybrid system combining both civil and common law. Major economies such as Japan and China are in this group, which applies to 25% of the world's population, and has a 16% share of the world's GDP.

Table 17.1 Statistics for the Legal Groups

Legal Group	Jurisdictions (out of 320 enlisted)	2007 GDP	Population	Area
English Common Law	27%	14%	30%	21%
Napoleonic Law	26%	23%	23%	34%
American Common Law	20%	26%	5%	7%
Roman-Germanic	10%	19%	11%	18%
New	6%	1%	5%	6%
Mixed Civil/Common law	5%	16%	25%	11%
Islamic	3%	1%	1%	3%
Unallocated	0%	1%	2%	0%

*GDP based on figures from the World Bank and IMF.

Source: Wood (2008)

2 For details refer to http://www.nationmaster.com/graph/eco_gdp_percap-economy-gdp-nominal-per-capita.

"Legal Framework" for Islamic Finance

A legal framework for Islamic finance in any jurisdiction reflects the policies adopted in regulating and supervising the Islamic financial industry by the executive arm of the government (through any of its ministries or agencies). Such a framework would always be comprised of:

1 The body or bodies empowered to enact the relevant laws

2 The applicable law themselves

3 The relevant authorities which will oversee the implementation or enforcement of the laws

4 The persons who are subject to the laws

5 The tribunals vested with the authority to rule, and/or to adjudicate, on issues and disputes relating to the matter

Strengthening the legal framework is material to ensure the effective and resilient development of Islamic finance.

A legal and regulatory framework that is effective for ensuring a resilient development of the Islamic financial services industry would be characterised by:

1 An enabling environment that accommodates and facilitates the development of the industry.

2 A legal framework that facilitates and allows access to investors to primary and secondary capital markets. It is a framework that facilitates business and finance (including a clear and efficient system that preserves the enforceability of Islamic financial contracts).

3 A credible and reliable forum for the settlement of legal disputes arising from Islamic finance transactions.

These features seem rather plain and straightforward, but in reality, the composition and the architecture of such a legal framework are multi-faceted, and therefore can be quite complex. Such a system allows sophisticated parties to implement their agreed-upon risk allocations with respect to market transactions. This entails access to accurate information and both the necessary flexibility to agree upon those risk allocations and an enforcement mechanism that honours and gives effect to those allocations. Such a framework is fair and equitable in effecting risk allocations where sophisticated participants have not otherwise agreed. An effective legal framework allows and facilitates, efficient formation and movement of capital, and fair and efficient operation of markets. It also promotes the stability of capital markets. Such a framework protects investors; it is fair, efficient and transparent, and reduces systemic risk.

An effective legal framework consists of an effective legal system that is responsive to the *Shari'ah* principles and creates confidence among investors.

McMillen clarifies that an effective legal framework is more than a code of rules, and a collection of substantive doctrinal legal rules. It includes stable institutions, including legal institutions. An effective legal framework, as with an effective legal system, embodies the entirety of the concept of the rule of law. It embodies the principles that the legitimate exercise of governmental authority requires written, publicly disclosed laws that are adopted and enforced in accordance with established procedures. It is a framework that is responsive to the essential nature of Islam, including the freedom of each market participant to determine *Shari'ah* compliance in accordance with that participant's personal choices and conscience, which includes the choice as to the governing school (*madhhab*) of Islamic jurisprudence, among other factors.[3] It can be considered as an ideal construct, but must be implemented in accordance with the realistic constraints of the then current state of development and level of sophistication of the existing legal system and existing capital markets, the sophistication of market participants that will be subjected to that framework, the existing culture, political system, history, and available resources, among others.

Taking the above into account, there is a wide array of distinctive legal frameworks required for different activities in the financial market. McMillen argues that an effective legal framework shall actually not be in reference to "a" legal framework, but rather an "inter-related set of legal frameworks" applying to different aspects or categories of Islamic finance and constituting, as an entirety, a legal system. For example, there has to be a specific and comprehensive legal framework for central banking activities, institutional and retail banking (including Islamic banking) activities, investment banking activities, *takaful* institutions, practices and activities, as well as securities issuance and trading of securities. Accounting and auditing practices also stand alone, although the legal framework should be cognizant of practices performed in, and with respect to, each of the foregoing categories and activities. Some aspects of these frameworks will be defined and shaped by the legal institutions that are created by and exist in those frameworks. Some aspects of these frameworks will be regulatory in nature. Other aspects will establish operational parameters to effectively bring about a wide range of policies, such as equality of opportunity and outcome, mandatory or preferred risk allocations that affect the implementation of social and political policies, and fairness of result within the parameters of the social and political system. Other aspects will be promotional in nature. Each must embody and fully and forcefully, implement the principles of "transparency", "disclosure" and "accountability" to ensure "effectiveness".

Effectiveness of the legal framework covers transparency, full disclosure and accountability.

3 *Author's insertion:* Note that in a small number of countries, such as Brunei, Indonesia, Malaysia, Pakistan and Sudan, a central *Shari'ah* authority is established and the market is not given absolute freedom to determine *Shari'ah* compliance according to the participant's personal choices and conscience.

In summary, for a legal framework to be "comprehensive" and "effective", naturally it will have numerous components, and therefore become quite complex.

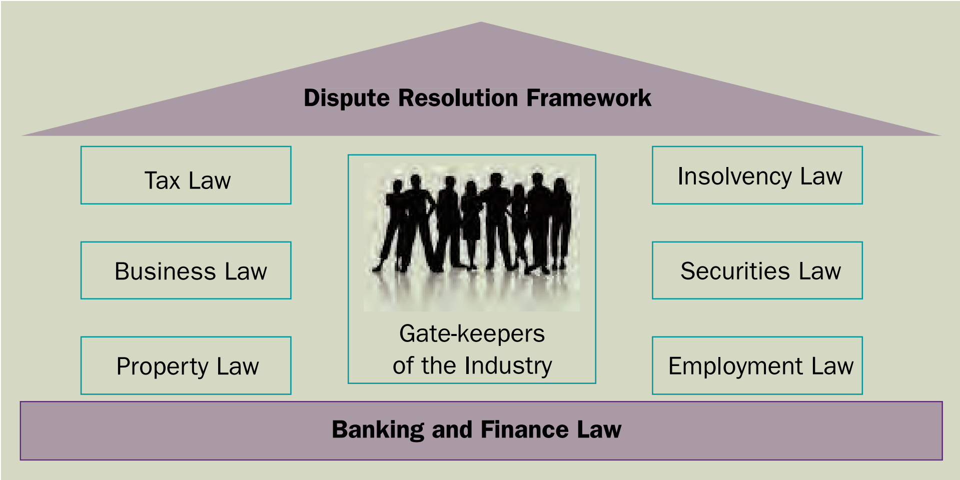


Figure 17.2
Components of a Legal Framework for Islamic Finance

Besides the above, policy decision is material in determining the effectiveness of the legal framework. Modern Islamic banking as we know it today, which started a few decades ago, was born amidst an environment whereby the legal framework had not been specifically laid down for it. In this respect, while acknowledging that there is public demand for Islamic finance, the authorities have a policy decision to make, i.e., whether to:

1. Apply the same existing legal framework (as for conventional finance) to Islamic finance.
2. Adapt or amend the existing legal framework, taking into consideration the specificities of Islamic finance, to accommodate this new area of finance.
3. Create a totally new and separate legal framework, tailored specifically for Islamic finance.

In setting out procedures, the relevant authorities would be faced by a policy option on whether to adopt a detailed, prescriptive, rule-based approach or a general, broad, principle-based approach in enacting laws and implementing the legal framework.

Of course such a policy decision shall take into consideration, among others, the level of demand for Islamic finance in the country, the sophistication of its target users in understanding the risks associated with it, the effectiveness and efficiency of the existing legal framework in responding to legal issues that may arise from Islamic finance business and transactions, and the capacity of legal institutions such as the regulators, the court of judicature and/or arbitration, as well as lawyers – in terms of knowledge and skill – to address those issues.

The significance of the impact of these policy decisions cannot be over-emphasised. Changes in many former communist countries have demonstrated the importance of a legal system for economic progress, as the legal system would define "property rights", allow for exchange of property rights, and protect property rights. Countries with a rule of law and well-established property rights are more prosperous and grow more quickly than countries lacking such a system.

In the context of Islamic finance, the law and the legal system define basic concepts like "deposit", "banking", "capital", etc., which certainly would have a long-lasting impact on how the Islamic finance business would be shaped. The law and the legal system will also empower the relevant authorities such as the central bank, monetary authorities and other financial regulatory and supervisory agencies to issue and prescribe subsidiary legislation in the form of regulations, guidelines, directives, and so on.

Existing Islamic Finance Legal Frameworks Across the Globe

This part briefly elaborates the existing legal framework in each country where Islamic finance operates. Table 17.2 briefly describes the legal mechanism governing Islamic finance from each country. It infers that the Islamic finance legal framework is still bolstering their legal framework at the domestic level. Should a dispute occur, the parties would normally choose the court of England to settle it.

Table 17.2 Summary of Supervisory and Legal frameworks in Countries Applying Islamic Finance

	Countries	Supervisory Authority/Regulation
1	Algeria	The primary law governing Islamic financial institutions (IFIs) is the Ordinance No 03-11 relating to credit and currency and addressing regulations, including the local currency, banking operations, required authorisations and approvals, control of banks, exchange controls. The Ordinance is implemented by 80 regulations, which themselves are also complemented and implemented by notes and instructions. Supervisory authority is Banque d'Algerie.
2	Bahrain	Governed by the Central Bank of Bahrain. The law is Prudential Information and Regulations for Islamic Banks (PIRI) 2000. The AAIOFI was established in 1991 to issue standards on accounting, auditing, governance and *Shari'ah* practices with which players in Bahrain are required to comply.
3	Bangladesh	Supervised by the Bangladesh Bank. The applicable law is the Banking Companies Act 1991, which contains provisions for Islamic banking activities, following an amendment in 1993.
4	Brunei	Governed by the Ministry of finance Brunei. Islamic finance is only offered through fully-fledged institutions offering Islamic financial services. A national *Shari'ah* Financial Supervisory Council was established in 2006. Banking Act Cap 95, Emergency Order (Islamic Bank) 1992 and Emergency Order (Islamic Trust Fund) 1991; Insurance and *Takaful*, Third Party Risk Act, Cap 90. International Banking Order 2000: the Order defines "International Islamic banking business contains provisions for *Shari'ah* law to over-ride a conflicting provision in the order subject to good banking practice and imposes a requirement for the appointment of a *Shari'ah* council". The restriction to local ownership which applies under the domestic Islamic Banking Act does not apply to the international regime. This Order governed under the segregated unit of the Ministry of Finance is called the Brunei International Financial Centre (BIFC).

	Countries	Supervisory Authority/Regulation
5	Iran	Governed by the Central Bank of Iran (Bank Markazi Jounhuri Islami Iran). The Law Ruled is the Law for Usury Free Banking 1983. There is no *Shari'ah* board for individual bank level, only at central bank level.
6	Kuwait	Supervised by the Central Bank of Kuwait. Ruled by Law No. 30 of 2003 on the addition of a specific section on Islamic banks to Chapter III of Law No. 32 of 1968 concerning currency, the Central Bank of Kuwait and the organisation of banking business. Disputes over *Shari'ah* issues will be referred to the Ministry of Awqaf.
7	Malaysia	The first Act enacted to facilitate the infrastructure of Islamic banking in Malaysia was the introduction of the Islamic Banking Act 1983 (Act 276) IBA, i.e., to govern the operations of Islamic banks in Malaysia. The amendment has also been made to the Government Investment Act (GIA) 1983, to facilitate both statutory reserves and liquidity reserve requirements, which are to be interest-free. The *Takaful* Act 1984 ("TA") was later enacted to allow the licencing and operation of Islamic insurance or *takaful* companies in Malaysia. Thereafter, the amendment in 1996 to Schedule 124 of the Banking and Financial Act (BAFIA) was to allow banks licenced under the Act to introduce the Islamic banking business. A new section has also been added to IBA in the 2003 amendment by inserting Section 13A which provides that an Islamic bank may seek the advice of the *Shari'ah* Advisory Council on *Shari'ah* matters relating to its banking business and the Islamic bank shall comply with the advice of the *Shari'ah* Advisory Council. In this section, "*Shari'ah* Advisory Council" means the *Shari'ah* Advisory Council established under sub-section 16B(1) of the Central Bank of Malaysia Act 1958 (before the new Act 701 was amended in 2009). The amendment to the IBA in 2003 with the inclusion of Section 13A enables Islamic banks to seek the advice of the *Shari'ah* Advisory Council ("SAC") of the BNM; and it is mandatory for the Islamic banks to comply with the advice given by the SAC pursuant to such request. This shows that the SAC has advisory powers over the Islamic banks, where liaison and common understanding between the *Shari'ah* Advisory Board (SAB) of the bank and the SAC is expected.
8	Thailand	Monitored by the Ministry of Finance. Islamic Bank of Thailand Act 2002 was legislated. The Act provides laws relating to the establishment and capital of the bank, its purpose, governance structure, supervision, operation, control, audit, report and inspection.
9	Tunisia	Governed by the Central Bank of Tunisia. The establishment and operations of banks in Tunisia are regulated by Law No. 2001-65, and banks offering Islamic financial products require approval under Law No. 33579.
10	Turkey	Regulated by the Central Bank of Turkey and the Banking Regulation and Supervisory Authority. Among the applied legislations are Bank Act No. 5411 and the Regulation on the Establishment and Operations of the Special Finance House pursuant to the Bank Act No. 4389.
11	UAE	Regulated by the Central Bank of UAE and the Dubai Financial Services Authority (DFSA).
12	UK	Monitored by the Financial Services Authority (FSA). The law applied is Financial Services and Market Act 2000.
13	US	Governed by the Federal Reserve, State Reserve Banks, Office of the Comptroller (OCC). The applicable legislation is The National Bank Act.
14	Yemen	Ruled by the Central Bank of Yemen via the Law on Islamic Banks 1996, which provides a regulatory framework for Islamic banking in the country.

Source: Adapted from Islamic Financial Services Board (IFSB) (2008).

Approaches Towards the Legal Framework for Islamic Finance

Having discussed in brief some of the differences of laws existing in each country, this section explains the study conducted by Thani & Othman concerning the differences of legal systems that covers 30 countries where Islamic financial institutions (IFIs) are known to have presence, covering all three types of major legal systems including the civil law systems, common law systems and the *Shari'ah* systems. Based on that study, and taking into consideration the further recent developments in Islamic financial services globally, it can be observed that these are the approaches adopted by different countries in regulating IFIs.

Table 17.3 Approaches Adopted by Different Countries in relation to their Legal Framework for Islamic Finance

	Approaches to Legal Framework	Countries (in alphabetical order)
1	Apply the same existing legal framework (as for conventional finance) to Islamic finance.	Algeria, Australia, Canada, China, Egypt, Germany, Maldives, Saudi Arabia, Singapore, South Africa, Switzerland, Nigeria, Russia, UK, US.
2	Adapt or amend the existing legal framework, mainly through subsidiary legislation or insertion of provisions under existing laws – taking into consideration the specificities of Islamic finance, to accommodate this new area of finance.	Bangladesh, Bahrain, Djibouti, Jordan, Mauritius, Pakistan, Palestine, Qatar, Sri Lanka, Turkey.
3	Create a totally new and separate legal framework, tailored specifically for Islamic finance.	Afghanistan, Brunei, Gambia, Indonesia, Iran, Kuwait, Kazakhstan, Kyrgyz, Lebanon, Malaysia, Philippines, Sudan, Syria, Thailand, Tunisia, UAE, Yemen.

Source: Adapted and summarised from Thani & Othman (2008), updated June 2010.

As aforementioned, the legal framework does not exist in a vacuum, and has to be supported by infrastructures in the form of effective legal institutions and competent legal workforce. There is no assurance, for example, that simply because a country introduces a tailor-made legal framework for its Islamic financial services industry, it will thrive. Similarly, there is no proof that simply because a country applies the same legal framework for Islamic and conventional finance, the development of the Islamic financial services industry will be hampered and stagnant. A number of countries in the second and third rows of Table 17.3 do not have vibrant Islamic finance activities as seen in Saudi Arabia or the UK in the first row. However, it is easily noticed that regional Islamic finance hubs such as Bahrain, Malaysia and the UAE have adopted frameworks that are more actively supportive of Islamic finance.

Rationale and Justification for Different Approaches

Why do the authorities take different approaches when it comes to legislating laws for Islamic finance? Fundamentally, the distinction depends very much on whether the authorities are of the view that:

1 The system is good and working well – so there is no need to fix or tweak anything;

2 The system needs a minor improvement – so there is only a need for a little "plumbing" type of work, i.e., adding capacity and plugging up loopholes here and there;

3 There is something absolutely inadequate in the system – so there is a need for a major overhaul, i.e., designing a whole new financial architecture.

Some of the common rationale and justifications considered by the authorities when they contemplate the legal approaches are:

1 To what extent is Islamic finance going to be a major component within the financial system, especially in terms of market share and asset size? If it is only small and negligible, then perhaps no special accommodation is needed. If it is going to be quite substantial, then some adaptation in the legal framework would do. But if it is going to be really major, then a comprehensive separate framework must be seriously considered.

2 How sophisticated will Islamic finance clientele be? If it is sophisticated, i.e., for institutional or high net-worth clients only, then there is less need, i.e., for authorities' intervention or prescriptive regulations. If it is going to be offered to the general public, then there is a stronger need for authorities' intervention in order to ensure a reasonable level of protection for depositors and investors.

3 Does the existing framework enable a conducive business environment whereby Islamic and conventional financial institutions can compete in the market on a level playing field? The more even the playing field, the lesser the need for the authorities to intervene.

4 What kind of interface would happen between *Shari'ah* rules and principles that underlie the Islamic financial contracts, and the existing legal framework? The more harmonious such interface is, the less need for the authorities to intervene and vice-versa.

Ensuring a Coherent Interaction between Different Sets of Laws

In any event, a country must carefully assess the adequacy of its existing legal framework before deciding to embark on any of the aforementioned options. It is encouraging to know that countries like Indonesia, Malaysia and Pakistan have developed a 10-year master plan that identifies strategic needs and goals for their Islamic finance sector before they introduced changes to the legal framework. This

Islamic finance needs a comprehensive legal framework that recognises the *Shari'ah* contract and other components of law that are aligned with its business model.

indeed should be adopted as the best practice. The advantage of having a strategic long-term master plan is not only for authorities to know exactly what goals to achieve and how to achieve them, but quite importantly, to monitor the progress of development of their Islamic finance sector and adjust the laid out plans in response to the changing dynamics in the marketplace.

In principle, any Islamic finance contract per se will be recognised and enforceable under a country's contract law. In other words, the contract law alone should be sufficient if the concern is only with regard to enforcing the rights and duties of the contracting parties. However, the reality is that Islamic finance does not exist in a vacuum, and may require the support from *other* laws in order for the whole business to be viable and sustainable. For example, Islamic finance transactions which involve the sale and buy-back or lease-back contracts usually attract double stamp duties under the tax law. Similarly, participatory financing structures which are quite common in Islamic finance may attract tax on "dividends" distributed, while parties usually are not required to pay tax on interest paid in conventional finance. It follows that without tax neutrality treatment compared to its conventional counterpart, the specificities of Islamic finance transactions can render the business to be more costly, and hence non-competitive.

This is why Islamic finance needs a legal "framework" not only in the form of contract law that recognises and enforces Islamic financial contracts, but also other law components that are aligned or harmonised with its business model. These include, among others:

1 Banking and finance law that provides for the licencing, regulation and supervision of Islamic finance business by a credible financial authority;

2 Tax law that provides for some incentives to undertake financing in a *Shari'ah*-compliant manner or at least neutrality in tax treatment when it comes to Islamic finance documentation and process-flow;

An effective legal framework consists of an effective legal system that is responsive to the *Shari'ah* principles and creates confidence among investors.

3 Business law that permits an IFI, notwithstanding its fundamental role as a financial intermediary, to participate in real economic activities such as trading of assets or properties and investment activities, which conventional financial institutions are generally prohibited to undertake;

4 Property law that empowers an IFI to hold properties as assets or receive properties as collaterals;

5 Insolvency law that enables IFIs to enforce their claims against debtors and defend themselves against creditors, as the case may be;

6 Securities law that allows parties to offer or trade capital market instruments that are *Shari'ah*-compliant;

7 Employment law that accommodates and facilitates the flow of international talents to meet the industry's demand for highly qualified human capital; and

8 A dispute resolution framework that is well equipped with lawyers, judges and other experts who are competent and knowledgeable in Islamic finance.

The real test on the effectiveness of a legal framework is in its implementation and enforcement, and therefore qualified and competent personnel are a key success factor. Islamic finance, therefore needs among others, compliance officers, financial regulators and supervisors, *Shari'ah* scholars, lawyers, judges, arbitrators, and other gate-keepers, who have the correct skill-set and dedication to man the system and ensure that it works.

Legal Issues and Challenges in Islamic Finance

The Enforceability of Contracts

Dispute between contracting parties arises for many reasons, whether under conventional financial contracts or Islamic financial contracts, no matter how well-drafted the contractual documents are.

If Islamic capital markets are to develop on a globally integrated basis and not remain isolated within rather limited confines (defined not only by national boundaries, but also by differing interpretations of *Shari'ah*), enforceability of contracts must be considered (and achieved) in both, "purely secular jurisdictions" and in "*Shari'ah*-incorporated jurisdictions". In purely secular jurisdictions, contracts among the transacting parties will be enforced as governing the relationships among the parties. Enforceability of contracts in such jurisdictions will extend to the agreed risk allocations as evidenced by contractual agreements pertaining to rights, obligations and remedies. Thus, if the parties desire to implement the *Shari'ah*, they will have to draft the contract in accordance with, and incorporate, the relevant *Shari'ah* principles. If New York or English law, or the law of any other purely secular jurisdiction, is chosen as the governing law of a contract, the court will give effect to the terms of the contract in accordance with the chosen governing law of that contract. If the parties to the contract chose, in the alternative, the *Shari'ah* itself as the law governing the contract, there is, at present, significantly less transparency, certainty and predictability as to how the contract will be enforced by a non-*Shari'ah* court.

The enforceability of a contract needs to be eyed from the *Shari'ah* validity and the contract law.

Case Study 1 Implied Terms and Case Study on the Judgement on *Bay' Bithaman Ajil* and *Ibra'*

Contracts in English law can contain two kinds of terms: express and implied. Implied terms are extra terms read into contracts by the courts in order to give effect to statutory requirements and common law presumptions. In a separate Malaysian court decision, *Bank Islam Malaysia Berhad v Azhar bin Osman and 3 Other Cases* (2010), what initially appears to be a straightforward case of determining the quantum of claims to be paid by a debtor to his bank (creditor) turned out to be a landmark decision whereby the court ruled that, in relation to *ibra'* (i.e., rebate for an early settlement of a financing facility):

- the court may infer an *implied term* from evidence that the parties to a contract must have intended to include it in the contract, though it has not been expressly set out in the contract; and
- therefore, when an Islamic bank practices granting of rebate on a premature termination, it creates an implied term and legitimate expectation on the part of the customer.

In terms of chronology, the case of *Azhar bin Osman* originated from the infamous *Taman Ihsan Jaya* case of 2009, in which the High Court decision was reversed on appeal by the Court of Appeal – the appeal decision reported as *Bank Islam Malaysia Berhad v Lim Kok Hoe & Anor and 8 Other Cases* (2009). All the cases were then sent to the High Court for determination of the quantum of claim.

The High Court observed that in specifying the amount due, the issues which confront a *bay' bithaman ajil* (BBA) contract are that the agreement is silent on:

- the amount due to the bank when the tenure of the BBA contract has not completed, whether due to prepayment or termination due to breach; and
- the amount payable when the bank has not paid the purchase price in full under the Property Purchase Agreement.

The High Court noted that since the tenure of the contract has not completed, normally the bank will further deduct as *ibra'* what it refers to as "unearned profit", i.e., the amount which has yet to be earned by the bank, based on an amortisation table. Just like the *Riyad Bank* case above, the judge based her decision on the evidence deduced from the facts surrounding the case, whereby it was found that the approach Islamic banks used to deduct unearned profit as *ibra'* is consistent with the requirement of Section 266 (l) of the Malaysian National Land Code which is designed to protect the chargor, whose property is about to be sold at an auction. The chargor is supposedly entitled to know exactly where he stands in terms of the amount of repayment in order to give him the opportunity to redeem his position.

The demands for clarity in the contract, and fairness to the debtor, were reflected in the judge's decision, when she said:

> "This issue in fact could have been easily resolved. The legal documentations used by Islamic banks should have addressed the peculiarity of Islamic banking transaction, instead of adopting a cut and paste approach of the conventional banking documents. If the documents of the banks had in fact specified a formula of rebate or *ibra'*, it will demystify the intricacies of a BBA transaction. It will be easily understood by the customer who would then not be put in the dark as to what is *ibra'* and what would be the amount of *ibra'* he should be receiving. In that way, the court need not have to interfere with the terms of the agreement or to add implied terms as I am now doing."

The case shows that the inclusion of *ibra'* or rebate clause should be expressly written in order to avoid any interference by the court in future. By writing the documentation into general clauses, the parties are exposing themselves to the risk of being interpreted impliedly.

At the moment, due to the civil law systems' way of codification and the common law systems' long records of court decisions on conventional finance disputes, the purely secular jurisdictions seem to be able to provide parties with more transparency, certainty and predictability of outcomes, compared to the *Shari'ah*-incorporated jurisdictions which lack in both codification and records of court decisions. In this respect, it is important to acknowledge that parties involved in financial transactions (including Islamic financial transactions) make their decisions based on their analysis of "risk/return" factors, which also are guided by the transparency, certainty and predictability of dispute resolution processes. Without clarity on these issues, parties may become more averse to undertaking transactions.

Indeed some legal issues, such as questions of governing laws and jurisdictions, may arise across all areas of Islamic finance, while certain legal issues are more specific to the respective sectors, such as *sukuk*/securitisation, *takaful*, etc. Due to the constraint of space, this chapter will focus on some of the most common legal issues and challenges facing the broader Islamic finance industry around the world, without being specific to sectors.

Support of the Legislative, Executive and Judicial Bodies

In most countries, the institutions of government are divided into the legislative body (that enacts or passes laws), the executive body (that implements or executes the law)

and the judiciary (that interprets the law and imposes it by sanctions). Even in countries ruled by monarchs, whereby the laws are enacted and passed by kings through a royal decree instead of a statute passed by parliament, there would still be executive and judiciary institutions which shall oversee that the people abide by the law.

While the separation of legal functions and the complexity of due legal processes basically mean that every law generally would have to undergo a thorough and meticulous scrutiny before it is brought into force, quite often this also leads to inefficiency and ineffectiveness when it comes to putting the law into practice. This explains why from time to time, the law has to undergo revisions and amendments, as it is only through practice that any loophole or *lacuna* in the law could be detected.

Islamic finance needs to be fully supported by our existing Montesquieu model which separates the powers of executive, legislative and judiciary.

In the context of Islamic finance, it has to be noted that it is a very niche industry and a highly specialised area of knowledge which requires specific skills and understanding that may easily be beyond the grasp of the relevant members in the legislative and executive bodies and the judiciary. Notwithstanding that all the basic due process of law-making may be adhered to, an Islamic finance law could be tabled before a legislative assembly that is totally ignorant of Islamic finance, passed on and then expected to be implemented by an executive body that does not have adequate training and skills in Islamic finance, resulting in it triggering a dispute later on that lands it in a court of judiciary, presided over by a judge who is not equipped with any knowledge of Islamic law and jurisprudence. A situation such as this would certainly be disastrous!

It must be appreciated that, while one can argue that in a similar manner, it is impossible to expect the legislative, executive and judicial branches to comprise people who are experts in sophisticated sciences like DNA, stem cell or renewable energy which may need their own laws to be passed. Financial sector in particular, is an industry that directly impacts the economy, and therefore the livelihood of almost everyone in the country. Islamic finance, albeit a small component of the financial system, may pose systemic risks to the stability of the whole financial system, and therefore must be treated as crucial a subject as conventional finance.

Therefore, there is a need for the relevant authorities, especially the central bank or monetary authorities, to ensure that specific awareness and enlightenment programmes are afforded to the members of the legislative, executive and judicial branches to gain at least some basic understanding of Islamic finance, before an Islamic finance law or legal framework is adopted. Continuing training and education programmes need to be crafted, especially for relevant members of the executive body and judiciary who are more likely to deal with Islamic finance issues on a frequent basis.

Case Study 2 Courts and Jurisdictions – The Islamic Finance Dilemma

Islamic products are actually adapted and modified conventional products. They are created in civil law surroundings. Creating them requires expertise in both the civil law and the *Shari'ah*, something that is quite impossible to find in one person. Quite often, those who know civil law do not know the *Shari'ah*. Those who know the *Shari'ah*, do not know the civil law. There is a third category: those who think they know both but have never practised law. There are at least two legal implications arising from this situation. First, there is a need for Islamic finance contracts to comply with the requirements of both civil laws and *Shari'ah* laws. Another instance is when Islamic finance contracts are also required to comply with the requirements of validating the contract as provided under the civil laws, such as applying the Uniform Customs and Practice for Documentary Credits (UCP 600) on a Letter of Credit. It is the accepted worldwide uniform rule on Letters of Credit.

A letter of credit (LC) is a payment term generally used for international sales transactions. It is basically a mechanism, which allows importers/buyers to offer secure terms of payment to exporters/sellers in which a bank (or more than one bank) gets involved. The technical term for a letter of credit is "Documentary Credit". On the very outset, one must understand that the letter of credit deals in documents, not goods. The idea in an international trade transaction is to shift the risk from the actual buyer to a bank. Thus, LC is a payment undertaking given by a bank to the seller and is issued on behalf of the applicant, i.e., the buyer. The buyer is the applicant and the seller is the benefriciary. The bank that issues the LC is referred to as the issuing bank which is generally in the country of the buyer. The bank that advises the LC to the seller is called the advising bank which is generally in the country of the seller. Art 13(iii) of the UCP 600 states that an issuing bank will be responsible for any loss of interest, together with any expenses incurred if reimbursement is not provided on first demand by a reimbursing bank in accordance with the terms and conditions of the credit. *Shari'ah* does not allow any interest which is known as *riba*, what more on the loss of interest. The UCP 600 also applies the transit interest upon negotiation (foreign based interest) and standard remittance (days interest). The UCP 600 which is the latest and sixth revised version of the rules came into effect on 1 July 2007. Today, the vast majority of commercial LCs opened all around the world are subject to UCP 600.

To complement the knowledge and skills gaps that may exist in the executive branch and judiciary, specific legal structures and processes must be in place to allow them access to expert assistance and consultation such as to a *Shari'ah* advisory council, Islamic economists, specialist Islamic finance lawyers, and so on.

When an Islamic finance dispute is brought into courts, the following are some factors that may demand a reality check on whether the legal framework and infrastructure are appropriate and adequate to administer "justice":

1 One party may not be a person "professing the religion of Islam". In fact, both parties may not be "Muslims", for e.g., if the financier is a conventional bank offering Islamic financing through its Islamic windows, and the financed party is a non-Muslim. So, we need a court system that either has jurisdiction over both Muslims and non-Muslims or is simply neutral to any religion.

2 Enforcement of obligations, e.g., through bankruptcy law, companies' winding-up laws and land laws are outside the purview of the Islamic finance contracts, and very much depend on the existing legal framework. Hence, we need a court that has expertise and jurisdiction over laws other than just the *Shari'ah* and *mu'amalat*.

3 If the decision of the court is also expected to be enforced against a party in a foreign country, the court requires recognition of reciprocal enforcement of judgement in that foreign country. In other words, that court must be a court of "competent jurisdiction".

4 Cosmetic change like naming a court as a "*Mu'amalat* Court" will not make the judge a *Shari'ah* scholar or an expert in Islamic finance. Even if one manages to find a civil judge who is knowledgeable and also well-versed in *fiqh mu'amalat* (Islamic law of commercial transactions) in particular, and the *Shari'ah* in general, it is far from sufficient. This is because he will be overwhelmed by the back-log of cases, causing immense difficulties to the parties and witnesses, besides being costly. Cases pending at every level of the courts, whether at the first instance or appellate levels, would still stay in the respective courts and remain unsolved. Hence, capacity building must always be aimed at throughout the whole system.

Status and Enforceability of *Shari'ah* Pronouncements

Compliance to the *Shari'ah* rules and principles is the *raison d'être* for Islamic finance. The legal framework must therefore provide for an enabling environment whereby the *Shari'ah* governance structures and processes shall be established to ensure efficient and effective *Shari'ah* compliance of Islamic finance products and institutions.

We are not going to repeat our deliberation on the *Shari'ah* governance aspect of the Islamic financial system in this chapter since the subject has been previously discussed. Nevertheless, it is important to stress here that without the force of law, the *Shari'ah* governance will remain a purely voluntary process, which is unsatisfactory and far from prudent in protecting the integrity of the Islamic finance industry.

Therefore, in order to empower *Shari'ah* scholars to become effective gate-keepers and whistle blowers for Islamic finance, it is appropriate to ensure that there is adequate legal framework to determine their competence through a "fit and proper" criteria, due recognition of their roles and responsibilities, as well as clarity on their liabilities and level of professional accountabilities. For example, Bank Indonesia, Bank Negara Malaysia (BNM) and the State Bank of Pakistan have issued subsidiary legislation (specifically, through guidelines and directives) in the area of *Shari'ah* governance for IFIs, based on the explicit powers granted to them under the central bank laws to regulate Islamic finance.

In addition to establishing and safeguarding the integrity of the *Shari'ah* governance systems for Islamic finance, the legal framework has to provide sufficient support for the relevant *Shari'ah* pronouncements, or *fatwas,* of the *Shari'ah* boards to be upheld and respected. Otherwise, there is a concern that the integrity of the *Shari'ah* pronouncements can be compromised out of ignorance or negligence.

The recent case of *The Investment Dar Company KSSC v Blom Developments Bank SAL* (2009) heard in the High Court of England is a classic example of how the *Shari'ah* pronouncement by the *Shari'ah* board of an Islamic bank was actually questioned and undermined — by the Islamic bank itself. Case Study 3 provides an illustration of the case for better comprehension on the conflict between *Shari'ah* Law and English Law.

The case study of The Investment Dar Company KSSC v Blom Developments Bank SAL poses one important question: How damaging is the decision? Firstly, it has increased the level of difficulty in obtaining summary judgement decisions in favour of the creditor. There are substantial delays and costs involved in going to trial on matters such as this. Inability to obtain summary judgement will cost the creditors involved. Secondly, the word of the *Shari'ah* board carries no legal authority in courts, especially in English courts. As the High Court of England proceeds to determine the question of fact as to the "*Shari'ah* compliance" of the MWC based on the expert evidence to be brought in by both TID and Blom, the earlier *Shari'ah* pronouncement by the TID *Shari'ah* board regarding the MWC could be rendered irrelevant. This totally ignores and undermines the role of the *Shari'ah* board and its ex-ante pronouncements that are often issued before IFIs enter into a financial contract.

It was certainly for this reason the new Central Bank of Malaysia Act 2009 has specific provisions under Part VII Chapter 1 that recognises the status of the National *Shari'ah* Advisory Council as the highest *Shari'ah* authority for ascertainment of Islamic law for the purpose of Islamic financial business, and its rulings are binding on IFIs, courts or arbitrators in Malaysia. The quagmire triggered by the TID case, whereby a civil court intervened and was adamant on addressing a *Shari'ah* point in a legal dispute, was earlier observed in Malaysia *(Mohd Alias Ibrahim v RHB Bank Bhd & Anor,* reported in *[2011] CLJ JT(2)).*

Case Study 3 Investment Dar Company KSSC v Blom Development Bank SAL (2009)

The Investment Dar Co. KSCC ("TID") is a Kuwaiti holding company with diverse business interests that include commercial and consumer finance, real estate and asset management. At issue in the litigation was an investment by Blom Development Bank SAL ("Blom"), a Lebanese bank, pursuant to a master *wakalah* agreement with TID. The agreement provided that Blom deposit a certain amount of money with TID, appointing TID as its *wakil* (agent) to manage the money as an investment. The *wakalah* appointment was for TID to invest the money in its treasury pool (which included monies of other depositors). Among the salient terms of the agreement was that the choice of law and jurisdiction for the transaction would be the laws of England, and the contract was determined by TID's *Shari'ah* committee to conform with the *Shari'ah* — a determination that the agreement specifically precluded TID from challenging. In addition, each time Blom made a deposit, an individual *wakalah* contract was to be signed. At the end of every *wakalah* period, TID would pay 5% profit to Blom. Under this arrangement, Blom deposited over US$10 million with TID.

The issue arose when TID came into serious financial difficulty and defaulted payments of Blom's principal and the agreed profits. Blom claimed that TID should pay it the principal deposits (which were rightly Blom's) plus 5% profit (which was held by TID on trust for Blom). However, TID argued that the agreement was not *Shari'ah*-compliant, being an agreement for deposit taking with interest, and therefore null, being *ultra vires* and beyond its legal capacity to conform. Even if it is valid, according to the agreement, profits payable to Blom should be limited to 5%; any extras should be retained by TID as its own profits. If there are any losses, the losses would be borne entirely by Blom. In the initial hearing before the Chancery Division, the court ruled that TID's assertion of *ultra vires* was an arguable defence to Blom's contract case but not to its trust claim. On that basis, the court granted Blom a summary judgement for the return of its principal but not the agreed profits. Blom appealed.

The court allowed the appeal, dismissing the summary judgement and allowing both the contract and trust claims to proceed to full trial. This was on the condition that TID first pay Blom the principal amount invested by Blom. It is notable that the court refused to discuss the *Shari'ah* compliance of the deposit products, as the *Shari'ah* committee of TID had already ruled that they were compliant, and the court relied on their expert evidence. The court scrutinised the provisions in the master *wakalah* agreement and gave way for *Shari'ah* experts to give evidence on matters not within the knowledge of the court. Furthermore, the court held that Blom is rightly entitled to the deposits, but there are triable issues as to whether Blom is also entitled to the 5% profits. In addition, the provision on the 5% profits in the master *wakalah* agreement is construed under English law to be fixed at 5%, and Blom should not be entitled to more or less than 5%, regardless of whether TID makes a profit or loss out of the investment. In this context, the court opined that there was nothing in the agreements that mentioned creating a trust over the deposits and profits by Blom, and neither parties intended the deposits to be held on trust, hence the claim by Blom on the grounds of trust should fail.

Although both parties are from different Middle Eastern countries, they agreed that the Master *Wakalah* Contract (MWC) will be governed by the English law. TID confirmed that the terms of the MWC and the transactions to be made under the MWC are in accordance with the *Shari'ah* as interpreted by a *Shari'ah* committee in Kuwait. It went further to undertake that it will not at any time assert that any provisions of the contract or any transactions are contrary to the *Shari'ah*. This confirmation and undertaking were possibly thought to be necessary because any dispute that arises under the MWC or in a transaction related to such a dispute is to be resolved by a system of law with no *Shari'ah* component.

As the years rolled on, contrary to TID's initial confidence in its business model, its investments failed. After a time, TID failed to make payment to Blom. This is a clear breach of the terms of the MWC which provides that Blom is to get a fixed rate of return no matter what the conditions of TID's investments are. Blom sued TID and the legal saga began.

Blom's claim is that TID is in breach of contract ("the contractual claim"). However, Blom also raises a claim based on a breach of trusts ("the claim in equity"). Blom applies for summary judgement on the basis that TID's liability is clear and there is no need to have any issue tried. Blom is successful but only on the claim in equity. The court holds that the monies Blom deposited with TID was impressed by a trust. The court orders TID to repay all the principal sums but not the specified profit.

TID is still not happy. It appeals to the Court of Appeal. Blom, on the other hand, asserts that it should have been awarded summary judgement on both its contractual claim and claim in equity. On appeal, the judge decides that TID had an arguable defence on both claims – the contractual and in equity. He dismisses Blom's appeal and allows TID's appeal.

TID had raised two points to argue that the matter had to go to trial to be determined. The first was that TID was constitutionally barred from entering into the MWC, as its Memorandum and Articles of Association permits it to enter only into *Shari'ah*-compliant transactions, which it argued the MWC is not. In short, TID was arguing that it had no power to do what it did, or that its actions with respect to the MWC and the associated transaction was *ultra vires* (i.e., beyond the powers of) its constitution. The second point raised by TID was that the scheme of the *wakalah* arrangements was not *Shari'ah*-compliant in itself. To rebut this argument, Blom would have to bring expert evidence at trial to establish the *Shari'ah* credentials of the MWC and the associated transactions. It should be remembered that TID had agreed that the transactions met the approval of the *Shari'ah* committee in Kuwait. TID had further agreed not to raise issues of non-compliance. Nevertheless, the court was willing to allow the findings of the *Shari'ah* board as to the *Shari'ah* compliance to be challenged. Furthermore, the court did not question the clear warranty that TID had taken with regard to its undertaking not to raise issues of noncompliance.

In the cases of *Affin Bank Bhd v Zulkifly bin Abdullah* (2006) and *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors; Koperasi Seri Kota Bukit Cheraka Bhd (Third Party) And Other Cases* (2009), which was further followed by *Majlis Amanah Rakyat v Bass bin Lai* (2009), the judges at the High Court were of the view that the BBA home financing contracts which were widely used by Islamic banks in Malaysia were not a *bona fide* (i.e., in good faith) sale and purchase contract and could be construed as a back door to *riba*. The judges ruled that it is essential to maintain a *bona fide* sale so that the profit does not become an element disapproved by the religion of Islam. Even so, an interpretation of the selling price must not be such that it would impose a heavier burden than on a loan with interest, for that would obviously be contrary to the intent and purpose of the *Shari'ah*. If efforts to maintain a *bona fide* sale are abandoned, the deferred payment of a sale price is effectively a credit or loan extended and any profits would be prohibited as *riba*.

Although the Court of Appeal in the case of *Bank Islam Malaysia Bhd v Lim Kok Hoe and Anor and Other Appeals* (2009) reversed the decisions in *Taman Ihsan Jaya*, and therefore reinstated the validity of BBA contracts as a legitimate Islamic finance contract under the Malaysian law, BNM decided to incorporate an explicit legal provision under its new Central Bank of Malaysia Act 2009 so that the National *Shari'ah* Advisory Council becomes the final arbiter for ascertainment of Islamic law for the purpose of Islamic financial business.

This should ensure the finality on *Shari'ah* matters in Islamic finance in Malaysia, so that IFIs will not again be trapped in a dilemma between the rulings of a court and the pronouncements of the National *Shari'ah* Advisory Council.

Governing Laws and Jurisdiction of Choice

The parties to a contract are given exclusive autonomy to decide their own governing laws. However, the parties are advised to make sure that any *Shari'ah*-compliant arrangement, also conforms to the chosen national law.

The majority of legal systems are not based first and foremost on the *Shari'ah* and, as a result, the courts will apply *Shari'ah* law in the context of its interplay with the national laws. This raises issues both in relation to the status of *Shari'ah* law within the contract, court adjudication process and also in relation to the enforcement of overseas judgement. In international Islamic finance deals, a vast amount of contracts name the courts of England and Wales as the applicable forum and the law of England and Wales as the governing law. Naturally, the English courts have addressed the extent of applicability of *Shari'ah* law to certain contracts.

For example, in the case of *Shamil Bank of Bahrain (EC) v Beximco Pharmaceuticals Ltd* (2004), the court considered the status of a purportedly dual *Shari'ah* and English governing law clause. Contracts between the parties stated that they were "subject to the principles of the glorious *Shari'ah*" and would be governed by and construed in accordance with the laws of England and Wales. Beximco claimed that the dual reference to the *Shari'ah* and English laws meant that the contract had to be recognised as binding by both systems of the law (and that the contract was not *Shari'ah*-compliant). The Court of Appeal ruled that because the *Shari'ah* law was not the law of any individual country and there was too much uncertainty as to its terms for it to be a binding system of law, English law was the sole governing law.

This case has caused controversy, given the popularity of English governing law clauses in the Islamic finance industry. Parties are now advised to make sure that any *Shari'ah*-compliant arrangements and mechanisms included within their agreements also conform to the chosen national law. However, there may be circumstances where this simply is not possible and the *Shari'ah* principles may be sacrificed. Whilst the *Shamil* case is limited to England and Wales, it is possible that other common law legal systems may apply similar reasoning. In cases where the parties are considering to choose a specific national law, the legal system of which includes the *Shari'ah* law, they must ensure that there is a reciprocal enforcement treaty in place between both countries. However, in certain circumstances, even when such arrangements are in place, a successful enforcement may be impossible. For example, if the decision of a foreign court involves payment of interest, such a decision will not be enforced in Saudi Arabia since it contravenes the basic precepts of *Shari'ah*.

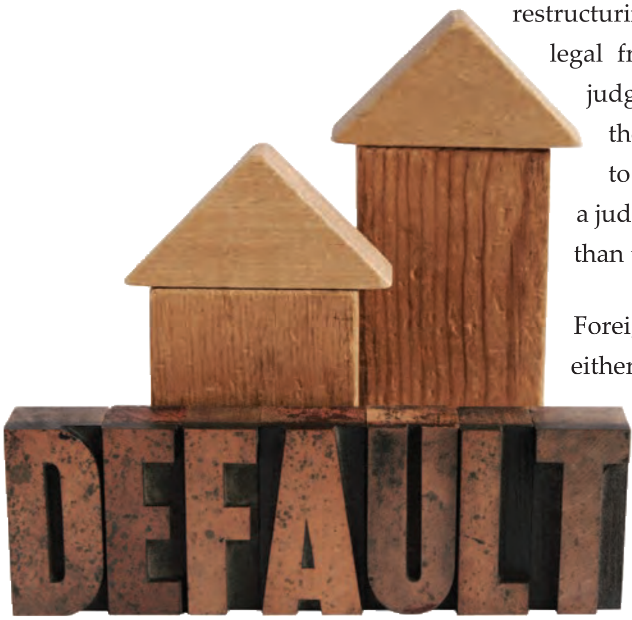
Therefore, it is important to note that submitting an Islamic finance matter to a state court of any jurisdiction may bring up various issues, which include enforcement, adjudication in accordance with the *Shari'ah* law, lack of competent and adequately trained judges, and conflict of law issues, among others.

Laws Supporting Reciprocal Enforcement of Judgement

Defaults of obligations by the financed parties in any financing deals are bound to happen from time to time, due to, among others, the changing credit environment. However, the recent global financial crisis has seen for the first time, multi-billion dollars worth of cross-border Islamic financing deals be troubled by such defaults.

Judgements or awards are enforceable via multilateral treaties and bilateral agreements.

Among the notable defaults were the *sukuk* issued by Al-Saad Group (of Saudi Arabia), as well as The Investment Dar and Global Investment House (of Kuwait). East Cameron Gas, the first *sukuk* issuer out of the US, has also gone bankrupt and the *sukuk* holders are involved in the bankruptcy proceeding in a court in Louisiana. Nakheel and Dubai World, despite causing a widespread concern over potential defaults on their *sukuk* in November 2009, managed to obtain a bail-out from the state and are currently



restructuring their debts. These cases pose a major test on the legal framework supporting "reciprocal enforcement of judgement" between the country of the *sukuk* issuers and the country of their creditors. In particular, this refers to the situation whereby the financier seeks to enforce a judgement already made by a court (in a country other than the country of the financed party).

Foreign judgement/awards usually can be enforced either via multilateral treaties, bilateral agreements or procedures of local laws regarding enforcement action. The legal framework for this stands on its own and need not necessarily be associated with Islamic finance.

Examples of multilateral treaties to facilitate reciprocal enforcement of foreign judgements/awards are the 1995 Protocol on the Enforcement of Judgements, Letters of Rogatory and Judicial Notices (GCC Protocol), the 1983 Convention of Judicial Cooperation between the State of Arab League (Riyadh Convention), the 1952 Inter-Arab Convention on the Enforcement of Judgement and Awards, and the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Examples of local laws recognising enforcement of foreign judgement is Malaysia's Reciprocal of Foreign Judgements Act 1958 and Singapore's similar Act of 1959.

A short analysis of the position of enforcement of foreign judgements and arbitral awards in five of the key jurisdictions in Islamic finance, namely Bahrain, Kuwait, Malaysia, Saudi Arabia and the UAE are indicated as follows:

Table 17.4 Reciprocal Enforcement of Judgements/Awards in Five Key Islamic Finance Jurisdictions

Court Judgements	Arbitration Awards
1. Bahrain	
■ No treaty between Bahrain and the UK. ■ Enforcement of foreign judgement is governed by Articles 252 and 253 of Law No 12 of 1971 on Civil and Commercial Procedures. ■ Article 252: "Court judgements and orders passed in any foreign country may be ordered to be enforced on the same conditions as are laid down in the law of that country for enforcing court judgements and orders issued in Bahrain." ■ It means the Bahrain court will: (i) Examine the situation in the country of origin; (ii) Apply the same rules and conditions for the enforcement of the foreign judgement.	■ There are two arbitration bodies in Bahrain: (i) The Bahrain International Commercial Arbitration Centre; and (ii) The GCC Commercial Arbitration Centre. ■ Arbitration system is divided into domestic and international arbitration. <u>Domestic arbitration:</u> – Subject to rules set out in Civil and Commercial Procedures Law of 1971. – Applies to any civil or commercial dispute where the seat of arbitration is in Bahrain, regardless of place of contract, nationality of parties or choice of law.

Court Judgements	Arbitration Awards
■ In the case of *Merril Lynch v Abdul Jalil Behbehani* (1985), the court had to decide whether to permit enforcement of English judgement in Bahrain, pursuant to Article 252. The Civil High Court ruled that conditions under Article 252 are fulfilled on the following basis: – Judgement passed by a foreign court of competent jurisdiction. – Rules of the court have been complied with (for e.g., notice and defence). – Judgements are final. – Judgements are consistent with the rules of public order and morality.	International arbitration: – Governed by The International Commercial Arbitration Law (Decree No. 9 of 1994) and applies to commercial disputes only. International means if both parties conduct their business in different states, contract is performed or seat of arbitration is outside one or both parties' place of business. – United Nations Commission on International Trade Law Arbitration (UNCITRAL) model law applies if parties fail to refer their disputes for resolution under the relevant rules. ■ Hence, a foreign arbitral award can be enforced in Bahrain as Bahrain is a signatory to the New York Convention. ■ International arbitral awards are binding upon written application to the High Civil Court (Article 35 of UNCITRAL). ■ However, the recognition and enforcement can be refused if it is contrary to the public policy in Bahrain.
2. Kuwait	
■ No reciprocity treaty between the UK and Kuwait. ■ Recognition of English judgement rests with the trial courts on ad hoc basis (to determine reciprocity) on passing of a writ of execution. ■ Subject to public order and morals. ■ Therefore enforcement of foreign judgement in Kuwait is not impossible.	■ The Commercial Arbitration Centre of the Kuwait Chamber of Commerce and Industry was set up in 2000, with enforcement of awards set out in the Code of Civil and Commercial Procedure (not based on UNCITRAL). ■ Kuwait is a signatory to the New York Convention; therefore if an award is rendered in a New York Convention member state, then the Kuwaiti courts will recognise and enforce it without retrial or examination. Awards from non-member states are also enforceable provided there is reciprocity of enforcement between Kuwait and such country. ■ In practice, the Kuwaiti courts will only recognise and enforce the award if the procedural requirements have been satisfied and no conflict with public order or morality in Kuwait. ■ Hence, arbitration is a better option if the client is a plaintiff pursuing assets in Kuwait.
3. Malaysia	
■ Certain foreign judgements are enforceable in Malaysia, by virtue of the Reciprocal Enforcement of Judgement Act 1958 (REJA). However, before a foreign judgement can be enforceable, it has to be registered. The registration of foreign judgement is only possible if the judgement is for a monetary sum and was given by a Superior Court from a country listed in the First Schedule of the REJA. Those countries include, the UK, Singapore, New Zealand and India. ■ If the judgement is not from a country listed in the First Schedule to the REJA, the only method of enforcement at common law is by securing a Malaysian judgement. This involves suing on the judgement in the local courts as an action in debt.	■ Malaysia's arbitral legislation has seen an overhaul with the passing of the Arbitration Act 2005. The Arbitration Act 2005 is based on, but is not identical to the UNCITRAL Model Law, and was initiated to bring Malaysia in line with modern international practice. ■ The Arbitration Act 2005 commenced from March 15 2006, and the Arbitration Act 1952 continues to apply to all arbitrations commenced before that date. The Arbitration Act 2005 is applicable across the board to all international and domestic arbitrations regardless of the rules of arbitral regime selected. ■ Awards made by an arbitral tribunal, pursuant to an agreement, are final and binding on the parties. The Arbitration Act 2005 provides that the mode of enforcement of awards is by application in writing to the High Court, and is recognised as binding and enforceable by entry as a judgement. However, the High Court has the discretion to refuse the recognition or enforcement of awards in certain stipulated circumstances.

<table>
<tr><th>Court Judgements</th><th>Arbitration Awards</th></tr>
<tr><td>4. Saudi Arabia</td><td></td></tr>
<tr><td>■ In principle, a foreign judgement can be enforced. However, in practice, the Board of Grievances (BOG) will assess the judgement based on the following:
– Reciprocity of enforcement of Saudi judgement in the foreign jurisdiction.
– Consistency with Shari'ah rules and principles as applied in Saudi.
■ Fanari case (1992): the BOG ruled that a judgement of the English High Court was not enforceable on the basis of reciprocity in Saudi.
■ Judgements which are enforceable on the basis of reciprocity are judgements from countries who: (a) are a party to a treaty (b) whose authorities would give executive force to judgements of the Saudi courts.
■ The only relevant treaties where Saudi is a party are Arab League Treaty 1983 and the GCC Protocol 1995.
■ Hence, there is no conclusive answer on enforceability. Since there is no judicial precedent in Saudi Arabia, there is always a possibility of BOG ruling differently today (from the Fanari case).</td><td>■ In theory, a foreign arbitral award can be enforced in Saudi Arabia since Saudi Arabia has ratified the New York Convention in 1993.
■ However, in practice, the enforcement remains problematic, as:
– the BOG may consider that an award is not compatible with public policy or with the rules and principles of the Shari'ah.
– Arbitrators must be male Saudi or Muslim male expatriates.
– Saudi governmental entities may submit to resolving disputes through arbitration only with permission of the Prime Minister (this position often held by the King himself). The interpretation of "government entities" may include government-owned corporation; although they are not strictly governmental entities.
■ Hence, there is no conclusive answer on enforceability. Extremely unlikely to be possible in practice.</td></tr>
<tr><td>5. UAE</td><td></td></tr>
<tr><td>■ No bilateral enforcement treaty with the UK but has ratified the Riyadh Convention.
■ In theory, there is recognition of foreign judgements, since the UAE has treaties with various countries.
■ However, there is no treaty on judicial cooperation and recognition of judgements and awards between the UAE and the UK, save for criminal matters.
■ Therefore, for an English judgement to be enforceable in the UAE, conditions under Article 235 of the UAE Civil Procedure Code must be satisfied:
– Judgements and orders passed in a foreign country may be ordered for execution and implementation within UAE under the same conditions provided for in the law of foreign state for the execution of judgements and orders passed in the state.
– Petition for execution order shall be filed before the Court of First Instance under which jurisdiction execution is sought under the lawsuit filing standard procedures. Execution may not be ordered unless the following was verified:
● State courts have no jurisdiction over the dispute in which the judgement or the order was passed and that the issuing foreign courts have such jurisdiction in accordance with the International Judicial Jurisdiction Rules decided in its applicable law.
● Judgement or order was passed by the competent court according to the law of the country in which it was passed.
● Adversaries in the lawsuit on which the foreign judgement was passed were summoned and duly represented.
● Judgement or order had obtained the absolute degree in accordance with the law of the issuing court.
● It does not conflict or contradict with a judgement or order previously passed by another court in the state and does not include any violation of moral code or public order.
■ This may make enforcement of foreign judgement difficult.</td><td>■ The UAE is a signatory to the New York Convention since November 2006.
■ It has several arbitration bodies including the Dubai International Arbitration Centre, the Abu Dhabi Conciliation and Arbitration Centre, as well as the International Islamic Centre for Reconciliation and Arbitration.
■ Article 203 to 218 of UAE Civil Procedure Code 1992 provide for arbitration procedures.
■ In theory, it will enforce foreign arbitration awards, since the UAE has ratified the New York Convention (though no case seems to have gone through the UAE courts yet). Arbitration award must be enforced through the courts.
■ Article 236 of the UAE Civil Procedure Code (enforcement of foreign arbitration awards): "Foreign awards can be executed and implemented in the UAE under the same conditions provided in the issuing country."
■ No special status given to a member state when it comes to enforcement. All conditions for the execution and recognition of the awards must be satisfied.
■ Therefore, enforcement of foreign arbitral awards in the UAE is not impossible.</td></tr>
</table>

Source: Adapted and summarised from Atta & Ibrahim (2009).

Case Study 4 Alternative Dispute Resolution (ADR): A viable option for Islamic finance

Looking into various impediments in the legal framework, Islamic finance may need to relocate its interest of settling disputes to Alternative Dispute Resolution (ADR). Alternative dispute resolution may be defined as procedures that serve as alternatives to litigation for the resolution of disputes. It generally involves the intervention and assistance of a neutral and impartial third party. It can be formal (e.g., arbitration) or informal (negotiation and mediation), and is a private and binding process where disputes are resolved by an award made by an independent tribunal (third party or parties, mediator, negotiator, or the arbitrator). The tribunal is either agreed by the party or nominated by an independent body, e.g., a court or a professional institution such as the Chartered Institute of Arbitrators. Alternative dispute resolution can be of many types such as mediation, arbitration, expert determination, mini trial, facilitation, *tahkim* (*Shari'ah* arbitration), negotiation and so on. Islamic finance nowadays is international in nature and the trade is widely accepted globally. International contracts can be resolved according to the ground rules which the parties would have agreed upon before commencing the arbitration processes, thereby avoiding the uncertainty element inherent in submitting to the jurisdiction of foreign courts. There are many institutions established to cater to disputes in commercial dealings but they are not limited to Islamic finance per se. Under the auspices of the Asian African Legal Consultative Organisation (AALCO), a memorandum of understanding was signed with the relevant governments to set up a Regional Centre for Arbitration in the selected region. Below are a few institutions established under AALCO:

1 Kuala Lumpur Regional Centre for Arbitration, Malaysia (KLRCA)

2 Cairo Regional Centre for International Commercial Arbitration (CRCICA)

3 Regional Centre for International Commercial Arbitration – Lagos (RCICAL)

4 Tehran Regional Arbitration Centre (TRAC), the Islamic Republic of Iran

However, there are other international institutions which can be approached for applying arbitration and mediation in settling disputes in other regions:

1 International Islamic Mediation & Arbitration Centre (IMAC)

2 Hong Kong International Arbitration Centre (HKIAC)

3 Singapore International Arbitration Centre (SIAC)

4 Dubai International Arbitration Centre (DIAC)

It goes without saying that in order to facilitate further international recognition of Islamic financial contracts, the development of the framework for reciprocal enforcement of foreign judgements and awards, in Islamic countries, in particular, and other countries in general, will be crucial indeed.

The lack of preference for ADR means the court system, in particular the civil courts, remains relevant and indeed, irreplaceable for the resolution of Islamic finance disputes. What are the reasons for this? The following are the most likely reasons:

1 Most Islamic banking cases, if not all, arise from defaults in instalment payments. The customers either cannot pay or would like to delay or avoid paying the debts. In all these cases, it is in their interest to delay proceedings, especially when they realise they will not be penalised with interest. So, they raise all kinds of defences, including lately, that the contract is void; being non-compliant with the *Shari'ah*. Under the circumstances, it is unlikely that they would agree to arbitration. If they sincerely want to settle the debt but are unable to do so, it is better for them to negotiate directly with the financial institutions. They do not have to spend money on lawyers and/or arbitrators. The fees for hiring lawyers and arbitrators are not cheap either.

2 Financial institutions would not go to court unless all avenues have been exhausted. It costs them money to go to court or, for that matter, to go for arbitration. When they do go to court, the first remedy that they would seek is an order for the sale of the charged asset. That order can only be made by the High Court. If there is a short-fall, the financial institutions would file a suit for it. With the judgement, they have many ways of executing it such as bankruptcy and winding-up proceedings. Arbitrators do not have all these remedies.

3 While it is well recognised that civil court judges may not be conversant in the *Shari'ah* and Islamic finance, it is indeed equally difficult to find arbitrators who are knowledgeable in the *Shari'ah*, Islamic finance, civil law and procedure. After all, most of the registered arbitrators are either civil law lawyers or ex-judges of the civil court. We are back to square one.

If we look at *takaful* cases:

1 Most of the cases are claims for damages for personal injuries caused by road accidents. So, due to the straightforwardness of the claims, why go for arbitration under the system?

2 Lawyers representing the claimants would themselves try to work out a settlement, directly with the insurance company or through the company's

lawyers. Quite often, the claims are settled without even going to court. From experience, lawyers from both sides can reasonably assess the liability, damages and amount of compensations that should be paid.

3 Where the claims are big, the insurance companies would not want to settle them easily and promptly. The "weapon" that the claimant lawyer has is to file a suit in court. Delay tactics can be used more effectively in courts rather than in arbitration.

Common Clauses in Financial Contracts

It is very common in legal practice that lawyers drafting Islamic financial contracts adapt the clauses that have commonly been used in conventional financial contracts. They should be careful in this aspect: just because the word "interest" was not used or had been removed from a conventional financial contract, it does not mean that it could easily be adopted into an Islamic financial contract. A number of these clauses can potentially become points of contention in legal disputes. Some examples are explained below.

Indemnities

Under the general principle of *Shari'ah*, it is unfair to seek from the counter-party an indemnity for loss or damage, especially if it is not caused by him. Hence, for instance, in an *ijarah* contract the bank as lessor is not supposed to seek from the customer (lessee) an indemnity. This is in contrast to conventional financing where the desire is to simply allocate risk. However, acknowledging that if the bank is to assume more risk which then would require commensurate reward, the question is, if an increased return is not available what are the alternatives? The bank should consider obtaining warranties from the supplier/manufacturer of the underlying subject matter; subscribe to an insurance or *takaful* policy or seek indemnities only on the basis of necessity or public need. When the loss and damage arise out of the use and operation of the asset by the customer, then it is reasonable to seek an indemnity from him.

Warranties

The general principle of *Shari'ah* requires that the grant or restriction of warranties by an Islamic lessor must be fair and reasonable. Hence, it is not always possible to exclude warranties (for e.g., in relation to ownership title and fitness for use/purpose).

The position in sale transactions differs from leasing deals, as in sale transaction, the principle of *caveat emptor* (buyers beware) may apply. The lessor can assign benefit of third party warranties to the lessee in substitution, and subscribe to insurance or *takaful* policy, in order to mitigate his risks. It is also noted that warranty claims may trigger an event of mandatory prepayment, which again borders along the lines of justice, fairness and equity in the *Shari'ah*.

Rental Period and Term

Prior to 2001, rental rate under *ijarah* could be adjusted periodically. However, some scholars objected to this on the basis that it causes *gharar* (i.e., dubious ambiguity) to the contract, as the total rent over the life of the lease is actually unknown at the outset. It was required that before each rent adjustment, notice shall be duly served, which would give the lessee an option to accept or reject the adjusted rent offered for each period. However, a rejection may trigger a pre-agreed obligation to purchase the asset, hence, the economic effect remains that an *ijarah* is still long-term financing with a right to prepay.

Rent Calculation

An *ijarah* in its classical application is really an operating lease. Hence, the *al-ijarah al-muntahiyah bittamlik* (hire and purchase) is an operating lease with an option to purchase and has been developed to have some of the characteristics of a finance lease. The rental payment often combines the principal (which can be a bullet or amortised) and the profit element/*ijarah* return. The profit element/*ijarah* return can be adjusted periodically, but often attracts a benchmarking issue, in particular, the link to interest-rate benchmarks such as LIBOR, which *Shari'ah* scholars generally do not prefer.

Compensation and Liquidated Damages

The general *Shari'ah* principle recommends that a customer struggling to pay a debt should not be further penalised by the Islamic financier but to be given forbearance (*hilm*). Over the years, there have been various attempts to impose an incentive to pay on time, either via specified compensation (with various formulations) or fixed (i.e., liquidated) daily sum, which often are payable to charity by the financier. Such a clause often triggers a dispute, as the financed party would argue that a penalty for delay or default, under whatever name, is tantamount to *riba*.

Set-off and Netting

The main question with this clause is whether it is fair and reasonable for a financier to set off a debt of the financed party with another account which he is holding with the financier. This may give rise to a disclosure issue. Many countries have laws for set-off and netting, and therefore the laws may apply regardless of the provisions of the contract.

Events of Default

The general *Shari'ah* principle requires that defaults must have arisen owing to the act or omission of the customer. The customer ought not to be responsible for something over which he has no control. However, in conventional financing, this distinction is rarely made. Especially in multi-tranche financings, a default clause may cover events such as *force majeure*, nationalisation, and so on, that is beyond the control of the customer.

Insurance and Maintenance

Under the general *Shari'ah* principle, the lessor in an *ijarah* must retain the responsibility for certain insurance and maintenance functions, while in a conventional lease, the lessee bears all these responsibilities. *Shari'ah* scholars have recommended that, among others, both the lessor and lessee shall look after the insurance and maintenance, depending on the asset class (e.g., ships, real estate, aircraft) as the approach to insurance and maintenance will differ for each asset class. For insurance, there can be a distinction between asset insurance and liability insurance, while for maintenance, a distinction between major and minor (or day-to-day) maintenance is permitted.

Total Loss

The general *Shari'ah* principle requires that once a total loss has occurred and the asset can no longer be used for its intended purpose, the lessor cannot continue to charge rental. It is recommended therefore for the lessor to acquire a loss of hire or business interruption insurance.

Case Study 5 Tort Liability and Implied Terms of Contract

As the interaction between Islamic financial contracts and the existing legal system becomes more widespread and active, there will be closer scrutiny on the application of terms incorporated in these contracts, especially by the courts. In this respect, it is interesting to observe that there have been cases whereby the courts, using the jurisprudence it is more familiar with, have assumed the incorporation of tortious liability and implied terms in the Islamic financial contracts in order to administer justice.

Tortious Liability: Duty of Care

While fiduciary duties and responsibilities, especially between principal (*muwakkil*) and agent (*wakil*), are well-recognised under the *Shari'ah*, they have not been extensively refined in the forms of duty of care, duty of loyalty, etc., as it has been seen under the common law system. Tortious liability arises when there is a need to observe duty of care, but consequently, it is breached and causes damage and harm to the other party. This tortious liability is indeed important, and should be duly considered in the domain of Islamic finance.

Inevitably, the application of such laws has to happen in a common law country, the UK. In **Riyad Bank and Others v Ahli United Bank (UK) Plc (2006),** the UBK had established a *Shari'ah*-compliant fund, whereby to comply with Islamic restrictions on how money can be invested to make a profit, the fund had invested assets in the operating leases of equipment, making a profit on the reversion of the leases. UBK initially approached Riyad Bank (Riyad) and its English subsidiary RBE to market its fund to Riyad's customers in Saudi Arabia. Commercially, however, this was unattractive to Riyad and RBE (which did not wish to market a Kuwait-based fund created by a smaller competitor). However, at the suggestion of UBK, RBE decided to set up its own fund, which would mirror that of UBK. It was agreed that UBK would bring its experience to the fund by assisting and advising RBE behind the scenes on its investments. To document the structure, UBK and RBE entered into a technical services agreement, which set out the ambit of UBK's services to RBE. A company was then acquired to embody the fund – RBE Ijara Fund Plc (the Fund). In turn, the Fund entered into an investment advisory agreement with RBE, under which RBE agreed to act as a general investment adviser to the Fund.

Following the advice from UBK, the Fund purchased a number of leases from US leasing companies which turned out to be significantly over-valued. The Fund's operation was suspended. To protect its reputation, Riyad purchased from all investors the entire issued shares in the fund at par value.

In the ensuing litigation, the Fund claimed that UBK had breached its *duty of care* and, as a result, it was entitled to damages following from UBK's negligent misstatements when giving advice. For obvious commercial reasons, the Fund did not seek to sue RBE under the investment advisory agreement. Had it done so, RBE would have been entitled to claim its losses from such action from UBK under the technical services agreement.

In response to the Fund's claim, UBK argued that no duty of care could arise because the parties had deliberately chosen to put in place a contractual structure excluding liability by UBK to the Fund. It argued that a tortious duty should not be imposed on parties to commercial contracts where (as in Riyad) there was no "liability gap" and the contractual arrangements enabled losses to be claimed within such a structure.

Upholding the Commercial Court's decision, the UK Court of Appeal unanimously held that UBK owed the Fund a duty of care. Referring to Lord Goff's leading judgement in **Henderson v Merrett Syndicates Ltd**, the Court of Appeal considered that its task was to consider whether in law, a duty should be imposed as a result of an assumption of responsibility by UBK and concomitant reliance by the Fund on it. It was then necessary to ascertain whether or not such liability had been excluded within the contractual arrangements put in place by the parties. The main findings were as follows:

1 A duty could arise if there was an assumption of responsibility by an advisor to an advisee if the relationship was akin to or the equivalent of a contract.

2 Once such assumption and reliance on the advisee's part had been found, there was no requirement for the Court to go on to consider whether the imposition of a duty on the defendant would be fair, just and reasonable.

3 It was for UBK to establish that the contractual context negated an assumption of liability. It was not the task of the Fund to show the assumption of responsibility survived notwithstanding the contractual structure of the Fund.

4 A duty of care could exist in cases where a contractual chain had been put in place in circumstances where no liability under that chain arose between the parties (in other words where there was no "liability gap").

5 The technical services agreement and the investment advisory agreement did not go so far as to exclude or negate a tortious liability between UBK and the Fund.

> In reaching their decisions, both the Court of Appeal and the High Court relied heavily on a number of factual findings made by Moore-Bick J (as he then was) during trial. In particular, the judge had found that, as UBK knew, the only reason RBE was interposed between UBK and the Fund was because the Fund (and consequently Riyad and RBE) did not want to appear to be a product of a Kuwaiti competitor bank. In addition, the precise structure had been designed at the parties' agreement to replicate UBK's original fund. The UBK fund had a UBK investment advisor and, accordingly, RBE had taken on that role in the Fund. Moreover, it was clear from the facts that UBK was perfectly aware that RBE had no expertise in the field in which it was purportedly advising the Fund: it was simply a face for investors enabling Riyad to get around its commercial reluctance, with UBK playing a public role.
>
> UBK had been involved from the outset and one of its senior employees had been the main source of advice on investment throughout the life of the Fund. That employee had attended all bar one of the investment meetings held by the Fund and actively advised the Fund at those meetings to invest in the (what turned out to be under-valued) leases.

The decision in *Riyad* reflects how the court may take a position that duty of care will not be avoided by the mere existence of a contractual chain in which liability for the ultimate loss is sufficiently addressed, albeit indirectly. As a consequence, advisors need to ensure that the paperwork between the advisor and its direct advisee, and also those further down the chain, sufficiently addresses or excludes liability by the adviser to the person ultimately acting on their advice, if they wish to limit this type of tortious liability.

Summary

1 This chapter introduced a few considerations for authorities to contemplate when deciding what should the appropriate legal framework for Islamic finance in their respective countries be.

2 Various factors, including the historical setting of the legal systems and the level of economic development of the country will influence the approaches adopted.

3 Compliance to the *Shari'ah* rules and principles is the *raison d'être* for Islamic finance. The legal framework must, therefore provide for an enabling environment whereby *Shari'ah* governance structures and processes shall be established to ensure efficient and effective *Shari'ah* compliance of Islamic financial products and institutions.

4 Since there is no single or uniformed legal system for Islamic finance, this, in particular, raises the challenge of ensuring a harmonious interface between *Shari'ah* rules and principles that underlie the Islamic commercial and financial contracts and the existing legal framework.

5 One of the key legal issues arising from the lack of codification of *Shari'ah* rules and principles is that there could be a lack of certainty and predictability of court decisions in any Islamic finance dispute, especially since under the *Shari'ah,* the doctrine of *stare decisis* (judicial precedent) is not applied. As a result, court decisions are rarely reported.

6 Without the force of law, *Shari'ah* governance will remain a purely voluntary process, which is unsatisfactory and far from prudent in protecting the integrity of the Islamic finance industry.

7 Given all the abovementioned issues, Islamic finance will continue to face numerous challenges on the legal front, as it is still in its infancy, and has a long way to go before its legal framework and infrastructure mature.

Key Terms and Concepts

Jurisdiction
Alternative Dispute Resolution (ADR)
Procedures
Legal System
Legal Framework
Shari'ah
Indemnity
Civil Law
Napoleonic Law
Common Law
Binding precedent
Case Law
Shari'ah Governance
Warranty

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Review Questions and Problems

1. There are at least three main legal systems that are applicable to jurisdictions that have the presence of Islamic financial services, namely the common law, civil law, and *Shari'ah* systems. Compare and contrast between each legal system when it comes to regulating Islamic finance.

2. Disputes arise whenever either party to a contract is alleged to have breached his or her duties and obligations. While the parties may bring the disputes to various forums in order to be resolved, the court normally is the only forum that has powers to legally bind or sanction parties to adhere to its orders. In your view, notwithstanding this, can alternative dispute resolutions such as arbitration and mediation be effective mechanisms for parties of an Islamic finance contract to resolve their disputes? Why?

3. One of the key legal issues arising from the lack of codification of the *Shari'ah* rules and principles is that there could be a lack of certainty and predictability of court decisions in any Islamic finance dispute, especially since under the *Shari'ah,* the doctrine of *stare decisis* (judicial precedent) is not applied. As a result, court decisions are rarely reported. Should *stare decisis* be adopted into the *Shari'ah*? Discuss the pros and cons of such a proposal.

4. Do we need standardisation of a legal framework in Islamic finance? To what extent does standardisation help in alleviating the current problems?

5. The English court is regarded as the final arbiter relating to international contracts. Can they be regarded as competent parties to decide the cases related to Islamic finance? Why or why not?

6. The enforceability of *Shari'ah* pronouncements vary from one state to another. Do you think this practice will help to enhance the industry's growth?

7. There are a number of international standard-setting bodies in operation, but none has a binding effect on Islamic financial institutions. What is your opinion on this issue and what are your suggestions to overcome it?

8. Do you think a court should respect the party autonomy rule and apply it in every legal contract of the parties involved?

9. International treaties are designed for the purpose of standardisation. The state party which ratified the convention would have to incorporate the treaty into the domestic legislation. Do you think having an international treaty for Islamic finance is the way forward for standardisation?

10. In your opinion, what is the best mechanism to settle disputes in Islamic finance?

Chapter 18

Accounting, Auditing and Taxation of Islamic Financial Institutions

Preview

The rapid growth of Islamic finance worldwide must be accompanied by robust regulation and supervision if Islamic financial institutions (IFIs) are to operate effectively, efficiently and competitively. Some of the key elements of regulation that need to be considered are accounting, auditing, and taxation.

With respect to accounting, some standard-setters such as the Malaysian Accounting Standards Board (MASB) have concluded that it would not be in conflict with the *Shari'ah* to apply conventional accounting standards, namely the International Financial Reporting Standards (IFRSs), to Islamic financial transactions. Conversely, others such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) believe that not all IFRS principles can be applied, and have formulated alternative accounting standards for certain transactions.

The first part of this chapter will compare and contrast the differing views regarding accounting for Islamic financial transactions. It will also discuss the role of regulators and standard-setters in the development of accounting standards for IFIs and conclude with an examination of comparative accounting treatments for selected Islamic transactions. The second part of the chapter presents the issues relating to *Shari'ah* auditing and its relationship with conventional financial auditing. Finally, the third part of this chapter will discuss tax issues in Islamic finance.

Learning Outcomes

At the end of this chapter, you should be able to:

- Explain the regulatory framework relating to the accounting, auditing and taxation of IFIs.
- Identify the accounting objectives, reports and disclosure requirements for IFIs.
- Understand the different accounting treatments for Islamic financial transactions under IFRS and AAOIFI standards.
- Demonstrate the application of account principles in the recording, classification, and reporting of various Islamic financial transactions.
- Examine the auditing and *Shari'ah* supervisory requirements in IFIs.
- Understand the tax issues relating to Islamic financial transactions and the importance of considering tax costs in undertaking Islamic financial transactions.

Part A: Accounting

Introduction

Accounting is the process of identifying, measuring, analysing and communicating economic information for financial statement users to make decisions. Thus, accounting is a special "language" used to communicate financial information about a business to those who wish to use the information to make decisions. There are two bases of accounting information:

1 Financial accounting, which is concerned with providing relevant financial information to various external users; and

2 Managerial accounting, which deals with the concepts and methods used to provide information to an organisation's internal users, that is, its management. This chapter will focus on financial accounting.

Islamic Accounting

Many academic writings on Islamic finance contend that there are aspects of accounting that do not accord with Islamic principles, thus giving rise to the need for "Islamic accounting". Islamic accounting has been described as the "accounting process" which provides appropriate information (not necessarily limited to financial data) to stakeholders of an entity, to ensure that the entity is continuously operating within the bounds of the *Shari'ah* and delivering its socioeconomic objectives (Mohamed Ibrahim, 2009).

Islamic accounting has been described as the "accounting process" which provides appropriate information (not necessarily limited to financial data) to stakeholders of an entity, to ensure that the entity is continuously operating within the bounds of the *Shari'ah* and delivering its socioeconomic objectives.

The importance of accounting is stressed in the *Qur'an*, in Surah *Al-Baqarah* verse 282, which reads: "*Oh you who believe! When you deal with each other in transactions involving future obligations in a fixed period of time, record it in writing. Let a scribe write down faithfully as between parties.*" This provides general approval and guidelines for the recording and reporting of transactions. In business affairs, all parties' rights and obligations should be fully documented for verification and exploration. This verse places an emphasis on recording material credit loans and transactions, and advises that these transactions are to be signed by debtors (to acknowledge their indebtedness and the amount thereof). This shows the importance of recording transactions, which represents the accounting process.

It is conceded that both Islamic and conventional accounting refer to the same process of providing information to financial statement users. However, proponents expound that Islamic accounting aims to enable users to ensure that Islamic organisations abide by the principles of the *Shari'ah* in their dealings and assess whether the objectives of the organisation are being met. At the very basic level, Islamic organisations differ from their conventional counterparts by having to adhere to certain *Shari'ah* principles and rules and achieve certain socioeconomic objectives encouraged by Islam. Thus, under Islamic accounting, social and environmental information is discussed in addition to economic information.

Additionally, Islamic accounting recognises that there may be a more diverse group of users than those addressed in conventional accounting. For example, the *Shari'ah* supervisory board, *zakat* authority, and the unrestricted and restricted investment account holders all look to the financial statements for entity-specific information. Many users of an IFI's financial statements desire information about its compliance with the principles of *Shari'ah* in all of its financial and other dealings, such as information disclosing the income earned and expenditure incurred by Islamic banks from prohibited transactions or sources, if any, and the manner in which these were disposed of. In addition, information about an entity's economic resources and related obligations, and the effect of transactions, other events and circumstances of the entity's economic resources and related obligations are also important. The information used to assist in the determination of *zakat* on an Islamic bank's funds and the purpose for which it will be disbursed, and to estimate cash flows that might be realised from dealing with the Islamic bank, should also be included in this statement. Information needed to assist users in evaluating the IFI's discharge of its fiduciary responsibility to safeguard funds and to invest at reasonable rates of return, and information about the Islamic bank's discharge of its social responsibilities should be incorporated as well.

Islamic accounting recognises that there may be a more diverse group of users than those addressed in conventional accounting, e.g., the *Shari'ah* supervisory board.

Finally, in certain circumstances Islamic accounting may require different statements altogether to de-emphasise the focus on profits by the income statement provided by conventional accounting. For example, Baydoun and Willett (2000) have suggested a Value Added Statement and Environmental Statement to be added in Islamic accounting.

Given that the stakeholders of entities engaged in Islamic financial transactions have different information needs from other users, and that the focus of accounting is different from an Islamic perspective, the question that consequently arises is whether different accounting treatments, and hence, different financial reporting standards would be needed as well, and whether financial statements should be the sole delivery method for such information. Perhaps additional statements should be required for other information relevant to the stakeholders.

Financial reporting standards lay down the principles relating to recognition (what item is to be recorded and when it is to be recorded), measurement (the amount at which an item is recorded), disclosure (information about the item recorded), and presentation (where in the financial statements an item is recorded). Many standard-setters believe that it is generally permissible to apply the principles in conventional standards such as the IFRS to Islamic financial transactions. However, the extent of what is deemed

Many standard-setters believe that it is generally permissible to apply the principles in conventional standards such as the IFRS to Islamic financial transactions.

permissible varies among standard-setters. Some, such as the MASB, believe that enhanced disclosures and presentation together with supplementary guidance could satisfactorily cater for the uniqueness of Islamic transactions and provide users with the additional information they seek. Others, in particular AAOIFI, insist that separate recognition and measurement principles must prevail for certain transactions. In later sections, we shall demonstrate these contrasting views by elaborating on differences between the requirements of MASB-approved accounting standards (which are adopted from IFRS) and AAOIFI financial accounting standards.

Accounting Standard-Setters

IASB

The International Accounting Standards Board (IASB) is an international accounting standard-setting body formed in 2001 as a result of restructuring of the International Accounting Standards Committee (IASC) which was originally established in 1973. The IASB issues International Financial Reporting Standards (IFRSs), which include the International Accounting Standards (IASs) issued by its predecessor, IASC. Among the IASB's principal objectives are "to develop a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards". To date, over 100 countries around the world have adopted, or are in the process of adopting, IFRSs. Although the IASB does not have a formal specific agenda on Islamic accounting, its transparent and consultative approach to standard-setting provides an avenue for affected and interested parties to forward issues or concerns regarding the accounting of Islamic financial transactions.

To date, over 100 countries around the world have adopted, or are in the process of adopting, IFRSs.

MASB

The MASB was established under the Financial Reporting Act 1997 as an independent authority to develop and issue accounting and financial reporting standards in Malaysia. In August 2008, the MASB announced its convergence plans to fully adopt IFRS by 1 January 2012. In view of convergence, the MASB had to decide whether the standards would also apply to Islamic financial transactions since the IFRS may not have taken into consideration Islamic transactions. After extensive deliberation and consultation, the MASB was assured that application of generally accepted accounting principles would not be in conflict with *Shari'ah*, and concluded that its accounting standards would apply to Islamic financial transactions unless there is a *Shari'ah* prohibition. The MASB's conclusion was documented in its Statement of Principles *i*-1 (SOP *i*-1), *Financial Reporting from an Islamic Perspective*, issued in September 2009, and reviewed by the *Shari'ah* Advisory Council of the Central Bank of Malaysia (*Bank Negara Malaysia*, or BNM). Any additional guidance that may be needed would be issued by way of other pronouncements such as technical releases, which would supplement rather than override the standards.

AAOIFI

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1990, and registered in Bahrain in 1991. In addition to issuing accounting standards, AAOIFI also issues standards on auditing, governance, ethics and *Shari'ah*. According to the Secretary-General's foreword to AAOIFI's bound standards, the impetus for its establishment as a standard-setting body was that some believed "the existing international standards were inadequate to cater for [the Islamic finance industry's] needs". AAOIFI also explained in the Introduction to its standards that in the early 1990's, research was conducted to determine the "appropriate methods for preparing accounting standards for IFIs". Additionally, AAOIFI wanted to address the lack of standardisation of *Shari'ah* accounting and auditing standards for IFIs in the GCC countries. AAOIFI standards are adopted in Bahrain, Dubai International Financial Centre (DIFC), Jordan, Lebanon, Qatar, Sudan and Syria. Some other jurisdictions such as Indonesia and Pakistan have issued their own Islamic accounting standards with requirements similar to AAOIFI.

Objectives and Concepts of Financial Reporting

The IASB and the US Financial Accounting Standards Board (FASB) have engaged in a project for a joint conceptual framework that would serve to bridge the gap between the two standard-setters, as well as to update and eventually replace the IASB's *Framework for the Preparation and Presentation of Financial Statements* issued in July 1989, and the FASB's Concept Statements. The project will take place over eight phases and would deal with the following topics:

Phase	Topic
A	Objectives and qualitative characteristics
B	Definitions of elements, recognition, and de-recognition
C	Measurement
D	The reporting entity concept
E	Boundaries of financial reporting, disclosure and presentation
F	Purpose and status of the framework
G	Application of the framework for not-for-profit entities
H	Remaining issues, if any

As of March 2011, Phases A, B, C and D are active; and two chapters, i.e., on the objective of financial reporting, and the qualitative characteristics of financial reporting information, were issued in September 2010.

AAOIFI's views on the objectives and concepts of financial accounting were originally encapsulated in its Statements of Financial Accounting (SFAs), i.e., SFA 1, *Objectives of*

Financial Accounting for Islamic Banks and Financial Institutions; and SFA 2, *Concepts of Financial Accounting for Islamic Banks and Financial Institutions*. In August 2010, SFA 1 and SFA 2 were replaced by a single Statement of Financial Accounting 1 (new SFA 1), *Conceptual Framework for Financial Reporting by Islamic Financial Institutions*.

Objectives of Financial Accounting

The first chapter of the IASB/FASB's joint conceptual framework states that "the objective of general purpose financial statements is to provide financial information about the reporting entity that is useful to potential investors, lenders and other creditors in making decisions about providing resources to the entity".

As discussed earlier, from an Islamic perspective, users of financial statements may desire more information than what is usually found in general-purpose financial statements. MASB SOP *i*-1 acknowledges this in paragraphs 4 to 5 by stating that "an entity does not only owe a fiduciary duty to investors, but is accountable to society as a whole. The preparation of financial reports to meet the needs of investors may not necessarily meet the needs of other users. Thus, additional information may be included in financial reports to meet the needs of those other users. The process of financial reporting from an Islamic perspective may require extended information in the financial statement and its notes, and may extend to areas outside of the financial statement, for example: (a) reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report, (b) social or environmental reports, (c) other items of non-financial reporting".

Similarly, AAOIFI's new SFA 1 states that "financial reporting is but one source of information needed by users of the reports. Users of financial reports also need to consider pertinent information from other sources, for example, information about the general economic conditions or expectations, political events and political climate and industry and company outlook".

Both within and without the Islamic sphere, there is growing pressure from stakeholders for sustainability reporting.

Both within and without the Islamic sphere, there is growing pressure from stakeholders for sustainability reporting. These reports may not be included in financial statements, but instead, may be placed in additional statements, like a Director's Report or a Corporate Sustainability Report.

It may be noted that the concerns raised by the MASB and AAOIFI could be said to relate to the boundaries of financial reporting, rather than to its objectives. The IASB and FASB plan to address the boundaries of financial reporting in Phase E of their joint conceptual framework project. However, as of March 2011 this phase of the project is not yet active.

Concepts of Financial Accounting

Under the IASB/FASB joint conceptual framework, the fundamental qualitative characteristics of financial reporting information are thought to be relevance and faithful representation, accompanied by the enhancing qualitative characteristics of comparability, verifiability, timeliness and understandability.

Completeness of a financial report requires inclusion of information regarding the full economic effect of the series of transactions.

Relevance

The IASB/FASB joint conceptual framework states that "relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or already are aware of it from other sources". For example, information on the permissibility of a transaction would influence a Muslim's economic decision, while a non-Muslim may be indifferent to it. Thus, relevance in the Islamic sphere may require an entity to take into account the information needs of Muslim users.

Faithful representation

A financial report ought to represent both the qualitative and quantitative aspects of economic phenomena. It must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction should have the characteristics of completeness, neutrality, and freedom from error.

A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. Modern-day Islamic financial phenomena often consist of a series of closely inter-related transactions. Completeness would require inclusion of information regarding the full economic effect of the series of transactions, in addition to information based on the legal form of the individual component transactions.

A neutral depiction is without bias in the selection or presentation of financial information, meaning that information is not manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions. Being neutral or free from bias is a concept that can be found in Islamic principles, as Muslims are enjoined to be fair in their dealings.

Faithful representation does not mean accuracy in all respects. Freedom from error does not mean perfect accuracy in all respects. The IASB/FASB joint conceptual framework gives the following example: "… an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate".

Enhancing qualitative characteristics

Comparability, verifiability, timeliness, and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented.

Comparability, verifiability, timeliness, and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. The enhancing qualitative characteristics may also help determine which of the two ways should be used to depict a phenomenon if both are considered equally relevant and faithfully represented.

Comparability

The quality of comparability enables users to identify and understand similarities in, and differences among, items. Users of the financial statements of an IFI would not only need to be able to compare the IFI's performance over time, or its performance with other IFIs, but may also require information to compare an IFI with conventional financial institutions.

However, comparability is not uniformity. For information to be comparable, like things must look alike and different things must look different. For example, when financing income from different sources are economically similar, that similarity must be shown; however, from an Islamic perspective it is equally important (or, even more so) to show the different sources of that financing income, i.e., how much of it arose from interest-based transactions, and how much from permissible contracts.

Verifiability

Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. This quality is important, especially within the context of *Shari'ah* audits of Islamic entities.

Timeliness

Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.

Understandability

Understandability must be tempered with the assumption that users of financial statements have a reasonable knowledge of business and economic activities. There must be balance in the information provided as the inclusion of some information could promote completeness, but obfuscate the nature of an economic phenomenon, while exclusion of some information could make the report easier to understand, but its incompleteness could mislead. As for reports on Islamic transactions, additional explanatory information may be required to enhance understandability when the intended user is a non-Muslim, or is unfamiliar with the Islamic transaction.

Additional explanatory information may be required to enhance the understandability of reports on Islamic transactions when the intended user is a non-Muslim.

MASB and AAOIFI Views on Concepts of Financial Accounting

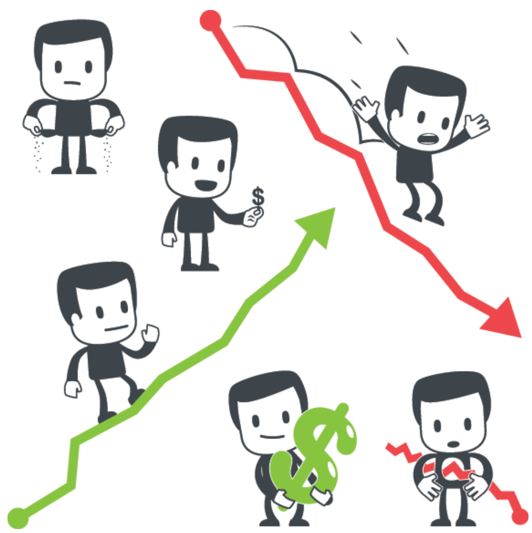
Both MASB SOP *i*-1 and AAOIFI's new SFA 1 find that the concepts of financial accounting found in conventional texts generally do not contradict with *Shari'ah* requirements, and therefore can be accepted in Islamic accounting. However, the main points of departure for the two standard-setters are their views on "substance over form" and "time value of money". In the IASB/FASB conceptual framework, substance over form is subsumed in faithful representation of the economic behaviour, and is deemed to be an inherent part of it. MASB accepts substance over form for financial reporting purposes, and AAOIFI's new SFA 1 acknowledges that "it is necessary that [transactions] are accounted for and presented in accordance with its substance and economic reality as well as the legal form". However, some of AAOIFI's standards, for example AAOIFI Financial Accounting Standard 8 (FAS 8), *ijarah* and *al-ijarah al-muntahiyah bittamlik*, seem to emphasise legal form for recognition and measurement purposes.

Similarly, the MASB has been assured that the concept of "time value of money" may be applied in the recognition and measurement of Islamic transactions (with the exception of *qard*). One reason why the MASB allows the use of the time value of money in valuation is because it is already a market practice to do so in the absence of a liquid market price. AAOIFI had historically rejected the concept of time value of money. Paragraphs 7 to 8 of the previous SFA 2 state that concepts used in traditional financial accounting but are inconsistent with *Shari'ah* were either rejected or sufficiently modified to comply with *Shari'ah* in order to make them useful. SFA 2 further states that "an example of such concepts is the time value of money as a measurement attribute. Indeed, money does not have a time value aside from the value of goods that are being exchanged through the use of money, in accordance with *Shari'ah*". It may be noted, however, that the new SFA 1 is silent on the matter of time value of money and it is unclear whether the new thinking at AAOIFI is more receptive of the concept. Chapter 11 explains the Islamic jurists' opinions regarding the concept of time value of money.

Accounting Recognition[1]

In IASB's *Framework for the Preparation and Presentation of Financial Statements (Framework)*, recognition is described as "the process of incorporating in the statement of financial position and income statement an item that meets the definition of an element" (i.e., asset, liability, equity, income or expense). Recognition principles determine the timing of revenue, expense, gain and loss recognition in the entity's income statement, as well as the timing of asset and liability recognition. The IASB *Framework* states that "an item that meets the definition of an element should be recognised if (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and (b) the item has a cost or value that can be measured with reliability".

Integral to the IASB Framework's concept of recognition is "probability". An element of the financial statement is recognised when it is probable to occur, which could include transactions and events which have yet to actually occur, or yet to be contractual. This concept has far-reaching consequences for an Islamic financial arrangement where one or more *wa'd* form part of the arrangement. Although *wa'd* is legally merely a promise and not a contract, IFRS may require its economic effect to be recognised in the financial statements if it is probable that any future economic benefit associated with the item will flow to or from the entity, and that economic benefit can be reliably measured.



Accounting Measurement[2]

The IASB Framework defines measurement as "the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried on the statement of financial position and income statement". Many of the newer accounting standards require measurement at fair value, or disclosure of fair value in the notes. However, other bases of measurement may be required for certain types of assets, liabilities, income and expenses, such as historical cost (the amount

The IASB Framework defines measurement as "the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried on the statement of financial position and income statement".

1 As of March 2011, the IASB is engaged in a joint project with the FASB to re-draft their respective conceptual frameworks and have not finalised the phases on recognition and measurement. Thus, this chapter's discussion on recognition and measurement relates to the IASB's *Framework* of July 1989, which was adopted by MASB in 2007.

2 See footnote 1 to "Accounting Recognition".

of cash or cash equivalents paid, or the fair value of the consideration given at time of acquisition), current cost (the amount of cash or cash equivalents that would have to be paid if the asset was currently acquired), realisable/settlement value (the amount of cash or cash equivalents that could currently be obtained by selling the asset in ordinary disposal), and present value (the present discounted value of the future net cash flows that an item is expected to generate in the normal course of business).

The use of fair value measurement is consistent with the Islamic point of view in order to ensure fairness and justice. For example, in determining *zakat* payable by an entity, the majority of *Shari'ah* scholars recommend the use of current prices on the due date of *zakat*. The argument for the use of current market value is based on the need for the most accurate valuation of wealth to be subjected to *zakat* in order to serve justice to both the *zakat* recipients and *zakat* payers.

In contrast, measurement based on present value appears to have received a lukewarm reception among the accounting fraternity in Islamic finance. Some are disconcerted by the need to refer to a rate of return, most commonly an interest rate, in discounting a stream of cash flows to its present value. While the MASB is satisfied that this merely requires a reference to an interest rate, and not the imposition of actual interest to the transaction, some other standard-setters have steered clear of requiring present value measurement, or discounting, for Islamic transactions under their jurisdictions. Similarly, standard-setters that have produced separate standards for Islamic transactions tend not to require measurement at amortised cost (which is not the same as measurement at cost, and which requires the application of an "effective interest method").

AAOIFI, however, asserts that the measurement attributes should be guided by the relevance, reliability, understandability and comparability of the information to be provided to the users. AAOIFI has recommended the use of cash equivalent value that indicates the value that would be realised if an asset was sold for cash in the normal course of business as at the date of the financial statement. As stated in AAOIFI Financial Accounting Standard 1 (FAS 1), *General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions*, in order to ensure the reliability and comparability of the cash equivalent value, it must be supported with objective indicators, logical and relevant valuation methods, consistency of the use of valuation methods, expert valuation, and conservatism in the valuation process. AAOIFI also recommends an alternative method, i.e., historical cost.

Accounting Disclosure and Presentation

The MASB acknowledges that where the application of MASB-approved accounting standards to a *Shari'ah*-compliant transaction does not adequately convey compliance with *Shari'ah* precepts, additional disclosures may be required to explain compliance with *Shari'ah* principles.

Adequate disclosure means that the financial statements should contain all the material information necessary to make them useful to users. The MASB acknowledges that where the application of MASB-approved accounting standards to a *Shari'ah*-compliant transaction does not adequately convey compliance with *Shari'ah* precepts, additional disclosures may be required to explain compliance with *Shari'ah* principles. Thus, IFIs are encouraged to provide additional disclosures to convey adequate information about its transactions and events.

MASB Technical Release *i*-3 (TR *i*-3), *Presentation of Financial Statements of Islamic Financial Institutions,*[3] provides the basis for the presentation and disclosure of financial statements of IFIs that conduct Islamic banking activities. TR *i*-3 sets out the overall considerations for the presentation and disclosure of the financial statements specific to these institutions to ensure the comparability of these statements with those in previous periods and with those of other IFIs. In addition, TR *i*-3 provides guidelines for the structure and basis of the content of financial statements to ensure conformity with *Shari'ah* requirements, and prescribes minimum disclosure requirements.

Certain required disclosures in TR *i*-3 include capital requirements, unusual supervisory restrictions, the role and authority of the *Shari'ah* advisor/board, significant asset and investment concentrations, information on the disposition of assets, and the entity's profit distribution policy. In addition to the above, TR *i*-3 requires an IFI to present, outside its financial statements, any other statements useful to users, for example, *zakat* fund and *qard* fund. An IFI is also encouraged to disclose:

1. The amount and nature of earnings realised from sources or means which are not permitted by *Shari'ah*;
2. The amount and nature of expenses not permitted by *Shari'ah*; and
3. The manner of disposal of prohibited earnings.

It is important to note that TR *i*-3 should be read in conjunction with all other MASB approved accounting standards, particularly MASB Financial Reporting Standard 101 (FRS 101), *Presentation of Financial Statements*, as together they form the basis for presentation and disclosure requirements for IFIs. Additionally, the recognition, measurement, and disclosure of specific Islamic-based transactions and events, such as *ijarah*, are discussed in other MASB Islamic accounting pronouncements.

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3 In 2001, MASB issued a standard entitled MASB *i*-l, *Presentation of Financial Statements of Islamic Financial Institutions*, later re-numbered FRS *i*-1_{2004}. This was the only Islamic accounting standard issued by MASB. Subsequent to MASB's announced convergence with IFRS, FRS *i*-1 was withdrawn in 2009, and in accordance with MASB's position as stated in SOP *i*-1, additional guidance on presentation of financial statements of Islamic financial institutions was instead issued in the form of a technical release, i.e., TR *i*-3.

AAOIFI FAS 1 discusses disclosure requirements for IFIs. FAS 1 requires general disclosures such as the currency used for measurement, significant accounting policies, unusual supervisory restrictions, prohibited earnings and expenditures, asset and investment concentrations, asset distributions, contingencies, restricted assets, subsequent events, and related party transactions. Many of the AAOIFI disclosure requirements are similar to those required under MASB's guidance.

In addition to accounting standards, IFIs may also be required to comply with accounting-related directives from other regulatory authorities. In Malaysia, BNM has issued *Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks* (GP8-*i*)[4] which sets out the minimum requirements for the presentation and disclosure of reports and financial statements of Islamic banks. GP8-*i* is also aimed at ensuring consistency and comparability of the reports and financial statements amongst the Islamic banks in complying with the provisions of the Islamic Banking Act 1983, Companies Act 1965, *Shari'ah* requirements and other BNM guidelines. The salient features of GP8-*i* are as follows:

In Malaysia, BNM has issued *Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks* (GP8-*i*) which sets out the minimum requirements for the presentation and disclosure of reports and financial statements of Islamic banks.

1 Performance overview and statement of corporate governance.
2 Disclosure of *Shari'ah* Advisory Board/Committee and *zakat* obligations.
3 Report of the *Shari'ah* Advisory Board/Committee.
4 Profit Equalisation Reserves (PER).
5 Classification of deposits from customers and placement from banks and other financial institutions.
6 Presentation of income statement.

Accounting Treatment of Islamic Financial Transactions

This section will compare and contrast the requirements for the recognition, measurement, disclosure and presentation of selected Islamic financial transactions under an IFRS framework and under AAOIFI standards. The transactions considered include *mudarabah*, *musharakah*, *murabahah*, *ijarah* and *sukuk*.

4 GP8-*i* was first issued in August 2003. Since then several supplementary circulars have been issued, and at the time of writing, a revision to GP8-*i* is underway. The revised GP8-*i* is expected to incorporate, among others, the new requirements of MASB-approved accounting standards.

Islamic financial transactions under IFRS

In an IFRS environment, the accounting treatment for an Islamic transaction depends less on the "name" of the transaction (e.g., *mudarabah*, *musharakah*, *murabahah*) and more on the economic substance of the transaction. While technically all IFRSs must be taken into consideration, those IFRS that would most affect the accounting of Islamic transactions are the following:

1. IAS 39 *Financial Instruments: Recognition and Measurement* (to be replaced by IFRS 9 *Financial Instruments*)
2. IFRS 7 *Financial Instruments: Disclosures*
3. IAS 32 *Financial Instruments: Presentation*
4. IAS 17 *Leases* (to be revised; proposed revisions issued as IASB Exposure Draft 2010/9 Leases)
5. IAS 18 *Revenue* (to be revised; proposed revisions issued as IASB Exposure Draft 2010/6 *Revenue from Contracts with Customers*)
6. IAS 23 *Borrowing Costs*
7. IFRS 4 *Insurance Contracts*

Additionally, the following Interpretations to the standards would also be of significance to Islamic finance:

1. SIC 12 *Consolidation – Special Purpose Entities*
2. SIC 27 *Evaluating the Substance of Transactions involving the Legal Form of a Lease*

Most Islamic transactions, as conducted by IFIs, would likely be deemed financial instruments and fall within the scope of IAS 39 (adopted by MASB as FRS 139). Under IAS 39, financial assets would be classified as one of four categories, depending on the criteria met:

1. Financial assets with fair value changes through the profit and loss statement.
2. Held-to-maturity investments.
3. Loans and receivables.
4. Available-for-sale financial assets with fair value changes through other comprehensive income.

Financial liabilities would be categorised as either:

1. Financial liabilities at fair value through profit or loss.

2 Other financial liabilities measured at amortised cost using the effective interest method.

These categories are used to determine how financial instruments (i.e., financial assets and financial liabilities) would be recognised and measured in the financial statements. After initial recognition, financial assets and liabilities (including derivatives) should be measured at fair value, with the following exceptions:

1 Loans and receivables, held-to-maturity investments, and non-derivative financial liabilities should be measured at amortised cost using the effective interest method.

2 Investments in equity instruments with no reliable fair value measurement (and derivatives indexed to such equity instruments) should be measured at cost.

3 Financial assets and liabilities that are designated as a hedged item or hedging instrument are subject to measurement under the hedge accounting requirements of the IAS 39.

Exhibit 18.1 Amortised Cost and the Effective Interest Method

Measurement at amortised cost is not measurement at cost. Amortised cost is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

Illustrative example

On 1 January 2011, an entity purchased *sukuk* with a 5-year maturity for a fair value of $1,000. The *sukuk* has a face value of $1,250 and is expected to bear a rate of return of 4.7% that would be paid annually. The effective interest rate is 10%.

The cash flows would be as follows:

Year	Principal	Returns	Net cash flow
2011	(1,000)	59	(941)
2012		59	59
2013		59	59
2014		59	59
2015	1,250	59	1,309

Exhibit 18.1 Amortised Cost and the Effective Interest Method (continued)

Applying the effective interest method, the amortised cost would be:

Year	Principal	Returns	Net cash flow
2011	1,000	100	1,041
2012	1,041	104	1,086
2013	1,086	109	1,136
2014	1,136	113	1,190
2015	1,190	119	0

A comparison of the accounting entries between measurement at cost, and at amortised cost is as follows:

At Cost (with accretion of discount)			At Amortised Cost		
2011 – on initial recognition			**2011 – on initial recognition**		
DR Investment	1,000		DR Investment	1,000	
CR Cash		1,000	CR Cash		1,000
2011 – on recognition of income			**2011 – on recognition of income**		
DR Cash	59		DR Cash	59	
CR *Sukuk* income		59	DR Investment discount	41	
DR Investment	50		CR *Sukuk* income		100
CR Accretion of discount		50			
2012 to 2015 – on recognition of income			**2012 – on recognition of income**		
DR Cash	59		DR Cash	59	
CR *Sukuk* income		59	DR Investment discount	45	
DR Investment	50		CR *Sukuk* income		104
CR Accretion of discount		50			
2015 – on redemption of *sukuk*			**2013 – on recognition of income**		
DR Cash	1,250		DR Cash	59	
CR Investment		1,250	DR Investment discount	50	
			CR *Sukuk* income		109
			2014 – on recognition of income		
			DR Cash	59	
			DR Investment discount	54	
			CR *Sukuk* income		113
			2015 – on recognition of income		
			DR Cash	59	
			DR Investment discount	60	
			CR *Sukuk* income		119
			2015 – on redemption of *sukuk*		
			DR Cash	1,250	
			CR Investment		1,000
			CR Investment discount		250

It is important to note that the IASB is in the midst of replacing IAS 39 with IFRS 9, *Financial Instruments*.[5] Phase 1 on classification and measurement was completed and issued in 2009. Under IFRS 9, financial assets are required to be measured at either amortised cost or fair value. IFRS 9 limits measurement at amortised cost to assets that are: (a) held within a business model whose objective is to hold financial assets in order to collect contractual cash flows, and (b) the contractual terms of the financial asset, which gives rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding. All other financial assets would be required to be accounted for at fair value. Any fair value changes for financial assets not measured at amortised cost would immediately be charged to profit and loss, unless the financial asset is an equity instrument. Phase 1 of IFRS 9 only amended the guidance related to financial assets; the IASB has not indicated that there would be any significant change to the guidance related to financial liabilities.

The exposure draft on Phase 2, amortised cost and impairment, introduces the concept of "expected loss"; an entity would be required to assess and recognise the expected losses on a financial asset even though no trigger event (such as financial difficulties, or late payment) has occurred. With regard to Islamic finance, the up-front recognition of "expected losses" may potentially impact the *mudarabah* and *musharakah* profits distributed to the different "generations" of account holders. Expected losses could also be seen as a form of a statistical-based provision reflecting actual current market behaviour of certain asset classes.

The exposure draft on Phase 2, amortised cost and impairment, introduces the concept of "expected loss".

Phase 3, hedge accounting, aims to improve existing guidelines on transactions that qualify for hedge accounting. Islamic hedging is a comparatively new field, and those involved or interested in the area may wish to note how it may impact the accounting for Islamic hedging mechanisms, such as profit rate swaps and Islamic cross-currency swaps, as these usually make use of commodity *murabahah* contracts rather than the derivatives common to conventional hedging.

Accounting for *Mudarabah*

Definition

Mudarabah is a contract in which one party provides capital (*rabbul mal*, i.e., the capital provider) and the other party provides work (*mudarib*, i.e., the entrepreneur). Under *mudarabah*, profits are shared between the parties according to a pre-determined profit-sharing ratio, whereas the losses are to be borne by the capital providers unless due to violation of the stipulated contract by the entrepreneur, where the entrepreneur bears such loss. There are three types of *mudarabah* as illustrated in Table 18.1.

5 IFRS 9 is being developed over three phases, i.e., Phase 1: Classification and Measurement, Phase 2: Amortised Cost and Impairment, and Phase 3: Hedge Accounting. As of March 2011, the IASB has finalised Phase 1 and has issued exposure drafts on Phase 2 and Phase 3 for public comment.

Table 18.1 Types of *Mudarabah*

Type of Mudarabah	Description
1 Bilateral *Mudarabah* (Simple *Mudarabah*)	One party is the capital provider and another party is the entrepreneur. Example: A customer provides RM10,000 to the bank who acts as an entrepreneur. The profits are to be shared 40:60 (bank). If the profit is RM2,000, the customer will get RM800 and the bank will get RM1,200. If the loss is RM500, all the losses will be borne by the capital provider, i.e., the customer.
2 Multilateral *Mudarabah*	Several parties are the capital provider and one party is the entrepreneur. Example: Customer A and customer B provide RM10,000 and RM10,000, respectively to the bank who acts as an entrepreneur. The profit-sharing ratio is 70:30 (bank). The profits and losses are to be shared between the capital providers based on the capital contribution. If the profit is RM10,000, the bank will get RM3,000. Customer A will get RM3,500 and customer B will get RM3,500. If the loss is RM1,000, customer A will bear RM500 and customer B will bear RM500.
3 Re-*mudarabah* (Two-tier *mudarabah*)	Three parties, which include the capital provider, intermediate *mudarib* (entrepreneur) and final *mudarib* (entrepreneur). Example: Customer A provides RM10,000 to the bank (intermediate entrepreneur), which then invests it with company XYZ (final entrepreneur). The profit-sharing between customer A and the bank is 60:40 (bank) and between the bank and company XYZ is 70:30 (company XYZ). If the profit is RM10,000, company XYZ will get RM3,000, the bank will get RM2,800 and customer A will get RM4,200. If the loss is RM1,000, all the losses will be borne by customer A unless it is due to the negligence of the bank or company XYZ.

Mudarabah under IFRS

If the actual returns on *mudarabah* financing are expected to be closely based on some indicative rate of return, the transaction may be viewed under IAS 39 as a financial asset with fixed or determinable payments that are not quoted in an active market. As such, it would likely be classified in the loans and receivables category.

Conversely, as *mudarabah* financing often relates to a business or entre-preneurial operation, the valuation of the *mudarabah* financial asset could depend on the revenue generated by the operation. In such circumstances, the *mudarabah* financial asset is likely to be measured at fair value, with subsequent changes in fair value either recognised in profit and loss or other comprehensive income (depending on the entity's intent for the asset).

However, under the new guidance in IFRS 9, *mudarabah* financial assets may have to be accounted for at fair value with changes recognised in profit and loss, if the payments do not consist of only principal and interest, and *mudarabah* is not considered an equity instrument. This could result in significant changes for some entities, as under IAS 39, certain fair value changes could be recognised in other comprehensive income.

In Malaysia, *mudarabah* placed by customers with Islamic banks are usually classified as liabilities, as originally interpreted by the Islamic Banking Act 1983[6]. As such, these acceptances would receive similar classification as their *mudarabah* asset counterparts, i.e., categorised as loans and receivables. *Mudarabah* structured as "restricted investments" as described by AAOIFI are more likely to occur within the ambit of fund management activities. In such cases, the *mudarabah* would be reported in an "off-balance sheet" format, somewhat similar to that of a unit trust manager and the funds it manages.

In Malaysia, *mudarabah* placed by customers with Islamic banks are usually classified as liabilities, as originally interpreted by the Islamic Banking Act 1983.

Mudarabah under AAOIFI

In jurisdictions where AAOIFI applies, AAOIFI Financial Accounting Standard 3 (FAS 3), *Mudaraba Financing* prescribes the accounting for *mudarabah* financing by Islamic banks, but does not deal with funds received on *mudarabah* basis. Accrual basis is used in recording *mudarabah* financing.

The *mudarabah* capital is to be measured at the initial carry value except for the repayment of capital which should be deducted from the *mudarabah* financing. However, if the partial loss of the capital occurs (e.g., theft or fire) before work on the *mudarabah* contract begins (and not due to negligence of the *mudarib*), this should also be deducted from the *mudarabah* financing account and debited to the profit and loss account. If the complete *mudarabah* capital is lost, the *rabbul mal* must bear the loss and terminate the contract. Any unpaid amounts remaining become a receivable of the bank from the ex-*mudarib*.

In addition to the capital provided in the form of cash at the time of contracting, FAS 3 also caters for the capital provided in the form of trading assets (goods) or non-monetary assets for utilisation (land, ships, equipment). In the case of trading assets or non-monetary assets for utilisation, the standard requires that these assets be measured at their fair value (the value agreed between the Islamic bank and the client), and any difference between the fair value of the assets and their book value should be recognised as profit or loss to the Islamic bank. The account should be called "*Mudarabah* Financing" and in the case of non-monetary assets, "Non-monetary *Mudarabah* Assets".

6 The original Islamic Banking Act 1983 considered a *mudarabah* placed by customers with an Islamic bank to be "investment account liabilities" or "deposit liabilities". Presumably, this was for consumer protection; in case of insolvency, *mudarabah* account holders would likely rank *pari passu* with other depositors and thus would not be exposed to equity holders' risk. In 2005, the Act was amended to, among others, remove the requirement for classification as liabilities.

FAS 3 requires the recognition of profits or losses either at the time of liquidation if the transaction is concluded within the financial period or when both the Islamic bank and the client make partial or full settlement.

Table 18.2 Accounting Treatments for *Mudarabah* Financing

Transactions	Effect	Journal Entries
1 Provided financing to *mudarib*	Increase asset of *mudarabah* financing Decrease asset of cash	Dr *Mudarabah* Financing Cr Cash
2 Repayment of *mudarabah* financing to *rabbul mal* (capital provider)	Decrease asset of *mudarabah* financing Increase asset of cash	Dr Cash Cr *Mudarabah* Financing
3 Received profit from *mudarabah* financing	Increase asset of cash Increase revenue	Dr Cash Cr Income Statement
4 Incurred losses from *mudarabah* financing (to be borne by *rabbul mal* only)	Increase expenses Decrease asset of *mudarabah* financing	Dr Income Statement Cr *Mudarabah* Financing

With regard to presentation in the financial statements, FAS 3 requires *mudarabah* financing to be presented under asset in the Statement of Financial Position of the bank, and profits and losses resulting from *mudarabah* financing shall be presented in the Income Statement under Income from *mudarabah* financing.

Statement of Financial Position

Mudarabah Financing (Non-Monetary *Mudarabah* Asset)*
Less : Provision for decline in value of *Mudarabah* Assets
Net *Mudarabah* Financing
*Jointly or self-finance assets

Income Statement

Mudarabah Income

Issues in Accounting for Mudarabah

As mentioned earlier, FAS 3 only covers *mudarabah* from the financing aspect and not *mudarabah* as a deposit. In the case of a *mudarabah* deposit for unrestricted investments (where the bank can commingle the funds with any funds and invest at the discretion of the bank), AAOIFI FAS 1 recommends to disclose it between liability and equity as this fund is neither liability nor equity. It is not a liability because the bank as an entrepreneur has no obligation to pay back to the capital provider in full in the case of a loss. It is also not an equity because these investment account holders are not owners of the bank.

However, for restricted investment accounts (where the bank cannot commingle these funds with any other funds and must be invested based on the request of the investment account holder), AAOIFI suggests presenting items related to the restricted investment account in a separate Statement of Restricted Investment Accounts. In other words, it will be an off-statement of financial position.

Accounting for *Musharakah* and *Musharakah Mutanaqisah*

Definition

Musharakah is a partnership between the Islamic bank and its clients, where both parties:

1. Contribute equal or varying amounts of capital to establish a new project or share in an existing one.
2. Have capital, which can be on a permanent or declining (capital) basis and the partner will have his due share of the profits.
3. Share the proportionate losses according to the capital contribution and not otherwise.

Musharakah *under IFRS*

Similar to *mudarabah* financing, *musharakah* transactions undertaken by an Islamic bank would likely be accounted for under IAS 39, which would typically result in *musharakah* assets being accounted for at fair value (with fair value changes going through either profit and loss or other comprehensive income, depending on the classification). Also similar to *mudarabah*, a transition to IFRS 9 may require fair value changes of *musharakah* assets to be recognised in profit and loss.

Similar to *mudarabah* financing, *musharakah* transactions undertaken by an Islamic bank would likely be accounted for under IAS 39.

Musharakah *under AAOIFI*

AAOIFI Financial Accounting Standard 4 (FAS 4), *Musharakah* Financing, provides accounting guidance on the recording of *musharakah* for entities in AAOIFI jurisdictions. According to FAS 4, *musharakah* is divided into constant *musharakah*, in which the partners' shares in the capital remain constant throughout the period as specified in the contract and *musharakah mutanaqisah* (diminishing *musharakah*), in which the Islamic bank agrees to gradually transfer to the other partner its (the Islamic bank's) share in the *musharakah* financing, so that the Islamic bank's share declines and the other partner's share increases until the latter becomes the sole proprietor of the venture. *Musharakah mutanaqisah*, or diminishing *musharakah*, is based on a partnership under the concept of *shirkah al-milk* or joint-ownership with an element of rental or *ijarah*.

Musharakah mutanaqisah, or diminishing *musharakah*, is based on a partnership under the concept of *shirkah al-milk* or joint-ownership with an element of rental or *ijarah*.

The accounting treatment for *musharakah* financing, with regard to the measurement of capital in kind and profit recognition is similar to *mudarabah* financing as per FAS 3. In the case of diminishing musharakah financing, at the end of a financial period, the share of the Islamic bank is measured at historical cost less the portion transferred to the partner at fair value. The difference is recognised as profit (loss) in the income statement. In addition, if the diminishing *musharakah* financing is liquidated before the share of the bank is transferred to the partner, the recovered amount (by liquidation) from the Islamic bank's share therein should be deducted from the *musharakah* financing capital and the resulting profit (loss) from the difference between the book value and the recovered amount should be recognised in the income statement. Table 18.3 provides the accounting treatment for *musharakah* financing which are similar to *mudarabah* financing, except in the case of losses where both partners share the loss based on capital contribution.

Table 18.3 Accounting Treatment for *Musharakah* Financing

Transactions	Effect	Journal Entries
1 Provided financing to *musharik*	Increase asset of *musharakah* financing Decrease asset of cash	Dr *Musharakah* Financing Cr Cash
2 Repayment of *musharakah* financing to capital provider	Decrease asset of *musharakah* financing Increase asset of cash	Dr Cash Cr *Musharakah* Financing
3 Received profit from *musharakah* financing	Increase asset of cash Increase revenue	Dr Cash Cr Income Statement
4 Incurred losses from *musharakah* financing (to be shared between the parties based on capital contribution)	Increase expenses Decrease asset of *musharakah* financing	Dr Income Statement Cr *Musharakah* Financing

With regard to presentation in the financial statements, *musharakah* financing, which is similar to *mudarabah* financing, is disclosed under asset in the statement of financial position of the bank and the *musharakah* income will be disclosed in the income statement.

Statement of Financial Position

Musharakah Financing (Non-Monetary *Musharakah* Asset)*
Less : Provision for decline in value of *Musharakah* Assets
Net *Musharakah* Financing
*Jointly or self-finance assets

Income Statement

Musharakah Income

Accounting for *Murabahah*

Definition

There are two types of *murabahah*: *murabahah* and *murabahah* to the purchase orderer. In Malaysia, *murabahah* financing is known as *bay' bithaman ajil* (BBA). *Murabahah* is frequently referred to as "cost-plus financing" and commonly appears as a form of trade finance based upon letters of credit. In its simplest form, this agreement entails the sale of an item on a deferred basis. A commodity *murabahah* transaction is a sale of an asset to a purchaser for payment on a deferred basis, who then sells the asset to a third party for cash.

The commodity *murabahah* concept is widely used in *Shari'ah*-compliant financing and deposit products as well as in liquidity management/treasury instruments and other investment products or securities.

Murabahah to the purchase orderer is a sale in which two or more parties negotiate and promise with each other to execute an agreement according to the customer's specifications. The customer (orderer) asks the bank (purchaser) to purchase an asset, which it promises to buy from the bank at a price plus specified profit. The bank, then purchases the asset from the vendor and executes a *murabahah* contract of sale to the customer and delivers the asset. However, the customer may or may not be obliged to conclude the sale.

Murabahah *under IFRS*

Murabahah as a sale may fall under IAS 18, *Revenue Recognition* (adopted by MASB as FRS 118). In the purchaser's books, the purchaser would view the transaction as a purchase of assets. However, although the purchaser's acquisition of the asset occurred through a sale, IAS 18 and IAS 23, *Borrowing Cost* (adopted by MASB as FRS 123) would most likely disallow the purchaser from recognising the bank's mark-up portion as part of the carrying amount of the asset. Under paragraph 11 of IAS 18, the difference between the fair value and the nominal amount of consideration would need to be recognised as financing under IAS 39. However, if specific criteria are met under IAS 23, an entity would be allowed to capitalise borrowing (financing) costs, but must cease capitalisation when all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. As for *murabahah* conducted by IFIs, *murabahah* assets would most likely be treated in accordance with IAS 39 requirements for financial assets.

MASB Technical Release *i*-4 (TR *i*-4), *Shariah Compliant Sale Contracts*, re-affirms the above accounting treatment for Islamic sale-based transactions.

Murabahah *under AAOIFI*

AAOIFI Financial Accounting Standard 2 (FAS 2), *murabahah* and *murabahah* to the *Purchase Orderer*, is a standard that covers the treatment of *murabahah financing*. FAS 2 prescribes two accounting treatments to measure the asset value after its acquisition by the Islamic bank. In the sale of *murabahah* to the purchase orderer, if the bank follows the *Shari'ah ruling* that obliges the client to fulfil his promise after the bank acquires the asset, the bank is required to use the historical cost to measure the asset ordered by the client at the end of the financial period. Alternatively, if according to the bank's *Shari'ah* ruling, the client is at liberty to fulfil his promise or not, and the cash equivalent value of the asset at the end of the financial period was less than its historical cost, then the bank is required to use the cash equivalent value to record the value of the asset. The Islamic bank is also required to recognise the difference between the historical cost of the asset and its cash equivalent value by making a provision for the decline in the value of the asset. Upon financing the customer, the *murabahah* receivables should be recorded (by the bank) at face value (cash equivalent value) less provision for doubtful debts.

> In the sale of *murabahah* to the purchase orderer, if the bank follows the *Shari'ah* ruling that obliges the client to fulfil his promise after the bank acquires the asset, the bank is required to use the historical cost to measure the asset ordered by the client at the end of the financial period.

In a *murabahah* to the purchase orderer, the promise by the customer (the purchase orderer) to buy may be binding or non-binding. However, this will present problems to the Islamic banks as it incurs cost to purchase the goods, and as a financing institution would not want to be left with unsold inventory.

In order to reduce the risk of the Islamic bank, the bank may require a deposit from the orderer (potential customer) to ensure his seriousness. According to FAS 2, there are two types of deposits which the bank can demand. One is known as *hamish jiddiyyah* and the other one is *'urbun*, each with different characteristics. *Hamish jiddiyyah* is the amount paid by the purchase orderer upon request of the purchaser to make sure that the orderer is serious in his order of the asset. However, if the promise is binding and the purchase orderer declines to purchase the asset, the actual loss incurred to the purchaser shall be made good from this amount. On the other hand, *'urbun* is the amount paid by the client (orderer) to the seller (i.e., the original purchaser) when the former purchases an asset from the seller. If the customer proceeds with the sale and takes the asset, then the *'urbun* will be part of the price; otherwise, the *'urbun* will be for the seller.

> According to FAS 2, there are two types of deposits which the bank can demand – *hamish jiddiyyah* and *'urbun*, each with different characteristics.

Hamish jiddiyyah can cause problems because in the case of a non-binding promise, the bank will have to return the deposit in full to the potential customer, even if it subsequently incurs a loss in selling the goods, which the original orderer had refused to take delivery. In case the promise is binding and the customer declines, the bank can deduct any losses and expenses it incurs on the transaction from the deposit and return the excess. If the loss is greater than the deposit, the customer becomes liable for the balance.

Hamish jiddiyyah can cause problems because in the case of a non-binding promise, the bank will have to return the deposit in full to the potential customer, even if it subsequently incurs a loss in selling the goods, which the original orderer had refused to take delivery.

In the case of *'urbun* deposit, this is deducted from the purchase price if the customer proceeds with the sale. If not, the customer loses his deposit, even if the deposit is more than the loss incurred by the bank.

In order to make it safer for Islamic banks, it should make the contract a binding promise and then require *hamish jiddiyyah* or *'urbun*. However, this does not solve the problem of credit risk, i.e., payment default by the customer. To mitigate this, the bank may request for a guarantee from the customer. The goods sold under *murabahah* can be collateral for the debt. In this case, however, the customer cannot sell the goods until the debt is repaid to the bank.

FAS 2 also provides that in cases of late payment and procrastination by the customer, the bank normally cannot levy any penalty as this would amount to interest. However, if the *Shari'ah* board agrees on a penalty, then this penalty cannot be recognised as revenue but must be given away as charity. The Islamic bank can institute legal proceedings to recover the debt and financial damage caused by procrastination (e.g., legal fees, "lost opportunity"). Unless the goods sold are collateral, the goods cannot be taken by the Islamic bank to settle an outstanding debt. If the indebted owner is insolvent and fails to settle the debt, the bank should defer the collection until he becomes solvent.

If the bank gets a discount on the purchase price, this will belong to the bank unless it was obtained at the time the promise to buy (by the customer) was made or before the *murabahah* sale was concluded.

The last rule to consider is early settlement of the debt or a lump sum payment before the scheduled time. Since the transaction is a sale, the bank is under no obligation to give a discount to the customer. However, due to competitive pressures, the Islamic banks do give a discount for an early settlement. This is allowed under *Shari'ah* principles and is called *ibra'*. The amount must be agreed between the bank and the customer at the time of settlement or before the lump sum payment is made.

With regard to the profit, it is recognised at the time of contracting if the sale is for cash or on credit not exceeding the current financial period. If the credit period is more than one financial period with a single or several instalments, FAS 2 prescribes two

Cash basis method recognises profit as and when the instalments are received. The cash basis method requires the approval of the *Shari'ah* Supervisory Board.

accounting treatments for profit recognition which are on an accrual basis method and cash basis method. Accrual basis method recognises profit based on a proportionate allocation of profits whether cash is received or otherwise. Cash basis method recognises profit as and when the instalments are received. The cash basis method requires the approval of the *Shari'ah* Supervisory Board.

However, FAS 2 gives preference to the accrual method and requires the implementation of the cash basis method and the approval of either the bank's *Shari'ah* Supervisory Board or the concerned supervisory agency in the country.

At the time of the acquisition of an asset, the historical cost is used to record the asset. *Murabahah* receivables are recorded at face value. FAS 2 also requires the deferred profits to be offset against the *murabahah* receivables. Therefore, the net receivables recorded are equivalent to the original cost. This is meant to give relevant information and a faithful representation of the financial position of the Islamic bank. Under FAS 2, the instalments paid are split between a receivable reduction and a profit element. This is very similar to recording of loans and finance leases in lessors' books.

Table 18.4 Accounting Treatments for *Murabahah* Financing

Transactions	Effect	Journal Entries
1 Purchase of asset (equipment) by bank.	Increase asset of equipment Decrease asset of cash	Dr Equipment Cr Cash
2 Received *hamish jiddiyyah/'urbun* from customer.	Increase asset of cash Increase liability	Dr Cash Cr Customer
3 If the contract is concluded, *hamish jiddiyyah* is refunded in full to the customer for the binding contract. In the case of *'urbun*, the amount will be deducted from the purchase cost.	Decrease asset of cash Decrease liability	Dr Customer Cr Cash
4 Equipment sold to the customer under the *murabahah* contract.	Decrease asset of equipment Increase asset of *murabahah* financing Increase deferred profit	Dr *Murabahah* Financing (cost + profit) Cr Equipment Cr Deferred profit
5 Received instalment from the customer.	Increase asset of cash Decrease *murabahah* financing	Dr Cash Cr *Murabahah* Financing
6 Recognised profit as each instalment is received.	Increase revenue Decrease deferred profit	Dr Deferred profit Cr Income Statement
7 Termination of contract.	Increase asset of cash/receivable Decrease *murabahah* financing	Dr Cash/Receivable Cr *Murabahah* Financing
8 Rebate for early payment.	Decrease murabahah financing Decrease deferred profit	Dr Deferred profit Cr *Murabahah* Financing
9 Penalty for late payment.	Increase asset of cash/receivable Increase liability of charity payable	Dr Cash/Receivable Cr Charity Payable

FAS 2 requires the Islamic bank to disclose the *murabahah* receivables in the statement of financial position and any deferred profits (unearned) shall be offset against the *murabahah* receivables. FAS 2 also requires Islamic banks to disclose in the notes accompanying the financial statements, whether it considers the promise made in the sale of *murabahah* to purchase orderer, obligatory or not.

Statement of Financial Position

Murabahah Receivables
Less : Deferred Profit
Net *Murabahah* Financing

Income Statement

Murabahah Income

Accounting for *Ijarah*

Definition

Ijarah is an Islamic alternative to leasing. Leasing backed by an acceptable contract is an acceptable transaction under *Shari'ah*. *Ijarah* is a contract whereby the owner of an asset, other than consumables, transfers its usufruct to another person for an agreed period at an agreed consideration. AAOIFI Financial Accounting Standard 8 (FAS 8), *ijarah* and *al-ijarah al-muntahiyah bittamlik,* defines *ijarah* as "leasing of property pursuant to a contract under which a specified permissible benefit in the form of usufruct is obtained for a specified period in return for a specified permissible consideration".

Ijarah *under IFRS*

IAS 17, *leases* requires that a lease be classified as either a finance lease or an operating lease. A lease is classified as a finance lease if the lessor transfers substantially all the risks and rewards incidental to ownership of the asset to the lessee. The lessee, not the lessor, would recognise the leased asset regardless of whether title may or may not eventually be transferred. All other leases, which do not meet this criterion, are to be classified as operating leases in which case the lessor continues to recognise the leased asset.

A lease is classified as a finance lease if the lessor transfers substantially all the risks and rewards incidental to ownership of the asset to the lessee.

In Malaysia, the classification of *ijarah* would impact *al-ijarah thumma al-bay'* (AITAB) transactions, which under IAS 17 (adopted by MASB as FRS 117) would be treated as finance leases. Moreover, despite AITAB consisting of two different contracts, i.e., the contract of lease followed by the contract of sale, it would be accounted for as a single transaction under IFRS. As stated in SIC 27 (adopted by MASB as IC Interpretation 127), "a series of transactions that involve the legal form of a lease is linked and shall be accounted for as one transaction when the overall economic effect cannot be understood without reference to the series of transactions as a whole. This is the case, for example, when the series of transactions are closely inter-related, negotiated as a single transaction, and takes place concurrently, or in a continuous sequence".

MASB Technical Release *i*-2 (TR *i*-2), *Ijarah*, concedes that the "whole asset" approach espoused by IAS 17 may not be conceptually accurate. The essence of a lease or *ijarah* is that regardless of whether it is categorised as "finance" or "operating" it only confers on the lessee the usufruct of the leased asset, while ownership of the asset remains with the lessor. However, TR *i*-2 also acknowledges the difficulties in recognition and measurement in trying to "split" a leased asset into a lessee's right-of-use and a lessor's right of ownership. Thus, for reasons of practicality and in the absence of a workable, conceptually satisfying alternative model, TR *i*-2 confirms that the requirements of IAS 17 would apply to *ijarah*.

The essence of a lease or *ijarah* is that regardless of whether it is categorised as "finance" or "operating" it only confers on the lessee the usufruct of the leased asset, while ownership of the asset remains with the lessor.

The international accounting fraternity has long recognised the shortcomings of the "whole asset" approach to lease accounting. In 2010, the IASB issued an exposure draft on leases, detailing an alternative "right-of-use" model to lease accounting. The "right-of-use" model eliminates classification of a lease as either operating or finance. Under the IASB's tentative approach, the lessee would recognise a liability equal to the lease payments, and an asset related to the right to use (*usufruct*) transferred to the lessee. The lessor would similarly recognise a liability related to its obligation to provide the usufruct to the lessee with a corresponding asset related to the lease payments expected to be received. The lessor may be required to derecognise the asset if certain conditions are met. It is important to note that this approach is tentative until a final lease standard is released. Once issued, the MASB plans to amend TR *i*-2 accordingly to reflect the new IASB guidance.

Ijarah under AAOIFI

AAOIFI Financial Accounting Standard 8 (FAS 8), *Ijarah* and *Ijarah Muntahia Bittamleek*, states that when a lease does not include a promise that a legal title will pass to the lessee, it is classified as operating ijarah and if there is a promise, it is *al-ijarah al-muntahiyah bittamlik.* In essence, the difference between *ijarah* and *al-ijarah al-muntahiyah bittamlik* lies in the pre-existence of a promise whereby a lease concludes with the legal title passing to the lessee through one of the following methods:

1. Gift (transfer of legal title for no consideration).
2. Token consideration or other amount as specified in the lease.
3. Transfer prior to the end of a lease for a price equivalent to the remaining *ijarah* instalments.
4. Gradual transfer of the legal title (sale) of the leased asset.

Assets acquired are recognised at historical cost. This includes net purchasing price of all expenses necessary to bring the asset to its intended use. Examples of expenses are custom duties, taxes, freight, insurance, installation and testing.

If there is a permanent reduction in the estimated residual value, this reduction is recognised as a loss in the respective financial period. Leased assets are depreciated on a basis consistent with the lessor's normal depreciation policy for similar assets.

Ijarah revenue should be allocated proportionately to the financial period of the lease term. Direct initial cost (e.g., legal cost) which, if material, should be written off as incurred. If material, it should be allocated over the lease period, consistent with the lease revenue pattern.

Ijarah revenue should be allocated proportionately to the financial period of the lease term.

Repairs necessary to secure the services of the leased assets, if immaterial, should be written off in the period, while if repairs are material and varied, a provision is set up by regular charges to the income. If the lessee undertakes repairs with the lessor's consent and they are chargeable to the lessor, then it shall be expenses in the financial period and a payable set-up for an amount owed to the lessee. At the end of the financial period, amortisation of the initial material direct costs, cost of repairs to be charged against provision, depreciation of assets, and *ijarah* instalments receivable, are to be at cash equivalent. Table 18.5 provides the accounting treatments for *ijarah* financing.

Table 18.5 Accounting Treatments for *Ijarah* Financing (Operating *ijarah* and *al-ijarah al-muntahiyah bittamlik*) – Lessor's Books

Transactions	Effect	Journal entries
1 Purchase of *ijarah* assets	Increase asset of equipment Decrease asset of cash	Dr Equipment Cr Cash
2 Leasing of *ijarah* assets	Increase asset of *ijarah* Decrease asset of equipment	Dr *Ijarah* Asset Cr Equipment
3 Expenses incurred by lessor	Increase expense Decrease asset of cash	Dr *Ijarah* Expenses Cr Cash
4 Depreciation of *ijarah* assets	Increase expense Increase contra-asset (accumulated depreciation)	Dr Depreciation/Income Statement Cr Accumulated Depreciation
5 Receipts of *ijarah* rental	Increase asset of cash Increase revenue	Dr Cash Cr Income Statement
6 Sale of *ijarah* assets	Increase asset of cash Decrease asset of *ijarah*	Dr Cash Cr *Ijarah* Asset

Leased assets in the financial statements is presented as investments in *ijarah* assets. *Ijarah* revenue on the other hand, is presented in the income statement as *ijarah* revenue.

A unique requirement in the AAOIFI disclosure is that the lease assets for operating *ijarah* and *al-ijarah al-muntahiyah bittamlik* are to be distinguishable whereby assets for operating *ijarah* are recorded as investment in *ijarah* assets and assets for *al-ijarah al-muntahiyah bittamlik* are recorded as *al-ijarah al-muntahiyah bittamlik* assets.

Statement of Financial Position

Ijarah or *al-ijarah al-muntahiyah bittamlik* (IMBT)
Less : Accumulated Depreciation
Net Book Value of *Ijarah* or IMBT Assets

Income Statement

Ijarah Revenue
Less: Depreciation
Maintenance and other costs
Amortisation of direct initial costs

Accounting for *Sukuk*

Definition

Sukuk is a financial certificate that is often referred to as the Islamic equivalent of conventional bonds. Each *sukuk* normally represents an undivided interest in a debt (*sukuk murabahah*), asset (*sukuk ijarah*), project (*sukuk istisna'*) or business (*sukuk musharakah*).

Sukuk ijarah, for example represents securities in place of rights of well-defined existing and known assets tied up to a lease contract and the rental of which is the return payable to *sukuk* holders. Imbursement of *ijarah* rentals can be distinct to the period the usufruct (*manfa'ah*) is undertaken by the lessee. This flexibility of the *sukuk* can be used to develop diverse forms of contract and *sukuk* that may carry out different objectives of the issuers and holders.

"Some *sukuk* are issued through a special purpose vehicle (SPV) as shown in Figure 18.1. In other structures, no SPV issuer is used and the entity itself issues the *sukuk*."

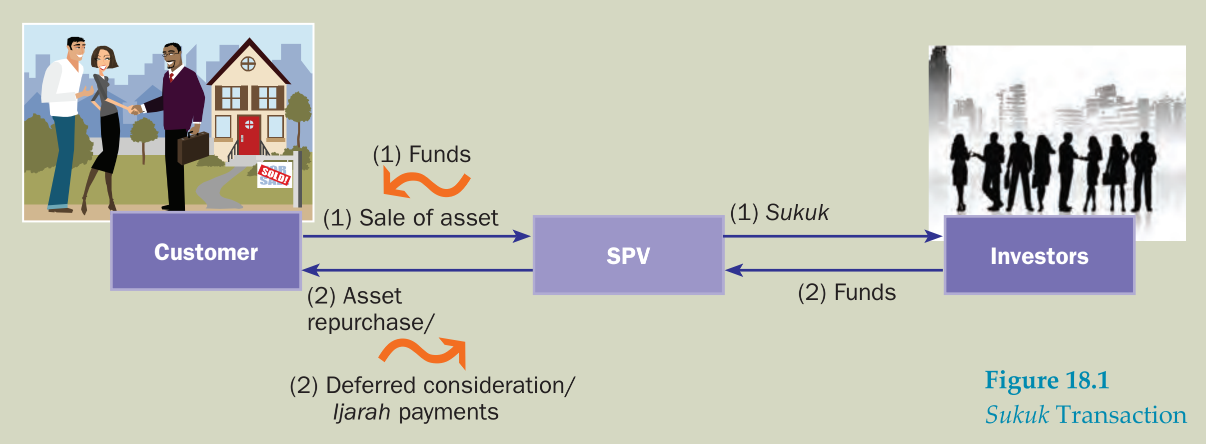


Figure 18.1
Sukuk Transaction

Sukuk *under IFRS*

Oftentimes, the secondary market for *sukuk* is illiquid or very little trading takes place. Under IAS 39, measuring financial assets in an inactive market requires the use of valuation techniques that invariably involve the calculation of net present value of future cash flows discounted at an appropriate rate of interest. Thus, the *sukuk* held for trading and available for sale in an inactive market should to be measured in this way under the IFRS (which is similar to *mudarabah* and *musharakah*).

As discussed above, the IASB amended guidance for financial assets through the issuance of IFRS 9. Similar to *mudarabah* and *musharakah*, investments in *sukuk* would still be at fair value, but the fair value changes may be limited to the profit and loss statement, and may no longer be allowed to be classified in other comprehensive income.

For the issuer of *sukuk*, consolidation considerations were originally found in IAS 27, Consolidated and Separate Financial Statements, and SIC 12, Consolidation – Special Purpose Entities. However, thse requirements will be replaced by IFRS 10, Consolidated Financial Statements, published in May 2011. Previously, in contrast to determining whether an originator had control over the SPV under IAS 27, SIC 12 had required the originator to assess

whether the risks and rewards of the SPV rested with the originator; if they did, then the originator would consolidate the SPV.

Conversely, IFRS 10 provides a single consolidation model; hence, eliminating potential differences in assessing the consolidation of SPVs. Regardless of whether an entity is an SPV or not, it should be consolidated with a parent if it is demonstrated that the parent has control over the entity. Although the control-based approach is brought over from IAS 27, IFRS 10 includes more detailed guidance to determine whether control exists.

The MASB is also studying issues related to accounting for *sukuk* transactions under IFRS/MASB guidance. This is because the legal form of a *sukuk* is not the same as a conventional asset-backed securitisation, and therefore it is accounted for as an unsecured financing. The study will be based on the IASB guidance pre- and post-2011 changes. It is envisioned that a discussion paper would be issued as a result of the study.

Sukuk *under AAOIFI*

In July 2010, AAOIFI replaced the requirements for investment in *sukuk* and shares in its Financial Accounting Standard 17 (FAS 17) Investments with Financial Accounting Standard 25 (FAS 25) *Investment in Sukuk, Shares and Similar Instruments*. Notably, there is a marked change in the requirements for classification and measurement of *sukuk*. FAS 17 had regarded investments in *sukuk* as being similar to an investment in an item of real asset, and had required *sukuk* to be classified as one of three classifications: for trading purposes, available for sale or held to maturity. Under FAS 25, *sukuk* is required to be classified as either a debt-type instrument or an equity-type instrument.

Where FAS 17 had required initial measurement to be at cost, FAS 25 now requires measurements at fair value or at amortised cost depending on the type of instrument. An equity-like investment is to be measured at fair value through income statement if it meets the following criteria:

(a) Such designation eliminates an accounting mismatch that would otherwise arise on measuring assets or liabilities or recognising the gains and losses on them on different bases; or

(b) the investment is managed and its performance is evaluated internally by the management on a fair value basis.

Otherwise, it is to be measured at fair value through equity.

> Under AAOIFI FAS 17, *sukuk* held to maturity is not re-measured at fair value at the end of the financial year, but is measured at historical cost, unless there is a permanent impairment in value.

Conversely, a debt-like instrument is to be measured at amortised cost unless it has been designated for measuement at fair value through income statement. FAS 25 describes amortised cost as "the amount at which the financial asset is measured at initial recognition minus capital/redemption payments, plus or minus the cumulative amortisation using the effective profit rate method of any difference between that initial amount and the maturity amount, and minus any reduction ... for impairment of uncollectibility". It may be further noted that the definition provided for "an effective profit rate" in the appendix to FAS 25 is very much similar to the IFRS definition for an effective interest rate.

Additionally, FAS 17 had allowed *sukuk* held to maturity to be measured at historical cost. FAS 25 now eliminates this measurement basis. Regardless of management's intended duration of holding the *sukuk*, it would be measured using one of the bases discussed above, depending on the criteria met.

Table 18.6 Accounting Treatments for *Sukuk Ijarah* – SPV's books

Transactions	Effect	Journal entries
1 Purchase asset from customers/government	Increase asset of equipment Decrease asset of cash	Dr Equipment Cr Cash
2 Issue *sukuk* to investors	Increase asset of cash Increase liability	Dr Cash Cr *Sukuk*
3 Lease asset to the customer and receive rental income	Increase asset of cash Increase revenue	Dr Cash Cr Rental income
4 Payment of return to *sukuk* holders	Increase expenses Decrease asset of cash	Dr Expenses Cr Cash
5 At maturity, sell back the asset	Increase asset of cash Decrease asset of equipment	Dr Cash Cr Equipment
6 Pay *sukuk* holders	Decrease asset of cash Decrease liability of *sukuk*	Dr *Sukuk* Cr Cash

In addition, the following points should be taken into account:

- To disclose the face value of *sukuk*, the percentage of *sukuk* acquired from each party issuing the *sukuk*, and each type of *sukuk*, if material.
- To disclose the party guaranteeing the *sukuk* and the nature of guarantee.
- To disclose the contractual relationship between the issuer and the holders of a particular *sukuk*.
- To disclose the classification of *sukuk* according to maturities.

Part B: Auditing in IFIs

Financial Statements and Audit

Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between information and the established criteria. Normally, auditors perform audit works on quantifiable information like the financial statements.

The goal of an audit is to express an opinion on the person/organisation/system etc., in question or under evaluation based on work done on a test basis.

Audits are performed to ascertain the validity and reliability of information and also to provide an assessment of a system´s internal control. The goal of an audit is to express an opinion on the person/organisation/system etc., in question or under evaluation based on work done on a test basis. Due to practical constraints, an audit seeks to provide only reasonable assurance that the statements are free from material error. Hence, statistical sampling is often adopted in audits. In the case of financial audits, a set of financial statements are said to be true and fair when they are free of material misstatements — a concept influenced by both quantitative and qualitative factors.

Audit is a vital part of accounting. Traditionally, audits were mainly associated with gaining information about financial systems and the financial records of a company or a business (see financial audit). However, recent auditing has begun to include other information about the system, such as information about security risks, information systems performance (beyond financial systems), and environmental performance. As a result, there are now professionals conducting security audits, IT audits, and environmental audits.

In financial accounting, an audit is an independent assessment of the fairness by which a company's financial statements are presented by its management. It is performed by competent, independent and objective person(s) known as auditors or accountants, who issue an auditor's report based on the results of the audit.

The requirements under the International Standards on Auditing are drafted broadly in order to apply to a multitude of business structures, including IFIs.

An auditor can have an unqualified opinion, in which he or she agrees with how the company prepared the statements, or a qualified opinion, in which he or she states which aspects of the company's statements he or she does not agree with. In extreme cases, the auditor may express no opinion on financial statements at all, such as when the scope of the audit was insufficient.

According to AAOIFI Auditing Standard for IFIs No. 1 (ASIFI 1), "The objective of an audit of the financial statements is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the *Shari'ah* rules and principles, the accounting standards of the Accounting and

Auditing Organization for IFIs (AAOIFI) and relevant national accounting standards and practices in the country in which the financial institution operates. The phrase used to express the auditor's opinion is to 'give a true and fair view'."

In Malaysia, company audits are performed under the International Standards on Auditing (ISAs) issued by the International Federation of Accountants (IFAC). The requirements under the ISAs are drafted broadly, in order to apply to a multitude of business structures, including IFIs. Thus, IFI audits in Malaysia should follow the guidance found in ISAs.

Currently, these institutions are being audited by conventional auditors mainly from the Big Four auditing firms. Table 18.7 provides a list of auditors for selected Islamic banks.

Table 18.7 Auditors of Islamic Banks

Country	Name of Bank	Auditor
Bahrain	Al Baraka Islamic Bank	PricewaterhouseCoopers
	Bahrain Islamic Bank	Ernst & Young
	Shamil Bank	Ernst & Young
	Kuwait Finance House	Ernst & Young
	ARCapita Investment Bank	Ernst & Young
Saudi Arabia	Al Baraka Banking Group	Ernst & Young
	Al Rajhi Bank	PricewaterhouseCoopers
Pakistan	Meezan Bank Limited	A.F. Ferguson & Co (Associate of PwC)
Malaysia	Bank Islam Malaysia Berhad	KPMG Desa Megat & Co

Source: Shahul, 2009.

In order for IFIs to uphold its transparency in terms of their operations towards the public, the institutions must be audited based on the *Shari'ah*, in addition to a conventional audit.

Shari'ah Audit

According to Bank Negara's *Shari'ah* Governance Framework paragraph 7.7, a *Shari'ah* audit refers to "the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for *Shari'ah* compliance."

Due to the salient features of the IFIs, which have been explained in the previous chapters, in particular, prohibition of *riba*, *gharar*, *maysir* and the requirement that its activities must be *Shari'ah*-compliant, the conventional audit may not be sufficient for the IFIs.

At present, there are variations of *Shari'ah* audit practices in IFIs. For example, some have an internal *Shari'ah* audit unit, some outsource their internal *Shari'ah* audit to external *Shari'ah* auditors and others conduct *Shari'ah* review. Acknowledging the importance of a *Shari'ah* audit, the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) has provided standards for the *Shari'ah* Supervisory Board (SSB), *Shari'ah* Review and Internal *Shari'ah* Review under the Governance Standard (AAOIFI, 1999).

According to the AAOIFI Governance Standard for IFIs (GSIFI) No. 1, an SSB is an independent body of jurists with expertise in *fiqh mu'amalat*. In terms of its composition, AAOIFI has stated that an SSB shall consist of at least three members (AAOIFI, 1999).

GSIFI No. 2 provides the definition of *Shari'ah* review as "an examination of the extent of an IFI's compliance, in all its activities, with *Shari'ah*. This examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc., (paragraph 3, GSIFI No. 2, AAOIFI Standards)." This could be seen as the most reflective description to define a *Shari'ah* audit.

At this point in time, it is important to clarify the different approaches to *Shari'ah* review and *Shari'ah* audit between AAOIFI, Islamic Financial Services Board (IFSB) and Bank Negara. Starting with AAOIFI's Governance Standards, the GSIFI discusses "audit" in relation to audit of financial statements, and refers to the term "*Shari'ah* review" exclusively as an "IFI's compliance, in all its activities, with *Shari'ah*." The IFSB on the other hand, in its Guiding Principles in *Shari'ah* Governance Systems, interchangeably uses *Shari'ah* "audit/review". In other words, audit and review have the same meaning. An example of how the IFSB interchangeably uses audit and review is: "An internal *Shari'ah* compliance **review/audit** is for verifying that *Shari'ah* compliance has been satisfied, during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified" — IFSB Guiding Principles in *Shari'ah* Governance Systems, Introduction 3(c).

It is in Bank Negara's *Shari'ah* Governance Framework that a definition has been assigned separately to *Shari'ah* "audit" and "review". As stated, Bank Negara's *Shari'ah* Governance Framework paragraph 7.6 defines the *Shari'ah* audit as "the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for *Shari'ah* compliance." The scope of a *Shari'ah* audit includes an audit of the financial statements, a compliance audit on organisational structure, people, process and information technology application systems, and a review of the adequacy of the *Shari'ah* governance process (paragraph 7.12 of the Framework). BNM states in paragraph 7.7 of the Framework that a *Shari'ah* audit can be performed by an IFI's internal auditors, "who have acquired adequate *Shari'ah*-related knowledge and training." Paragraph 7.2 on the other hand, defines "*Shari'ah* review" as "the *Shari'ah* review function refers to regular assessment on *Shari'ah* compliance in the activities and operations of the IFI, with the objective to ensure that the activities and operations carried out by the IFI do not contravene with *Shari'ah*." Thus, a *Shari'ah* review is specific to *Shari'ah* compliance in relation to the IFI's overall business operations, and does not scope in the entire financial statements (paragraphs 7.3-7.5 of the Framework). Unlike a *Shari'ah* audit, a *Shari'ah* review must be performed by "qualified *Shari'ah* officers", defined by BNM in paragraph 7.3 of the Framework as "an officer who holds at least a bachelor's degree in *Shari'ah*, which includes a study in *Usul Al-Fiqh* (the origin of Islamic law) and *Fiqh Mu'amalat* (Islamic transaction/commercial law)." As can be seen from these two definitions, the difference with "audit" and "review" according to BNM is that an "audit" is an "independent" and "periodical" assessment; whereas for "review" there is no requirement of independence but there has to be a "regular assessment" (meaning more frequent than an audit) and this is on the "*Shari'ah* compliance" of the activities and operations carried out by the IFI. In addition to the guidelines above, BNM also requires IFIs to have a *Shari'ah* committee, which must be composed of at least five members (paragraph 2.3 of the Framework). This committee facilitates proper communication between the *Shari'ah* scholars and the IFI's board of directors.

The scope of a *Shari'ah* audit includes an audit of the financial statements, a compliance audit on organisational structure, people, process.

On the regulatory aspect in the Malaysian context, the Islamic Banking Act (IBA) 1983 had provided the provision for the establishment of a *Shari'ah* Advisory Board as a requirement of granting licence to an Islamic financial institution. One of the requirements stipulated in the GPS-1 guideline is that all IFIs must establish a *Shari'ah* committee for the purpose of ensuring that the operations of the IFIs are in line with *Shari'ah* rules. However, the *Shari'ah* committee is not required to provide a thorough written report on the activities being carried out by the IFIs that would be included in the annual report of the IFIs. Its main function is basically to provide advice and guidance to the board of directors of the IFIs on *Shari'ah* matters, particularly on the new products to be introduced by the IFIs.

In terms of reporting, the *Shari'ah* committee is only required to report to the board of directors of the IFIs on their opinions pertaining to *Shari'ah* matters whereby the final decision on any operations or introduction of products is to be made or carried out by the board of directors (BNM, 2004).

It is not mandatory for the *Shari'ah* report to be prepared by the IFIs and there is no standard format issued by Bank Negara Malaysia on the report to be included in the annual report. However, AAOIFI GSIFI No. 1 outlines the basic elements which must be contained in the *Shari'ah* Supervisory Board's Report. These include:

1 Title.
2 Addressee.
3 Opening or introductory paragraph.
4 Scope of paragraph describing the nature of the work performed.
5 Opinion paragraph containing an expression of opinion on the compliance of the Islamic financial institution with *Shari'ah* rules and principles.
6 Date of report.
7 Signature of the members of the *Shari'ah* Supervisory Board.

It is not mandatory for the *Shari'ah* report to be prepared by the IFIs and there is no standard format issued by Bank Negara Malaysia on the report to be included in the annual report.

Shari'ah auditing has a key importance as there is a growing awareness among Islamic institutions that every such institution should contribute towards achieving the objectives of the Islamic law — the *maqasid al-shari'ah*. It is suggested that there is a need to have regular independent *Shari'ah* audits in the IFIs as people are now experiencing a movement along a continuum from a society that trusts everything and audits nothing, to a society that trusts nothing and audits everything. The concept of *Shari'ah* auditing should be extended to the activities relating to, among others, the system, the products, the employees, the environment and the society. There is a need to develop a useful *Shari'ah* audit framework to ensure the effectiveness of the goals of *Shari'ah* compliance in IFIs which in turn can contribute positively to the *ummah* (society) at large.

The *Shari'ah* committee must be independent in issuing their reports, i.e., they do not have any interests in the bank's operations, in order to be considered creditable.

The external auditor focuses mainly on the financial statements based on conventional auditing standards. Their assessment depends on the *Shari'ah* report prepared by the *Shari'ah* committee of the IFIs. The *Shari'ah* committee must be independent in issuing their reports, i.e., they do not have any interests in the bank's operations, in order to be considered creditable. Unlike the external auditors who are governed by specific code of ethics and legal rules in performing their duties, the *Shari'ah* committee basically conduct their work based on their moral beliefs and obligations to religion, their peers and society.

Challenges of a *Shari'ah* Auditor

A *Shari'ah* auditor faces many challenges in performing his or her duties. According to Abdul Rahman (2008), there are three challenges faced by *Shari'ah* auditors. The first challenge is to establish audit evidence, which is defined as any information used by the auditor to determine whether the information audited is in accordance with the established criteria. In conventional banking and finance, the criteria used are usually the IFRSs. For the *Shari'ah* auditing process, the criteria are limited to the written opinion of the *Shari'ah* Advisory Council (SAC), product manuals as well as standard operating procedures. The *Shari'ah* auditor should be involved in a systematic review of the operational aspects of an Islamic bank that includes an examination of the policies and procedures for each product manual, processes and contracts.

The second challenge is to develop a systematic and thorough audit programme. The *Shari'ah* audit programme contains the lists of audit procedures for a complete *Shari'ah* audit. To audit the IFIs, special audit programmes must be established because of the differences in the products offered as compared to conventional banking.

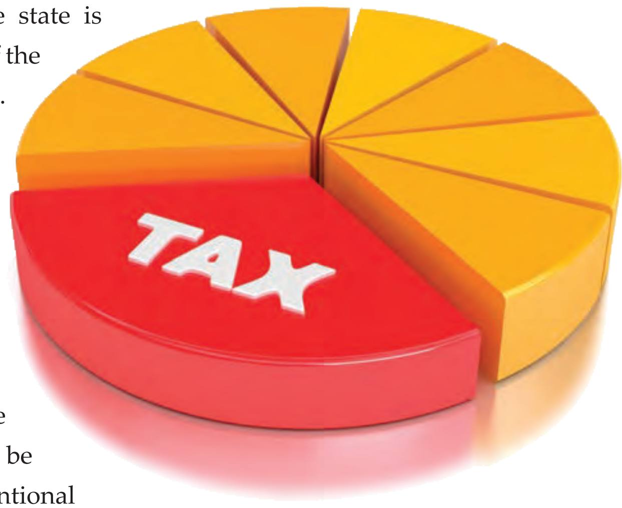
The final challenge is to produce competent and independent *Shari'ah* auditors. It is difficult to produce competent *Shari'ah* auditors because there is no specialised education or training programmes on *Shari'ah* audits that would fulfil the needs of the IFIs and regulators. There is a need for an education and training programme which provides relevant basic knowledge in *Shari'ah* accounting and auditing. According to Kasim & et al. (2009), there is a negative correlation between *Shari'ah* qualifications as well as accounting qualifications. Most *Shari'ah* auditors do not possess both qualifications.

There is a need for an education and training programme which provides relevant basic knowledge in *Shari'ah* accounting and auditing.

Part C: Taxation in IFIs

Tax and Islamic Finance

In any economic system, the main source of revenue for the state is taxation. Tax is payment due to a legislative authority as a result of the income or gains earned by the citizens or companies of the state. It is imposed by most countries in the world whether directly through income or gains made (such as income tax) or indirectly through consumption or transactions (such as a sales tax). Even though Islam has specific forms of taxation such as *zakat* (wealth tax), *ushr* and *kharaj* (land taxes), *jizyah* (poll tax) and *khums* (tax on natural resources), in a plural society, tax is still an obligatory payment imposed by the state. Since many countries impose tax in addition to *zakat* for the purposes of funding the government's public expenditure, tax is an almost certain cost to be borne; notwithstanding whether financing is done in the conventional way or if it complies with the Islamic laws.



Tax is a cost to a business as it affects the bottom line of the company. In undertaking financial transactions, there is a tax element that needs to be considered. In Islamic

In Islamic finance, the tax cost is magnified due to the additional transaction steps required (compared to conventional financing which is a straightforward loan of money).

finance, the tax cost is magnified due to the additional transaction steps required (compared to conventional financing which is a straightforward loan of money). Double or multiple tax charges can make Islamic finance more costly in certain jurisdictions. In a world where dual financial systems operate alongside each other, players and investors alike (putting aside religious considerations) would be looking at the costs involved in undertaking an Islamic transaction *vis-à-vis* the conventional way and ultimately, the costs involved may be the deciding factor between an Islamic and conventional financing.

Tax is a hidden cost in any financing structure. If the tax implications of a financing structure are not considered on the outset, the financing exercise may cost a lot more than it should, and thus may not achieve the benefit it is originally intended to. Potential additional tax liabilities and tax inefficiencies will affect any financing structure. Hence, there is a need to structure the fund-raising exercise in the most cost efficient and flexible manner, taking into account the after-tax effect.

Due to the underlying asset within each transaction in Islamic finance, additional tax liabilities may arise unless tax neutrality is accorded. When the rules and regulations of legislative requirements (which are primarily catered for conventional financial transactions) are being imposed on Islamic transactions, problems are bound to arise.

Tax Issues in Islamic Finance

The tax issues surrounding Islamic financial transactions stem from the underlying transactions needed to satisfy the *Shari'ah* requirements, which are distinctly different than an economically similar conventional financial transaction. The elements of trade, leasing and partnership brought about by the prohibition of *riba* mean that the legal substance of the transaction is different from the economic substance. As money is not a commodity in Islam, the use of money to generate more money is prohibited as the consideration earned out of such transaction is deemed as *riba*.

The differences between conventional and Islamic transactions can be illustrated in Figures 18.2 and 18.3.

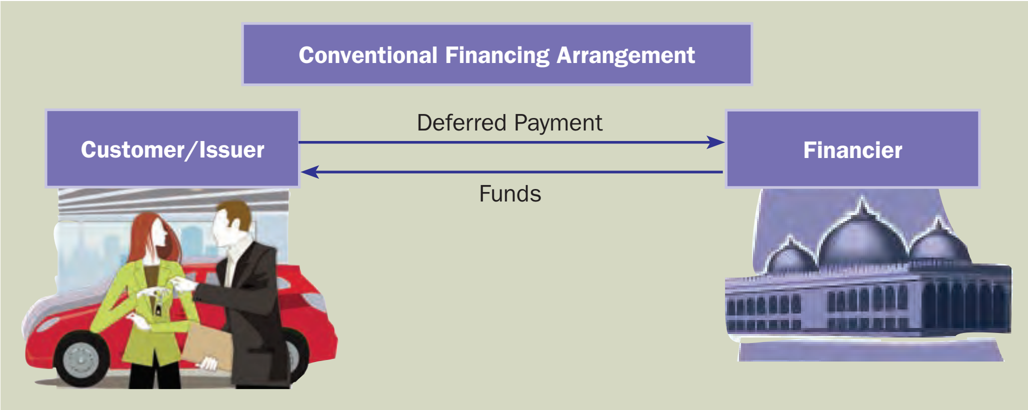


Figure 18.2 Conventional Financing

In a conventional financing transaction, the main tax issues to be determined would include the taxability of interest income and deductibility of interest and issuance costs.

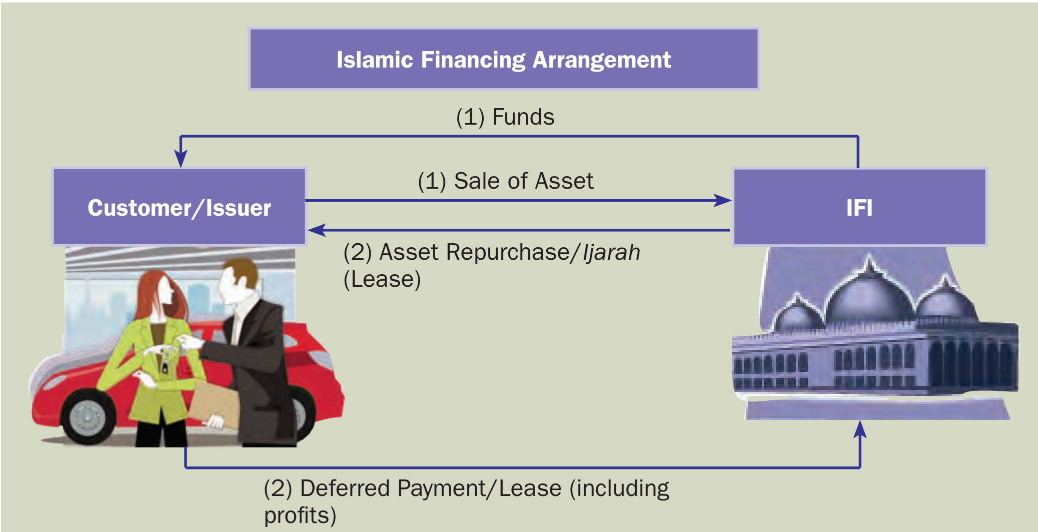


Figure 18.3 Islamic Financing

In an Islamic financing arrangement, there will be more complex tax considerations depending on the structure. As the IFIs are prohibited from providing a direct loan of money, financing is done (as in the example above), through a sale or lease of an asset. The above Islamic transaction would raise the following questions:

1 Would the income arising from the above transaction be seen as income from the sale of an asset (legal substance) or income from a financing arrangement (economic substance)?

2 Consequently, would the profit from the disposal of the underlying asset received by the IFI be seen as a revenue or capital income?

3 Would the customer be entitled to any tax deductions on the repayments made on the funds received which are essentially payment of marked-up profit from a trade or lease rental payment as the case may be?

4 Would the IFI be subjected to stamp duty upon purchase of assets and would the customer then be subjected to a similar stamp duty again?

5 Would there be capital gains or real property gains tax implications on the disposal if the properties are the underlying assets?

6 Would the disposal of the asset trigger any other tax issues relating to tax depreciation?

7 Would the sale and repurchase/lease be seen as a separate sale and buy-back transaction/sale and leaseback transactions?

8 Would there be any value added tax (VAT) or goods and services tax (GST) issues?

In a *wadi'ah* (Islamic principle of safe-keeping) savings account, the IFI is not allowed to promise a return to the depositors.

In an Islamic financing transaction, the IFI will be earning profit (such as in a *murabahah* financing) instead of interest, as in a conventional loan arrangement. Whether the "profit" is treated as profit from trade or the substance of the transaction as financing arrangement takes precedence, would be a question that the tax authorities would have to consider. In the case of a *mudarabah* or *musharakah* financing arrangement, the tax authorities would have to consider whether the share of profits received by the IFI would be seen as either a distribution of profits/dividends or a financing arrangement. For Islamic deposit products, one needs to consider whether the profit paid to the depositor is treated similarly as interest payment, which could result in a tax deduction for the IFI. For example, profits paid by an IFI to the *mudarabah* depositors may be seen as distribution of profits/dividends. In a *wadi'ah* (Islamic principle of safe-keeping) savings account, the IFI is not allowed to promise a return to the depositors. As the money in the *wadi'ah* accounts are used by the IFI for its financing and other banking activities, the IFI would sometimes provide a *hibah* or gift to depositors. *Hibah* is not meant to be a fixed return like an interest and as such, whether it is considered as interest for tax neutrality purposes would be the question.

If a transaction such as the *musharakah* is not seen from the perspective of its economic substance, then the IFI would be seen to be in a partnership arrangement with the customer. One can just imagine the statutory filing requirements needed if there are many customers under such financing arrangement.

In a *takaful* arrangement, the *takaful* operator acts only as a manager of the *takaful* funds as opposed to being the underwriter of the *takaful* claims. The relationship between the operator and the participants of the *takaful* funds and also among the participants is different from the conventional insurer and the policyholders. Therefore, would the tax treatment of a *takaful* company be the same as a conventional insurance company?

For example, in the case of the issuance of Islamic securities in an asset-based transaction (*sukuk*), a special purpose vehicle ("SPV") has to be set up to facilitate the transfer of the underlying asset; a step which would otherwise not be required in the issuance of conventional bonds. In a *sukuk* financing arrangement, the concept of true sale has to be present in order to reflect the ownership of the *sukuk* holders on the underlying assets. Again, this begs similar questions on the disposal of assets for tax purposes as well as the tax treatment of the SPV.

Another issue that needs to be considered is whether the accounting treatment of a transaction has any bearing on its tax treatment. Accounting advocates the notion of "substance over form", whereas in an Islamic financing arrangement the form takes precedence over the substance. The question would then be whether the economic substance or the legal form of a transaction should take precedence when prescribing a tax treatment to the transaction.

As Islamic finance is now widely used globally as a financing method, there will be cross-border tax issues to be considered in dealings between different countries; especially when the deals are done with countries where the tax treatment on Islamic financial transactions is not favourable. Even a simple and straightforward Islamic financial transaction has tax issues to be considered. As Islamic products become more sophisticated, there would be more tax issues that need to be resolved. This is one of the challenges of Islamic finance.

As Islamic products become more sophisticated, there would be more tax issues that need to be resolved.

Tax Implications of Islamic Financing Transactions

The main issues of the Islamic banking sector and other Islamic financing transactions are centred on the taxability of income and deductibility of expenses. Specific to *takaful* operators, taxation is especially important, as not all income of the *takaful* business belongs to the operator.

As shown in the foregoing section, Islamic financing transactions require additional steps, such as the purchase and sale of assets before funds are disbursed. This obviously necessitates additional transactions which will have tax incidence. If each step is to be considered separately for tax purposes, it would give rise to additional tax costs. Therefore, in order to circumvent this, the tax legislation has to be reviewed in order to recognise the intricacy of an Islamic financing transaction, looking at the substance of the transaction as a whole instead of its individual steps.

The following are the types of taxes that generally have to be considered in a financing transaction:

1 Income tax — this is a tax on income from trade or business activities, employment, interest, dividend, rent, etc.

2 Capital gains tax — gains arising from transactions in capital assets are subject to capital gains tax. In certain jurisdictions such as Malaysia, the tax is limited to gains arising from disposal of properties or shares in real property companies, i.e., real property gains tax.

3 Stamp duty — a levy on instruments of transfer involved in a financial transaction. The amount could be a fixed percentage or at *ad valorem* rate.

4 VAT or GST — this is a consumption tax that is levied along the supply chain of any business transactions.

Other types of taxes applicable to Islamic financial transactions would depend on the tax jurisdictions of the respective countries.

Essentially, in any financing transaction, one needs to consider whether the income due to the IFI from an Islamic financing transaction will be taxable and whether any expenses paid on financing by the customer will result in a tax deduction. In an Islamic deposit situation, the consideration is whether the profits received by the depositors is income from the sale of asset or simply income in lieu of interest, thus treated similarly as interest. Likewise to the IFI, the consideration is whether the profit paid to depositors is similar to the interest expense paid on conventional deposits. In order to determine the correct type of tax applicable, the nature of income, whether it is revenue or capital in nature would need to be considered. At the same time, the instruments of transfer executed on the financing transaction need to be stamped and paid its duties. In a country where a value added tax (VAT) or goods and services tax (GST) regime is in place, the financing transaction may have VAT/GST payable unless the financing transaction is specifically exempted or zero-rated. All the above would mean additional cost to the borrower. The following sections will go through the tax implications of some specific Islamic financial transactions:

Commodity *Murabahah*

The tax implications that need to be considered include:

1 The buying and selling of a commodity in its legal form is a sale and purchase transaction. Therefore, the profits earned by the IFI from the sale would be regarded as a gain on sale of an asset rather than an income from a financing activity unless the legislation recognises the economic substance of the

transaction as a financing arrangement. Where tax neutrality is available, the profit will be treated similarly as interest in a conventional transaction for tax purposes.

2 If the profit is seen as arising from a sale of asset, then the consideration is whether it would fall under the ambit of income tax or capital gains tax.

3 For the customer, whether the profit element paid on the purchase of the commodity would be given a tax deduction would be the issue as the money expended for transactions to acquire capital assets may be denied a tax deduction in many jurisdictions. If the profit is treated as interest, then a tax deduction should be allowed provided the expense was incurred to finance working capital or for business purposes. However, if considered solely based on the legal form, there is no cost of finance here.

4 Timing of payment could be deferred which means that the incurrence of the expense is only in the year of payment. The other consideration is whether the expense is recognised in that year of payment or over the financing period or similarly, whether the IFI would be taxed at the end or after the financing period.

5 In a conventional financing arrangement, stamp duty is levied on the loan agreement. Under Islamic financing arrangement, there may be more legal transactions and documentation and hence, multiple stamp duties may be applicable.

6 Similarly, VAT/GST implication may arise at each step of the transaction.

Ijarah

The tax implications that need to be considered for *ijarah* transactions are:

1 In an *al-ijarah al-muntahiyah bittamlik* transaction, the tax implication is similar to a conventional lease. The issue would be whether the lease rental paid, which contains an element of profit to the IFI, would be treated similarly as interest in a conventional lease.

2 The issue of ownership of risks and rewards of the leased asset has been a subject of many debates. In accounting terms, there is a concept of financial and operating lease whereas in *ijarah*, the substance of the transaction is an operating lease. The asset belongs to the lessor who will claim tax depreciation on the asset. However, in an *ijarah thumma al-bay'* (lease ending with sale) transaction, the transaction is normally reflected as similar to a hire purchase transaction which means that the lessee will reflect the ownership of the asset in the accounts and claim tax depreciation. This may not be in sync with the *Shari'ah* principles of *ijarah*. The issue will be whether the tax treatment

follows the accounting disclosure which takes the substance of the transaction or follows the legal form.

Musharakah Mutanaqisah

The tax implications that need to be considered here are as follows:

1 The legal form of the above transaction is one of partnership where two parties, the IFI and the customer agree to jointly purchase an investment and share in the profits arising from there. This raises the question of the nature of the share of profits received from the venture. If it is seen according to its legal form, this could be seen to be a distribution of profit or dividend. This would then mean the tax treatment is different than if it is seen as a financing arrangement where the profit is considered as a financing cost. If the first view is taken, then the payer will not be able to get a tax deduction and the recipient may not be taxable on the income. However, if one looks at the substance of the transaction, then profit is just a return on the financing arrangement, which is akin to interest for tax purposes.

2 Another consideration is whether the *musharakah* arrangement is tantamount to a partnership arrangement in which case a partnership tax return may need to be filed.

3 In addition, there will be the question of which party will claim the tax depreciation on the asset (if applicable) over the period of the diminishing *musharakah* and whether the claim is based on the gradual change in ownership of the asset or the full cost of the asset.

4 If each percentage acquisition of the share of the IFI's interest in the house is seen as a disposal of capital asset, the disposal may attract capital gains or real property tax.

5 The stamp duty and VAT/GST issues (if any) would also need to be considered for such transactions.

Sukuk

The tax implications that need to be considered for *sukuk* would depend on the type of sukuk structure being considered. Some of the considerations include:

1 Whether payment flows within the *sukuk* structure contains profit element. If so, the taxability or tax deduction for the profit element would need to be considered. At the same time, one also needs to consider whether payment of returns to *sukuk* holders will be allowed a tax deduction.

2 *Sukuk* issuance structures may involve the establishment of an SPV as issuer of the sukuk. This SPV would then enter into specific underlying transactions with the originator. It is important to determine how the transaction flows between the SPV and the originator is treated. As the SPV is essentially meant to be a flow-through vehicle, should the income and expenses be accounted for by the issuer instead?

For *sukuk*, it is important to determine how the transaction flows between the special purpose vehicle and the originator is treated.

3 The issue of transfer of underlying asset to an SPV prior to *sukuk* issuance and the eventual disposal of the leased asset back to the originator may also attract tax.

4 The additional steps as compared to conventional financing may also mean that the issuance of Islamic securities is subject to more stamp duties with additional VAT/GST implications.

Takaful

The tax issue of the *takaful* operator under the *mudarabah* model with regard to the participants' share of the investment profit included under the takaful business income would similarly apply to the *wakalah* operators. Therefore, the application of tax legislation of a conventional insurer puts the *takaful* operators in a disadvantageous position as they are taxed on the income that does not belong to them unless a mechanism is put in place to pass on the tax suffered by the operators on behalf of the participants back to them.

Takaful and conventional insurance are two distinct business models. On one hand, one can argue that the *takaful* operators are merely managing the *takaful* funds on behalf of the participants and hence, the tax treatment should reflect that of a fund manager. This would mean separation of the computation of tax for the *takaful* fund and the takaful operator. In practice, however, even though they are different in concept and principles, *takaful* operates based on a similar platform as conventional insurers in terms of underwriting considerations, processing, liability provisioning and reserving. Therefore, it is arguable that the tax treatment should be no different from the conventional insurer. It is also worth noting that different *takaful* operators operate under various models and different frameworks. In addition, different *takaful* products have different features and innovation, and the many variations of products may have different tax implications. Therefore, prescribing a tax law that fits all situations may be a difficult task. There is a need for further understanding on the concept and framework of takaful on the part of tax authorities and policy-setters in order to provide a tax treatment that correctly reflects the operations of a *takaful* operator.

Case Study Malaysia

Malaysia is a country that has successfully developed the Islamic finance industry through implementation of tax neutrality provisions. It has addressed the incongruity of current tax legislations when applied to Islamic financial transactions by amending the tax legislations to recognise the economic substance of Islamic transactions, and amendments have been progressively made to cater for new issues arising from Islamic financial transactions. The main tax neutrality provisions in the Income Tax Act, 1967 ("ITA") are Section 2(7) and Section 2(8). Section 2(7) provides a similar treatment to profit from Islamic transactions as interest in conventional financial transactions. In addition, Section 2(8) provides that the disposal of an asset or a lease by a person pursuant to a scheme of financing approved by the Central Bank, Securities Commission or Labuan Financial Services Authority, as a scheme which is in accordance with the principles of *Shari'ah*, and would thus be disregarded for tax purposes. There is a need to ensure that the disposal or lease is strictly for the purpose of complying with the *Shari'ah* principles for it to be disregarded for tax purposes. This is an important provision that equates an Islamic financing transaction to a conventional financing transaction. It eliminates the additional costs for entering into Islamic financing transactions by disregarding the additional steps required to cater for *Shari'ah* requirements, hence the additional tax costs applicable for each step.

Tax neutrality is also provided for other tax laws such as Schedule 2, Para 3(g) of the Real Property Gains Tax ("RPGT") and First Schedule, General Exemptions of the Stamp Act. By disregarding the additional steps in Islamic transaction, the end result is to equate Islamic financing transaction to a conventional financing transaction. The elements of tax neutrality in Malaysia are:

- Profits in Islamic transactions are treated similarly as interest in a conventional transaction which essentially means:
  - (i) Profits associated with Islamic finance will be taxable, just like the interest income under conventional financing.
  - (ii) Profits will be deductible if the funding has been used to generate business income or to purchase assets to generate income.
  - (iii) All other tax rules relating to "interest", such as withholding tax on interest and interest exemption, will also apply to profits.
- Disposal of assets to facilitate Islamic transactions is ignored for tax purposes.
- Stamp duty exemption is given upon the purchase of property by a financier for the purpose of resale under the principles of *Shari'ah*.
- *Musharakah* transaction is treated as a financing arrangement and there is no requirement to file a partnership tax return.
- SPV is treated as a pass-through vehicle.

With the presence of the tax neutrality provisions, customers have a choice between using a conventional financing arrangement or an Islamic financing arrangement. The market is set at a level playing field and market competition between conventional and Islamic financing is healthy.

All the above issues have a common feature in that the legal form of Islamic financial transactions when applied to tax legislations of conventional financial transactions would create anomalies and could result in additional tax costs.

Economic versus Legal Substance

From the above discussion of tax implications of Islamic financing transactions, it can be summarised that the tax issues in Islamic finance stems from the conflict between economic substance and the legal form of the transaction. According to Kevin Conway and Suzanne Feese in their article published in *International Tax Review*, Islamic finance arrangements use common legal structures in an unconventional way (insofar as debt is concerned) to achieve the financing objectives. However, for tax purposes, an Islamic finance transaction may or may not be treated as a financing transaction depending on its characteristics and local tax law requirements.

For tax purposes, an Islamic finance transaction may or may not be treated as a financing transaction depending on its characteristics and local tax law requirements.

It is noted for example, that the US adopts a substance over form approach, whereby there is limited or no requirement for specific tax law for Islamic finance. The UK law requires the arrangements to meet certain conditions, which means the tax law is amended to cater for specialised financing arrangements such as Islamic finance. It is therefore important to understand the common structures adopted for Islamic finance purposes so that the relevant components and aspects can be identified to allow a determination of how the relevant arrangements should be taxed.

Malaysia, on the other hand, has taken the approach of amending its existing tax legislation to insert clauses which caters specifically for Islamic finance transactions. This has proven to be effective as it eliminates double taxation or additional tax costs incurred in undertaking an Islamic finance transaction. The intended effect of the change in legislation is to give equal treatment between an Islamic financing and a conventional financing transaction. The tax neutrality provisions have contributed to the strong growth of the Islamic finance industry in Malaysia.

Tax Neutrality in Islamic Finance

Tax neutrality means regardless of the legal form of a transaction, the tax treatment accorded to that transaction is similar to the economic substance. In other words, a *murabahah* financing transaction which is essentially a trade transaction will be treated as a financing transaction whereby the profit received from a *murabahah* sale will be treated similarly as interest in a conventional loan transaction. This can be provided by way of changes to the legislation to recognise the uniqueness of an Islamic transaction and recognise that the underlying transactions are mainly performed to meet the *Shari'ah* requirements. Tax neutrality is normally provided in order to set a level playing field between conventional and Islamic financial players. With tax neutrality, Islamic financial transactions are accorded the same tax treatment

Tax neutrality is normally provided in order to set a level playing field between conventional and Islamic financial players.

as conventional financial transaction thereby eliminating additional tax costs and ambiguity.

Measures Taken to Facilitate Islamic Finance – Country Experience

How different countries around the world handle the tax issues surrounding the Islamic financing transactions depends on the government's will to provide the necessary platform for Islamic finance to operate. In some countries, such efforts have been delayed due to negative public perception of Islamic finance as being a religiously-motivated endeavour rather than driven by a commercial motive. Therefore, the challenges in developing Islamic finance are not purely technical or limited to establishing an infrastructure receptive to Islamic finance but also the public's perception on the soundness of Islamic finance. The following sections will go through some of the efforts that have been made by selected countries in facilitating Islamic finance to operate in their respective countries.

Indonesia

Although Indonesia boasts the largest Muslim population in the world, its tax regime had not been conducive to the development of interest-free banking until recently.

Indonesia has a strong potential for Islamic finance to grow, being the country with the largest Muslim population. Although Indonesia boasts the largest Muslim population in the world, its tax regime had not been conducive to the development of interest-free banking until recently.

The presence of *Shari'ah* banking started way back in 1992, but its development has been slow. The main barrier to development of Islamic finance in Indonesia is the double taxation that applies to transactions underlying *Shari'ah* banking which otherwise would not be needed in conventional banking system. This makes Islamic finance less competitive and attractive in Indonesia. However, Indonesia has recently made more concerted efforts to develop Islamic finance by enacting *sukuk* law in April 2008 which allows the country to launch its first sovereign *sukuk*. In September 2009, Indonesia passed a law on VAT which scrapped double taxation on transactions in Islamic financial markets. In April 2010, new Indonesian tax regulations, to better accommodate *Shari'ah* banking by eliminating double taxation on Islamic transactions, took effect. With further easing of the tax impediments, Indonesia is the next big market for Islamic finance in the region.

United Kingdom

The Islamic financial sector in the UK is one of the strongest in the world and the most advanced in Europe with five FSA-registered, fully *Shari'ah*-compliant banks and 22 other banks offering *Shari'ah*-compliant windows.

The Islamic financial sector in the UK is one of the strongest in the world and the most advanced in Europe with five FSA-registered, fully *Shari'ah*-compliant banks and 22 other banks offering *Shari'ah*-compliant windows. This success has been facilitated by the important legislative changes which have created a dynamic base for *Shari'ah*-compliant financial products.

The UK's journey to its current position as the Islamic financial centre in Europe started with amendments in its legislations to recognise Islamic finance as an "alternative financial arrangement" to mitigate the risk of tax avoidance whilst ensuring that such arrangements are not taxed more or less favourably than the equivalent finance arrangement involving interest. The removal of double taxation on Islamic mortgages and the extension of tax relief on Islamic mortgages to companies as well as individuals were given. Stamp duty neutrality was also provided. The legislation has been amended to equate, in substance, the return on an investment to that of money at interest. There is also a deeming approach whereby if a transaction falls within statutory definitions, the customer's expense is treated for tax purposes in the same way that interest is treated, and these have been progressively extended to cover more Islamic products. Even though UK amended the law without specific reference to *Shari'ah*, the tax definitions and its intended effects are quite precise and self-contained.

In early 2007, the Finance Bill 2007 introduced a legislation which facilitated the UK's issuance and trading of *sukuk*. Two separate guidances namely the Guidance on Diminishing *Musharakah* and Guidance on *Takaful* were also published alongside the Budget, and Islamic finance became a key priority of the Chancellor's High Level Group. In December 2009, measures were introduced to equalise the tax treatment of property refinancing transactions, and in January 2010, the UK Treasury introduced measures in Parliament to support the issue of *sukuk*, thus further increasing the investment potential of the UK in Muslim states. The amendment to the Financial Services and Markets Act 2000 Order 2010, which was announced by the Treasury at the start of 2010, has been designed to help provide "a level playing field" for corporate *sukuk* within the UK. The Order provides clarity on the regulation of corporate *sukuk*, reducing legal costs and removing unnecessary obstacles to their issuance.

United States of America

Despite the 9/11 World Trade Centre incident, the US has started to open up to the viability of Islamic finance as an alternative financial solution. The sub-prime crisis of two years ago has highlighted the need to go back to the roots in terms of business dealings. Ethical business practices have become the topic of the day.

Despite the 9/11 World Trade Centre incident, the US has started to open up to the viability of Islamic finance as an alternative financial solution.

Traditionally, the starting position for any US tax analysis of a transaction is the form of the transaction. However, in many instances, the US courts and the Inland Revenue Services ("IRS") have re-characterised transactions for US federal income tax purposes according to their economic substance by employing a substance-over-form analysis. In applying the substance-over-form doctrine, one looks at the objective economic realities of a transaction rather than at the particular form the parties employed, and does not regard the documentations being drawn up as controlling for tax purposes where the objective economic realities are to the contrary. The legal form of many Islamic finance arrangements is different from a conventional debt-financing arrangement. Accordingly, the US will often seek to apply the substance-over-form doctrine to the relevant arrangements. To achieve the desired debt result for US tax purposes, the substance of the transaction must be, in fact, that of a debt. Indebtedness also arises where one person sells a property to another and does not receive immediate payment for it, but the buyer is obligated to repay the stated amount on a deferred basis, thereby the inclusion of Islamic financing transactions in such a ruling.

The US has taken the simple approach of viewing transactions from the substance-over-form perspective without the need to amend any law. Whichever way that has been taken, it seeks to accord the same tax treatment to Islamic financing transactions to be similar to conventional ones. Notwithstanding, the US federal banking regulators have issued guidance on *ijarah* and *murabahah* mortgage financing.

Issues, Opportunities and Challenges

The Islamic accounting fraternity appears to be composed of those who are comfortable with the application of IFRS to Islamic transactions, and those who harbour reservations about the appropriateness of some IFRS principles, or indeed about its permissibility from a *Shari'ah* perspective. In particular, it is ironic that the concept of "substance over form" which has received much resistance in Islamic financial reporting is, in converse, voraciously advocated for taxation purposes to reduce the tax burden of Islamic financing structures.

In view of the exponential growth of Islamic finance, and its penetration into traditionally non-Muslim jurisdictions, it is imperative that financial reports are prepared, as well as audited, in a manner acceptable to all stakeholders. Hence, the level of discussion on Islamic accounting must accordingly be elevated beyond the rhetoric. There must be cutting-edge, multilateral discourse on concerns regarding the recognition, measurement, disclosure and presentation of Islamic transactions and other information deemed relevant from an Islamic perspective. Unfortunately, all too often discussions on the subject tend to be a re-hashing of earlier works, and a recount of out-dated or obsolete accounting thoughts. There is also a tendency to isolate Islamic accounting from international developments, hence detrimentally ignoring the interplay between the two.

It may be noted that the Asian-Oceanian Standard Setters Group (AOSSG), whose current membership represents 24 countries, is spearheading a study on the relationship between IFRS and Islamic finance. The AOSSG has set up an Islamic Finance Working Group to assist it in forwarding to the IASB input and feedback on the adequacy and appropriateness of a proposed and existing IFRS on Islamic financial transactions. The Working Group has produced a research paper on the subject entitled *Financial Reporting Issues Relating to Islamic Finance*, and actively studies and comments on IASB's exposure drafts and other publications.

Indeed, the IASB has taken a keen interest in the work of the AOSSG, and has indicated that Islamic accounting may be included in its future discussions.

Summary

1. The unique characteristics of IFIs need to be taken into consideration for accounting, auditing and taxation.
2. The definition of Islamic accounting goes beyond the definition used in conventional accounting as it also includes other information, mainly social and environmental information to be used by the existing and potential users and must comply with *Shari'ah*.
3. There are differences in opinions with regard to accounting for Islamic financial transactions.
4. Development must be made in strengthening the *Shari'ah* review which is required to support the *Shari'ah* report issued by the *Shari'ah* committee. Without a strong and proper *Shari'ah* review, the *Shari'ah* committee would not be able to support their opinion and thus fail to discharge their entrusted duties as expected by the stakeholders.
5. Tax is a very important consideration in Islamic financing transaction such that a country needs to look at its tax legislation in order to develop Islamic finance. The multiple taxes that an Islamic transaction may attract if it is not deemed a financing transaction can render it cost-ineffective. Therefore, tax neutrality is an important element to spur the growth of Islamic finance.

Key Terms and Concepts

Financial Accounting

Islamic Accounting

International Financial Reporting Standards (IFRS)

AAOIFI Financial Accounting Standards (AAOIFI FAS)

International Accounting Standard 39 (IAS 39), *Financial Instruments: Recognition and Measurement*

Fair value

Amortised cost

Effective interest method

Current value/cash equivalent value

Historical cost

AAOIFI Governance Standards for IFIs

AAOIFI Auditing Standards for IFIs

Shari'ah audit

Economic substance

Tax neutrality

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Review Questions and Problems

1 Describe four different objectives that must be provided by the financial reports of Islamic banks which are different from those of conventional banks. For these four objectives, list the corresponding reports which would provide the information.

2 Briefly explain the difference between *musharakah* and *murabahah* with regard to accounting recognition and measurement.

3 Select financial statements of two Islamic banks, one from Malaysia and another from Bahrain, and analyse the presentation of *mudarabah*, *musharakah*, *murabahah*, *ijarah* and *sukuk* in the income statements and statements of financial position of the banks. Also examine the *Shari'ah* report and auditor report of these banks.

4 Discuss the challenges faced by *Shari'ah* auditors.

5 Explain the concept of tax neutrality and why it is important in Islamic finance.

6 Illustrate, using an example, how an Islamic financial product can be more expensive than its conventional counterpart in terms of tax cost.

7 Select an Islamic financial product, other than one covered in this chapter, and identify the tax issues that need to be considered.

8 "Substance-over-form is important in taxation of Islamic financial products." Discuss the statement using examples.

Part 6

Moving Forward – Opportunities, Issues and Challenges

Chapter 19

Challenges and Opportunities

Preview

Islamic economics and the Islamic financial system operate and function in a way similar to the conventional system. Consequently, the Islamic financial industry faces relatively similar challenges to those faced by the conventional system. Due to their distinct features encompassed in the teachings of the *Shari'ah*, the ideal Islamic economic and financial systems are faced with additional challenges and opportunities. In theory, the Islamic financial system is inclined towards equity-based financial instruments that are related to the real economy. In reality, however, the Islamic finance industry is dominated by debt-based financial instruments that, more often than not, mirror conventional ones.

The global financial crisis of 2007-2009 brought the Islamic finance industry into the limelight as a possible alternative.

Overdependence on debt-based instruments makes the economy vulnerable to instability as it increases the disparity in the distribution of income and wealth, among other effects. The global financial crisis of 2007-2009 is the best indicator of the negative impact of debt-based financing, lax regulation, weak oversight mechanisms and imprudent growth of credit. The Islamic finance industry is also facing the very same challenges.

Learning Outcomes

At the end of this chapter, you should be able to:

- Explain the extent to which the Islamic finance industry – in its present state – can offer a better and more equitable financial system as an alternative to the global financial system and, hence, contribute to its stability.
- Identify areas that call for improvement in the current practice of the Islamic finance industry in order to achieve and promote *maqasid al-shari'ah*.
- Understand the ravaging impact of interest-rate-based debt dominance on the well-being of an economy, and how the Islamic finance industry fits within the conventional financial system.
- Highlight the pressing issues that need to be handled for the attainment of a better Islamic financial system.

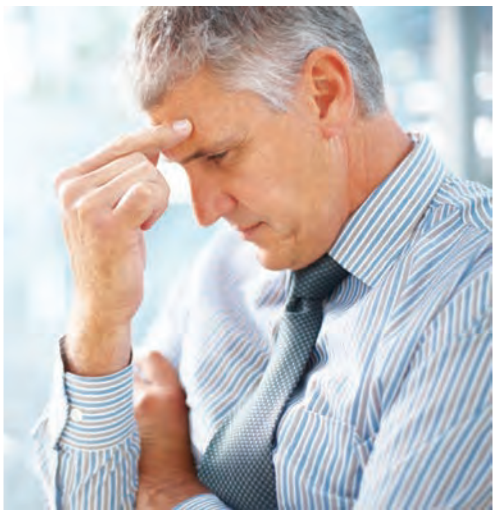
Islamic Finance in Light of the 2007–2009 Global Financial Crisis

The financial crisis triggered by sub-prime mortgages in the US in the second half of 2007, which later snowballed into an economic crisis throughout the world, has provoked much soul-searching among intellectuals, economists included. The long held confidence in the capitalist markets' ability to regulate themselves has receded, at least as far as the financial markets are concerned. Due to its severity, it has been labelled as the worst crisis since the Great Depression. It is now, more than ever before, clear that the current conventional financial system is not stable and that the invisible hand is not doing what its proponents claimed. The assertion by Minsky (1986) that stability of the conventional financial system at one stage breeds instability in the next stage, i.e., his "financial instability hypothesis," seems to be gaining greater acceptance.

The prolonged period of "the great moderation" together with runaway credit growth paved the way for the current crisis. Easy money, uncontrolled growth of credit and debt, lax regulation and supervision, innovation of complex and opaque financial products, mismanagement and mispricing of risks involved, lack of disclosure and transparency, predatory lending and high leverage, among other factors, are thought to be the main culprits of the crisis.

Easy money, uncontrolled growth of credit and debt, lax regulation and supervision, innovation of complex and opaque financial products, mismanagement and mispricing of risks involved, lack of disclosure and transparency, predatory lending and high leverage, among others, are thought to be the main culprits of the global financial crisis.

The global financial crisis of 2007-2009 brought the Islamic finance industry into the limelight as a possible alternative. However, the Islamic finance industry has not been totally immune to the crisis as it too has been hit, although to a much more moderate extent. This may indicate a possible correlation between the Islamic finance industry and its conventional counterpart as it operates within the same conventional system and is governed by the same rules of the game.



Consequently, the Islamic finance industry is seen by some critics as a subset of the conventional financial system that is governed by rules and regulations that may not be in line with the *maqasid al-shari'ah*. These critics suggest that copying conventional mechanisms and applying the "*Shari'ah* make-up" does not do justice to Islamic finance. Rather, Islamic finance is being made subordinate to the conventional financial system and thus not allowed to perform its major function of risk sharing.

Islamic economists' responses have generally focused on debt culture, speculation and contracts involving ambiguities and uncertainties (*gharar*) as the main causes of the current crisis. Most of them asserted that a financial system working in accordance with Islamic teachings such as risk-sharing, prohibition of interest, ban on trading in debts except at par and prohibition of contracts involving excessive *gharar* would never lead to such a crisis. This assertion understandably led to a debate on how far the Islamic financial industry itself remained unaffected by the crisis. To the extent that Islamic finance remained shielded from the gravity of the crisis, the main reason, everybody agreed, was its closer ties with the real economy.

The crisis offers a unique opportunity to rethink Islamic finance in general. Is Islamic finance an entirely different discipline from traditional finance or is it a subset of the traditional discipline? In theory, at least, we can say that Islamic finance is a different discipline all together, having in mind its underlying principles, worldview, objectives of *Shari'ah* and other related issues. Reality, however, indicates that the Islamic finance industry that has developed so far operates within the same boundaries of conventional finance and relies heavily on its principles and practices. Nevertheless, the progress made so far, considering the very short history of Islamic finance, is remarkable and promising.

Reality indicates that the Islamic finance industry that has developed so far operates within the same boundaries of conventional finance and relies heavily on its principles and practices.

Challenges Facing Islamic Finance

Islamic finance faces a number of challenges that need to be addressed in order to sustain its development in the future. In brief, Islamic finance being a niche industry, faces considerable challenges. The way the industry responds to these challenges will determine whether it will become a significant alternative to the conventional system in global financial markets. Moreover, the lack of efficient legal frameworks, standards and procedures, qualified manpower and effective government support enhances the risk exposures of the Islamic finance industry. Some of these challenges will be discussed later in more detail from two broad perspectives: macro and micro.

Islamic Finance: Between Ideals and Reality

Many Muslims are proud of the emergence and rapid growth of Islamic finance in the last half century. However, few claim it is what it should be. Mimicking the conventional system through juristic exercises, sometimes of dubious validity, might have soothed the conscience of the monied among Muslims by offering them "*Shari'ah*-compliant" ways of doing finance, but it has yet to reach the common man or earn credibility among Muslims in general.

Throughout the literature, there is overwhelming theoretical emphasis on the superiority of equity-based and risk-sharing modes of finance, for example, profit-and-loss-sharing (PLS), as envisioned by Muslim scholars. Unfortunately, the current practices of Islamic financial institutions (IFIs) differ from this "ideal" system to a great extent. In fact, fixed-return-cum debt-based financial instruments dominate the market with risk-sharing instruments being almost completely eliminated from the system. In general, IFIs have a strong tendency to mimic their conventional counterparts. Studies indicate that current financial instruments of IFIs are no different from those offered by conventional ones. The main difference between the two lies in the technicalities and legal forms that avoid explicit recognition of the interest rate mechanism, while the substance is the same.

Fixed-return-cum-debt-based financial instruments dominate the market with risk-sharing instruments being almost completely eliminated from the system.

Iqbal & Mirakhor (2007) addressed the dominance of debt-based over risk-sharing finance in modern history. Among the important reasons for the dominance of debt-based finance is the lack of trust among people and weak institutions, combined with a poor protection of property and investors' rights and weak enforcement of contracts. A study shows that there is a correlation between the level of trust, on one side, and development of institutions and the financial sector, on the other. Countries with a low level of trust and weak institutions are usually poorly performing countries, while the best performing countries are those with a relatively high level of trust and strong institutions. Hence, the reason risk-sharing finance was dominant during the Middle Ages is because of the high level of trust shared among the people and communities. Since risk-sharing instruments are trust-intensive and positively contribute to the overall development of financial systems, societies that exhibit high levels of trust are liable to have a more developed and stronger financial system.

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This disparity between ideal and reality could also be referred to as disparity between *theory* and *practice*. In order to overcome this challenge, some authors suggest further fundamental research be carried out in the near future. It is believed that theory should precede practice; this was the case with the development of conventional finance throughout its history. In the case of Islamic finance, there is a need for more thorough theoretical research within the discipline, although great progress has been made so far.

Be that as it may, common Muslims have not yet given up on the Islamic finance industry, the most innovative and promising offshoot of the movements for Islamic resurgence that emerged in the 20th century. Islamic financial institutions have sprung up in every country where Muslims live. Almost every locality with a sizeable number of Muslims seeks access to Islamic banks and other financial institutions as an increasing number take the courage to get rid of interest-tainted dealings. It is a mass movement that will snowball and could metamorphose into something we have not yet seen.

Maqasid Al-Shari'ah and Islamic Finance

Among the challenges faced by the Islamic financial system is to realise *maqasid al-shari'ah* both at the level of the general framework of Islamic finance, and at the level of product development and its implementation within the industry. *Maqasid al-shari'ah* reflects the holistic view of Islam. Islam is a complete and integrated code of life and its goals encompass everything in life. By acknowledging the *maqasid al-shari'ah*, Muslims commit themselves to justice, brotherhood and social welfare. Only by truly applying the principles of *maqasid al-shari'ah* and being rule-compliant can Muslims obtain the ultimate happiness (*falah*) and achieve the approval and satisfaction of their Creator. As a result, profit maximisation cannot be the only goal of Islamic finance, but rather it has to be accompanied with other goals such as spiritual health, justice, fairness and equitable distribution, among others.

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The focus of Islamic teachings related to economic life has been to teach people to care for others. This includes, among other things, sharing with them within a framework of sustaining themselves with ownership rights and freedom of enterprise. Finance is no exception. Financial facilities should be accessible to everyone and made to work towards the well-being of all. According to the *Qur'an*, life-sustaining resources in the universe are meant for all to share.

> "*We assuredly established you in the earth and arranged for your livelihood in it. Little do you give thanks*" (*Al-Qur'an*, 7:10).
>
> "*As for the earth, We have stretched it out and have cast on it firm mountains, and have caused to grow in it everything well-measured. And We have provided sustenance for you in it and also for those of whom you are not the providers*" (*Al-Qur'an*, 15:19-20).

It is in the nature of life that some need help from others; it is mandatory to arrange for their sustenance:

> "*…and those in whose wealth there is a known right for those that ask and those that are dispossessed.*" (*Al-Qur'an*, 70:24-25).
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> "*And in their wealth there was a rightful share for him who would ask and for the destitute*" (*Al-Qur'an*, 51:19).

In their writings, Muslim scholars attempt to explain how to keep a balance between individual freedoms and rights, including the right to the fruits of one's labour and property, and the need to provide sustenance to the have-nots and security to society as a whole. They adopted a three-pronged approach to realise this delicate balance: one, moral orientation of individual decision-makers; two, free competitive markets open to innovative enterprises and assuring adequate rewards. These two were complemented by state regulation to keep the market free of monopoly and other anti-social activities and guide it towards desirable goals, through public sector enterprises to the extent needed.

In designing a financial system in the 21st century, Muslims have to be aware of the difference between radical individualism, lately championed by secular-capitalists, and individual rights in the Islamic framework. The Islamic worldview, based on *Tawhid*, regards all human beings as members of one large family who are expected to care for one another and share God's gifts with each other. Nowhere does the impact of the Islamic worldview stand out as clearly as when facing the risks and uncertainties inevitably associated with living. The greatest departure of Islamic finance from capitalist finance may be in risk management, which we shall now explore.

Risk Management and *Maqasid Al-Shari'ah*

Uncertainty of future values makes productive enterprise risky.

Finance is needed for the production of goods and services now, in expectation of results that will occur in the future. The future cannot be known with certainty. Uncertainty of future values makes productive enterprise risky. If a person, firm or institution has to bear all the risks involved in the project under its management, the scale, scope and time horizon of projects will be constrained. But modern living increasingly involves long-term commitments, worldwide scope and huge scales of production. These are possible only by pooling together financial resources. This is best done if the risk is shared among all those involved: capital suppliers, entrepreneur-managers, employees, users of the products and citizens in general. Some risks, like those of fire (in case of homes and other buildings) and accidents (in case of motor vehicles, airplanes, etc.), can be met by utilising the law of large numbers just as actuarial tables help death-related risks. But market risks such as price changes cannot be met on the basis of insurance. Those who buy market risks actually gamble. The law of large numbers does not apply to these situations nor do actuarial tables exist to guide those making bets.

Special problems are involved in areas like the development of new drugs, designs, strategies, etc., that take place over a long period and require a huge investment but may yield uncertain results. Co-operation between private and public sectors has often worked, sometimes along international dimensions. But the whole area is open to experimentation and no rigid rules can be laid down. What can be safely said is that trading of the risks involved introduces a corrupting element in that area in which lives may be at risk.

The distinctive Islamic approach to risk and uncertainty has resulted in two inter-connected rules. Gambling is prohibited while risk-shifting against a price is shunned as it involves excessive *gharar*.

Gambling does not create wealth; it only redistributes what already exists. When the gambler satisfies his pleasure-loving instinct in the financial markets instead of confining himself or herself to casinos, the anti-social role of gambling magnifies, mainly for two reasons. Firstly, the betting is done on the basis of other people's wealth. The terms of betting are so designed that losses are distributed over other wealth owners but those making the bet share only the gains. Secondly, because speculation resembles gambling, it increases volatility in financial markets, making life difficult for those engaged in the production of real goods and services.

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The Islamic prohibition of interest and gambling coupled with a ban on trading debts and risks tell us a lot about how ***not*** to deal with risk and uncertainty. *Zakat* as the obligatory charity, the Islamic laws of inheritance, the Islamic institution of *waqf* and the Islamic rules relating to borrowers in difficulty, show the right direction towards risk-sharing in this regard.

Reading the verse of *Qur'an* (2:281), one cannot miss the point that something more than justice is required to keep the human society on an even keel. Referring to the problem of default, the verse noted below says:

> "*But if the debtor is in straightened circumstances, let him have respite until the time of ease; and whatever you remit by way of charity is better for you, if only you know*" (*Al-Qur'an*, 2:280-81).

Great strides in scientific research and technology have been made due to the ability of society to absorb the immense risks and uncertainties involved in such ventures. Though initiatives may come from the private sector, which has to be promised suitable rewards, the public sector has played a significant role through patent and licencing policies, as well as through grants to universities. These facts strengthen the case for sharing risks as opposed to trading with a view of making profits. The recent financial crisis was also a good proof for the case of sharing risk. In order for us not to fall into the same trap again, we should move towards the creation of more risk-sharing instruments as the future stability of the financial system provides motive to go in that direction.

It is for Islamic economists to make a convincing case for all the three components needed for a comprehensive reform, namely: moral rejuvenation, market regulation to free it from monopoly and other anti-social elements, and state regulation to secure desirable goals through the public sector. This would need fundamental contributions in economic analysis since radical secularists have kept away from morals for a long period. It will also require a fresh look at history to learn from periods less prone to crises than our own, and in which the level of anxiety is far below what afflicts modern man. The Islamic approach could also get a boost by some of the Muslim countries and communities giving a serious try to alternative monetary and financial arrangements, briefly noted previously.

The components mentioned previously seem to be a necessary pre-condition for Islam to interact with international monetary and fiscal institutions like the International Monetary Fund and the International Bank for Reconstruction and Development, the World Bank. There is nothing in the rule book of these institutions to make them stick to the institution of interest as such. But the fact that interest-bearing debts have been their main, if not sole, instrument has in reality made them impoverish the poorest countries of the world rather than enrich them. A reversal of that role is not possible unless an alternative vision prevails. It would help if the Organization of Islamic Conference (OIC) countries, preferably in co-operation with other emerging economies, take an initiative in demonstrating international monetary and fiscal relations based on participation rather than interest-based lending.

Shari'ah Governance

The core principles of the Islamic financial system are drawn from the *Shari'ah*. Hence, empowering *Shari'ah* within the Islamic financial system is of utmost importance. As has been pointed out, *Shari'ah* offers a wide range of financial products that can be utilised to meet the needs of customers. Furthermore, *Shari'ah* is open to new interpretation and provides room for innovation and financial engineering.

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As a result, *Shari'ah* governance and transparency is a very critical area in Islamic finance and is no less important than corporate governance is to any institution. In fact, *Shari'ah* governance was introduced to complement the existing corporate governance framework in IFIs. However, *Shari'ah* governance is particular to Islamic finance, as it is the mechanism which determines the "Islamicity" of any particular Islamic business or financial institution as well as the system as a whole. The significance of *Shari'ah* governance transpires via its role of fostering confidence in the Islamic finance industry on the part of the public. More importantly, *Shari'ah* governance ensures that the industry is at all times in accordance with the wishes and laws of the Almighty by ensuring the legitimacy of the products offered.

On the issue of transparency, IFIs must abide and adhere to the same regulatory requirements pertaining disclosures. This will ensure the smooth management of IFIs. *Shari'ah* governance as well as corporate governance is the subject matter of Chapter 16.

Consequently, we must ensure the maximum utilisation of *Shari'ah* principles in developing Islamic financial products. Since the emphasis of the Islamic finance industry currently has been a replication of instruments of conventional finance while avoiding the interest rate mechanism, certain debt-based products pre-dominate among the instruments used by IFIs.

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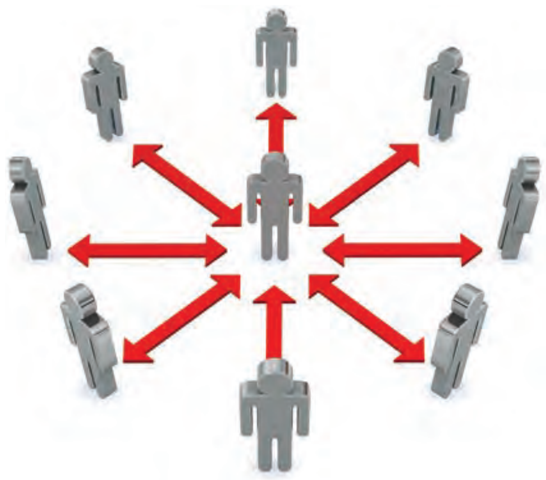
Standardisation

Another hindrance to the development of the Islamic financial system is the different interpretations of *Shari'ah* among *Shari'ah* scholars on what is *Shari'ah*-compliant. The different opinions among *Shari'ah* scholars on relatively similar issues may create confusion among the general public as well as practitioners of Islamic finance. In order to avoid the confusion among the market participants, there is a need for some sort of standardisation. In other words, standardising the rulings would make it easier for both companies and ordinary people to understand them better. In addition, the standardisation of the practices across the globe may bring about further growth and strength to the Islamic financial industry.



For the standardisation to work, however, it is important to create the atmosphere of respect and mutual recognition of *Shari'ah* interpretation across jurisdictions and *madhahib* (plural of *madhhab* – school of law). Furthermore, *Shari'ah* scholars across the globe should interact more frequently with one another and understand the rationale of a given *Shari'ah* view. Hence, a common platform for scholarly discussion and debate is needed.

In brief, what is needed for the future progress of the Islamic finance industry is to come up with unified, standardised and comprehensive guidelines. These guidelines will serve as a reference for the *Shari'ah* advisory board of each and every bank. Furthermore, these guidelines will take into consideration all the restrictions and jurisdictions. The

Shari'ah advisory board shall make sure that the core principles are upheld while, at the same time, they will have enough room for accommodating specific requirements demanded by each and every region or jurisdiction. Nevertheless, with the sort of standardisation briefly suggested previously, IFIs will be able to standardise, at least to some extent, the process of introducing new products in the market.

Developing a Comprehensive and Robust Islamic Financial System

It has been pointed out earlier in the book that the level of development of Islamic finance across jurisdictions varies significantly. In some countries, Islamic finance is at an advanced stage of development, while in others, more meaningful progress is yet to be made. As of now, Islamic finance is largely concentrated in a few regions, namely Southeast Asia and the Middle East, with a few Western countries taking an active role in promoting Islamic finance. Hence, the penetration of Islamic finance into other regions and countries is both a challenge and opportunity for Islamic finance. In order to do this, a robust Islamic financial system consisting of the banking and the non-banking Islamic financial intermediaries, the Islamic financial markets, a wide range of Islamic financial products, and a developed Islamic financial infrastructure is needed.

Furthermore, even countries where Islamic finance is relatively well-developed suffer from financial deficiencies when attempts are made for wholesale adoption of Islamic finance. More often than not, the fiscal, monetary and other regulatory policies are unable to meet the needs and requirements of Islamic finance. Hence, major structural adjustments are needed, especially in the areas of fiscal and monetary policies. Iqbal and Mirakhor (2007) argue that among the constraints faced by Islamic finance in most countries are pervasive government intervention and controls, inefficient and weak tax systems, financial repression, lack of capital markets, unavailability of a well-targeted and efficient social safety net, lack of a strong supervisory and prudential regulatory framework in the financial system, and deficiency of legal and institutional frameworks that provide *Shari'ah*-based definitions of property rights as well as the right of the parties to contracts.

Debt vs Equity

Since its inception, the pioneers of Islamic finance have promoted the idea of Islamic finance based on equity and a profit-and-loss-sharing (PLS) model. In fact, as stated by Shaykh Muhammad Taqi Usmani, the chairman of the *Shari'ah* Board of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), "the ideal mode of financing, according to *Shari'ah*, is *mudarabah* or *musharakah*."

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Nevertheless, the current financial industry is predominantly interest-based and debt-driven where risk-transfer rather than risk-sharing takes place. This over dependence on debt-based products led to imprudent growth of debt and easy availability of credit over the years, which in turn, were among the main culprits of major financial crises in history, the global financial crisis of 2007-2009 being no exception.

During his address to the World Economic Forum in Davos in 2010, Shaykh Muhammad Taqi Usmani called for the restructuring of the international financial system in general and Islamic finance in particular. He suggested for the current debt-based system to be replaced with an equity-based system that is more linked to the real economy. It is important to note that from the *Shari'ah* perspective, both non-interest-based debt and equity modes of financing are allowed and there is no indication showing that one is preferred over the other. It all depends on the need of the market to determine which mode is to be utilised. Nevertheless, although the role of debt in every financial system (be it Islamic or otherwise) is acknowledged, it is believed that debt should not pre-dominate. In other words, the use of debt should be a last resort approach, i.e., once all other options have been exhausted. Shaykh Taqi's recommendation has been supported by many Muslim scholars and economists.

Hence, it is argued that more attention should be given to alternative instruments, in particular, equity-based financial instruments such as *mudarabah* and *musharakah*. Overdependence on debt-based products reveals at the same time, the reluctance of market players to promote risk-sharing, equity-based financial products. It is believed that the promotion of risk-sharing, equity-based and partnership-like financing instruments is crucial in achieving the full potential of an Islamic financial system.

That said, if non-interest-based debt is to be used, the balance between the two must be preserved as each has its own role to play in the current financial system. If any shift is to be proposed in order to balance them, it should be done gradually as a drastic change might affect the market and the industry adversely. Finally, to make a real change for the better, goodwill and commitment from all parties involved are required as this will necessitate a lot of effort and time.

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Unfortunately, at present, the use of equity and PLS modes within the Islamic finance industry is insignificant. In fact, the industry is dominated by debt-creating instruments through sale- and/or lease-based modes. It is believed that the introduction of more PLS instruments in the financial system will make both financial institutions and entrepreneurs (borrowers) more responsible as they will assess the risks more carefully and efficiently. As a result, this would bring about more stability and justice in the market.

This would be a system, according to the pioneers of Islamic finance, where risk-sharing, justice, fairness and stability would prevail. In the long-run, the real investors would be better off, with the overall economy benefiting as well, while the effects of unproductive speculation and gambling would be reduced.

Finally, debt-oriented financing has to be viewed in the context of a monetary system based on a fractional reserve banking model. Under this system, debt financing has been accorded significant pricing advantages. Having this in mind, Islamic finance cannot refrain from debt-based financing unless the government is prepared to replace the existing fractional reserve banking model with an entirely *Shari'ah*-based model. However, until such time when a *Shari'ah*-based monetary system is implemented, Islamic financiers must ensure that the scope of Islamic debt financing is limited for constructive and essential purposes only. Likewise, debt financing should not be extended for irrational and wasteful consumption or speculation.

Debt-Based Monetary System

At present, fiat money created by a central bank, as authorised by the government, enters the economy as borrowings by commercial banks on one side, and lending to businesses and households on the other. Interest is involved in both cases. Money supply is increased by lowering the rate at which commercial banks can borrow from the central bank. Money supply can be decreased by raising that rate. Fiat money also enters the system directly as a result of open market operations by the central bank, i.e., purchase or sale of securities by the monetary authority in order to keep money supply in tune with the needs of the economy.

Similarly, commercial banks have deposits placed by the public into their current and savings/investment accounts. These banks can use a major portion of the current account balances as well as amounts in saving accounts supplemented by borrowings from central banks, for making loans to households and business firms. Thus, all these loans are interest bearing as are the bonds floated by central (federal), provincial (state) and local (city) governments, corporations or any institution authorised to borrow directly from the public. The same applies to foreign governments or private sector corporations selling or buying bonds in a particular country. All money is debt although not all debt is money. The supply of debts can be manipulated by the monetary authority. It is also vulnerable to manipulation by speculators, banks and other financial institutions. In a debt-based system, money and finance are inter-linked as interest-based debts form the backbone of both. This is the case despite the fact that part of the finance comes in the form of equities, such as stocks (shares) traded on the stock exchange or funds mobilised by investment companies, or venture capital supplied by fund owners, etc. Debt securitisation and derivatives help balloon the size of outstanding debts manifold.

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The financial sector, which collects savings, allocates capital and transfers funds, grows in size relative to the real sector that produces goods and services that people consume. This tends to redistribute social income in favour of those engaged in money and finance away from those engaged in agriculture, manufacturing and services such as education, healthcare, transport and communications, etc. As a result, the more talented people are attracted to the financial sector.

Inefficiency of Debt Finance

One of the main functions of a financial system is allocating financial resources (society's savings, past and present) to productive uses. Bank loans go to the most creditworthy people; creditworthiness being measured in terms of money and marketable assets owned by the loan-seeking person or firm that can serve as collateral. Those with the best collateral are not necessarily the people with the most productive projects, productivity being measured in terms of expected profits. The same applies to debt money mobilised through bond issues. Buyers of bonds prefer buying bonds of entities whose ability to pay promised interest is high, giving second consideration to continued viability of the entity itself. Productivity of the projects to be funded, as measured by expected profitability, is of no direct concern to the loan-making

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bank or buyer of bonds. But from the social point of view, it is the productivity itself that should guide capital allocation. Debt finance fails to allocate financial resources efficiently; efficiency defined in terms of expected value-productivity.

Another source of inefficiency in debt financing is its short-term nature. Banks tend to shun projects that take several years to produce marketable goods or services in view of short-time periods for which funds are deposited with them. As the investment horizon extends further over time, the risk premium (a constituent part of the rate of interest charged) needs to be larger, often too large for the market to sustain. The use of market rate of interest as the rate of discounting future expected values in project evaluation introduces a bias in favour of projects maturing sooner, rather than later. This has played havoc, especially with respect to infrastructure and other buildings like homes in which people live. For example, buying a house with a 25- or 30-year mortgage involves the buyer paying more than half of the cost as interest to those financing the deal. This short-term nature of debt financing has devastating implications for crucial issues such as climate change and inter-generational equity.

This brings us to another limitation from which the rate of interest suffers; a limitation which almost disqualifies it as an indicator of productivity of capital. The market rate of interest is largely based on the rate of interest set by the monetary authority (e.g., the Federal Reserve in US, the Bank of England in UK or Bank Negara Malaysia). That base rate is a policy tool. It is determined largely by considerations not closely related to the productivity of capital in the domestic economy. The Federal Reserve Rate reached 20% during Paul Volcker's anti-inflationary push in the 1980s whereas Alan Greenspan brought it down to almost zero in the last days of his chairmanship.

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The interest rate is frequently raised to curb inflation. It may be lowered to boost investment in recession. However, changes in the interest rate made due to monetary consideration may violate other social norms. More often than not, policy considerations by fiscal authorities are more concerned with poverty alleviation and equitable distribution of income than those of monetary authorities. This would dictate a change in the opposite direction, insofar as the rate of interest is concerned. A high interest rate imposed with the purpose of fighting inflation may result in immense hardship to farmers and home owners subject to a flexible rate, as has happened in the US during Paul Volcker's regime.

Vulnerability to Instability

There is a disconnection between the payment obligations of a borrowing firm and its revenues from sale of goods and services produced with the help of the borrowed capital. The former is fixed in amount and subject to a time-bound schedule whereas the revenues are subject to the vagaries of the market. This lack of synchronisation makes the debt-based capitalist system inherently unstable as so convincingly demonstrated by Minsky (1986). This mismatch between receipts and payments often obliges the firm to borrow. This further jeopardises the firm's chances of making a profit sometimes even breaking even in the long run. Interest-bearing debt finance lacks the flexibility required in dealing with man's uncertain environment. In circumstances where possible changes in tastes, technologies and international relations make a firm's revenue receipts uncertain both in amounts and time of accrual, it is obliged to commit to payments of given amounts at given dates. The result is frequent bankruptcies, destruction of social capital and redistribution of assets in favour of financiers. The resulting instability has a contagion effect in the global economy as plants are closed and workers are thrown out of work.

Political Impact of Debt Finance

As lenders grow in wealth, being enriched overtime by a continuous flow of interest from borrowers, they also grow in power. Their political clout increases as the government of the day resorts more and more to deficit financing. Financial giants have the money to hire lobbyists and contribute to campaign funds. Citizens acting through elected representatives may fail to get the policy decisions they prefer in a milieu in which financiers dominate the media; often dependent on their financing. Since modern governments at all levels, local, state and central, need to borrow heavily, it is very difficult for them to defy the lenders. This is most obvious when it comes to taxation, which is the number one alternative to borrowing insofar as the government is concerned. Not only does the pressure from the financial sector result in taxing the rich less than the circumstances call for, it creates a "bias-favouring debt finance" in tax policy, as a recent IMF study showed (IMF, 2010).

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Inequity of Debt Finance

A good financial system has been envisioned as one combining three things: "economic efficiency, social justice and individual liberty." Debt financing fails on all three accounts. But its most devastating effect has been on the poor. It has no compassion. It is completely out of sync with the nature of a man's sojourn on this planet, which requires sharing between haves and have-nots. It is based on a notion of private ownership that ignores the divine origins of property rights and their social dimensions. With regard to the lender-borrower relationship, the current system is heavily biased in favour of the lenders whose rights it protects and against borrowers whose plight it ignores. Among the seemingly endless innovations that have characterised modern finance recently, few are directed at helping the poor out of their plight. On the contrary, the current financial system has mercilessly exploited the needy by removing limits to interest on credit card debts imposed earlier and by tolerating loan sharks. As evidenced by the bailouts subsequent to the recent crisis, the ruling system prefers rescuing the lenders rather than relieving the borrowers' plight.

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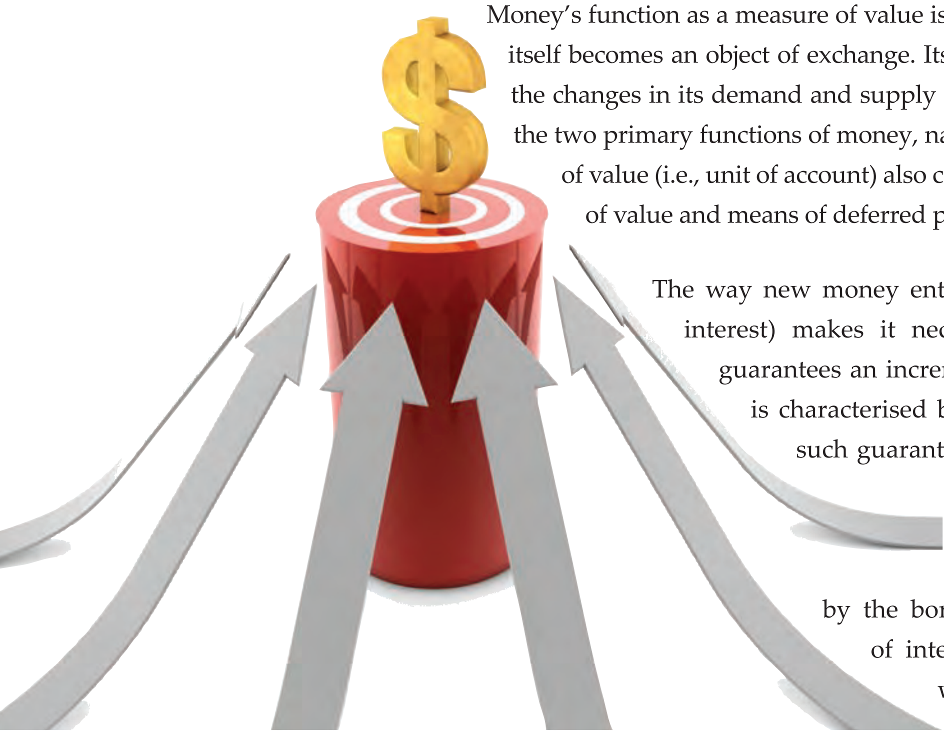
Perverse Effect of Interest

The creation of money in the form of interest-bearing debt obstructs the primary function of money as a medium of exchange by putting a price on money that depends on time. Instead of being used to get other objects of desire, because of interest, money is instead used to get more money. It was conceived as a lubricant facilitating exchange but the possibility of earning interest diverts it to other uses. Those who appropriate to themselves the privilege of creating money (as debt) ensure, through interest, that part of the social wealth passes on to them with every transaction involving the use of money.



Money's function as a measure of value is also adversely affected insofar as money itself becomes an object of exchange. Its purchasing power keeps changing with the changes in its demand and supply in the money market. The impairment of the two primary functions of money, namely, medium of exchange and measure of value (i.e., unit of account) also corrupts the two other functions, *viz*., store of value and means of deferred payment.

The way new money enters the system (debt to be repaid with interest) makes it necessary to be used in a manner that guarantees an increment over time. But man's environment is characterised by uncertainty of future values, making such guarantees impossible. In other words, it is not possible to guarantee that the total output, measured in terms of money, is larger than the total input financed by the borrowed capital, at least by the amount of interest due. There are only two ways in which this situation can be resolved: an inflationary pressure on prices boosting the market value of output or the borrowers meeting their payment obligations from out of their accumulated wealth. In practice, both may happen. The net result is enrichment of those who lend at the cost of fund users and ordinary consumers. Interest-based debt as the cornerstone of finance inevitably results in increasing inequality in the distribution of income and wealth.

A new dimension of the perverse role of interest-based debt finance relates to the intense pressure it generates in favour of accelerated growth. As noted above, successful working of debt financing requires that output in every round of production of wealth must be more than the input, at least by the amount of interest due. But our planet does not seem to have been designed to sustain accelerated growth till the end of time. There are limits to growth but debt finance is incapable of accommodating those limits due to interest.

Islamic Alternatives to Debt-Based System of Money and Finance

Islamic alternatives to debt-based monetary arrangements have taken a number of forms. A small minority would like to make gold the kingpin of monetary arrangements, advocating the introduction of gold *dinars*. The overwhelming majority of Islamic economists accept fiat money and have no problems with paper currency, electronic money, etc. Among these, some reject the fractional reserve system and advocate 100% reserves, separating the deposit-taking payment-making system from other banking functions, especially investment. The rest will try to live with the contemporary fractional reserve system of money creation but remove interest-bearing loans from it. The crucial point is not who creates new money but how it is created. In addition, when the supply of money is linked to the expansion in the supply of real goods and services via a profit-sharing arrangement between suppliers of money and users of money, the supply of money and that of goods and services will move together in the same direction. In the subsequent paragraphs, we attempt a brief review of current efforts at eliminating interest from monetary management.

The first issue to be resolved is how high-powered money, created by the monetary authority, reaches the banking system. The second issue is on what terms additional money is made available to households, trade, industry and agriculture, etc. To complete the system, we need a mechanism through which the monetary authority could withdraw some liquidity from the system should they desire to contract money supply as well.

The theoretical literature on the management of money in an interest-free system envisaged a key role for profit-sharing. The central bank could provide liquidity to commercial banks which would make it available to businesses on the basis of sharing the resulting profits. Part of the profits so acquired by the commercial banks could be passed over to the central bank which provided new money in the first place. It was emphasised that the central bank in an interest-free Islamic banking system could change the reserve ratio, lowering it to expand money supply and raising it to contract money supply. With regard to fine-tuning of money supply to keep it in sync with the demand for money, some suggested manipulating the ratio of profits between fund suppliers and fund users to achieve that end. In criticism of this suggestion, it was pointed out that manoeuvring profit-sharing ratios for money management may have effects on the real economy which are not desired. In practice, Khair (2000) found that profit-sharing funds had the capability to replace interest-bearing loans in a central bank-commercial bank relationship. The idea was put in effect in Sudan through an instrument named *Shamam* (Central Bank *Musharakah* Certificates or CMCs). *Shamams* are based on the central bank´s ownership of shares in commercial banks. Another instrument, *Shahamah* (Government *Musharakah* Certificates or GMCs), was devised to mobilise savings from the public, within the country and abroad, for investment in public sector enterprises and to meet the deficit in the state budget. It could also serve as a tool for liquidity management. The central bank was also authorised to buy and sell *sukuk Al-Tamweel* of various kinds from banks and financial institutions.

Iran has been exploring the possibility of introducing Participation Papers for the mobilisation of domestic savings since 1980s. Now, Participation Papers have been made available to foreign investors, too. The government of Iran had borrowed heavily from the central bank to finance social overheads and provide social goods. National Participation Papers (NPPs) would be the securities issued against these debts, to be sold in the open market to control liquidity. It was proposed that this instrument should pay a dividend of at least as high as the rate of return in the real sector of the economy but adjusted downward for the positive risk premium of the government. However, the actual application of NPPs was far more limited. It remains to be seen to what extent participation in profit actually replaces pre-determined interest rates in external financial relations of the Islamic Republic of Iran.

There is a popular demand in all Muslim countries to distance money and finance from debt culture and free it of interest. Many Gulf economies are increasingly using a variety of Islamic bonds (*sukuk*) for mobilising funds.

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There is a popular demand in all Muslim countries to distance money and finance from debt culture and free it of interest. Many Gulf economies are increasingly using a variety of Islamic bonds (*sukuk*) for mobilising funds. Similarly Algeria, no champion of Islamisation, has recently declared its intention of moving in that direction. Even though in a rudimentary state in practice, elimination of interest-bearing debts from the monetary system presents no insurmountable difficulties. In a fiat money regime, the central bank should be authorised to print as much currency as is needed for meeting transaction demand. The newly created money has three ways to reach the hands of those who would use it: participation money claiming a share in the profits accruing upon its use; loans without interest (*qard hasan*), with or without service charges; and outright grants. The central bank could use the certificates of ownership in its possession as a means of open market operations. These securities may relate to public as well as private sector projects, issued as *sukuk* to mobilise funds. *Qard hasan* or interest-free loans can go directly to *waqf-zakat* based voluntary institutions providing public services, especially to the poor. The same applies to grants. The timing and amounts of these payments can be attuned with the goals of the monetary policy. The reserve ratio, the fraction of deposits commercial banks must keep with the central bank, can be manoeuvred to fine-tune the supply of money. The fact that even the countries which have declared their intention to eliminate interest from their systems have not been able to take all these steps may owe itself to an unfriendly international framework.

Once interest-bearing debts disappear from the monetary system, the financial institutions can work without interest-bearing debts in a number of ways. Those who envisage commercial banks as financial intermediaries still prefer two-tier *mudarabah* as the basic principle. They have no objection to *murabahah*, *ijarah*, *salam*, *istisna'* and any other trade-based modes of finance (that create debts) being grafted to the profit-sharing-based intermediation as long as these trade-based modes of financing play a subsidiary role. However, debt trading should not be allowed in any case. If *murabahah* receivables were allowed to be sold on the market, they should be sold at par value and not at a discount.

Others are of the view that private sector Islamic financial institutions should be engaged in productive enterprise. Thus, under this scenario, banks, as we know them, are not needed. Islamic financial institutions would accept savings on *musharakah*/*mudarabah* basis and engage in productive enterprises, sharing the profits with fund owners. A prominent role is envisaged for *qard hasan*, i.e., interest-free loans.

There is also a vision of Islamic finance that incorporates *zakat* and *waqf*; the two premier Islamic institutions that relate to money and finance in particular, and man's economic life in general. *Waqf* in the voluntary sector is a possible complement to state-owned financial institutions. They have the advantage of evoking greater public trust in an environment of changing political regimes often influenced by vested interests. *Waqf* in Islamic history played a dominant role in providing public goods like education and healthcare. They can be supplemented by *zakat* collections awaiting distribution to those who deserve it. Since the record of profit-motivated financial institutions like banks, investment companies, insurance companies, etc., in uplifting the poor has been insignificant and, at the best, indirect, the *zakat-waqf* sector can devote itself especially to financing the poor. The interface of *zakat-waqf* establishment with profit-motivated financial institutions could be through technical support and international guarantees.

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Although there is little actual practice to report, there are clear indications of awareness that such possibilities exist. It requires Muslim financiers as well as academics to come out of the box and make new experiments. As one of the earliest examples, one can cite Malaysia's Lembaga Tabung Haji. There are moves in India to officially launch a corporation attracting savings in preparation for the *hajj* pilgrimage and arranging for their investment in *waqf* properties with a view of increasing their revenue yields, to be shared between the *waqf* and the *hajj* fund. There lies a possibility to demonstrate that money need not necessarily be associated with making profits, that it can serve other life goals directly, and that people can be motivated by attractions other than accumulating wealth.

The inability of the profit-sharing model of Islamic finance to cater for consumption needs, and cash needed for other purposes not amenable to calculation of yields in money terms, is quite understandable. That gap has traditionally been filled by charitable giving and *qard hasan* (interest-free loans). Insofar as private persons and the voluntary sector fail to fill the gap, state-funded institutions will have to step in. Recent attempts by a section of the Islamic finance industry to make recourse to *tawarruq* for these purposes have not been met with general approval, and rightly so.

A Way Forward

A lot needs to be done for Islamic finance to have a better future. On top of the agenda should be finding the ways out of the pitfalls entrenched in the conventional financial arrangements, especially with regard to debt-based instruments and problems related to the impoverishment of the masses. Finance is difficult to segregate. The most efficient solutions will be those to which the largest numbers subscribe. Many faith groups, as well as other well-meaning persons, have organised ethical finance or socially responsible finance schemes. There is a vast scope for networking and reaping the advantages of scale.

The journey from the capitalist financial system, designed to serve radical individualism and Western hegemony, to a morally informed system, designed to realise co-operative universal brotherhood, requires technological prowess as well as spiritual clarity. A system of participatory wealth management geared to serving all and also giving sufficient incentives to bring out the best from all participants may need experimentation more than mechanical enforcement of rules devised by experts.

Most of the experimentation is expected to belong to two areas, namely: incentives and risk management. Economics has rightly emphasised the role of motivation, often underestimated by utopia makers and moralists. The ill effects of radical individualism are long-term while the gains seem to be here and now, occurring directly to the person concerned. It requires a lot of arguing and some lessons from history to convince the individual decision-maker that greed is not good and that caring and sharing lessen anxiety and contribute to health and well-being.

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Modern capitalist finance has succeeded in shaping the political system to serve its ends. The role of money in determining which persons reach positions of power, the role of lobbyists in influencing decision-makers and the subservience of the media and even universities to financially vested interests should serve as warnings for those who frame new constitutions. To avoid all this and to overcome the resistance of vested interests to replacing debt-based systems with participatory systems poses a political challenge as much as an economic one. The recent crisis opened up an opportunity by putting the advocates of debt-based systems in a defensive position. The time is ripe for change.

The Islamic financial movement got a good start with the patronage of many pious businessmen and some well-meaning men in power. It was welcomed by Muslim masses and supported by Muslim religious scholars as well as Muslim economists. But the deficiencies noted above have to be addressed before it can surge further ahead. Simultaneous efforts on two fronts are called for: grass-root penetration by community sponsored micro-finance and *zakat-waqf*-Islamic investment units and national level initiatives in a systemic reform linked together at the world level.

Need For a New Approach

We need a fresh vision of the future we wish to create. The earlier vision, created during the second quarter of the last century, bore the stamp of a fragmented world of nation states, a bipolar world torn by cold war at the world level and majority-minority conflicts within countries. That world is receding. The new vision should take into consideration the realities of the globalised world in which we live. It should look forward to the future toward which the Internet, genetic science, economics and a host of technological advances are taking us. Islam's universal moral teachings and the binding glue of *Tawhid*, rather than the Islamic law codified in earlier times to maintain order in a smaller population with limited sources of energy and primitive technology, should guide us in forging an alliance with seekers of a spiritually inspired, morally informed living style among humanity, insofar as money and finance are concerned.

The new vision, with its implied new goals to target, will necessitate a fresh reading of Islamic history, creating a new version that focuses on life-beautifying values and ideas that dignify living for everyone. It is time to move away from obsession with who conquered whom and rediscover the art of living under God, as children of Adam, sharing a common abode and destined to be judged by the same moral standards. You cannot create a new future without a fresh understanding of history.

Going Beyond *Shari'ah*-Compliance

One of the ongoing challenges of Islamic finance is the arena in which it operates. Right now, Islamic finance is bound to operate within the conventional interest-based system. As a result, a number of Islamic financial instruments, as pointed out earlier, are considered to be mere replications or mirrors of conventional instruments. The very objectives of Islamic commercial law could be jeopardised, due to, among other things, mainstream legal and regulatory requirements underlying the limited space in which Islamic finance operates. It is for this reason that *Shari'ah* scholars or *mujtahids* in exercising their function must open their minds to the current development and realities and interpret the whole text in its totality by looking at the *maqasid al-shari'ah* in order to materialise the ultimate objectives of *Shari'ah* as discussed earlier.

The focus of Islamic financial instruments should be realigned with substance and *maqasid al-shari'ah*, and not merely be *Shari'ah*-compliant.

All in all, the above discussion leads us to conclude that Islam calls for justice, fairness, co-operation and shared responsibility in commercial transactions. With regard to debt transactions, Islam recognises its role within the system. However, when using debt-based financial instruments, IFIs should be very careful and transparent. Not only that, Haneef and Smolo (2010) argued that we have to bring the standards of debt-based products to the next level, whereby the debt-based Islamic financial products should not only be *Shari'ah*-compliant or *halal* but also "*tayyib*" (wholesome, good). In other words, the focus of Islamic financial instruments should be realigned with substance and *maqasid al-shari'ah* and not merely be *Shari'ah*-compliant (Dusuki, 2008).

In this regard, reference is made to several *Qur'anic* verses in which Allah (s.w.t.) states that He has provided us with sustenance that is "*halal tayyib*" (i.e., lawful and good).[1] Going through these verses, it can be concluded that the sustenance that Allah (s.w.t.) has provided for us is not only *halal* (lawful) in nature but it is also *tayyib* (wholesome, good) for us. The same approach should be applied to financial instruments, i.e., they should not only be *Shari'ah*-compliant (i.e., *halal* or lawful) but also *tayyib* (wholesome, good) in nature. This means that the products should, among other things, be just to both seller (creditor) and buyer (debtor) (see Haneef and Smolo 2010).

The main focus of Islamic financial institutions, up until now, has been on making their products *halal* from a purely legal perspective.

In reality, however, the history of IFIs is a witness to the contrary. The main focus of IFIs, up until now, has been on making their products *halal* from a purely legal perspective. Islamic financial institutions have, unfortunately, failed to take into consideration the higher objectives of *Shari'ah* and to focus on substance over form. Thus, there is a dire need for the Islamic financial institutions to evolve from the mere *halal* stage to the "*halalan tayyiban*" stage!

In the final analysis, we should also be aware of the realities on the ground. Subjecting IFIs to these higher standards will not be possible unless we impose similar standards on conventional financial institutions as well. By imposing these standards on IFIs alone, we will make them less competitive in the market. Nevertheless, in the aftermath of the global financial crisis of 2007–2009, IFIs should take a proactive role in reshaping the global financial system based on *maqasid al-shari'ah*. However, without reforming the Islamic financial system, we will not be able to reform the conventional financial system either.

1 See for example: 2:168; 5:88; 8:69 and 16:114.

Summary

1 The global financial crisis raised many questions about the stability of the current financial system. It seems that the current global financial system is unstable and there is a need for an alternative system that can address the shortcomings of the system. An Islamic financial system could be a viable alternative, although it is not free from its own shortcomings.

2 While the ideal Islamic financial system promotes equity-based and risk-sharing instruments, the reality is quite different. Due to the heavy reliance on debt-based products and the mimicking of conventional financial instruments, the Islamic finance industry is seen as a subset of the conventional financial system. As a result, the challenges faced by the Islamic finance industry are similar to the challenges faced by the conventional system. However, the Islamic finance industry faces even more challenges due to its reliance on *Shari'ah* teachings. Hence, while dealing with the challenges that are inherited from the conventional financial system, the Islamic finance industry must ensure its compliance with *Shari'ah* and, at the same time, promote the *maqasid al-shari'ah*.

3 Interest-based debt financing afflicts the monetary system as well as financial system at both domestic and international levels, causing impoverishment of the poor and enrichment of the rich. While the role of non-interest-based debt instruments is acknowledged, a greater emphasis should be given to the equity-based and risk-sharing instruments as well, in order to strengthen the industry.

4 With reference to the objectives of the *Shari'ah*, an interest-free, risk-sharing financial system is believed to be a better alternative to the conventional system. However, in order to make the Islamic finance industry stronger, *Shari'ah* governance should be improved. Furthermore, a standardisation of Islamic financial products could further enhance the stability, credibility and transparency of the industry.

5 The global financial crisis also provided an avenue for rethinking the vision and mission of the Islamic finance industry. Fresh ideas are needed to make it more coherent with *Shari'ah* teachings. This, in turn, will lead to a new level that the Islamic finance industry should move to, which is to go beyond the *Shari'ah*-compliance stage that is dominated by a *halal* (legal) focus, to the stage where the products are both *halal* (legal) and *tayyib* (wholesome).

6 Finally, although the reality of the Islamic finance industry falls short of its ideal vision, the fact that it has established itself in an unfriendly environment is a source of hope for the future.

Key Terms and Concepts

Debt-finance
Inefficiency Supervision
Bank of England
Short-term
Speculation
Vulnerability
Interest-based Debt
Individualism
Islamic Financial System
Capitalist Market
Central-Commercial Bank Relation
Economy
Instability
Islamic Alternative
Tawarruq
Sukuk
Shari'ah
Federal Reserve
Gambling
Shahamah
Halalan tayyiban

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Review Questions and Problems

1. How can Islamic finance provide solutions to the perils of the interest-based financial system? Enumerate the areas that need improvement in the current practice of Islamic finance to enhance its ideals.

2. Despite the credible growth and popularity of Islamic finance, even among non-Muslims, only a few claim it is what it should be. Is this a true fact about the present reality of Islamic finance industry? Explain with reasons and cite relevant examples.

3. The use of debt-based instruments pre-dominate the Islamic finance industry and many believe that this goes against the true spirit of an Islamic financial system. In your opinion, should the Islamic finance industry be more equity- or debt-based? Why?

4. If the usage of equity-based instruments were to be increased, what are the approach(es) Islamic financial institutions should take?

5. Many critics oppose the call for standardisation of Islamic finance. They say that the standardisation goes against the spirit of *Shari'ah* that cherishes the differences of opinions. Do you think that standardisation goes against *Shari'ah* and that it can hurt future progress? Explain.

6. Moving from the *Shari'ah*-compliance stage to the *halalan tayyiban* stage is an abstract idea and cannot be achieved within the current financial environment. Do you agree? Why?

7. Can you think of any other challenges/opportunities for the Islamic finance industry?

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Dr. Engku is currently an Associate Professor at IIUM Institute of Islamic Banking and Finance (IIiBF). She obtained her LLB and LLB (*Shari'ah*) (First Class Honours) and Master of Comparative Laws from IIUM, and a PhD in Law from the University of Aberdeen, UK in 1998. She teaches both *Shari'ah* and civil law. She has published several books and articles in local and international journals and participates regularly at conferences, seminars and workshops as a speaker and conducts in-house training on Islamic finance. She has also served as a member of the *Shari'ah* Committee to a number of financial institutions in the past. Currently, she is a member of the *Shari'ah* Advisory Council of Bank Negara Malaysia.

Faizal Ahmad Manjoo

Mr. Faizal was born in Mauritius in 1960. He did most of his tertiary studies in South Africa at the Rand Afrikaans University and Madrasah Arabia Islamia. He holds many qualifications in the fields of Law, Management, Islamic Studies, Mediation & Arbitration, and Finance. He is an admitted attorney-at-law at the Pretoria High Court, South Africa. Presently he is lecturing on Islamic law and Islamic finance at the Markfield Institute of Higher Education, UK, as well as doing his PhD on Islamic pensions. He has authored many articles on Islamic finance and sits on the *Shari'ah* Supervisory Boards of a few Islamic financial institutions.

Habib Ahmed

Dr. Ahmed has a Master of Arts (Economics) from the University of Chittagong, Bangladesh, Cand. Oecon. from the University of Oslo, Norway, and a PhD (Economics) from the University of Connecticut, US. Before joining Durham University as Professor and *Shari'ah* Chair in Islamic Finance in September 2008, Professor Ahmed worked at The National Commercial Bank and Islamic Research & Training Institute of the Islamic Development Bank Group in Saudi Arabia and also taught at the University of Connecticut, US, the National University of Singapore, and the University of Bahrain. Dr. Ahmed has authored/edited more than 50 papers and publications.

Hakimah Yaacob

Mrs. Hakimah is currently a researcher at ISRA. She is the author of several books such as *ISRA Report on International Legal Framework in Islamic Finance, Malaysian Legal History* and *Alternative Dispute Resolution in Islamic Finance*. She graduated in law from IIUM and her areas of interest are financial victimology, Islamic finance, legal and alternative dispute resolution.

Hamim Syahrum Ahmad Mokhtar

Dr. Hamim is currently Deputy Director at the Financial Surveillance Department, Bank Negara Malaysia. He is an active member of a number of working groups and taskforces established by the Islamic Financial Services Board (IFSB). Dr Hamim holds a degree in Accounting (Honours), Master's degree in Business Administration and PhD in Islamic Banking & Finance. He has published and presented a number of papers at both domestic and international conferences. His latest paper, titled *Efficiency & Competition of Islamic Banking in Malaysia*, was accorded "Highly Commended Award 2009" by the Emerald Literati Network. He is also a Chartered Accountant of the Malaysian Institute of Accountants.

Madzlan Mohamad Hussain

Mr. Madzlan is a Partner and Head of the Islamic Financial Services Practice at Zaid Ibrahim & Co., a premier regional law firm. He specialises in Islamic finance, capital market exercises, as well as corporate and debt restructurings. In between his stint in private legal practice, he served the IFSB for six years, with the responsibility of overseeing the development of IFSB prudential standards on corporate governance practices for all segments of Islamic financial services. Mr. Madzlan graduated with a Bachelor of Laws (Honours) from the IIUM and a Master of Science in Islamic Economics, Banking and Finance from Loughborough University, UK.

Mansor Ibrahim

Prof. Mansor is currently a professor of Economics at the Department of Economics, Universiti Putra Malaysia (UPM). He received his PhD in Economics from Washington University, St. Louis in 1996, after which he served as an academic staff at IIUM for 12 years before joining UPM. His areas of interest are monetary economics and time series analyses of macro-economic and financial data. His research in Islamic economics centres on the role of gold in the monetary system and its hedging property, and the dynamics of Islamic financing. His publications appear in various internationally refereed journals.

Marjan Muhammad

Dr. Marjan Muhammad is currently a researcher at ISRA. She obtained her Bachelor, Master and Doctoral degrees in Islamic Revealed Knowledge and Heritage (*Fiqh* and *Usul al-Fiqh*) from IIUM. She now sits as a member of *Shari'ah* Advisory Committee at RHB Islamic Bank as well as at the Malaysia Building Society Berhad (MBSB). Prior to joining ISRA, she was a tutor at the Faculty of Law and *Shari'ah*, Islamic Science University of Malaysia (USIM). She also used to teach at the Matriculation Centre, IIUM on a part-time basis. She has written several papers related to Islamic financial transaction and *Usul al-Fiqh* subjects.

Mohamad Akram Laldin

Dr. Mohamad Akram is currently the Executive Director of ISRA. Prior to joining ISRA, he was an Assistant Professor at the *Kulliyyah* of Islamic Revealed Knowledge and Human Sciences, IIUM. At present, he is a member of various *Shari'ah* advisory boards locally and internationally. He is also a member of Bank Negara Malaysia's *Shari'ah*

Advisory Council and committee member of AAOIFI's *Shari'ah* Standards, Bahrain. Dr. Akram holds a Bachelor of Arts (Honours) degree in Islamic Jurisprudence and Legislation from the University of Jordan, Amman, Jordan and a PhD in Principles of Islamic Jurisprudence (*Usul al-Fiqh*) from the University of Edinburgh, Scotland, UK. He is the recipient of the Zaki Badawi Award for Excellence in *Shari'ah* Advisory and Research in 2010.

Mohamed Fairooz Abdul Khir

Mr. Fairooz holds a Master of *Shari'ah* degree with specialisation in *Fiqh* and *Usul al-Fiqh* from University of Malaya, Malaysia and a bachelor's degree in the same field from IIUM. He is also one of the recipients of the *Shari'ah* Scholarship Award from Bank Negara Malaysia for his PhD study in Islamic finance. Currently, he is attached to ISRA as a researcher and previously served IIUM for eight years as a lecturer at the Department of Islamic Revealed Knowledge and Human Sciences. He is actively involved in research activities in Islamic finance. He has presented many academic papers at various conferences, locally as well as internationally.

Mohammad Kabir Hassan

Dr. Hassan is a Professor at the Department of Economics and Finance, University of New Orleans, Louisiana, US. He has more than 100 papers published in refereed academic journals to his credit and has presented over 150 research papers at professional conferences. In addition, Dr. Hassan has supervised 27 doctoral theses. He is editor and co-editor of several international journals. Dr. Hassan is co-editor (with M. K. Lewis) of *Handbook of Islamic Banking and Islamic Finance* (Edward Elgar, 2007), and co-editor (with Michael Mahlknecht) *Islamic Capital Market: Products and Strategies*. He is also the co-author of *Islamic Entrepreneurship* (Routledge UK, 2010).

Mohammad Nejatullah Siddiqi

Prof. Nejatullah is a Winner of the King Faisal International Prize for Islamic Studies (1982). He served as Associate Professor of Economics and Professor of Islamic Studies at the Aligarh University, then as Professor of Economics at King Abdulaziz University in Jeddah. He also worked as visiting scholar at the Islamic Research and Training Institute of the Islamic Development Bank at Jeddah. Prof. Nejatullah published several books and a number of articles in international journals and his works have been translated into several languages. Besides being an Emeritus Professor at Aligarh Muslim University's Faculty of Business Administration, where he recently helped launch a programme in Islamic Finance, Prof. Nejatullah continues to be associated with a number of Islamic institutions at the international level.

Mohd. Azmi Omar

Prof. Azmi is currently the Dean of IIUM's Institute of Islamic Banking and Finance. He obtained his Bachelor and Master's degrees in Finance from Northern Illinois

University, US and PhD in Finance from Bangor University, UK. His teaching, research, consultancy and publication interests include Islamic banking and finance, corporate finance, investment management and balanced scorecard. He is currently the *Shari'ah* adviser to Bank Rakyat Malaysia Berhad and Amanah Ikhtiar Malaysia (a microfinance institution) and an investment committee member of Permodalan BSN Berhad (a unit trust company). He also chairs the investment committee of IIUM's investment fund.

Muhammad Ali Jinnah Ahmad

Mr. Ali is a researcher at ISRA. He holds a Bachelor of Arts (Honours) in Islamic Jurisprudence from Al-Bayt University, Jordan and Masters in Islamic Management, Banking and Finance from Loughborough University, UK. Prior to joining ISRA, he served as a lecturer and Head of Banking and Finance Department at Selangor International Islamic University College, Malaysia. He has written a number of research papers and articles on Islamic banking and finance.

Nazrol Kamil Mustaffa Kamil

Mr. Nazrol holds a Postgraduate Diploma in Finance, Bachelor of Commerce (Melbourne) and Master of Business Administration degree from IIUM. He is currently pursuing a PhD in Islamic finance at the International Centre for Education in Islamic Finance (INCEIF). He joined academia in 2005. Prior to that, his work experiences were in the areas of oil and gas as well as IT and management consulting. He has taught, and continues to teach, a number of courses on Islamic finance at both undergraduate and postgraduate levels. In addition, he has been involved in a number of consultancy projects related to Islamic finance. His particular research interest is in the field of Islamic capital markets.

Noraini Mohd Ariffin

Dr. Noraini is currently an Assistant Professor at the Department of Accounting, *Kulliyyah* of Economics and Management Sciences, IIUM. She obtained her Bachelor of Economics (majoring in Accounting) from the University of Aberystwyth, Wales, UK. She then received her Master in Accountancy (with Distinction) from the University of Dundee, Scotland, UK. Later, she received her PhD from the University of Surrey, England, UK. The title of her PhD thesis is *Enhancing Transparency and Risk Reporting in Islamic Banks*. Dr. Noraini is an Associate Member of the Malaysian Institute of Accountants. She has participated in many international conferences and her main areas of interest are on financial reporting of Islamic banks, risk disclosure and risk management perspective.

Nurdianawati Irwani Abdullah

Dr. Irwani is an Associate Professor of Laws at the *Kulliyyah* of Economics and Management Sciences, IIUM. She is also the *Shari'ah* Advisor of Standard and

Chartered Saadiq Bank of Malaysia and *Shari'ah* consultant of ARSA *Shari'ah* Advisory Board. Her expertise is in Islamic law of banking, *Shari'ah law*, *fiqh mu'amalat*, *takaful*, corporate governance, Islamic capital market, business law and commercial law. Dr. Irwani holds an LL.B, LL.B (*Shari'ah*) and Master of Comparative Laws (MCL) from IIUM, and a PhD in Islamic Banking and Finance from Loughborough University, UK. She has produced many journal articles and conference papers in the area of Islamic commercial law and Islamic banking and finance.

Obiyathulla Ismath Bacha

Dr. Obiyathulla is a Professor of Finance and Head of Graduate Studies and the Finance & Accounting Department, INCEIF. Prior to joining INCEIF, he was a Professor and Director of the Management Centre at IIUM. He sits on several boards as adviser. He holds a Doctoral degree in Finance, Master of Business Administration (High Honours) and Master of Arts in Economics from Boston University, US, and an undergraduate degree from Universiti Sains Malaysia. He has published numerous academic papers in local and international journals. His work on the Nikkei Stock Index Futures Contracts won the 1993 Chicago Mercantile Exchange (CME) Competitive Research Award. His book on financial derivatives is currently used as a course textbook at several Malaysian universities.

Saadiah Mohamad

Prof. Saadiah is a professor of Economics at the Faculty of Business Management, Universiti Teknologi MARA, Malaysia. She holds an undergraduate degree from the University of Manchester, UK, a Master's from the University of Missouri, Kansas City, US, and a PhD in Economics from Universiti Kebangsaan Malaysia in 2003. In 2001, she had a research stint at the World Bank and the International Monetary Fund, and in 2006 she was a Fulbright visiting scholar at the University of Evansville, Indiana, US. Her interests are exchange rates, Islamic finance, small and medium enterprises (SMEs) and issues of women in economic development. Currently, she is an associate research fellow at the Asian Institute of Finance, an affiliate institute of Bank Negara Malaysia.

Said Bouheraoua

Dr. Said received his bachelor's degree in Islamic Science (*Fiqh* and *Usul al-Fiqh)* from the University of Algiers, Masters in *Qur'an* and *Sunnah*, PhD in Islamic Law & Islamic Jurisprudence (*Fiqh* and *Usul Fiqh*), and diploma in Human Sciences from IIUM. He is a senior researcher at ISRA, and prior to that he worked as a lecturer at the Islamic Science University of Malaysia from 2003 to 2004, and assistant professor and associate professor at the Department of Islamic Law (Ahmad Ibrahim *Kulliyyah* of Laws), IIUM from 2004 to 2009. He has published three books, contributed chapters to books and several articles in refereed journals.

Seif Ibrahim Tag el-Din

Dr. Seif is currently a Professor of Economics at Imam University in Riyadh, Saudi Arabia. He is also a member of the Academic Panel, SABIC Chair for Financial Market Studies at Imam University. He is actively involved in the International Islamic Organisation for Economics & Finance with Islamic World League in Riyadh. He received his PhD in Econometrics from Edinburgh University, Master of Science degree (Probability and Mathematical Statistics) from Glasgow University, and Bachelor of Science in Econometrics and Statistics from Khartoum University. Dr. Seif's main interests are mathematical applications of probability theory in the analysis of interest-free financial systems, methodology of Islamic economics and development of *Shari'ah*-compliant banking and financial investment products.

Shabana Hasan

Ms. Hasan represents a new generation of Islamic economists in the making. As a graduate of IIUM, she is fully committed to the cause of Islamic economics, banking and finance. Ms. Hasan holds a diploma in Accounting and Finance from Temasek Polytechnic Singapore followed by a Bachelor of Economics (Honours) from IIUM with specialisation in Islamic Economics. She then obtained Master of Science in Islamic Finance (with distinction) from the University of Durham, UK. Currently, she is a researcher at ISRA. She has also taken up the position as an editorial assistant of the upcoming Islamic finance review online.

Shabnam Mokhtar

Mrs. Shabnam is currently the Assistant Vice President of SHAPE™ Financial Corporation, a financial consulting firm based in Kuwait. Shabnam also serves as a member of MARC's *Syariah* Advisory Panel. Prior to this, Shabnam was a researcher heading the Islamic Capital Market Unit with ISRA. Shabnam has conducted many training programmes on Islamic banking, *sukuk* and Islamic capital market products, risk management and AAOIFI accounting for clients in the ASEAN region, East Asia, Gulf Corporation Council and Europe. She received her Bachelor of Accountancy (First Class Honours) degree from UPM, and a Master of Accounting from University of Illinois at Urbana Champaign, US.

Sherin Kunhibava

Dr. Sherin is currently a Senior Lecturer at the Law Faculty of Universiti Malaya (UM). She was formerly a researcher at ISRA. She has a Bachelor's degree in Law (LLB), a Professional Certificate to Practice Law (CLP) and a Master's in Law (LLM). Dr. Sherin was conferred a scholarship from Monash University to pursue her PhD in Islamic Banking and Finance, which she completed in 2009. Her area of specialisation is in Islamic derivatives and Islamic banking law. She was also the editor of the ISRA *International Journal of Islamic Finance* while at ISRA. Dr. Sherin has published in international refereed journals, contributed chapters to books and presented at a number of international conferences.

Siti Salwani

Dr. Salwani is an Associate Professor at the Department of Business Administration, *Kulliyyah* of Economics and Management Sciences, IIUM since 2001. She obtained her Bachelor of Laws and Master's of Comparative Laws from IIUM. She was conferred with PhD (Islamic Law of Contract) from UPM. She is a member of the *Shari'ah* committee for Bank Rakyat Malaysia, *Shari'ah* Panel for SilverBirds Group of Companies, board member for the Institute of Islamic Banking and Finance, IIUM and Associate Advisor for AFTAAS *Shari'ah* Advisory Sdn. Bhd. She has written several books, journals and presented in international conferences.

Staff of the Islamic Technical Unit, Malaysian Accounting Standards Board

The Islamic Technical Unit of the Malaysian Accounting Standards Board (MASB), together with the MASB's working group on Islamic financial reporting, is responsible for undertaking research and assisting the MASB in developing Islamic financial reporting pronouncements. In addition, the Islamic Technical Unit has also been instrumental in raising the international level of discourse on accounting for Islamic financial transactions by producing ground-breaking research for the Asian-Oceanian Standard Setters Group (AOSSG) as well as providing constructive comments to the International Accounting Standards Board (IASB) on the adequacy and appropriateness of its standards to Islamic financial transactions.

Wan Norhaziki Wan Abd. Halim

Mr. Wan Norhaziki joined ISRA in October 2010 as a researcher, specialising in Islamic banking and finance law, Islamic legal theory, and Islamic commercial jurisprudence. Prior to joining ISRA, he was a Senior Executive at Bank Negara Malaysia and has been involved in Islamic finance-related works and projects. He is a recipient of the Bank's Excellent Team Performance Award (2009) for the notable accomplishment of the Commodity Murabahah House project (now known as Bursa *Suq al-Sila'*) under the MIFC initiative. He has also worked as a knowledge management officer and compliance officer of exchange control regulations. He holds an LLM in Banking Law from IIUM.

Zainal Hasfi Hashim

Dr. Zainal is the Acting Deputy Director at the Islamic Banking and *Takaful* Department, Bank Negara Malaysia. He started his career in central banking in 1990 and was seconded to the Labuan Financial Services Authority (FSA) in 1996. He has, on several occasions, been invited as a resource person for the Central Banking Course, Islamic Fundamental Regulator Programme and as a moderator for the examination courses of the Chartered Islamic Finance Professional (CIFP). He holds two bachelor's degrees, one in Business Administration from Ohio University, and another in Politics/International Relations from the University of London. Zainal also holds Master's degrees from the UM and IIUM. He obtained his PhD from the University of Manchester, UK.

Zulkifli Hasan

Mr. Zulkifli is a senior lecturer at the Faculty of *Shari'ah* and Law, Islamic Science University of Malaysia. Prior to joining academia, he worked extensively in the Islamic finance industry. He holds various academic positions such as legislation editor for the *Malaysian Journal of Shari'ah and Law*, *Shari'ah* panel for the Institute of *Fatwa* Management and Research, as well as a member of the editorial board of the *Shari'ah Law Reports and Global Islamic Finance Magazine*. He has published numerous articles in refereed journals and presented many papers in various conferences, both local and abroad. His research interest includes corporate and *Shari'ah* governance and regulation in Islamic finance.

Glossary of Terms

AAOIFI: The Accounting and Auditing Organization for Islamic Financial Institutions – a Bahrain-based Islamic international standard-setting body established in 1991 for Islamic corporations and the industry. Members include central banks, Islamic financial institutions and other industry participants.

Actuarial Investigation Report: A report on the financial standing of *takaful* funds conducted by an actuary to assess if the assets of a *takaful* fund could meet its liabilities.

'Adl: A general term which conveys the meaning of justice, equity and fairness.

Ajr: A payment or compensation such as commission, fees or wages charged for services. See also *ujrah*.

Al-Falah* or *Falah: From a verb meaning to thrive, to become happy or to have luck and success. In Islamic terms, the noun implies success both in this world and in the *Akhirah* (Hereafter). It presumes belief in one God, the apostlehood of the Prophet Muhammad (peace be upon him), *Akhirah* and conformity to *Shari'ah*.

Al-Ghunm bil Ghurm: The benefit of a thing is a return for the liability for loss from that thing. It means that one is entitled to a gain only if he or she assumes the responsibility for possible loss.

Al-Qur'an* or *Qur'an: The speech of Allah (*subhanahu wa' ta'ala*), sent down upon Prophet Muhammad (p.b.u.h.), in its precise meaning and precise wording, and transmitted to us by numerous persons (*tawatur*).

Al-Rahn: A pledge or collateral.

Al-Kafalah: A guarantee, e.g., when a person guarantees a liability or duty (especially debt) of another person.

Al-Kharaj bil-Daman: The fact that "gain accompanies liability for loss". See also *Al-Ghunm bil Ghurm*.

Al-Mal Al-Mutaqawwim: Refers to things, the use of which is lawful under the *Shari'ah*; or wealth that has a commercial value. Legal tender of the modern age that carries monetary value is included in *al-mal al-mutaqawwim*. It is possible that certain wealth has no commercial value for Muslims, e.g., pork or wine.

Al-Sarf* or *Sarf: Refers to currency exchange.

Amanah: Trust. Used in Islamic finance in relation to deposit accounts, such as current accounts.

'Aqd: Refers to a contract or an agreement between two parties. Synonymous with the word "contract" in modern law, i.e., it consists of all tenets of a contract.

'Arbun* or *'Urbun: A non-refundable down payment.

Bay' Al-Dayn: A sale of debt or receivables.

Bay' Al-'Inah: A sale and buy-back contract. In this case, *A* agrees to buy an asset from *B* for a given price (on credit) and then sells the same asset to *B* (for cash but at a lower price). See also *'Inah* below.

Bay' al-Kali' bi al-Kali': A sale in which both the delivery of the object of sale and the payment of its price are delayed. Similar to a modern forward contract.

Bay' Al-Salaf: An alternative term for *bay' al-salam.*

Bay' Al-Salam: A trust sale where the payments are made in advance by the buyer and the delivery is deferred to a future date. *Bay' al-salam* covers almost everything which can be described in terms of quantity, quality and workmanship.

***Bay' Bithaman Ajil* (BBA):** Refers to a sale contract where the payment is deferred and usually made in instalments over an agreed period of time.

Capital Adequacy Ratio: Percentage ratio of a financial institution's primary capital to its assets (loans and investments). It is used as a measure of a financial institution's financial strength and stability. According to the Capital Adequacy Standard set by the Bank for International Settlements (BIS), banks must have a primary capital base equal to at least 8% of their assets.

Capital Requirement: A bank regulation, which sets a framework on how banks and depository institutions must handle their capital.

Corporate Governance: A set of organisational arrangements on how a corporation is directed, managed, governed and controlled.

Derivative: A financial instrument whose value depends on the value of other, more basic variables.

Due Diligence: Refers to the task of carefully confirming all critical assumptions and facts presented by a borrower. This includes verifying sources of income, accuracy of financial statements, value of assets that will serve as collateral, tax status of the borrower and any other material facts presented by the borrower.

Exchange Rate: The price of a foreign currency in terms of a local currency.

Exchange Rate Risk: The potential change in the value of assets/liabilities or revenues/costs as a result of changes in the exchange rate.

Fatwa: The embodiment of religious decrees, edicts, opinions or judgement based on scholarly discussions derived from religious sources.

Fiqh: The Islamic term for jurisprudence. It refers to the whole corpus of Islamic jurisprudence. It may also be termed as the jurists' understanding of the *Shari'ah*. It comprises, among other things, the exercise of intelligence in deciding a point of law in the absence of a binding text (*nass*) of the *Qur'an* or the *Sunnah*.

Fiqh Al-Mu'amalat: Islamic commercial jurisprudence or jurisprudence of financial transactions.

Forward: A contract whereby two parties undertake to complete a transaction at a future date but at a price that is determined today.

Futures: A forward contract which is standardised with respect to contract size, maturity, product quality, place of delivery, etc. Futures contracts are traded on exchanges that mediate the transactions of all buyers and sellers.

Gharar: Literally, deception, danger, risk, and uncertainty. It is used to denote any element of absolute or excessive uncertainty in any business or about the subject of a contract or its price, or mere speculative risk. It has the potential to lead to undue loss to one party of a contract and unjustified enrichment of another, which is prohibited.

Hadith: Refers to sayings, deeds, and endorsements of the Prophet Muhammad (p.b.u.h.) narrated by his companions. It is the highest authority after the Holy *Qur'an* in the hierarchy of Islamic sources.

Halal: Refers to anything permitted by the *Shari'ah*.

Haram: Refers to anything prohibited by the *Shari'ah*.

Hedging: An offsetting position in a derivative in order to balance any gains and losses to the underlying asset. Hedging attempts to eliminate the volatility associated with the price of an asset by taking offsetting positions contrary to what the customer currently has.

Hibah: A gift. It signifies a transfer of a certain property (*mal*) without any material consideration. Islamic banks may use their discretion to make a payment by way of a "gift (*hibah*)" to their customers on non-investment account balances and to attract more deposits for the bank.

Hisbah: A reward or calculation. A term used by the classical Muslim jurists to describe the function carried out by the state or appropriate Islamic authority to regulate the marketplace (ombudsman). It includes whatever steps may be needed in order to maintain fair and orderly market operation.

Hiwalah: A transfer. Legally, it is an agreement by which a debtor is freed from a debt by another party who becomes responsible for it, or the transfer of a claim of a debt by shifting the responsibility from one person to another.

IFIs: Islamic financial institutions. This encompasses all financial institutions that offer Islamic financial services and products.

Ijab: One of the tenets of a contract which denotes "offer". See also *qabul*.

Ijarah: Leasing; the sale of the usufruct of an asset.

Ijarah Wa Al-Iqtina: Hire-purchase or lease ending in ownership.

Ijma': A consensus of all (or, according to some scholars, a majority of leading) qualified jurists on a certain *Shari'ah* matter in a certain age. *Ijma'* is one of the sources of Islamic law.

Ijtihad: The endeavour of a qualified jurist to derive or formulate a rule of law that he/she believes to be the true ruling of the divine law on a matter in the basis of evidence found in the Holy *Qur'an* or the *Sunnah*.

'Illah: Effective cause; the attribute of an event that entails a particular Divine ruling. The ruling is thus applied to all cases possessing that attribute. '*Illah* is the basis for applying analogy for determining permissibility or otherwise of any act or transaction.

'Inah: A form of *bay'* that involves a double sale by which the borrower and the lender sell and then resell an object between themselves, once for cash and once for a higher price on credit, with the net result being a loan with interest.

'Inan: A type of *shirkah* or a form of partnership in which each partner contributes capital and has a right to work for the business, not necessarily in equal shares.

Islamic Cross Currency Swap (ICCS): A bilateral agreement between two parties to make regular payments to each other at an agreed interval, but in two different currencies. It is used as a risk management tool to hedge both foreign exchange-rate risk and profit-rate risk. The bilateral payments can be done in different arrangements: fixed-floating, floating-floating, fixed-fixed and floating-fixed. A commodity transaction is used to facilitate the transfer of the cash flow at every settlement date.

Islamic Finance: A term used to denote financial services that comply with the requirements of *Shari'ah*. The adjective "Islamic" precedes the word "finance" to distinguish financial services based on Islamic fundamentals from those based on mundane principles (i.e., conventional finance).

Islamic FX Swap: A Foreign Exchange Swap based on the concept of *wa'd*. This arrangement consists of a *bay' al-sarf* at the beginning of the transaction followed by an undertaking (*wa'd*) by the customer to enter into a currency exchange (*bay' al-sarf*) at a future date at today's exchange rate. On the future date, another *bay' al-sarf* takes place at the rate which was promised at the earlier date.

Islamic Options: A *wa'd* foreign exchange structure very similar to the conventional option. It uses the *wa'd* promise which is binding on one party. On the start date of the transaction, the bank will undertake to exchange Currency 1 for Currency 2 for a customer at a pre-agreed rate on a future date. On the same date, the bank will receive a fee from the customer for its undertaking. On the future date, the customer might ask the bank to fulfil its promise or might release the bank from its undertaking. On the maturity date, if the customer wants to execute the *wa'd*, the bank and the customer will exchange the currencies.

Islamic Profit Rate Swap (IPRS): A bilateral agreement between parties to make regular payments to each other at agreed intervals. These instruments are used to hedge against adverse profit-rate movements, usually by exchanging cash flow from fixed to floating (or vice-versa) within the same currency. The commodity transaction is used to facilitate the transfer of cash flow at each settlement date. The amount and the period of the time between the regular payments are customisable according to the client's and bank's needs.

Islamic Promissory Forward Contract: A foreign exchange forward *wa'd* product that is a unilateral contract involving two parties, whereby the first party promises the latter party to buy or sell currency for settlement on a forward value date at the rate and amount agreed today. The party who makes the promise is obliged to honour the contract. However, the other party is not obliged to do the same.

Israf: Extravagance or excessiveness (especially in expenditure). However, this is not only limited to unlawful things. It also covers spending on lawful things as Islam calls for moderation.

Istihsan: A doctrine of Islamic law promoted by Hanafi jurists that allows exception to strict legal reasoning, or guiding the choice among possible legal outcomes, where considerations of human welfare so demand.

Istisna': A contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery, or a future payment and future delivery. Payment can also be made in instalments upon mutual agreement between the parties.

Jahalah: Ignorance or lack of knowledge. In case of financial contracts, it refers to a lack of clarity that may lead to *gharar*.

Khiyar: Option to annul or cancel a contract.

Khiyar Al-Majlis: The power to annul a contract possessed by both contracting parties as long as they do not separate from each other.

Khiyar Al-Shart: A right, stipulated by one of or both the parties to a contract, to cancel the contract for any reason for a fixed period of time.

Legal Maxim: A general rule which is applied to all its particulars.

Limited Liability: The limitation of shareholders' losses to the amount invested.

Madhhab: A *fiqh* school or orientation characterised by differences in the methods or approaches by which certain sources and texts are understood and therefore differences in the *Shari'ah* rulings which are deduced from them.

Maqasid Al-Shari'ah: The objectives of *Shari'ah*. The deeper meanings and inner aspects of wisdom (*hikam*) considered by the Lawgiver in all or most of the areas and circumstances of legislation.

Maysir: A synonym for all games of chance and gambling. It also refers to an ancient Arabian game of chance played with arrows without heads and feathering, for stakes of slaughtered and quartered camels.

Mithli: Fungible goods, i.e., goods that can be returned in kind, e.g., gold for gold, silver for silver, US$ for US$, wheat for wheat, and so on.

Mu'amalat: Dealings between humans including economic transactions related to exchange of goods and services and financial transactions.

Mubah: Things or acts permissible by *Shari'ah*.

Mudarabah: An investment partnership with profit-loss-sharing implications. One or more partners as investors (*rabbul mal*) provide 100% of the capital to an entrepreneur (the partner who provides entrepreneurship and management known as *mudarib*) to undertake a business activity. Profit is shared between the partners on a pre-agreed ratio; any loss is borne only by the investing partner(s).

Mudarib: The partner in a *mudarabah* contract providing entrepreneurship and management for a partner providing the capital.

Muhtasib: An ombudsman.

Murabahah: A sale on a mutually agreed profit. Technically, it is a contract of sale in which the seller declares his cost and the profit. *Murabahah* has been adopted by Islamic banks as a mode of financing. As a financing technique, it can involve a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is stipulated in advance, or cost-plus sale (financing).

Musawamah: A general kind of sale in which the price of the commodity to be traded is reached by bargaining between the seller and the purchaser without any reference to the price paid or cost incurred by the former. It is also known as a simple sale.

Musharakah: A partnership. A *musharakah* contract is similar to *mudarabah* but with the difference that both partners contribute funds to the partnership. All providers of capital are entitled to participate in management are but not necessarily required to do so. The profit is distributed among the partners on pre-agreed ratios, while the loss is borne by every partner strictly in proportion to the respective capital contributions.

Musharakah Mutanaqisah: An agreement that utilises the concept of partnership as in *musharakah* to invest in a joint asset followed by leasing. It allows equity participation by both a bank and a customer in an asset and provides a method for transferring ownership of the asset to the customer. The concept implies that the customer pays rent while at the same time keeps purchasing the bank's equity stake in the form of unit shares, progressively reducing it until the bank's equity stake is depleted and the bank thus ceases to be a partner.

Participants' Investment Account (PIA): An account in which a portion of the contributions paid by *takaful* participants is allocated for the purpose of investment and/or savings.

Participants' Risk Account (PRA): An account in which a portion of the contributions paid by *takaful* participants is allocated for the purpose of meeting claims by *takaful* participants on the basis of mutual assistance or protection.

Pre-contract Illustration: A numerical representation and basic terms and conditions used by a *takaful* operator to explain a *takaful* product to a potential *takaful* participant.

Provisions: The amounts set aside on the balance sheet to meet liabilities arising out of *takaful* contracts, including claims provision (whether reported or not), provision for unearned contribution, provision for unexpired risks, *takaful* provision, and other liabilities related to *takaful* contracts (e.g., contributions, deposits, savings accumulated over the term of a *takaful* contract).

Qabul: One of the tenets of a contract which denotes "acceptance". See also *ijab*.

Qard: Loan.

Qard Hasan: Benevolent loan. A loan that is interest-free and extended on a goodwill basis, primarily for welfare purposes, i.e., the borrower pays back only the amount borrowed. The loan is payable on demand and repayment is obligatory. But if a debtor is in difficulty, the creditor is expected to extend time or even voluntarily remit the whole or part of the loan amount.

Qimar: Gambling.

Qiyas: Literally this means measure, example, comparison or analogy. Technically, it means a derivation of the law on the analogy of an existing law if the basis (*'illah*) of the two is the same. It is one of the sources of Islamic law.

Rabbul Mal: The owner of capital (financier) in a *mudarabah* contract.

Rahn: A pledge or collateral.

Regulation: A principle, rule, or law designed to control or govern conduct.

Riba: Usury (interest). An excess or increase. Technically, it means an increase over the principal in a loan transaction or in exchange for a commodity accrued to the owner (lender) without giving an equivalent counter-value or recompense (*'iwad*) to the other party; every increase which is without an *'iwad* or equal counter-value.

Riba Al-Fadl: *Riba* pertaining to trade contracts. *Riba al-fadl* (excess) is the quality premium in exchanging low quality with better quality goods e.g., dates for dates, wheat for wheat, and so on – an excess in the exchange of *ribawi* goods within a single genus. The concept of *riba al-fadl* refers to sale transactions.

Riba Al-Nasi'ah: *Riba al-nasi'ah* or the *riba* of delay is due to an exchange not being made immediately. It refers to the practice of lending money for any length of time on the understanding that the borrower would return to the lender at the end of the period the amount originally lent together with an increase on it, in consideration of the lender having granted him time to pay. Interest, in all modern banking transactions falls under the purview of *riba al-nasi'ah*. As money in the present banking system is exchanged for money with excess and delay, it falls under the definition of *riba*.

Ribawi: Goods subject to *fiqh* rules on *riba* in sales, explained in various definitions by the schools of Islamic law; items sold by weight and by measure, food, and so on.

Risk Management: Risk management is defined in ISO 31000 as the effect of uncertainty on objectives (whether positive or negative). Risk management can therefore be considered the identification, assessment and prioritisation of risks, followed by coordinated and economical application of means to minimise, monitor, and control the probability and/or impact of unfortunate events or to maximise the realisation of opportunities.

Shari'ah: The corpus of Islamic law based on the *Qur'an* and the *Sunnah*. Literally, it means a way or a path.

***Shari'ah* Advisor:** An independent Islamic scholar who advises Islamic financial institutions, providing guidance and supervision in the development of *Shari'ah*-compliant products and maintaining *Shari'ah*-compliant operations.

***Shari'ah* Board:** An authority, usually a committee of Islamic scholars well-versed with and competent in *Shari'ah* and its approaches to economics and finance, appointed by an Islamic financial institution, which supervises and ensures both the *Shari'ah* compliance of new product development and the operations. They have both consultative and supervisory functions.

***Shari'ah*-compliant:** A financial product or activity that complies with the requirements of the *Shari'ah*.

***Shari'ah* Governance:** A set of institutional and organisational arrangements through which Islamic financial institutions ensure that there is effective independent oversight of *Shari'ah* compliance over the issuance of relevant *Shari'ah* pronouncements, dissemination of information and internal *Shari'ah* compliance review.

***Shari'ah* Scholar:** A Muslim jurist who is well-versed with the necessary knowledge and competencies in *Shari'ah* and its approaches to economic and financial issues.

Shirkah or Sharikah: Partnership.

Stakeholders of *Takaful* Operators: Those with a vested interest in the well-being of *takaful* operators, including:
(i) employees;
(ii) *takaful* participants;
(iii) suppliers;
(iv) the community and
(v) supervisors and governments, based on the unique role of *takaful operators* in national and local economies and financial systems.

Structured Products: Structured products are investment instruments specially created to meet specific needs that cannot be met from the standardised financial instruments available in the markets. Structured products can be used as: an alternative to a direct investment; as part of the asset allocation process to reduce risk exposure of a portfolio; or to utilise the current market trend.

Sukuk: A financial certificate with characteristics similar to a conventional bond. However, the key difference is that, *sukuk* are asset-backed since *sukuk* represent proportionate beneficial ownership in the underlying tangible asset(s) of particular projects or investment activities.

Sunnah: "Habit" or "usual practice". Technically, this term refers to whatever was reported that the Prophet Muhammad (p.b.u.h.) said, did, or gave his tacit approval.

Supervision: Management by overseeing the performance or operations of a person or group.

Swap: A contractual agreement in which two parties agree to exchange payments over a period of time, based on a notional amount of the underlying asset. The rate at which the payments would be exchanged would be pre-determined based on either a fixed amount or an amount based on a reference measure.

Tabarru': A donation or gift, the purpose of which is not commercial but to seek the pleasure of Allah (s.w.t.). Any benefit that is given by one person to another without getting anything in exchange is called *tabarru'*. It is absolutely at the donor's own discretion and without any prior condition or inducement for reward.

Tabdhir: Unreasonable (impermissible) and wasteful spending. See also *israf.*

Takaful: "Mutual guaranteeing" through mutual support and shared responsibility whereby a group of people agree to jointly guarantee one another against a defined loss. *Takaful* is an alternative to contemporary insurance.

***Takaful* Fund:** A fund based on *takaful*, i.e., participants' risk account (PRA).

***Takaful* Operator (TO):** Any establishment or entity that manages a *takaful* business.

***Takaful* Participants:** A party that participates in the *takaful* product with the *takaful* operator and has the right to benefit under a *takaful* contract (similar to "policyholders" in conventional insurance).

***Takaful* Undertakings:** A hybrid structure comprising a *takaful* operator and one or more underwriting funds (*takaful* funds) that belong to the *takaful* participants.

Tawarruq: Reverse *murabahah* for the purpose of acquiring cash through trade activities. It refers to buying of an item on credit (on a deferred payment basis) and then immediately reselling it for cash at a discounted price to a third party.

Underwriting Surplus or Deficit: The *takaful* fund's financial outturn from the risk elements of its business, being the balance after deducting expenses and claims (including any movement in provision for outstanding claims) from the contribution income and adding the investment returns (income and gains on investment assets).

Ujrah: A compensation or service charge also, a contract of agency in which one person appoints someone else to perform a certain task on his or her behalf, usually conducted against a certain fee.

Usul Al-Fiqh: The methods by which the rules of *fiqh* are deduced from their sources.

Wa'd: A promise or undertaking. A promise, such as the one found in purchase and sale undertakings used in certain Islamic finance transactions; a promise to buy or sell certain goods in a certain quantity at a certain time in the future at a certain price.

Wadi'ah: The literal meaning of *wadi'ah* is custody or safekeeping. In Islamic banking, *wadi'ah* refers to acceptance of sums of money for safe-keeping in a *Shari'ah*-compliant framework. Islamic banks use the concept of *wadi'ah* (and *amanah*) to accept deposits from customers. A bank is deemed as a keeper and trustee of funds and becomes wholly responsible and liable for its safekeeping with a guaranteed refund of the entire amount of the deposit, or any part of the outstanding amount, when the depositor demands repayment.

Wakalah: A contract of agency in which one party appoints another party to perform a certain task on its behalf, usually for payment of a fee or commission.

Waqf: An endowment of charitable trust whereby a certain property is held and preserved for the exclusive benefit of a certain charitable objective, and any use or disposition of it outside that specific objective is prohibited.

Zakat: Religious tax. An obligatory contribution which every wealthy Muslim is required to pay to the Islamic state or to distribute amongst the poor. According to Islam, *zakat*, which is the third pillar of Islam, purifies wealth and souls. *Zakat* is levied on cash, cattle, agricultural produce, minerals, and capital invested in business. Although there is a modern opinion that includes industrial capital in *zakatable* wealth, it is not the majority opinion. There are two types of *zakat*: *zakat al fitr*, which is payable by every Muslim who is able to pay at the end of Ramadan. This is also called *zakah al-nafs* (poll tax). *Zakah al-mal* is an annual levy on the wealth of a Muslim above a certain level. The rate paid differs according to the type of property owned.

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