Proceedings of the

Third Harvard University Forum on Islamic Finance

Local Challenges, Global Opportunities

Harvard University
Cambridge, Massachusetts

October 1, 1999

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<Arabic calligraphy>

IN THE NAME OF GOD, THE MOST MERCIFUL, THE MOST KIND

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Third Harvard University Forum on Islamic Finance

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Harvard University
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Organized by

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Center for Middle Eastern Studies

in association with

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The following pages feature the work of individuals who authored papers presented at the Third Forum, and these contributors merit first mention. Of those who garnished these papers with supplementary contributions, I would like to thank Thomas D. Mullins (Executive Director of HIFIP and Associate Director of Harvard's Center for Middle Eastern Studies) for the Preface, Samuel L. Hayes, III (Conference Chairman) for the Foreword, and four leaders in the Islamic financial industry who reviewed and formally introduced individual sections of the Proceedings: M. Nejatullah Siddiqi, Frank E. Vogel, Mahmoud A. El-Gamal, and Iqbal Ahmad Khan.

HIFIP continues to thrive on the hard work of its staff members; the growth and very existence of the Program is a testimony to their dedication. I take this opportunity to express my heartfelt gratitude for their commitment and perseverance. For their volunteered efforts in assisting us with editing, I thank: Imran S. Javaid (A.B., Harvard College '00), Fuaad A. Qureshi (Research Associate, Harvard Business School), M. Mohsin Ansari (MBA, Harvard Business School '00), Amna Husain (A.B., Harvard College '00), Abdur-Rahman Syed (A.B., Harvard College '99), Gohar Bilal (Visiting Research Scholar, HIFIP), and Mustafa M. Siddiqui (A.M., A.B., Harvard College '00). Particular recognition goes to HIFIP staff members Saif I. Shah Mohammed (Harvard College '02) and Fatima Raja (Harvard College '03), who carried much of the editorial burden. Finally, the one individual I would like to thank personally is Munir Zilanawala (Harvard College '01). From the first calling of the Forum papers to their compilation to their final editing, the weight of these Proceedings rests almost solely on his shoulders.

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Finally, the Harvard Finance Information Program has been successful to a large extent due to the support and faith of the many Program members (please see back cover for a complete list). I sincerely extend my appreciation to them all.

S. Nazim Ali, Ph.D.
Director of Operations
Harvard Islamic Finance Information Program

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Preface

Once again, it gives me great pleasure to present these Proceedings of the Third Harvard University Forum on Islamic Finance, which was held at Harvard University in Cambridge, Massachusetts, on October 1, 1999. This gathering of nearly three hundred leading academics, Islamic scholars, financial professionals, and students was unified in its enthusiastic interest in Islamic financial and economic practice and theory.

The Forum remains an integral component of the Harvard Islamic Finance Information Program (HIFIP), a program founded in December 1995 under the auspices of the Center for Middle Eastern Studies (CMES) at Harvard. Initial funding for HIFIP was provided by a generous grant from the Islamic Investment Company of the Gulf, a member of the Dar Al-Maal Al-Islami Trust of Switzerland. The Program has been maintained by a wide range of loyal and enlightened donors and the membership of many leading Islamic financial institutions, both of whom realize the true worth of HIFIP as a long-term academic endeavor.

HIFIP seeks to serve as an information clearinghouse and a venue for productive and engaging research in the field. From its inception, it has been dedicated to the acquisition, compilation, analysis, and diffusion of knowledge about the rapidly expanding field of Islamic finance. It has been our vision that this Forum serve as a meeting point for an interdisciplinary dialogue among those who study and practice in the field. While recognizing variations in understanding and interpretations, we have consistently tried to present, without bias, the ideas and experiences of those institutions and personalities that are both authoritative and innovative. We also seek and encourage originality and clarity of presentation in our speakers.

The Third Forum and the resulting Proceedings represent the coordinated efforts of the wide range of speakers whose work is presented here. Unfortunately, a few of the papers presented at the Forum could not be included in these Proceedings, but the great majority are here and give a virtually complete picture of the range and depth of topics covered.

The Proceedings present the Forum papers in four sections: Part I – Islamic Economics; Part II – The *Sharīʿa*; Part III – Islamic Finance; and Part IV – Commercial Products, Business Models, and Other. While this provides a framework to organize and locate the papers, it is true that a number of them overlap in content and theme, and could well be classified in different categories. The Third Forum's Program of Events, short biographies of speakers, a description of HIFIP, and lists of HIFIP members and Forum sponsors can be found at the end of the Proceedings, after the Index.

As always, full credit for the overall organization and direction of the Forum and these Proceedings must be given to S. Nazim Ali, Director of Operations at HIFIP, who has been the moving spirit behind this entire Program. His dedication to expanding understanding of the Islamic financial community, its rationale and activities, and thus the Islamic faith itself, remains an inspiration to all who have had the opportunity to work with him.

Thomas D. Mullins
Executive Director, Harvard Islamic Finance Information Program
Associate Director, Center for Middle Eastern Studies

Forum Opening Address

A Review of Islamic Finance

Mohamed Al Faisal Al Saud*

In discussions on Islamic finance, a common mistake is to go straight to a branch before looking to the root. It is important thus to identify the root first. Islamic finance is based on a larger concept of Islamic economics. The theory of Islamic economics cannot be understood without delving into Islam itself. It is important to note that Islam does not separate church and state; it thus presents a separate set of concepts than are prevalent in the Western world. But it is also important to realize that Islam *does* denote a separation between *aqeedah* (faith or doctrine) and *muaamalat* (the practices of daily life). Once these two points are noted, certain things become clearer for our understanding. It not surprising that the *sharīᶜa*, as a body of law that arises out of Islam, governs the interaction in this world between humans and God, in spiritual matters as well as profane, worldly ones.

I feel that an important error is often made in the use of the term "Islamic banking" in place of the more appropriate "*sharīᶜa* banking." Perhaps making this change can make the concept more comprehensible to Muslims and adjust the vision of their glassy eyes, so to speak, to make it clearer, less hazy, less out of shape, less confused. To this end, perhaps some basics need to be defined: What is Islamic economics, or *sharīᶜa* economics? A definition ought to be as concise and as general as possible to be workable, and yet precise in its description to be true. When we talk about Islamic economics, we mean the system by which man interacts with his environment and society in order to provide for his worldly needs without conflict with the principles of the *sharīᶜa*. Perhaps somewhere in this context we find that we are able to define our terms when we talk about Islamic economics. I note humbly though that I may be under false pretenses because I am neither a banker nor an intellectual. Perhaps I should put my definition as a question for bankers and intellectuals to answer. It is with questions that I come to you, not ready-made answers.

And that is the point: The first generation of practitioners, among them myself, were and are trying to arrive at answers. We were not trying to provide competitive alternatives to the present system. Our objective was to find answers to be able create products that, within the global economic system, would permit Muslims to choose how they want to do business. We felt that the *sharīᶜa* covered concepts that are important to Muslims but were not included in the capitalism that presented itself as the only option in the global economic system.

What we are doing, in a sense, is increasing competition within the world economic system rather than creating competition to it, by providing a choice in the global marketplace. In our thinking, the Islamic system is the system of enterprise that is most free, for it stems from an important principle of Islam that Sovereignty is God's alone, and that outside of Him, in this world there are no sovereigns. The Islamic economic system does not call for state involvement, for the state in Islam is only secondary. Who owns capital should not be primary either. Rather, it is private initiative that is the primary force of enterprise. Again, how this view, which arises naturally in Islamic economics, should be put into practice is another question that I would like to place to this Forum.

* Chairman, Dar Al-Maal Al-Islami Trust, Geneva, Switzerland.

Perhaps among the most misinformed about the Islamic economic system are Muslims themselves, for they tend to concentrate solely on *aqeedah* and take a dogmatic approach that excludes the *muaamalat* side of Islamic economics. We tend to look at things solely spiritually and shut out the earthly, practical side of affairs. We need to look at both, for Islam includes both. Another aspect of the problem is legal infrastructure. The legal infrastructure of the *sharīᶜa* has been neglected and not been serviced for a thousand years for similar reasons. There is much catching up to do to make the infrastructure workable in the present, and for that we have to come together. Contrary to what comes out in the press, Muslims are not all "wide-eyed fanatics." The vast majority are very reasonable people, which means that though much needs to be done, much can be done.

Forums such as this are highly encouraging—especially in the United States, with its advances in technology, management, intellectualism, and internationalization that put it ahead of the rest of the world. Muslims have to connect with each other and with the present, and we have to connect here. In the process, we can also try to be cooperative promoters, to build relationships between the West and ourselves. We feel that our philosophy of life has merit, and by applying them with American tools, perhaps we can develop a system where philosophies that appear to be in competition, appear to clash, can find a clear point of meeting. Those of us who have been educated in the United States can see that there is no reason for such an illusion of adversity that colors relationships between Islam and the West.

The scope of Islamic finance thus increases if we look at it from this perspective. Looking at just the branch, we only see one branch. But looking up from the root, we see many branches intertwined, each and all reaching for something higher.

Foreword

Samuel L. Hayes, III*

Since the Second Harvard University Forum on Islamic Finance, I have been asked on a number of occasions about the relevance to or importance for the Islamic financial sector of current trends in the global financial services industry. A consideration of a number of interesting parallels as well as major differences can set the stage for a better treatment of various aspects of Islamic finance in the contemporary world. Enormous consolidation is taking place within the financial services sector—not just among commercial and investment banks, but across the lines to other types of financial institutions. The arguments used to justify such consolidation in some cases have interesting parallels with and contrasts to Islamic banking.

For instance, it is pointed out that banks need to reduce costs, and a major vehicle for this is consolidation of expensive back-office activities and elimination of redundancies. This is critical to the renewal and reinvention of the mature banking industry of today. By contrast, Islamic banking is not a mature industry. We see a nascent industry, one that has been in existence for barely a quarter century. The typical S-curve for growth in the life cycle of a firm begins with a period in which the firm is getting its act together, and it then starts moving at an accelerated rate of growth before reaching a relative plateau of maturity. Unless the business finds a way to renew itself, it later slides back down the other side of that plateau. This is characteristic of the conventional banking system: commercial banks, both in the United States and in other nations, are finding that their customers are moving away from them, and so the banks, in addition to cutting costs, must reorient themselves to their customers' changing needs. Meanwhile, the Islamic banking sector is at the very outset of its S-curve life cycle. It is in the process of organizing and developing the necessary infrastructure and solid foundation that can precede rapid growth in the use of Islamic financial practices, practices that solve problems for both investors and for Muslim businesspeople who wish to follow their faith in their commercial dealings. So on the one hand, Islamic finance is at the beginning of its career, while on the other the Western banking industry is at a mature phase in which it is trying to find a way to redefine itself to renew its growth.

We can also draw to Islamic banking the parallel that commercial banks are trying to follow their customers. The customers have moved into the public financial markets, away from the private accommodations that in past generations had been the norm. Formerly, one dealt with private banks—through short-term and long-term financing—before going to the public market, such as to float an initial public equity offering. But now, we find that any financing that a capital user needs can be accommodated—and often more cheaply—in the public marketplace rather than through private placement. And so banks are trying to follow their customers into that public marketplace. This offers a direct parallel to Islamic banking, which must also follow its customers by finding solutions that its customers need. In both cases, we see efforts to try to define those customers' needs and then, in the case of Islamic finance, meet these within the constraints imposed by religious requirements.

* Jacob Schiff Professor Emeritus, Harvard Business School, Cambridge, Mass. The following is the text of Hayes' Conference Chairman's Address at the Third Harvard University Forum on Islamic Finance.

The Western commercial banking sector is also trying to bulk up, to become larger and larger. They believe that size counts—that is, that the size of a bank's assets and its market capitalization both are important yardsticks, and that larger is usually better. Although I personally believe that there is a need for some consolidation within the Islamic banking sector in order to achieve the necessary size to take new initiatives and assume risks, there is very little to recommend size just for size's sake. The largest Western banking enterprises have very large pools of assets and high stock market values. But why is this particularly important? Is there not a point at which sheer size limits a bank's capacity to respond, by creating such bureaucracy that even if an employee knows what must be done, he or she personally lacks (and has difficulty getting) the authority to do it? In any dynamic sector of the financial industry, those that can identify change and respond quickly to it are the ones that will succeed. A 500-pound gorilla, for instance, is hard pressed to respond to a bee sting that can have real venom in it; indeed, it may be so muscle bound that it can't even get its arm around to the place where the bee stung! Thus, the consolidation trend can actually open up new opportunities for smaller and more flexible financial vendors. Obviously, Islamic banking is in a very special niche where it is not possible to follow every opportunity that comes along. But Islamic financial institutions are in a much better position to make some timely and imaginative decisions than huge bureaucratic Goliaths. That is a very sharp difference. Granted, it is important to have a global reach, and part of the consolidation in the financial services industry is attributable to the need for just such a worldwide presence. But even some Islamic banks have achieved a substantial multinational presence.

Given both the parallels and the differences between Islamic and Western financial services, several important issues are at the forefront as we contemplate an Islamic banking sector at the front end of the S-curve, poised for potentially rapid growth in the twenty-first century. These issues are, to be sure, not new, but they loom importantly. Some of them will find fuller expression in various of the papers that follow.

One critical issue is the need for additional variety of products for Islamic customers. This is a special problem for Islamic banks because of the religious constraints with which they must deal. Some scholarly articles published in the past couple of years have called for more research and development in an effort to find acceptable new products, rather than attempting to adapt to conventional Western instruments by simply changing the labels. They must be developed from the ground up, along lines that are fully in accordance with *sharīʿa* principles. At the same time, one must recognize that customers have needs, as they are living in a largely non-Islamic, global commercial and financial system. Although many in the Muslim world hope for the elimination of the western capitalist system and its replacement by one based on Islamic principles, that is not realistic. It is unlikely to come about during the lifetimes of many who are now present. Islamic capital users and investors will continue operating as a satellite around a global sun that represents the conventional international financial and commercial markets. Accordingly, we have to find accommodations for the legitimate needs of Islamic businesspeople, especially capital users.

That must be emphasized because much of the attention paid by the Islamic world to Islamic finance has been directed at investors, not at users. If Islamic finance is to flourish and grow, Muslim vendors must broaden their interests and reach out to Islamic businesses that would like to practice their religious principles in the realm of corporate finance but must still compete in a non-Islamic world. This is true even in the several countries with comprehensive Islamic banking systems. While Iran makes very sincere efforts to operate within the dictates of the Islamic banking system, there are certain needs that Islamic financial contracts do not provide. In dealing internationally, Iran is forced to suspend Islamic rules and deal with other countries in a conventional Western manner. Frank Vogel and I have proposed a number of modifications in Islamic contracts that we believe would be in accordance with *sharīᶜa* principles, but adoption of these ideas has been very slow, probably because practical barriers only become evident when one actually tries to implement something.

A second important issue facing the industry is the need for liquidity. If anything, Islamic investors have a predisposition for liquidity, and yet the nature of many Islamic contracts is of long-term commitment. In fact, some have suggested that it is inaccurate to characterize Islamic institutions as banks because they are much more suited to be investors rather than lenders in the commercial banking sense. So, with Islamic contracts predisposed toward illiquidity and with an Islamic investor group that places a very high premium on liquidity, the establishment of a bona fide secondary market for Islamic instruments is an important goal.

There has been much discussion about this. Professor Vogel and I have concluded that no insuperable barriers, from a religious point of view, exist to the establishment of secondary markets in certain Islamic instruments. However, at least one practical barrier endures: it is almost inevitable that in the early stages of the establishment of a secondary market, participants will lose money. The costs of setting up the market, the early paucity of active traders, and potential large gaps between bid and ask prices would be off-putting to both vendors (Islamic banks) as well as customers (investors). In order to establish a liquid secondary market, somebody must be willing to take the long view and sustain whatever initial costs are involved.

A third area, directly connected to the notion of a liquid and a secondary market, is the need for uniform financial contract terms. It is impossible to trade in instruments that are not identical. Buyers of a particular financial instrument in a public market need to be assured that they will get the product they ordered. Like a quarter-pounder from McDonald's, no matter where in the world you are, the product is reliably the same. For Islamic financial contracts, similar uniformity and standardization of terms is required.

Finally, there is a need for a stepped-up educational program to spread information about Islamic solutions for financial requirements. This need is almost as great for Muslims as it is for non-Muslims.

I would like to close by urging the leadership of Islamic banking and the distinguished scholars who provide guidance to work diligently to resolve these and other issues with as much dispatch as possible so that the potential for Islamic finance can be realized.

PART I

ISLAMIC ECONOMICS

Introduction
M. Nejatullah Siddiqi

Recovering the Islamic Economic Intellectual Heritage:
Problems and Possibilities
Waleed El-Ansary

Islamic Venture Capital: A Critical Examination
Masudul Alam Choudhury

An Economic Explication of the Prohibition of *Ribā*
in Classical Islamic Jurisprudence
Mahmoud A. El-Gamal

Islamic Banking and the Conduct of Monetary Policy:
Lessons from the Islamic Republic of Iran
Ramin Cooper Maysami

Islamic Finance and Beyond: Premises and Promises of Islamic Economics
M. Nejatullah Siddiqi

Experimental Tests of the *Homo Economicus*:
The Implications for the Research on Islamic Economics
Abdullah Yavas

Introduction

M. Nejatullah Siddiqi[*]

The six contributions in this section offer a rich variety that encompasses the potentiality of the past of Islamic economics, the reservations about its current thought and actions, and ambitious looks forward.

Waleed El-Ansary's piece on the Islamic economic intellectual heritage is unique in its self-conscious, self-confident assertion of an approach to economics that takes ethics seriously. Rejecting the neoclassical axiom of continuity of all values, El-Ansary rightly points out that tastes are reducible to a single level of utility whereas ethical values are not. Ethical values operate at a higher level than mere "preferences," and "a theory of spiritual values or ethics is logically prior to a theory of exchange." "Thus, the Islamic sciences of nature provide the ontological background for the Islamic sciences of man," to which Islamic economics obviously belongs. The author very briefly refers to a survey effort currently underway that will hopefully help recover the Islamic heritage in economics.

Such a "recovery" is indeed a necessary condition. But can it be sufficient to provide an alternative to neoclassical economics, which the author is convinced "cannot accommodate Islamic values, but only serves to undermine them?" The author neither raises nor answers this question. But one gets the feeling that he needs nothing beyond the full recovery of the heritage. He exhibits a strong tendency to rely on "our" thinkers only, expecting nothing from the "others." One wonders why the entire future of humanity should be condemned to the divisions that obtained in the past. It is safer, and I think mandatory, to stick to what is above time and place—the divine guidance of the Qur'ān and the Sunna—rather than committing unreservedly to a heritage to the exclusion of all that lies outside. By looking into the "problems and possibilities" of recovering our heritage, Waleed El-Ansary has been able to initiate a debate with great promises. It must continue.

Choudhury's focus in his exposition on Islamic venture capital is on the present. Nothing short of participatory finance qualifies to be called truly Islamic. His critique is especially directed to sleeping profit sharing or partnership—*muḏāraba*—which happens to be at the core of Islamic banking theory and practice. The chief reason for his aversion to it is that the current *muḏāraba*-based model fails to be consultative, *shuratic* in Choudhury's terminology. Forms of management, such as certain forms of agency including *muḏāraba*, that are devoid of consultative decision-making do not fit in Choudhury's epistemology.

It always uplifts the spirit to have a grand vision in which everything hangs on everything else, and all are firmly rooted through a single stem. But is it workable, and more importantly, did Islam commit itself to participatory finance and consultative decision-making in production, distribution, and exchange, to the exclusion of all other forms of financial management? Choudhury's contention that only consultative participatory integrative interaction suits a knowledge-based economy may fit well into *tawhidi* epistemology as he conceives it, but that does not raise it to the status of the dos and do nots of Islamic law. One should never confuse one's favorite path through the vast expanses of terrain with the terrain itself. The latter is wider then the former and leaves people the right to choose between alternative paths.

Choudhury's contention that the details of the law of *muḏāraba* are based on its pre-Islamic practice and not on what the Prophet Muhammad himself legislated is true but misleading, as the Sunna includes tacit approval (*taqrir*). Whether it is a financial transaction or an exchange of goods and services for money, the Prophet explicitly dealt only with such pre-Islamic practices as needed correction. However, this does not imply that the law of *muḏāraba* or other contracts cannot be improved to meet changing human needs.

Choudhury's major economic critique of *muḏāraba*/*mushāraka* is based on "a lack of precision in capitalizing the value of time or wages." As currently conceived, "the share of capital is well-determined but the non-capital factor shares remain vague. Only if a value can be imputed for the work effort that goes into production and profit generation can this value … be treated as a form of capitalized investment done by workers in the enterprise." What follows leaves one in no doubt that Choudhury is dealing with a world devoid of uncertainty. Also, he seems to have been entrapped by the Marxian fallacy of considering "profits" as the creation of labor. The entire twentieth century focus on the place of uncertainty of future values, which then become the basis of profit-loss calculation, seems to have missed his attention!

---

[*] Professor of Economics, Center for Research in Islamic Economics, King Abdulaziz University, Jeddah, Saudi Arabia.

I do not think that Choudhury can find support from "the Medinah Charter that was signed under the directions of the Prophet Muhammad between the Meccan emigrants (*muhajirs*) and the Muslims of Medinah (*Ansar*)." First, he is confusing the brotherhood informally instituted between *muhajirs* and *Ansar* with the *mithaq* of Medinah, to which the Jews too were a party. The core of the former was economic, but the core of the latter was political. Unfortunately, Choudhury's method of referring to whole books without citing chapter and verse makes it impossible to discover how the confusion arose.

As usual with the contribution of a gifted writer like Choudhury, his piece has gems to be treasured, such as, "Interest-abolition is fundamentally an ethical issue in Islam that endogenously affects preference formation and subsequently market exchanges and transactions at all levels." Islamic economists, including this writer, have a lot to learn from him.

The jewel of the crown in this section is Mahmoud El-Gamal's paper on *ribā*. Inspired by a text from the philosopher-jurist Ibn Rushd, El-Gamal has been able to project efficiency as the major objective of prohibition of *ribā*, especially of *ribā al-fa<u>d</u>l*, which then prepares the ground for ensuring economic justice in exchange. "The various legal methods of avoiding *ribā al-fa<u>d</u>l* constitute pre-commitment mechanisms that ensure economic efficiency through 'marking to market.' "

This interpretation then enables El-Gamal to reassure us that "the pre-commitment inherent in equity financing can also be welfare enhancing on a project-by-project basis, if entrepreneurs are feared to exhibit dynamically inconsistent behavior" and that the "economic logic of pre-commitment can support the position long adopted by Islamic economists that equity-based financing is preferred to its debt-based counterpart."

A major contribution indeed. But we need some follow-up. Having put efficiency in its rightful place in Islamic economic thinking, one must proceed to focus on the interaction between justice and efficiency, back and forth. What a better subject than the prohibition of *ribā* to explore the linkages between justice and efficiency in the Law, which cares for both?

The fourth contribution describes the conduct of monetary policy in Iran after the abolition of interest. Ramin Cooper Maysami succeeds in outlining the main features of the highly regulated financial structures in present-day Iran, which one finds to be too rigid to efficiently meet the needs of today's fast-changing economy. But the promise of drawing "lessons" is hardly fulfilled. Sooner or later, increasing inefficiencies will force deregulation and a greater reliance on incentives rather than edicts. Our writer does not seem to share this view. Part of the reason may lie in such dubious propositions as "since the cost of bank facilities are not pre-determined for the client and will be determined and paid only after the completion of the project, it should not be considered a cost and, thus, not be reflected in the price." Though not pre-determined quantitatively, bank facilities surely have a cost. Clients must make their own guess about the likely magnitude of these costs and make calculations accordingly. The claim that expected costs would not be reflected in price needs reconsideration.

Maysami's worries about "the lack of appropriate non-interest-based investments for financing budget deficits" are understandable. However, a reference to the instruments recently designed and put into practice in Sudan and to some of the recent theoretical contributions would have been appropriate.[1]

The sixth contribution, by Abdullah Yavas, tries to introduce some much-needed empiricism into Islamic economic research. Yavas focuses on the crucial assumption about rationality and selfish/altruistic behavior and concludes, "The results of economic experiments show us that human beings are neither as selfish and rational as the *homo economicus* nor as cooperative and norm-oriented as the *homo sociologicus* or *homo Islamicus*." That justifies his advice that the neoclassical "assumptions regarding incentives should be taken more seriously by the researchers in Islamic economics." The paper does not lack in criticism of "the universality of selfishness and rationality postulates of neoclassical theory." However, what it does, especially in our not-very-long section on Islamic economics, is provide an antidote to the vision of Islamic economic research held by the likes of our first writer, Waleed El-Ansary. Let the debate continue.

My own brief piece, fifth in sequence, aspires to focus on justice and morality in the ordinary business of life that is economics, arguing that "as regards Islamic economics the moral dimension is its raison d'être." I agree, with El-Gamal, that efficiency is the bedrock without which it would be impossible to sustain justice in the long run. We find no fault with modern economics' quest for efficiency, but do think that its increasing neglect of justice has been detrimental to human felicity. Part of the reason for its failure in ensuring both justice and efficiency has been its faulty vision of man.

I have tried, in a modest way, to show how the Islamic vision of man, which regards care for others going along with the prior care for the self in man's economic quest, made Muslims modify certain modern financial arrangements to good effects. Should that interpretation of what has been going on for the last fifty years be accepted, it can serve as a guide to the future research agenda of Islamic economists. This is the subject to which the remaining paragraphs of this Introduction are devoted.

The bane of modern economics has been its failure to integrate the moral dimension of man into the analysis of man's pursuit of his material interests. Whether it was a mere abstraction, a methodological device, or the result of Benthamite utilitarianism, which regards morality as mere sentimentalism, the result is there for all to see and suffer. Nowhere are the evils of amoral economics more obvious than in the practice of international finance in the 1990s.

What is needed is a restoration of ethics to its rightful place in economic analysis and policymaking—a step toward its reinstitution in the behavior of economic agents and decisions of economic institutions. Of all people, Islamic economists are best suited to do so, as they draw upon the authentic Prophetic tradition of ethics along with economics.

But we cannot do it alone in economics, and there is no need to do so. It is in search of economic arrangements better suited to the needs of the entire humanity, and not only of Muslim peoples, that the future flourishing of Islamic economics should be envisaged. The Islamic heritage is rich indeed. Let all men and women get the benefits of what it has to offer. But there is no justification of rejecting the entire non-Islamic "heritage" in the production, distribution, and exchange of wealth. The Prophet Muhammad did not do so. He endorsed most of the extant practices in agriculture, animal husbandry, crafts, and trade and commerce, modifying only what was unjust, inefficient, or injurious, as the abolition of interest, gambling, and some transactions of dubious nature indicates. There should be no inhibition in learning. Truth never hurts and what is good (judged on our own criteria) can be adopted without bothering about its origin and antecedents.

Islamic economic research in the year 2000 seems to be a little off the lines suggested above. The main reason seems to be its preoccupation with practical problems particular to Muslims and theoretical issues thrown up by the particular juristic approaches dominating Islamic scholarship in general. I am not the one to deny their need. Perhaps they deserve some of our intellectual and financial resources. But I do feel that attending to the problems of entire humanity, problems that affect all peoples, including Muslims, should have greater priority. The same applies to the theoretical issues proffered by recent critiques of capitalism and socialism, issues that are linked to broader philosophical questions as well as to the so-called natural sciences.

All is not well with the world we live in, and everybody is worried, the strong as well as the weak, the rich as well as the poor. Let us contribute to the ongoing debate on these issues in our own light. People may listen. Will they? It depends on what we are talking about. We have succeeded, though only to some extent, in making scholars talk about topics with wide appeal.

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[1] Ahmed, Ausaf and Tariqullah Khan (eds.). Islamic Financial Instruments for Public Sector Resource Mobilization. Islamic Research and Training Institute, Seminar Papers No. 39. Jeddah: Islamic Development Bank, 1997.

V. Sundrarajan, David Marston and Ghiath Shabsigh. "Monetary Operations and Government Debt Management under Islamic Banking." Washington: International Monetary Fund Working Paper, 1998 [WP/98/144].

Recovering the Islamic Economic Intellectual Heritage

Problems and Possibilities

Waleed El-Ansary*

ABSTRACT

The title of this paper suggests four questions: What is the "Islamic economic intellectual heritage?" Why does it need "recovering?" What problems prevent its recovery? How might these problems be addressed? This paper argues that Islamic economic theory is derived from the fundamental Islamic doctrine of Unity (*tawhid*), which implies a hierarchy of levels of reality and the need for spiritual principles in equilibrium. It further argues that the Islamic intellectual sciences of nature are necessary for the Islamic sciences of man, and that accepting the axioms of the secular sciences of nature implies that Islamic economic theory does not exist. Indeed, the loss of understanding of the Islamic sciences of nature and economic theory has inhibited current attempts to create an Islamic economic system in spite of the knowledge of the *sharī*ᶜ*a* sciences. The intellectual forces that prevent the recovery of the Islamic economic tradition are examined, and possible ways to address these problems are suggested.

I. INTRODUCTION

The inspiration for this paper is William Chittick's remarkable essay "Recovering the Islamic Intellectual Heritage: Problems and Possibilities." Chittick begins the essay by pointing out that his title "suggests four basic questions: What is the 'Islamic intellectual heritage'? Why does it need 'recovering'? What problems prevent its recovery? How might these problems be addressed?"[1] Because these questions are of fundamental importance to Islamic economic theory, and Chittick's proposed answers have important implications for the corresponding answers in Islamic economics, we adopted the title of his paper for the present study, inserting the word "economic." We will therefore organize this paper according to Chittick's four questions as they apply to Islamic economic theory, and examine how the answers for economic theory are related to the answers for other intellectual sciences. We shall attempt to demonstrate that the Islamic intellectual sciences of man, which include economics, are intimately related to the Islamic sciences of nature. Specifically, we shall argue that the former are not possible without the latter, and that if we accept the axioms of the secular sciences of nature, then there is no such thing as "Islamic economics."

II. WHAT IS THE "ISLAMIC ECONOMIC INTELLECTUAL HERITAGE?"

To answer this question, let us first define the "Islamic intellectual heritage" in general. Chittick begins by offering a one-sentence definition: "The Islamic intellectual heritage is the ways of thinking about God, the world, and the human being established by the Koran and the Prophet's Sunna and elaborated upon by generations of practicing Muslims."[2]

He uses the word "intellectual" to translate the word "ᶜ*aqlī*," by which he distinguishes this heritage from another closely related "transmitted" (*naqli*) heritage. Transmitted knowledge is learned by "imitation" (*taqlid*), or "by following the authority of those who possess it."[3] Such imitation applies to learning Qur'ānic recitation, hadith, and Arabic grammar. As Chittick points out, "Just as you learn to speak a language by imitating those who know the language, so also you learn the text of the Qur'ān and how to say your prayers by imitating those who already know such things."[4] If we ask "why" concerning this transmitted knowledge, "the answer, for example, is that the Qur'ān says what it says, or that you have to follow the rules of grammar for your speech to be understood."[5] In this sense, many elements of Islamic economic law such as the prohibition of the consumption of wine and gambling belong to the transmitted sciences.

Intellectual knowledge, on the other hand, is clearly different from transmitted knowledge "because the only way to learn (the former)... is to understand it... (not) by simply accepting it on the basis of authority."[6] We cannot learn intellectual knowledge such as mathematics, logic, and much of theology simply by *taqlid*. To gain

* School of Islamic and Social Sciences, Leesburg, Va.

such knowledge, we must pose different questions than those in learning transmitted knowledge, such as asking "Why?" "It makes no sense to say 2 + 2 = 4 on the basis of someone else's opinion... The goal in intellectual knowledge is not *taqlid*, but *tahqiq*, which can be translated as 'verification' or 'realization.' "[7] In this sense, Islamic economic theory is an intellectual science that involves the analysis of Islamic and non-Islamic economic behavior and economies.

Unfortunately, many authors confuse Islamic economics with Islamic economic law, failing to recognize the significance or even existence of Islamic economic theory. Discussions of Islamic economics therefore typically focus on the *naqli* sciences, completely neglecting the *ᶜaqlī* sciences. Indeed, the transmitted sciences have generally been better preserved than the intellectual sciences because "anyone can learn Qur'ān and hadith, but very few people can truly understand what God and the Prophet are talking about."[8] Although both types of knowledge are gradually being lost in the Islamic world, the loss has been particularly great in intellectual sciences such as economics.

Like all the Islamic intellectual sciences, Islamic economic theory is derived from the fundamental Islamic doctrine of Unity (*tawhid*).[9] This doctrine is expressed in its most universal manner in the first "testimony" of the Islamic faith, *La ilaha illa'Llah* (there is no god but God). "In all the different schools of thought that have appeared over Islamic history, one principle has been agreed by everyone... the fact that God is one and that He is the only source of truth and reality... To think Islamically is to recognize God's unity and draw the proper consequences from His unity. Differences of opinion arise concerning the consequences, not the fact that God is one."[10]

Tawhid clearly has important implications for the intellectual sciences of man and nature, or the microcosm and the macrocosm. The recognition of the Absolute implies multiple levels of reality and meaning for all aspects of creation as signs of God, or *ayat Allah*. As Kalin points out, *tawhid* leads to

> a clear-cut relationship of hierarchy between the absolute and the relative, the eternal and the temporal, the necessary and the contingent… Instead of relegating reality to a lower plane of existence, namely to matter, the sacred sciences analyze each domain of reality in its own level, thus resting on a metaphysical framework within which it is possible to maintain the vision of the One and the many without confounding the two.[11]

Since hierarchy implies a multi-layered structure, the Islamic sciences of man and nature are essentially anti-reductionist. Rather than understanding a whole in terms of its parts, Islamic sciences seek to understand the parts with respect to the whole. Whereas the former approach applies to aggregates made up of qualitatively identical parts, the latter approach applies to wholes made up of qualitatively different and interdependent members. "In this view, nature… is regarded as a sacred being, as *vestigia Dei*, or as *ayat Allah*, e.g., as the signs of God which point to the 'symbolic significance' of the world of nature." Similarly, man is a unified whole in which all the parts (body, soul, and spirit) are interdependent, and there is no longer any distinction between the spiritual and the temporal. Because nature worships, loves, and obeys God, there is order in the cosmos. Similarly, for order to exist within man, he must worship, love, and obey God. Thus, the laws of man and nature are related to the laws of God operating on various levels of reality.

This has crucial implications for Islamic economic theory. First, it implies that a theory of spiritual values or ethics is logically prior to a theory of exchange. If man can only be integrated around a Sacred Center, then spiritual ends are necessary for having integrated, self-consistent preferences, or being "instrumentally rational." This is critical for economic theory because without such self-consistent preferences, there is no equilibrium for individual choice. And without equilibrium, "maximizing efficiency" is meaningless because there is no integrated goal as the object of efficiency. Thus, equilibrium and efficiency are only possible when man successfully integrates the whole of life around God.[12]

Second, hierarchy implies that spiritual values based on multiple levels of utilities cannot be reduced to a single level utility function appropriate for tastes. Whereas tastes relate to a single level of desire that is not subject to criticism, and is unmodified by understanding, Islamic values relate to a hierarchy of spiritual, psychological, and physical needs. Thus, the former may be aggregated in a single level utility function that is reducible to the sum of its parts, whereas the latter requires a multiple utility function involving qualitatively different and interdependent levels that form a whole.

Third, the previous arguments imply that a theory of non-market transaction is logically prior to a theory of market transaction. This is because some spiritual and ethical "goods" such as love and friendship require non-market exchange, and non-market institutions such as households and states that are necessary for markets to exist require these "goods." Indeed, a market for friendship would necessarily imply unethical values and a "counterfeit" leading to disintegration, and the same applies to the governance of non-market institutions.

Thus, Tusi's classic book *The Nasirean Ethics* is divided into three sections on ethics, household economics, and politics.[13] The first section is on ethics because self-governance is necessary for integrated preferences and the necessary baseline for further analysis. The second and third sections are on household economics and politics because governance of the household and state are logically necessary for markets to exist, and non-market transactions are necessary in these non-market institutions. Otherwise, unethical values and disorder emerge, and equilibrium within the individual, household, state, and market are impossible.

Consequently, market transactions are necessarily embedded within non-market transactions that have their basis in spiritual values. A theory of the market is impossible without a theory of ethics and non-market exchange. And the latter are impossible without the Islamic sciences of nature that argue for the ontological basis of hierarchy in the cosmos and the role of spiritual laws in its harmonious operation.

III. Why Does the Islamic Economic Intellectual Heritage Need Recovering?

As we saw in the previous section, the hierarchy that exists in both man and nature provides the ontological basis of Islamic values. This makes possible the reasoned character of moral and ethical judgments. From the Islamic point of view, values and ethical judgments can be substantively rational or irrational, or "right" and "wrong." They are not "arational" such as the preference of apples to pears, or vice-versa, which is not a matter of ethical dispute since "there is no arguing over tastes."

Unfortunately, secular economic theory approaches man's hierarchy of needs as an aggregate of tastes rather than a whole of values. Indeed, neoclassical economics reduces values to tastes based on a single level desire, and denies the need for spiritual principles in integrated preferences. Witness to this the fact that Milton Friedman declared in his Nobel acceptance address, "The great Saints of history have served their 'private interest' just as the most money grubbing miser has served his interest."[14] Economists typically argue that a single model that assumes "egoistic consumerism" provides a "baseline" approximation of actual economic choices, and that the model can be amended to introduce ethical values as "disturbance terms."[15] However, we maintain that a single level "utility," whether defined as pleasure, happiness, or satisfaction of desire, negates spiritual values by negating hierarchy, and implies relativism. In short, we argue that neoclassical theory cannot accommodate Islamic values, but only serves to undermine them.

The problem is not that neoclassical theory assumes that Islamic preferences are "complete" (that agents can rank preferences for any bundles A, B, and C) or "consistent" (if agents prefer A to B, and B to C, they prefer A to C), but that it assumes Islamic preferences are "continuous." Indeed, consistency and completeness apply to ranking good and evil alternatives, are consistent with meaning in choices, and do not exclude a hierarchy of multiple utilities. Consistency and completeness clearly accommodate both values and tastes, and are necessary for "rational preference functions."

A major difficulty arises with the neoclassical axiom of "continuity" which is necessary to derive a "utility preference function" from a "rational preference function." This reduces all values to tastes in a single level of utility, inverting ethical values. Consider the following example. If we have the authority to prevent an evil act such as pollution, and a polluting company is trying to bribe us to permit it, we may be unwilling to accept any amount of money to permit the evil act. However, we may have a limit on how much we would be willing to pay to stop the pollution if the company owns the "property right" to pollute. Let us say that we are willing to pay $100 to stop the pollution and not willing to accept any amount of money as a bribe to allow it. This implies a "discontinuity" between the "willingness to accept" and "willingness to pay." The continuity axiom, however, requires the two numbers to be the same. If we are willing to pay $100, we should be willing to accept $100 as a bribe. This clearly implies unethical values, excluding the ethical values of one who "cannot be bought at any price."

The problem is that continuity reduces the costs and benefits to a single level, denying a qualitative distinction between the two situations. From the Islamic point of view, the former is an "act" in which we participate to accomplish an evil, whereas the latter is an evil "event" others perform that we may not be able to afford to stop. The two situations are qualitatively different, and discontinuity is necessary to accommodate these values.

Continuity is appropriate, however, for choices involving tastes. For example, if we are willing to pay two apples for one pear in moving from bundle A to B, we should be willing to accept two apples for one pear in moving back from bundle B to A if we are indifferent between the two bundles. In this case, there is no qualitative difference between WTA and WTP because they are simply movements between two bundles on the same "indifference curve," a locus of points between which the consumer is indifferent. We suggest that this is because tastes are reducible to a single level of utility, whereas ethical values are not. The latter are based on a hierarchy of spiritual and other needs that do not "collapse" to a single level, and this creates discontinuities that allow WTA to diverge from WTP.

Thus, continuity is appropriate only when intrinsic good and evil does not apply, as in the case of tastes. The misapplication of neoclassical theory to ethical choices therefore implies the denial of intrinsic good and evil in values, as well as the loss of meaning in choice. With mono-utility, "nothing is 'good' or 'evil' in itself, there is only 'more' or 'less.' "[16] The elimination of hierarchy substitutes market solutions for ethical discussion, denying any basis for non-market solutions and any space for non-market transactions. God cannot be the End in a mono-utility function, and Truth cannot be the motivating cause. In a sense, neoclassical theory replaces the unity of God with the uniformity of utility in the reduction of quality to quantity.

It is hardly coincidental that secular economic theory emerged after a secular science of nature denied objective meaning to the hierarchic, qualitative aspects of nature. Object reality was reduced to the spatio-temporal world of the senses, and the knowing subject was limited to reason, the shadow of intellection.[17] Indeed, higher levels of meaning in the beauty and harmony of nature as signs of God (*ayat Allah*) were reduced to the "subjective" and "unscientific." Spiritual values similarly lost their objective meaning, and were reduced to the subjective realm of tastes. Just as a hierarchy of multiple levels of meaning in nature gave way to the lowest level of understanding in the physical domain, a hierarchy of spiritual and other needs was reduced to a single level of desire based on tastes. Without reasons to justify values, there were only external causes of tastes, and loss of moral agency.

Similarly, the laws of nature were no longer known to be the laws of God operating on a particular level of reality, as pointed out in the profound book Religion and the Order of Nature.[18] The concept that nature worships, loves, and obeys God, thereby producing order in the cosmos, was unscientific. Order without spiritual values therefore became a possibility for man, and science was divorced from ethics. Hence, the possibility of economics as a "separate science." As Schuon explains,

> At the time of the Revolution of the late eighteenth century, the earth had become definitely and exclusively the goal of man; the "Supreme Being" was merely a consolation and as such a target for ridicule; the seemingly infinite multitude of things on earth called for an infinity of activities, which furnished a pretext for rejecting contemplation and with it repose in "being" and in the profound nature of things; man was at last free to busy himself, on the hither side of all transcendence, with the discovery of the terrestrial world and the exploitation of its riches; he was at last rid of symbols, rid of metaphysical transparence; there was no longer anything but the agreeable or disagreeable, the useful or the useless, whence the anarchic and irresponsible development of the experimental sciences.[19]

With the loss of an ontology and epistemology to provide intellectual support for ethical values and constraints, it was only a matter of time before secular economics emerged to draw out the logical consequences of a world without meaning.

Indeed, Adam Smith examined the wealth of nations from the point of view of material pursuits without spiritual ends. He did not believe in revelation, and was a Deist who believed that God's hands were "cut-off" from the world. In fact, Deism implies a mechanical cosmos reducible to the sum of its parts, an aggregate in which God is a clock-maker. There is no qualitative, symbolic meaning of nature as *ayat Allah* that also worships Him. Smith believed that men did not need to be consciously aware of spiritual principles for economic equilibrium, just as nature is ignorant of spiritual principles. Egoistic desires thus became the base case of analysis, and economics became a separate science divorced from ethics.

The Deistic view of man and nature set the stage for the atheistic view of economics based on psychological egoism. Already Smith's close friend, the philosopher and economist David Hume, explicitly used the denial of qualities such as sounds and colors as objective realities to deny values as well, thereby eliminating their role in economic analysis. As Veatch notes in his wonderful book For an Ontology of Morals, Hume drew the ethical implications of this loss of an ontological basis of values to its logical conclusion, arguing that our aversion to willful murder is a taste.[20]

Hume thus denied an intellectual basis for ethics based on the reduction of quality to quantity, which neoclassical economics expresses with great rigor. Perhaps the most aggressive economist against religion during this period was Jeremy Bentham, the founding father of utilitarianism. Indeed, Bentham hated God and religion and vehemently attacked both, and it is instructive to examine his motivation in some detail. John Colls, a former disciple of Bentham who turned against him, described Bentham's volumes on religion as "volumes of blasphemy and slander... against the Author of Christianity and His people."[21] Bentham attacked the Church's teachings in the name of utility, arguing that bans against practices which did not "harm others," such as sexual indulgence and homosexuality actually decreased utility.

For Bentham, the question on the truth of religion was irrelevant and relegated to a second-order consideration, if it was divorced from its justification in utility. He explicitly subordinated Truth to utility, arguing that even if religious truths could be established, "Utility as to affairs of this life being the sole object... any argument founded on the will of the founder of religion, or on any other part of Scripture, cannot be in place here."[22] Completely disregarding the status of religious beliefs, he wrote, "When instead of proving that their tenets are more conducive to peace and utility than their opposites, men betake themselves to declamations on the (beauty and) necessity of Religion in general, I desire them to take notice, that they have abandon'd the cause for which they are contending."[23] For Bentham, questions about the nature of Ultimate Reality are insoluble and their solution is unimportant:

> it is one thing for a proposition to be true, and another for its being [sic] necessary for us to concern ourselves about it—the dwelling upon a mystery tho' true from whence no practical consequences are deducible, may... weaken a Religion, and the passing it by unnoticed though true, can be productive of no bad consequences.[24]

Bentham's book An Introduction to the Principles of Moral Legislation established the utilitarian principles on which the state should discard religious laws governing society, and replace them with a secular science of legislation based on utilitarianism. In trying to influence others after writing the book and before its publication, Bentham dreamed that he was "a founder of a sect, of course a personage of great sanctity and importance."[25] Bentham viewed himself in the dream as the savior of England and quite possibly the world, and when he was asked by "a great man" what he should do "to save the nation," Bentham replied, "take up my book, & follow me."[26] Bentham clearly implied his book should replace Scripture as the best plan for the salvation of the world. According to Bentham, it is a book with "the true flavour of the fruit of the tree of knowledge," and the angel who delivered it to him said that Bentham "had no occasion to eat it... as St John did his: all I had to do was cram it as well as I could down the throats of other people..."[27]

Contemporary scholars such as Muhammad Sa‘id Ramadan al-Buti have correctly argued that secular utilitarian philosophy, of which economics is the central application, represents nothing short of an attempt to destroy Islam.[28] We suggest that Islamic civilization never developed secular economics because "both the subject and object are considered to be hierarchic"[29] in the traditional Islamic universe. This provided an ontological and epistemological basis for reading the sacred message of creation, and the intellectual support for ethical values and constraints. Hierarchy in both subject and object prevented the reduction of values to tastes, and asserted the role of spiritual principles in creating order in man and nature. The combination placed all the Islamic sciences in a universe filled with meaning, asserting hierarchy and the need for spiritual principles. Recovering the Islamic intellectual heritage in both economics and the natural sciences is therefore crucial for the preservation of Islamic civilization. However, we face important obstacles in this recovery, to which we now turn.

IV. What Obstacles Prevent the Recovery of the Islamic Economic Intellectual Heritage?

The obstacles preventing the recovery of the Islamic economic intellectual heritage are many. We suggest that three of the most important obstacles are: 1) the widespread view that Islamic economic theory is simply a "special case" of neoclassical theory, 2) the Orientalist assertion that Islamic economic thought is the effect of political, social, and other historical contingencies, and 3) the failure to understand the Islamic intellectual sciences of nature. We shall focus on the first problem since other scholars have addressed the other two in different contexts.

The first obstacle regarding Islamic economic theory as a "special case" implies that neoclassical theory has "surpassed" the Islamic economic intellectual heritage. According to this view, the heritage is not worth studying except for historical curiosity.

Unfortunately, many Muslim economists subscribe to this position. Because of the eclipse of the Islamic economic intellectual heritage, many Muslim economists simply accept the neoclassical theory of choice and attempt to combine it with an Islamic theory of welfare for "Islamic economics." A similar problem has plagued departments of "Islamic economics" where students are taught the *sharīʿa* sciences as the source of Islamic norms on one hand and the neoclassical theory of choice on the other. Such an approach implies that Islamic economics cannot offer a distinct theory of choice, the neoclassical view accommodates spiritual values, and the two could be integrated. Those who hold this view attempt to reduce the history of Islamic economic thought to a forerunner of secular economics, fundamentally misunderstanding the nature of Islamic thought.

Although most Muslim economists currently recognize the need to go beyond economic assumptions of "consumerism," few seem to recognize that the neoclassical model cannot be amended to introduce Islamic values, and that abstracting from spiritual values leaves economics "fatally incomplete" with respect to consistency of preferences. Even worse are attempts by some Muslims to equate utility with *maslaha*, or total welfare including a spiritual dimension, and assert that the neoclassical theory of welfare is also "Islamic." We maintain that such attempts are intellectually flawed, and that the failure to refute the neoclassical assertion that Islamic economics is a "special case" of neoclassical theory has impoverished the discourse on Islamic economic policy. Indeed, this approach has inhibited attempts to create an Islamic economic system in spite of the knowledge of *fiqh* and other transmitted sciences.

The second problem on the Orientalist approach to Islamic economic theory applies to other intellectual and transmitted sciences as well. According to the Orientalist view, the "Islamic" sciences are not really Islamic, but are simply the product of historical contingencies. Political power, social factors, or foreign borrowings are the basis of the "Islamic" sciences, not the application of Islamic principles. Thus, there may be Muslims who "do science," but there are no authentic Islamic sciences. This view has been challenged by Muslims with respect to the transmitted sciences, but only a handful of scholars have addressed this challenge in the intellectual sciences, largely because of the third problem.

This regards the lack of understanding of the Islamic natural sciences by many contemporary Muslim scholars. Indeed, it is a daunting task for many thinkers because understanding this requires an understanding of traditional metaphysics. And as we saw in the previous sections, the Islamic sciences of nature are critical to providing the ontological background for the Islamic sciences of man. Without a recovery of an understanding of the Islamic natural sciences, a recovery of Islamic economic theory is almost impossible.

V. How Might These Problems Be Addressed?

We suggest that the first step to recovering the Islamic economic intellectual heritage is recovering the Islamic sciences of nature. Careful review of previous research by scholars such as Seyyed Hossein Nasr, Osman Bakar, and others will be essential to this task. This will provide arguments to simultaneously critique the secular sciences of nature from the Islamic point of view, and refute Orientalist assertions on the supposedly non-Islamic origin of Islamic sciences. Of course, such an effort can require a significant investment of time to understand traditional metaphysics.

In addition to this, a careful survey of the Islamic economic intellectual heritage in light of its relation to the Islamic sciences of nature will reveal both the beauty and rigor of Islamic economic thought. Indeed, such an effort will provide a thorough refutation of the reduction of Islamic economics to a "special case" of neoclassical theory.

It will also point out internal inconsistencies in secular economic theory. For example, consistency of preferences has no purchase if one acts directly counter to one's goal. Thus, instrumental rationality involves the capacity to "have the will one wants," or a second-order preference over first-order desires. This is what gives preferences their "authority," and constitutes human agency. However, the continuity axiom denies preferences their authority and the possibility of such agency by reducing values to tastes, for one cannot have a second-order preference over tastes such as a preference of apples to pears, or vice-versa. Thus, the axioms in the neoclassical theory of choice are internally inconsistent because they deny preferences their authority while "feeding off" them.

Such a survey effort is currently underway at the Graduate School of Islamic Social Sciences and the Cairo branch of the International Institute of Islamic Thought. Scholars from several institutions are collaborating on a study of the Islamic economic heritage in both economic theory and law. The survey includes over 130 classical Islamic texts by over 100 classical scholars. They range from Ghazzali to Ibn Taymiyyah to Ibn `Arabi, representing many different schools of classical Islamic thought. Moreover, the study employs an index to these classical works comprising over 150 economic categories to provide a basis for ongoing research. With the collaboration of many scholars, such research can be a humble contribution to recovering the Islamic economic intellectual heritage.

VI. Conclusion

The Islamic economic intellectual heritage is distinct from the transmitted heritage, just as economic theory is distinct from economic law. Intellectual knowledge in Islam is derived from the fundamental doctrine of *tawhid*, which asserts hierarchy in both man and nature. The qualitatively different levels of reality implied by this hierarchy are interdependent, and form a whole that is not reducible to a quantitative aggregate. According to this view, spiritual laws are therefore necessary for integration on any level of reality. Thus, the Islamic sciences of nature provide the ontological background for the Islamic sciences of man, and the latter are not possible without the former.

Applied to economic theory, *tawhid* asserts that spiritual ends are necessary for integrated preferences, and that spiritual values are not reducible to "arational" tastes such as the preference of apples to pears. *Tawhid* therefore denies that egoism can be the baseline case of economic analysis, and that spiritual values based on hierarchy can be reduced to tastes in a single level desire, or "utility function." Because neoclassical economics asserts both, we maintain that it inverts spiritual principles and denies an intellectual basis for ethics.

Recovering the Islamic economic intellectual heritage is therefore necessary for Islamic civilization. However, the common view that Islamic economics is a "special case" of neoclassical theory, the Orientalist assertion that "Islamic" sciences have non-Islamic origins, and the eclipse of the Islamic sciences of nature represent obstacles to recovering the Islamic economic intellectual heritage. We suggest that these problems can only be overcome by recovering the Islamic sciences of nature, critiquing the internal inconsistencies of neoclassical economic theory, and surveying the Islamic economic intellectual heritage in light of its relation to the Islamic sciences of nature.

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[1] Chittick, William. Recovering the Islamic Intellectual Heritage: Problems and Possibilities. Forthcoming. p. 1.

[2] Ibid.

[3] Ibid.

[4] Ibid.

[5] Ibid. This does not imply that language has no metaphysical basis, but only that one does not have to know its metaphysical basis to learn a language.

[6] Ibid.

[7] Ibid.

[8] Ibid.

[9] Ibid., p. 3.

[10] Ibid.

[11] Ibrahim Kalin. The Sacred versus the Secular: Nasr on Science. Forthcoming.

[12] For a more complete analysis, see section 2 of Al-Alwani, Taha and Waleed El-Ansary. "Linking Ethics and Economics: The Role of *Ijtihad* in the Regulation and Correction of Capital Markets." Georgetown University: Center for Muslim-Christian Understanding Occasional Paper, 1999.

[13] Rosenthal, Franz. The Nasirean Ethics. Cambridge: Harvard University Press, 19.

[14] Quoted in Machan, Tibor. "Reason in Economics versus Ethics." International Journal of Social Economics (1996), p. 21.

[15] For an excellent presentation of this concept, see Hausman, Daniel. The Inexact and Separate Science of Economics. Cambridge: Cambridge University Press, 1992.

[16] Schuon, Frithjof. The Play of Masks. Bloomington: World Wisdom Books, 1992. p. 61.

[17] See Nasr, Seyyed Hossein. Knowledge and the Sacred. New York: Crossroad, 1981.

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[19] Schuon, Frithjof. Light on the Ancient Worlds. Bloomington: World Wisdom Books, 1980. p. 30.

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[21] Quoted from Crimmins, James. Secular Utilitarianism. Oxford: Clarendon Press, 1990. p. 148.

[22] Ibid., p. 278.

[23] Ibid., p. 279.

[24] Ibid.

[25] Ibid., p. 287.

[26] Ibid., p. 315.

[27] Ibid., p. 315.

[28] Masud, Muhammad Khalid. Shatibi's Philosophy of Islamic Law. Islamabad: Islamic Research Institute, 1995. p. 132.

[29] Nasr, Seyyed Hossein. "Foreword" in Bakar, Osman. Classification of Knowledge in Islam. Kuala Lumpur: Institute for Policy Research, 1992. p. xi.

Islamic Venture Capital

A Critical Examination

Masudul Alam Choudhury*

ABSTRACT

The well-known modes of raising and mobilizing venture capital in Islam known as *muḏāraba* and *mushāraka* are critically examined. As they presently exist, they are pointed out to be pre-Islamic financing instruments that came into usage in the Islamic economic literature. The inability to realize the extensively relational perspectives of Islamic socioeconomic cooperation, of extensive participation across agents, firms, and sectors by means of these instruments, which are essential requirements for the Islamic political economy, is shown to make the instruments fraught with many technical and ethical problems of development financing. The alternative—to transform *muḏāraba* and *mushāraka* into a more integrated financing instrument of Islamic venture capital—is formalized. Empirical evidence is given. Institutional issues are examined in light of Islamic joint venture financing.

I. INTRODUCTION

It is well known from the Islamic economics literature that interest-free instruments must guide the raising and mobilization of financial resources in an Islamic economy. This is a requirement that stems from the moral injunctions of the Qur'ān and the Sunna, the epistemological sources of the *sharīᶜa*. The *sharīᶜa* invokes an extensively participatory form of profit-sharing system that can replace interest-based financial instruments. Such instruments are traditionally termed profit sharing, or *muḏāraba*, and equity participation with profit as well as loss sharing, or *mushāraka*. The fact that an extensively participatory enterprise is in the essence of the *sharīᶜa* pertaining to economic and financial matters (*muamalat*) can be deduced from the universally unified, diversified and knowledge-centered cosmology of Qur'ān, as is seen in Qur'ānic verses 16:1-22. Furthermore, cooperation and unity across systems is a central note throughout the Qur'ān (cf. Qur'ān 49:13). These epistemological grounds make the criterion of pervasively participatory, cooperative, and coordinated enterprise under *muḏāraba* and *mushāraka* a *sharīᶜa* requirement in Islamic joint venture.

Despite the claimed Islamic implications of raising and mobilizing venture capital through *muḏāraba* and *mushāraka* for attaining cooperative participation, serious impediments have appeared in realizing this goal through such instruments. Problems have arisen because of the restrictive and dichotomous ways in which these two instruments are used. Sharing profits through them has been non-participatory. Agents, the non-entrepreneur owners of capital and the effort-producing and profit-creating workers remain in sleeping partnership. Sharing then effectively devolves into bondholding or shareholding, with a lack of extensive participation. Extensively active participation, economic cooperation and coordination among agents, so much needed in an environment of co-determined decision-making in the Islamic order, is not found. The two instruments fail to qualify as truly Islamic ones in this absence of participation that could have provided equity, entitlement, and empowerment as developmental effects. An Islamic transformation of such instruments is thus required.

II. OBJECTIVES

This paper has several objectives. First, we will explain the inherent problem in the prevailing Islamic joint venture financing instruments: *muḏāraba*, or profit sharing between owners and workers or between owners of capital; and *mushāraka*, or equity participation. We will critically examine each of these separately. We will also consider a compound joint venture financing instrument of the two and call it *muḏāraba-mushāraka*, or henceforth as "m-m." The inherent problem in the existing *muḏāraba* and *mushāraka* joint venture financing instruments results in a lack of precision in capitalizing the value of time or wages that workers and similar participants

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* Professor of Economics, King Fahd University of Petroleum and Minerals, Dhahran, Saudi Arabia.

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contribute in a joint venture. The profit-sharing ratios thus remain poorly determined. This problem of imprecision raises other questions, such as entitlement, empowerment, and the possibility of continuous re-contracting between labor and capital owners. All of these are linked with issues in development of equitable distribution of resources among participants.

Our second objective is to show that the presence of these problems raises the question inequity, counter to the goals of Islamic law (*maqā<u>s</u>id al-sharīʿa*). Islamic banks are found to have pursued the goals of capital accumulation rather than resource mobilization. The latter is embedded in the issue of distributive equity as well as capital accumulation.

Our third objective is to point out that in contradistinction to the usually held view regarding *mu<u>d</u>āraba* and *mushāraka*, in an Islamic political economy, an extensively participatory system, joint ventures with the m-m instruments, logically raise certain organizational issues in institutional decision-making will have to be addressed. In an Islamic political economy, participation and interactions are necessarily promoted. The participatory nature of the m-m contract will be shown to span across agents, firms, sectors and the interrelationships among these. In Islamic terminology, we refer to the embedded interaction and integration followed by evolutionary decision-making as the process of *shura*. This is termed as the "*shuratic*" process in this paper.

The main focus of this paper in view of the above three objectives is to point out the limitations of the existing joint venture financing instruments of *mu<u>d</u>āraba* and *mushāraka*. We will transform these instruments into a more cogent compound, the m-m instrument. Such a joint venture financing instrument will be shown to be capable of eliminating the problems of imprecision and inequity arising from a lack of extensively cooperative and coordinated participation and the absence of a method that could otherwise capitalize the value of effort by labor in generating profits. In this way, we claim, the existing problems of m-m can be replaced by a more exact representation of the intent of Islamic law (*maqā<u>s</u>id al-sharīʿa*) in an Islamic joint venture enterprise.

III. Review of Literature

A. Critique of the *Mu<u>d</u>āraba* Contract as Perceived in Islamic Economics

In the literature of Islamic economics *mu<u>d</u>āraba* is treated as a sharing of resources in an enterprise in which one set of partners supplies capital and the other set of partners supplies expertise, management or work-effort (Siddiqi, 1985). The sharing of profits at the end of a contracted time-period is carried out in proportion to the capital investment of the owners of financial capital in the first place. The other partners (labor, expertise, management) are given either wages or agreed upon profit-shares. But the basis of determining the individual profit-shares among the non-capital partners is not a precise one other than being a mutually agreed upon financial contract in which the share of capital is well-determined but the non-capital factor shares remain vague. Only if a value can be imputed for the work-effort that goes into production and profit generation can this value, which may be foregone by the participating labor wholly or in part with the other part being made up of wages, be treated as a form of capitalized investment done by workers in the enterprise. This capitalized value of work-effort can now determine well the share of profits for non-capital owning partners as well. Siddiqi raises this distributive question of *mu<u>d</u>āraba* mentioning that this remains an unexplored issue among Islamic economists.

The literature in Islamic economics has paid only marginal attention to the imputing of capitalized values to work-effort so as to make the wages and profit-shares foregone by labor in a *mu<u>d</u>āraba* contract (Choudhury, 1992) a real investment share in the joint venture. Consequently, this has remained a technical problem. How can a fair contract can be established in a situation where wages and profit-shares emerge as dual methods of payments to labor and expertise whereas the capital owners take their well-determined share of profits according to the ratio of his initial capital investment?

The fact of the matter is that non-capital factors of production enter a pure *mu<u>d</u>āraba* contract as if they own no equipment. Hence there exists no well-determined basis to measure the share of profit at the end of a contract period. There cannot then exist the opportunity to re-negotiate contracts that would otherwise emerge from increasing levels of ownership by the non-capital owning factor even before the end of a given contract period. The capital-labor relationship in a financial contract that should be generating empowerment and increasing entitlement through ownership is not realized in such a fixed wage-profit contractual relationship that does not display the required capitalization of work-effort.

This situation with the existing *mu<u>d</u>āraba* and *mushāraka* financial instruments is no different from the one that is encountered in the critique of capitalism in Marxist arguments (Phelps, 1985). In the *mu<u>d</u>āraba* and *mushāraka* case such an instrument is simply a contract between owners or between workers and owners in the sharing of profits *ex-post* according to pre-determined sharing ratios. Two problems arise at once. First, the profit-sharing ratio remains an agreed-upon ratio, but not a precise basis for the capitalized value of work-effort. This limits distributive issues of entitlement, empowerment, participation, and re-contracting among participants. Second, owners of capital pass the enterprise on to labor to work with it. Alternatively, *muḏāraba* and *mushāraka* are given up for management to a third party, such as an Islamic bank. In either of these two cases, there exists a sleeping partnership between the owners of capital and labor which in turn devolves into a dominant interest for the owners of capital at the expense of the empowerment of workers in the enterprise.

Marx criticized the capitalist mode of capital accumulation on similar grounds. He saw that by entering into a wage contract with labor, owners of capital ceased to be productive factors, even though they reap the economic surplus as profit to the detriment of workers.

We now find that in the existing case of the sleeping partnership between owners and workers in *muḏāraba* and *mushāraka* contracts, an emphasis on capital accumulation rather than distribution. This results in the dominance of the interest of the owners at the expense of the entitlement and empowerment for labor. Therefore, the existing *muḏāraba* and *mushāraka* instruments of joint venture financing turn out to be simply like the capitalist instruments for capital accumulation.

It has been argued elsewhere that as long as the wage-economy remains the focus of Islamic economics no real ownership can be attained (Choudhury and Malik, 1992). This, of course, is not to imply that an Islamic economy would turn into a purely profit-sharing one. That scope would be limited even by the fact that the transformation process in a wage-economy will always involve those who must be paid wages combined with profit-shares over a period of time. Wage-payment in such circumstances is an established Islamic practice. But the dynamic nature of enterprise in Islam has always aimed at ameliorating labor. This was exemplified by the classical event of the Medinah Charter that was signed under the directions of Prophet Muhammad between the Meccan emigrants (*muhajirs*) and the Muslims of Medinah (*Ansars*) (Umari, 1991). Even in the Ottoman world we find that the sultans treated state property as a distributive resource to the landless in newly conquered areas (Garraty and Gay, 1972). Property, and hence, ownership, entitlement and the resulting empowerment, have always been given higher status in Islam than wage-payment, even though a concept of just wages has always existed. Given these observations, *muḏāraba* contracts, as treated in Islamic economics, without a precise method of valuation of work-effort or expertise, cannot help in realizing a transformation process from dependency to ownership for labor.

B. Critique of the *Mushāraka* Contract

In the case of the *mushāraka* contract, the partners are both capital owners who can pool their financial capital in a joint venture and thus, share the profits and losses at the end of the contract period according to their initial shares. Other variations of *mushāraka* are co-financing and equity participation that can proceed on the basis of various forms of capital investments, whether real, financial or in combination.

As in the case of *muḏāraba* and *mushāraka*, yields earned by the contracting partners are influenced by two compounding factors. The first factor is the productivity of capital yielding profit. This causes capital accumulation to occur. The second factor is the profit-sharing ratio that distributes the profits. The more frequent are the re-negotiated contracts, the more effective the compounding effect becomes. The possibility of re-contracting is causally linked to varying profit-sharing ratios that can emerge by virtue of the increasing levels of ownership gained in the enterprise by the partners, especially labor. Re-contracting is also causally related to increasing risk-diversification and product diversification in the enterprise. As capital accumulates, this causes diverse opportunities to open up. The reverse relationship is also true.

The management *mushāraka* venture capital faces the same problems of asymmetrical ownership and income/wealth distribution as seen in the case of *muḏāraba*. The fact of the matter is that any truly cooperative and well-coordinated enterprise must be extensively participatory in nature. We would then expect labor relations from a *muḏāraba* contract to intertwine with *mushāraka* contracts. This would re-create the same kinds of problems that we noticed in the case of the former.

The implications here are that the absence of a common participatory basis between the two contracts makes *muḏāraba* and *mushāraka* to be dichotomous. Hence, the decision-making and the institutional organization of the two contracts remain independent of each other. On the other hand, it is the jointly owned active partnership between capital owners and labor that turns out to be the more interesting enterprise to consider.

An important labor relation of this type that now appears in the U.S. is “industrial democracy,” wherein capitalists and workers are required to collaborate in management and production. Good examples of industrial workplace democracy are the employee savings and ownership plans (ESOPs) and the universal savings and ownership plans (USOPs) (Ellerman, 1991). Workers can buy shares in enterprises with the hope of buying back failing companies. In this kind of a re-contracting situation, ownership can increase, even though wage-payment remains extant. The same kind of co-determination and re-negotiations are not available in *muḏāraba* and *mushāraka* enterprises as long as these contracts remain dichotomous and de-linked from the productive factors and outlets.

C. Problems Arising from Interlinking *Muḏāraba* and *Mushāraka*

Whereas in the case of *mushāraka* the distribution of profit-shares is well determined as a function of the contracted proportions of initial investments, the same is not straightforward in the case of *muḏāraba*. Despite this fact, when wages are mixed with profit-shares as modes of factor payments, then too the determination of profit-shares is not straightforward. This interlinking of *muḏāraba* and *mushāraka* contracts is not possible in the profit-sharing and loss-sharing framework within the existing dichotomy of the two contracts. On the contrary however, such and other financial and ownership relationships are liable to increase further with the frequency of re-negotiated contracts.

In both instruments for raising and mobilizing Islamic venture capital, we find that democratic decision-making and participation are not explicitly built into the financial and distributive contracts. In the case of *muḏāraba*, after a negotiated contract is initially established, subsequent management of the enterprise does not rest on the joint decision-making powers of the two sets of partners. Rather it devolves to the major controlling owners of capital or to the externally arranged management whom the owners employ, such as an Islamic bank. Thereby, in cases of financial loss, the capital owners and not labor become liable to bear the loss. The resulting higher risk borne by the capital owner puts him or his appointed management at the helm of decision-making.

In the case of *mushāraka* too it is quite possible for any of the partners to remain in sleeping partnership after they have allayed their capital shares in the enterprise. This is particularly the case with financial *mushāraka*, wherein a corporation may act as an investment firm to look after the shares of depositors. The Islamic bank is an instance. No portfolio of Islamic banks has so far been known to be influenced by voting rights of common shareholders and stakeholders. The common stockholders are found to reserve the sole right of deciding how to direct and raise funds in the interest of the enterprise.

We therefore find that in both *muḏāraba* and *mushāraka*, active cooperative and coordinated participation among owners, managers, shareholders, and factors of production does not exist, either explicitly or through financial intermediation. The result is that a truly dynamic nature of shareholding, one that could provide active participation at the level of decision-making and also entrepreneurial contribution, is absent. Instead, the powers of decision-making are relinquished to those in authority. With this kind of a sleeping partnership, enterprises lose their capability to enhance empowerment and entitlement, learning and participation among factors of production. An industrial workplace democracy fails to exist (Wisman, 1991). This in turn adversely affects the possibility of growing out of dependency into active re-contracting with dynamic ownership of assets in the enterprise. The development perspectives of enterprises financed or managed by *muḏāraba* and *mushāraka* contracts thus remain unrealized in the midst of sleeping partnership among partners.

Because the partnership implied in these modes of venture capital financing is not of an active type, the shares act simply as a technical method of distributing profits in interest-free financing. In essence, however, the nature of such shares is no different from that of bonds in which no active two-sided participation is required. Islamic economists have thus modeled profit sharing on bondholding behavior while the *muḏāraba* and *mushāraka* devolved into one of sleeping partnership (Bashir, 1983; Bashir et al., 1992; Ebrahim and Bashir, 1998).

Siddiqi tries to bring out the cooperative and dynamic nature of *muḏāraba* contracts by referring to the associated financial securities as *muḏāraba* shares (Siddiqi, 1983). Yet, nowhere in his book does one finds explicit rules for co-determination and participatory decision-making between workers and capital owners. Likewise, the portfolio of such shares held by *muḏāraba* and *mushāraka* savers in Islamic banks is shown to be vested fully with management without representation from the clientele. There is no mention in Siddiqi's book about the valuation of work-effort as a capitalized profit-sharing measure along with wages paid.

Technical problems thus arises, first, in failing to make the management practice responsive to cooperative participation among all business partners, and second,, in failing to introduce a well-determined method of *muḏāraba* and *mushāraka* profit sharing in which value imputation of work-effort would become a positive sharing measure along with wages and the shares of capital owners. The empowerment and ownership interests of productive factors are thus left out in such financial contracts. As long as *muḏāraba* and *mushāraka* fail to incorporate a positive transformation into profit sharing by ownership on the part of labor, such contracts face the problem of industrial unemployment and distributive inequity associated with wage-paying production menus.

One is to note the intrinsic difference between wage-contract and a pure *muḏāraba* and *mushāraka* contract. Capitalists (or owners of capital) base wage-contract on a fixed payment to labor, whereas *muḏāraba* and *mushāraka* offer *ex post* payment of shares of profits. However, it is perfectly permissible under Islamic law to combine wage-payment with *muḏāraba* and *mushāraka* contracts. These contracts then interact when wages forgone or proportionately invested in the enterprise enables a new m-m to emerge. This is the mechanism of m-m re-contracting that we referred to in this paper as the medium to develop entitlement and empowerment for labor.

IV. Identifying the Points for Reformulation of Participatory Instruments in Islamic Financial Ventures

The technical problems of *muḏāraba* and *mushāraka* arise first, due to their restrictive terminological usage among Islamic economists, and second, because of their peculiar financial definitions that fail to realize cooperative partnership among capital owners and non-capital partners including labor. It is true that the desired intent is to attain cooperative and participatory goals by using the instruments. Yet, no methodology has been developed to manifest the desired goal of cooperative participation in any technical understanding of the financing methods. Consequently, the objectives of socioeconomic development promoting entitlement, ownership, and decision-making by participation on the one hand, and on the other, bringing about financial risk-diversification through re-negotiated contracts, are not found to emerge from these two financial instruments as they exist.

In order to transform these financial instruments to realize the ameliorative goals of the *sharīʿa*, extensively cooperative participation must be explicitly introduced into the m-m instruments. Such rules must reflect the organizational and management processes involved in such extensively cooperative and coordinated participatory enterprises. In the absence of this key factor, both the conceptual as well as the applied aspects of participatory financing spelled out by *muḏāraba* and *mushāraka* and as understood by Islamic economists, would fail to be truly Islamic instruments. As we have argued, they devolve into bondholding or managed shareholding with profit sharing among sleeping partners.

The principal-agent utility-maximization problem in managerial decision-making in managed shareholding is well known (Shy, 1995). Such a management model can also be shown to characterize sleeping partnerships in the existing form of the *muḏāraba* and *mushāraka* instruments, wherein as we have noted, owners of capital give away the management of the enterprise to a third party, such as the Islamic bank, while participation by labor remains absent in decision-making in the enterprise. The appointed management then plays the dominant role of maximizing the welfare of the preferred shareholders and common stockholders, instead of workers' as well. In the literature on managerial economics, there is no theory of principal-agent game that maximizes the welfare of labor in the enterprise. For any such theory, we need to turn to industrial management and study unions vis-à-vis management. This observation is universally true of all managerial approaches taking place in capitalistic financial environments.

Hence, there remains no particular challenge in the existing *muḏāraba* and *mushāraka* model toward invoking exclusively Islamic financing practices. Consequently, any difference in decision-making between a *muḏāraba* and *mushāraka* enterprise and the others is no more a relevant issue. The complete adoption of the basic methodology of principal-agent problem, now repeated for *muḏāraba* and *mushāraka*, imitates the usual risk-aversion behavior solely premised on the assumption of economic rationality and equilibrium-optimal allocation of resources.

The above-mentioned axioms of any principal-agent problem are known to emanate from the neoclassical background of economic reasoning (Khan, 1985). But it is well known that in neoclassical economic methodology issues of ethics and morality remain exogenously neutral preferences of agents. Neoclassical methodology must necessarily treat ethical issues in conflict with purely economic issues, for example, the problem of economic efficiency versus distributive equity. It is this intrinsic rule of marginal substitution among alternatives that gives rise to the discount factor for valuation of assets and which simply represents the opportunity cost of capital or interest rate. In the face of such methodological conditions, by applying a neoclassical theory to *muḏāraba* and *mushāraka*, it would become impossible to reduce and then eliminate interest rate from an Islamic economic system. Thereby, a pure theory of raising and mobilizing capital through an interest-free system remains impossible in the prevailing neoclassical approach to *muḏāraba* and *mushāraka* instruments. To the contrary, interest-abolition is fundamentally an ethical issue in Islam that endogenously affects preference formation and subsequently market exchanges and transactions at all levels.

V. A Critique of *Muḏāraba* and *Mushāraka* in Reference to the Classical Islamic Period

It is no wonder that *muḏāraba* and *mushāraka* as understood in their present form fall short of having a true grounding in either the Qur'ān or the Sunna. The acceptance of these pre-Islamic instruments came about by implication, not by a direct reference to either (Siddiqi, 1991).

We can examine how these pre-Islamic practices entered the Muslim way of doing business during the Prophet's time in Medinah, and why they were allowed to exist. Ismail makes a good study of this issue and finds that there exists no evidence as to whether the Prophet categorically approved of these modes of financing although he did not ban them (Ismail, 1989). The closest that the practice of *muḏāraba* came to being endorsed is found in the works of the jurist, Imam Malik, who lived many years after Prophet Muhammad. But here too it is Imam Malik's opinion and not a clear Prophetic guidance that is the basis of the endorsement for *muḏāraba*. Subsequently, it is found that those Companions of the Prophet who practiced *muḏāraba* during the Prophet's time did so in view of putting the property of orphans in trust with partners in such ventures. There is no real possibility for orphans to interact with financial managers in cooperative decision-making. Consequently, sleeping partnerships could be accepted in such cases, and the property of orphans could be placed in trust with *muḏāraba* partners.

Even the meaning of *muḏāraba* varies among different schools of Islamic jurisprudence. Our definition provided so far complies with the Hanafi School. But among the Hanbali and Shafi schools *muḏāraba* means loaning a certain amount of capital to a partner(s) with whom business can be conducted and profits shared in proportions agreed upon by the capital owner in the first place. In the case of loss there would be no return to the non-capital partner and the capital owner would bear all the loss. Since there does not exist any clear saying and practice of the Prophet with regard to *muḏāraba* financing of venture capital, and all cases wherein the companions of the Prophet participated in such business remain circumstantial rather than precise rules of business ethics, the pre-Islamic character of *muḏāraba* bears little resemblance to the truly Islamic mode of conducting business under the *sharīᶜa*.

In the Qur'ān and *ahadith* (Prophetic sayings) appears the central role of economic cooperation and active participation for purposes of generating productive yields that bring about wellbeing to society. This is a goal of the *sharīᶜa* (*maqāṣid al-sharīᶜa*). This affirmative approach was exemplified by the organization of the City State of Medinah by the Prophet himself. Many Qur'ānic verses and important *ahadith qudsi* emphasize the complementary relationship between avoidance of interest and the act of charity. "God blesses all acts of charity manifold and prohibits the evils of interest-based financing" (Qur'ān, 2:276; al-Shurawardy, 1990).

Thus, Islamic participatory instruments of venture capital have no grounds for relying on the pre-Islamic nature of *muḏāraba* and *mushāraka*. Instead, the accepted generalized instrument of Islamic financing, raising and mobilization of venture capital can be any mode of financing that promotes explicit rules of extensive participation among cooperative agents, businesses, sectors, variables and relations in the entire Islamic socioeconomic order. Through such participatory rules and cooperative relationships, an extensive web of socioeconomic of cooperation and coordination among possibilities is established. The result is a realization of community social wellbeing, wherein the ethics of elimination of interest is endogenously realized, put into effect, and re-generated within the system.

Money would endogenously be used in the valuation of real assets as well as real economic relations with the establishment of such a generalized participatory instrument. The result would be a realization of both financial profitability in terms of the productivity of capital and its developmental impact in increasing empowerment, entitlement, and ownership among partners including labor.

VI. A CRITIQUE OF *MUḎĀRABA* AND *MUSHĀRAKA* IN RELATION TO INTEREST-FREE FINANCING

The theory of endogenous money in Islam and its effectiveness in eliminating interest is an area of voluminous proportion (Choudhury, 1998a). Here we will simply state the basic arguments as to why the *muḏāraba* and *mushāraka* instruments cannot contribute toward attaining the goal of eliminating financial interest as an anti-social and unwanted economic variable in Islam.

Money in Islam is neither a commodity nor a medium of exchange. Here money is not a medium of exchange because, in the absence of interest rate as the price of money, there exists no money market where exchange in this commodity can be realized. On the other hand, the value of money is derived from the quantity of money in demand and thus in supply for transacting on "real" economic activities. Promissory notes are excluded, as they do not tie down "real" economic activities to money demand and supply. The quantity of money now values the actual exchange and transactions in "real" economic activities.

In the intertemporal case as well, there exists no "real" and realized exchange of goods and services in time. Hence there can be no time value of money. The intertemporal case of resource allocation on realized economic activities is thereby non-existent. Consequently, there can be no intertemporal price to measure the time value of money, as neoclassical economics will have us believe.

In the end, in both the non-temporal and intertemporal cases we find that money acquires its value from the value of real exchanges and transactions. Money in Islam has no intrinsic value of its own. That is to say, money in Islam is not a medium of exchange either in its own or in the case of intertemporal allocation of resources.

When money in Islam values the real economic transactions by means of bullion, such bullion or currencies acquire a store of value reflecting the valuation of real economic exchange. Commercial banks cannot supply promissory notes to transact on speculative grounds, for only real goods and services are to be exchanged. Deferred exchange if any, must show strong possibility of delivery of the traded goods in the immediate future. Despite the fact that future expectations of prospects may be capitalized in terms of expected prices, yet such a valuation is good only for reasons of economic planning. It cannot be indicative of actual exchange and financial policy-making, since no actual but merely notional concept of future prices and contingencies exist at the present time-period.

Now, if we take these arguments at the level of the pre-Islamic definitions of *muḏāraba* and *mushāraka* we find no participatory role of these instruments in decision-making between the central monetary authority and the Islamic financial institutions. Consequently, there can exist neither policies enacted by the monetary authority nor discourse among the financial intermediaries, the monetary authority and entrepreneurial partners (*muḏārib*) in the productive sectors, to ascertain what would be the real demand for money for valuing the real economic transactions. It is this lack of interrelationship among partners as mentioned here, caused by the absence of explicit and active participation among the monetary authority, the financial intermediaries and participating factors of production, that leaves void the intrinsically endogenous interrelationships that must otherwise exist between real economic transactions and the quantity of money.

The elimination of interest from the economy can be realized by the above kind of money-goods causality in the midst of a banking transformation to 100% reserve requirement. Such a transformation would require a systemic understanding of inter-firm, inter-agent and inter-sectoral participation in raising and mobilizing financial requirements across productive enterprises. *Muḏāraba* and *mushāraka* financial instruments, as used in their pre-Islamic connotation, however, are not found to be premised on such a general outlook of extensively cooperative and coordinated participation.

VII. A Simple Formalism on Islamic Participatory Venture Capital

An Islamic financial instrument for extensively cooperative and coordinated participation must attain two results. First, it must yield prospective returns from resource mobilization into *sharīᶜa*-approved possibilities. These would then be causally related to the productivity of capital and risk-diversification. Second, the ethical recommendations and productivity of financial resources in possibilities acceptable to the *sharīᶜa* must generate developmental effects.

From the joint effects of these two expectations, Islamic participatory financing would generate extensively cooperative and coordinated interrelationships among agents, systems, and variables, making possibilities approved by the *sharīᶜa* universally complementary to each other. The enjoyment of all such complementary prospects together yields the social wellbeing of an Islamic community. A communitarian outlook of social wellbeing is thus established through such a medium of Islamic participatory. Such a characterization of the participatory instrument of Islamic venture capital is in close agreement with all the injunctions of the Qur'ān and the Sunna with respect to the idea of social wellbeing. In this way, the cumbersome and restrictive categorization of *muḏāraba* and *mushāraka* as dichotomous financial instruments is avoided. Sleeping partnerships between partners cease. Bondholding is replaced by shareholding and stake-holding with active participatory rules. Empowerment, entitlement, and ownership become developmental goals with the increasing possibility of re-contracting profit-and-loss sharing within capital-labor participatory relations (Tahir, 1997).

A. Inter-firm or Inter-sectoral Flow of Participatory Venture Capital and Profit-sharing

To formalize, we define the following variables:

Let, I_i denote the venture capital disbursed by investor i, say, $i=1,2$.
V denotes the value of work by the non-capital contracting partner (labor), with

$$V=\Sigma_{t=1}^{n} w_t.t + \Sigma_{t=1}^{n'} I_t,\ n' > n. \qquad \text{...... (1)}$$

Here t denotes the time-period over which wages w_t are foregone or proportionately reinvested in the enterprise. This helps to develop ownership among labor over the time-periods t = 1,2,…, n.

I_t denotes the capital investments progressively made by workers while re-contracting during the time-period t=1,2,.., n'. This may denote increased volumes of shares purchased and hence workplace rights earned by labor.

Now, total venture capital amounts to $I_1 + I_2 + V$. This amount of venture capital generates inter-sectoral or inter-firm linkages due to its cooperative nature. We denote the inter-firm or inter-sectoral flows of venture capital by K_{jk}, j, k=1,2,.., m sectors or firms.

Since all such venture capital across sectors or firms are participatory in nature in the sense of extensive linkages, therefore, the total venture capital of the cooperative economy is given by, $K = \Sigma_{j=1}^{m} \Sigma_{k=1}^{m} K_{jk}$. An economy-wide cooperative participation is thus extended across firms and sectors. We note that a matrix of input-output flows of venture capital is thus generated as in Figure 1 (Lange, 1966,7; Vanek, 1977; Weitzman, 1984):

FIGURE 1. INTER-SECTORAL FLOWS OF VENTURE CAPITAL

Industries

Industries		*1*	*2*	*3*	......	*m*
1	K_1	K_{11}	K_{12}	K_{13}	.....	K_{1m}
2	K_2	K_{21}	K_{22}	K_{23}	.....	K_{2m}
3	K_3	K_{31}	K_{32}	K_{33}	.....	K_{3m}
....						
m	K_m	K_{m1}	K_{m2}	K_{m3}	.....	K_{mm}

...... (2)

with, $K_j = \Sigma_{k=1}^{m} K_{jk}, j=1,2,..m; K= \Sigma_{j=1}^{m} K_j = \Sigma_{j=1}^{m} \Sigma_{k=1}^{m} K_{jk}$. ...... (3)

In the above expressions, K_{jk} denotes the total capitalized value of resources that flow from sector (or firm) j to sector (or firm) k in the midst of the unified and coordinated m-m contract, as defined in our case and sustained between these cooperating sectors (firms), $j, k = 1,2,.., m$.

We are assuming here that the economy has m sectors (firms). A more detailed analysis of the matrix (2) can further subscript these entries to give a distinct attention to firms within sectors. However, the analysis would then turn out to be more complex.

K_j denotes the total capitalized value of all kinds of capital formation arising from investment flows as mentioned above, for the j^{th} sector (firm) incorporating all contributions through the cooperative arrangement among linked markets in m-m contracts, $j = 1,2,.., m$.

Finally, $I_1 + I_2 + V = \Sigma_{j=1}^{m} \Sigma_{k=1}^{m} K_{jk} = \Sigma_{j=1}^{m} K_j = K$.

In a similar way we construct the inter-sectoral matrix of outputs that are then turned into profits, say $[\pi_{jk}]$. Now the profit-shares are obtained by $[(K_{jk}/K).\pi_{jk})]$. For a given sector in relation to inter-sectoral flows of resources and profits we obtain the sectoral profit share, $(K_j/K). (\pi_j)$, where $\pi_j = \Sigma_{k=1}^{m} \pi_{jk}, j=1,2,.., m$.

The share of each partner's profits in the total firm-specific or industry-specific profits is given by,

$$\rho_i = (I_i /K_j)(K_j/K).(\pi_j) = (I_i /K).\pi_j = (I_i /\Sigma_{j=1}^{m} \Sigma_{k=1}^{m} K_{jk}).\pi_j,\ i=1,2. \qquad ...... (4)$$

The sharing ratio is given by,

$$s_i = (I_i /K_j)(K_j/K) = (I_i /K) = (I_i /\Sigma_{j=1}^{m} \Sigma_{k=1}^{m} K_{jk}),\ i=1,2. \qquad ...... (5)$$

Likewise, the share for labor during the wage-earning and re-contracting period is,

$\rho_v = (V / \Sigma_{j=1}^m \Sigma_{k=1}^m K_{jk}).\pi_j.$ ...... *(6)*

The sharing ratio for labor is,

$s_v = (V / \Sigma_{j=1}^m \Sigma_{k=1}^m K_{jk}).$ ...... *(7)*

Obviously now, $s_1 + s_2 + s_v = 1.$ ...... *(8)*

The important difference between the expressions (1) – (8) and the existing *muḏāraba* and *mushāraka* sharing method used in the Islamic economic literature is the appearance of the *V*-valuation and its associated profit-sharing rate for labor in an extensively participatory Islamic joint venture. In any other case of *muḏāraba* and *mushāraka* contract in the literature of Islamic economics, *V* is not capitalized to make it play an important role in profit-sharing between owners of capital and labor. *V*-valuation essentially removes the imprecision encountered in the determination of the true profit-sharing ratios, especially that between labor and capital owners.

The above results also point out that profit sharing in an Islamic political economy is a wide-spread phenomenon of inter-firm and inter-sectoral linkages, where the venture capital of the three partners, namely, the capital owner (whose investment is I_1), Islamic bank (whose investment is I_2), and the non-capital factor, such as labor (whose investment is the capitalized value of effort and capital, *V*). The implication here is that each of these partners can engage the others in various sectors and firms in which they outlay their venture capital. Consequently, the capitalized value of venture capital denoted by K_{jk}, is deployed by the partners across firms or sectors in the form of inter-firm or inter-sectoral linkages, respectively. The above results can be generalized for any finite number of partners in the inter-firm and inter-sectoral participatory sense.

B. Explicit Rule of Decision-making in Participatory Contracts

As we have mentioned earlier, our third objective of this paper is to link up an Islamic participatory enterprise with the extensively cooperative and coordinated decision-making that is necessary. This involves specific rules and a particular form of approach. In the Islamic system, the approach is through an embryonic system of *shuras* (interactive organizations), not simply restricted to the political process. The underlying process associated with the *shura* form of organizational decision-making is referred to here as the "*shuratic*" process.

The next step then is to build the explicit rules of participatory negotiations and re-contracting in the above-mentioned flows of venture capital. This is done, first, by establishing what is known as the moral purpose of Islamic Law (*maqāṣid al-sharīᶜa*) with regards to the specific issues at hand. The attributes of *maqāṣid al-sharīᶜa* are justice, fairness, certainty, wellbeing and dynamic change along these same directions (Choudhury, 1998b). Thus a fair distribution of profits and the possibility of re-negotiating contracts as a result of and for the purpose of developing ownership and empowerment in labor within the enterprise are reflected in *maqāṣid al-sharīᶜa*.

The rule so set is the result of discourse among the partners, with the objective of arriving at a consensus on the set rules and their operational features. The rules of interactive and consensual participation in enterprise combined with an evolutionary learning-by-doing process are realized from the occasion of continuously re-negotiated contracts. This is based on the feature that new rules emerge along the lines of *maqāṣid al-sharīᶜa* through agent-specific inter-systemic discourse with the intent of attaining consensus, which in turn is evolved into better rules. This *shuratic* process continues indefinitely.

The re-contracting process progresses based on the emerging new rules of participation, which in turn are determined based on the attained values of the socioeconomic variables. In the present case for simplicity, we can restrict the socioeconomic variables to profit sharing and inter-firm linkages. Thus, two sequences of values emerge and evolve simultaneously. One is the discoursed knowledge in the light of the *sharīᶜa*-based rule set at the beginning of a process of discourse, and the other, the socioeconomic variables that are causally interrelated with and augmented by the evolutionary knowledge values.

Let, θ_{jk}^s denote the knowledge variable arising from discourse at each level of production inter-firms or inter-sectors, $j, k = 1,2,..., m$. $s=1,2,3$ denote capital owners and non-capital factors (e.g. workers). Such knowledge flows may be understood as assigned ordinal values evolved by discourse and consensus among cooperating participants in decision-making and are premised on *sharīᶜa* rules pertaining to the issues at hand.

Each inter-firm profit-sharing ratio is now qualified by θ_{jk}^s. We then obtain the knowledge-induced profit-shares as,

$$\rho_s(\theta_{jk}^s) = ((I_i / \Sigma_{j=1}^m \Sigma_{k=1}^m K_{jk}).\pi_j)[\theta_{jk}^s]. \qquad ...... (9)$$

The profit-sharing ratios are given by,

$$s_s(\theta_{jk}^s)=(I_i / \Sigma_{j=1}^m \Sigma_{k=1}^m K_{jk})[\theta_{jk}^s]; \Sigma_s\Sigma_j\Sigma_k s_s(\theta_{jk}^s) \qquad = 1 \qquad ...... (10)$$
$$j,k = 1,2,.., m; s = 1,2,3.$$

The appearance of $[\theta_{jk}^s]$ outside the bracket *(.)* means that these knowledge values augment all the variables within the bracketed term *(.)*. Also since θ_{jk}^s qualifies π_j, it at the same time must also qualify π_{jk} in the equation,

$$\pi_j = \Sigma_{k=1}^m \pi_{jk} \text{ and } \pi = \Sigma_{j=1}^m \pi_j. \qquad ...... (11)$$

The process-oriented interrelationships among the evolutionary knowledge flows, $\{\theta_{jk}^s\}$, generated by organizational discourse among partners in the light of *sharīʿa* rules, and in the cooperative institution of the organizational *shura*, set the rules of a truly participatory joint venture in Islam. These are the shares shown in equation (9) and the sharing ratios shown in equation (10).

In particular, the appearance of θ_{jk}^s-values in $I_s(\theta_{jk}^s)$ signifies raising of venture capital through extensively participatory processes. $K_{jk}(\theta_{jk}^s)$ signifies direction of the capitalized value of venture capital with extensive participation into productive directions permissible under the *sharīʿa*. $\pi_j(\theta_{jk}^s)$ signifies distribution of profits in the extensively participatory sense. The evolutionary nature of the knowledge-induced processes with discourse and consensus denote the possibilities of re-contracting in the extensively participatory framework of cooperative and coordinated decision-making.

In our *shuratic* process-model of cooperative participation and inter-firm linkages, it is implied that there are micro-*shuras* and thus micro-*shuratic* processes at each of the *(s,j,k)*-levels. Each such linked *shura* can elect its own representatives to higher echelons of interactive *shuras*. Once the initial rule of the *sharīʿa* on distribution of profits and re-contracting are set and accepted by the participants on the premise of the *maqāṣid al-sharīʿa*, the micro-processes interconnect through their feedback in the $(\theta_{jk}^s, I_s(\theta_{jk}^s), K_{jk}(\theta_{jk}^s), \pi_{jk}(\theta_{jk}^s))$-vector. Organizational planning is thus generated through continuous recursion of such feedback. The elements of novelty, search, discovery, and complementarity among diverse possibilities, are thereby causally enriched in such a cooperative and coordinated participatory system. The *shuratic* process of institutional organization shows characteristics similar to Simon's model of managerial decision-making (Simon, 1987).

VIII. Inferences Drawn

We have now formalized a complete system of profit sharing, invoking in it extensive participation by means of endogenous ethical values of cooperative and coordinated decision-making guided by *sharīʿa* rules. In this, we have argued that the pre-Islamic character of sleeping partnership found in *muḏāraba* and *mushāraka* instruments can be removed by introducing extensive participation, in which the value of wages forgone or reinvested in the enterprise can be capitalized in a new m-m sharing mechanism. In such a profit-sharing system there remains no need to make any dichotomous reference to *muḏāraba* and *mushāraka* separately. All that matters is extensively cooperative and coordinated participation as guided by *sharīʿa* rules in a purely Islamic venue where m-m is treated jointly while the ethically benign pre-Islamic flavor in them is removed.

Based on our above formalism, a unified Islamic *muḏāraba* and *mushāraka* profit-and-loss sharing contract can be developed, as shown in equations (9) and (10).

Financial loss-sharing aspect is built into the above-mentioned expressions by the fact that wages foregone or the imputation of labor-time in re-negotiated participatory contracts cannot be returned to the contracting partner. For this reason of risk, it is always advisable for nascent participatory enterprises to be combinations of wage-paying and profit-sharing types, with increasing possibility for re-negotiated contracts.

IX. Some Empirical Observations

Despite the overwhelming emphasis given to *muḏāraba* and *mushāraka* modes of financing in Islamic economics, recent empirical evidence on Islamic venture capital shows that only a marginal importance has been given to these instruments. This is further proof of the fact that not much capital can be raised and mobilized from these pre-Islamic modes of joint venture financing. Some evidence is considered here.

A. Islamic Development Bank and Islamic Banks

Over the 20-year period 1976 to 1996, the Islamic Development Bank has had only 3 projects in profit sharing, one in Somalia and two in the United Arab Emirates. In terms of money, these comprised a mere 0.15% of the total project financing (IDB, 1996).

Recently, IDB has established a number of cooperative projects with Islamic banks in several of her member countries. This Islamic Banks' Portfolio for Investment and Development is a fund jointly established by IDB and Islamic banks along with other participants. Cumulatively, between 1988 and 1996, the share components were as follows. Of the US$100 million total allayed in syndicated operations, IDB's participation was 24.5%, Islamic Banks' Portfolio's 8.7%, IDB Unit Investment Fund's 5.8%, pension funds' 3.5%; other Islamic banks' 57.5%. The syndicated operations have been opened up in only two countries, namely Pakistan and Egypt. They comprise mainly lease and trade operations, indicating that much of the subscribed capital in this portfolio revolves around foreign trade financing operations. The kind of participation in Islamic Banks' Portfolio is based on a *muḏārib* type, whereby IDB acts as the manager of the Islamic Banks' Portfolio.

Because of IDB's fixed rule over the inherent *muḏāraba* and *mushāraka* participation in these ventures, the management of the fund proceeds in the sense of a classical *muḏāraba*. Such a mode of financing has been shown here to be pre-Islamic, in which neither active nor extensive participation, in the sense explained here, exists among all partners.

B. Bank Islam Malaysia Berhad

Bank Islam Malaysia Berhad, one of the most progressive Islamic banks in the world today, quoted the following proportions in their *muḏāraba* and *mushāraka* funds (BIMB, 1994). *Muḏāraba* financing stood at 0.21% in 1993, 0.34% in 1994 of the total financing made to customers. For the same time period, *mushāraka* financing stood at 1.85% and 1.81%, respectively.

The *muḏāraba* and *mushāraka* funds so held by customers did not involve any active participation by the shareholders and stakeholders. The bank acts as the management *muḏārib* (partner) and thus involves itself in the kind of principal-agent contract that we have discussed previously, in which only a sleeping partnership exists. No active participation of shareholding and stakeholding is invoked except to allow major shareholders the privilege of decision-making.

The above two cases of *muḏāraba* and *mushāraka* financing hardly bring out any discernable effect of toward generating productive and participatory linkages in the economy. The picture one derives from this kind of management is that the rules governing the sharing of profits are determined solely among capital owners (shareholders) and financial managers. There is no question of participation by labor as shareholders and stakeholders in the enterprise. The inherent sleeping partnership in the two modes of financing makes the two contracts no different from any profit-participating contracts found to exist in other kinds of financial enterprises, except that the investment outlets are governed by *sharīᶜa* rules.

X. CONCLUSION

We have shown in this paper that the proper instrument for raising and mobilizing Islamic venture capital is centrally premised on a single unified or interactive principle between *muḏāraba* and *mushāraka*. This would be capable of bringing about extensively cooperative and coordinated participation among agents, firms and sectors in view of the socioeconomic relations that interactions generate and by the increase in entitlement and empowerment that arises. Such extensively participatory enterprises were studied elaborately by Vanek (1971). In this context, it may be possible to retain the integrated m-m terminology only if this is understood as a unified financial instrument of extensively cooperative and coordinated participation, as explained in this paper.

Since the central goal of Islamic development financing is to integrate the profitability and developmental perspectives in accordance with *maqāṣid al-sharīᶜa*, resource allocation in such a system follows the rule of developing complementarities across diversity of possibilities. The way toward this end is through knowledge-inducing discourse and its results, as we have explained by means of the *shuratic* process of organization behavior. A substantively new rule of m-m sharing emerges here, one that brings out it the essential ameliorative goal of the *sharīᶜa*.

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An Economic Explication of the Prohibition of *Ribā* in Classical Islamic Jurisprudence

Mahmoud A. El-Gamal*

ABSTRACT

This paper presents an economic argument that the prohibition of *ribā* in classical Islamic jurisprudence can be explained by appealing to pre-commitment and economic efficiency considerations. The starting point is an argument in Ibn Rushd's *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, whose juristic explication of the "objectives of the law" (*maqāṣid al-sharī'a*) in the prohibition of *ribā* is of a highly economic nature. This rare instance of economically sophisticated discussion of the *Maqāṣid* anticipates not only neoclassical economic notions of efficiency, but also recent studies of "law and economics." Building on the intuition provided by Ibn Rushd, mainly with respect to the prohibition of *ribā al-faḏl*, it is argued that various legal methods of avoiding *ribā al-faḏl* are in essence pre-commitment mechanisms ensuring economic efficiency through "marking to market." The analysis is extended to *ribā al-nasī'a*, utilizing recent experimental results on individual discounting anomalies. The assumptions of the model are supported by verses from the Qur'ān as well as experimental evidence. Given those assumptions, individuals are known to exhibit dynamically inconsistent behavior. The logic of the prohibition of *ribā al-nasī'a* in this case endorses the use of pre-commitment mechanisms inherent in equity-based financing, which are efficiency enhancing in the presence of dynamically inconsistent agents.

I. INTRODUCTION

The prohibition of *ribā* in Islam is perhaps the most commonly studied topic in Islamic economics and finance. Any attempt, therefore, to provide a fresh perspective on this issue must initially seem futile. This paper attempts to provide several motivations for this study, which hopefully covers the range of potential readers.

A. The Prohibition of *Ribā* Is Not Only about Exploitation

While the prohibition of *ribā* is partly in order to prevent rich creditors from exploiting poor debtors, this is not the only reason. The exploitation explanation has, in the past, been challenged by questions such as "How can I be exploiting the U.S. government by buying its T-bills?" or "Am I exploiting IBM if I buy its bonds?" While such dismissive questions do not merit much attention, they certainly point to the fact that the prohibition of *ribā* cannot be explained simply as a prevention of the exploitation of the poor.[1]

At the other extreme, some have used this incomplete understanding of the prohibition of *ribā* to argue that interest charged and paid by banks today is not prohibited. It has been argued by, for example, Tantawi (*Al-Ahram*, 1989), the past *Mufti* of Egypt and current Shaikh-ul-Azhar, and by Wasil (*Al-'Ittihad*, 1997), the current *Mufti* of Egypt; both of whom have issued controversial *fatāwā* on this issue, that conventional banking interest is a share in the profits of growth-inducing investments, and not the forbidden *ribā*. Not only is this argument built on an incomplete understanding of the prohibition of *ribā* based on exploitation, it also ignores the fact that much of the *ribā* used in pre-Islamic Arabia was indeed for commercial and business financing (cf. Al-Salus, 1998, vol.1, p. 29). This is in contrast to the European view of "usury" (a common but faulty translation of the term *ribā*), which evokes the image of exploitative consumption loans.

The issue is sometimes complicated by negligent interpretations of the verses of prohibition of *ribā* in the Qur'ān. For instance, one of the most popular translations of the meaning of the Qur'ān, (Yusuf Ali, 1991), translates the meaning of verses 2:278-279 thus:

> *278. O ye who believe! Fear God, and give up what remains of your demand for usury, if ye are Indeed* believers.
> *279. If ye do not, take notice of war from God and His Messenger: but if ye turn back, ye shall have your* capital *sums; deal not unjustly, and ye shall not be dealt with unjustly.*

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* Professor (Chair) of Islamic Economics, Finance, and Management and Professor of Economics and Statistics, Rice University, Houston, Tex.

Thus, the English reader who is not familiar with the end of verse 279 "*la taZlimuna wa la tuzlamun*," reads this translation as a proof that the sole objective of the prohibition of *ribā* is the avoidance of injustice (in the sense of exploitation of the poor debtor by the rich creditor). However, the meaning of the ending of the verse—as explained by Abu Ja`far, Ibn `Abbas, and others (cf. Al-Tabari, 1992, vol. 2, pp. 109-110)—is much closer to "if you turn back, then you should collect your principal, without inflicting or receiving injustice." The exegetes (ibid.) then explain the phrase "without inflicting or receiving injustice" to mean "without increase or diminution," where both an increase or a decrease in the amount returned relative to the amount lent is considered injustice.

An examination of this standard explanation shows that "injustice" here is a symmetric relation, which depends only on the lent sum and *not* on the relative wealth of the parties, or their respective positions as creditor and debtor. In other words, the "injustice" mentioned here is economic: there is no valid justification for any given increase or diminution; thus such increase or diminution lends itself to injustice. In Section 2 it is shown that Ibn Rushd provided a more detailed analysis of this notion of inequity or injustice as the rationale for the prohibition of *ribā*. Moreover, while many jurists have argued that *ribā al-fa̱dl* which is forbidden in the Hadith, was prohibited as it may lead to *ribā al-nasī'a*, prohibited in the Qur'ān (cf. the many references in Al-Jaziri, 1986, and Al-Zuhayli, 1997), Ibn Rushd provides a more direct economic argument for why both types of *ribā* contain the same type of injustice. The implications of Ibn Rushd's analysis shall be discussed later in the paper.

B. Not All Interest Is the Forbidden *Ribā*

It is undeniable that interest on loans is the forbidden *ribā al-nasī'a*. The term "interest," however, as used in today's economic and practical language, extends beyond fixed rates of return on loans in kind. To some extent, many Islamic economists recognized that the term "interest" is much more general, leading them to claim that Islam does not accept the notion of a "time value of money." There are many papers on Islamic economics that address the question whether or not Islam recognizes a time value of money, and many conclude that it does not. Assertions by later Islamic economists stem from two notable early denials of time preference and time value of money, cf. Al-Mawdudi (1979, pp. 20-21), and Al-Sadr (1980, p. 639).

Those denials contradict numerous statements by classical jurists of all the major schools that "time has a share in the price" (*lil-zamani HaZZun fi-l-thaman*; cf. Al-Misri (1997, pp. 39-48) for full references and quotations). Indeed, the juristic rulings on the basis of which all Islamic financial institutions have operated in recent years are based on cost-plus sales (*murābaẖa*) with deferred receipt of the price, or leasing (*ijāra*). This increase is justified as compensation to the trader, or financial commercial intermediary, for the cost of deferring the receipt of his compensation. Thus the fact that the same financial firm may sell an item for one price on a cash-and-carry basis and for a higher price on a deferred basis is not un-Islamic, provided that certain conditions are met. Whether or not that increase is called "interest" is sophistry, unworthy of serious academic discourse, and conducive to the type of skepticism about Islamic finance witnessed in recent years.

C. Not All *Ribā* Is Interest

While proving the previous point—that interest payments in the general sense are not necessarily *ribā*—required references to Islamic Jurisprudence, this point requires nothing more than quoting a well-known Hadith. This Hadith is narrated in numerous sources, of which we list one (cf. Sakhr, 1995). Muslim narrated on the authority of Abu Sa`id Al-Khudriy; The Messenger of God (peace be upon him) said (my translation):

> *Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt; like for like, hand to hand, in equal amounts; and any increase is* ribā.

This is the famous Hadith prohibiting *ribā al-fa̱dl*. Clearly, the transactions being prohibited here need not involve a temporal element, and therefore the prohibition of this *ribā* is not necessarily related to debts, deferment, or time.

Another Hadith which further illustrates this fact—that prohibited *ribā* and "interest" are not necessarily related—is the story (cf. Sakhr, 1995) Muslim narrated on the authority of Abu Sa`id Al-Khudriy (my translation):

> *Bilal visited the Messenger of God (peace be upon him) with some high quality dates, and the Prophet (peace be upon him) inquired about their source. Bilal explained that he had traded two volumes of lower quality dates for one volume of higher quality. The Messenger of God (peace be upon him) said: "this is precisely the forbidden* ribā*! Do not do this. Instead, sell the first type of dates, and use the proceeds to buy the other."*

The process of selling one type of dates in the market only to use the proceeds to buy the other type may seem to some to be obsessively ritualistic, or a nominal circumvention of the law. However, we shall see in Section 3 that it makes perfect sense in light of the analysis of Ibn Rushd and a direct economic elaboration on that analysis.

II. Ibn Rushd on the Objective Served by the Prohibition of *Ribā*

The *bidayat* argument [vol.3, pp. 183-184] was provided in the context of *tarjih*, a choice of one juristic opinion over another, regarding the set of goods to which the prohibition of *ribā al-faḏl* applies. The Zahiri opinion, not surprisingly, disallowed any reasoning by analogy (*qiyas*) beyond the goods mentioned in the Hadith cited above. The Shafi`is and Malikis, on the other hand, restricted such an inference by analogy to gold and silver (for their use to denominate prices; *thamaniyya*), and foodstuffs, with a further restriction by the Malikis to non-perishable foodstuffs. The Hanafis went to the extreme in reasoning by analogy, generalizing the prohibition in the Hadith to all items measured by volume or weight.

Ibn Rushd, despite being of the Maliki school, found the reasoning of the Hanafis the most compelling. While some contemporary jurists objected to Ibn Rushd's logic due to its dramatic enlarging of the scope of *ribā* (cf. Al-Zuhayly, 1997, vol.5, pp. 3724-3725), understanding the economic content of that logic can help us enhance our understanding of the law, and its economic and juristic implications.[2]

To justify siding with the Hanafi interpretation, Ibn Rushd (1997, vol. 3, p. 184) said (my translation):

> It is thus apparent from the law that what is intended by the prohibition of *ribā* is what it contains of excessive injustice (*ghubn fahish*). In this regard, justice in transactions is achieved by approaching equality. Since the attainment of such equality in items of different kinds is difficult, their values are determined instead in monetary terms (*with the Dirham and the Dinar*). For things that are not measured by weight and volume, justice can be determined by means of proportionality; I mean the ratio between the value of one item to its kind should be equal to the ratio of the value of the other item to its kind. For example, if a person sells a horse in exchange for clothes, justice is attained by making the ratio of the price of the horse to other horses the same as the ratio of the price of the clothes [for which it is traded, tr.] to other clothes. Thus, if the value of the horse is fifty, the value of the clothes should be fifty. [If each piece of clothing's value is five], then the horse should be exchanged for ten pieces of clothing.
>
> As for [fungible] goods measured by volume or weight, they are relatively homogenous, and thus have similar benefits [utilities]. Since it is not necessary for a person owning one type of those goods to exchange it for the exact same type, justice in this case is achieved by equating volume or weight since the benefits [utilities] are very similar…

III. Understanding the Prohibition of *Ribā al-Faḏl* in Economic Terms: Efficiency and Precommitment

We can now understand the economic logic of Ibn Rushd by converting his language to contemporary economic terminology. In the first paragraph, he proclaimed that justice is obtained if and only if the ratio at which non-fungible goods are traded for one another (e.g. clothes for a horse) is the reciprocal of the ratio of their prices. Thus, a horse worth 50 on the market is to be traded for 10 dresses each worth 5 on the market. Justice in this context is simply "marking to market." With very heterogeneous items (e.g. clothes for a horse), Ibn Rushd implicitly argues that it is obvious that the parties to such a transaction would make sure that the ratio at which they trade is close to the ratio of market prices. Moreover, since non-fungibles vary widely in prices (the ratio of the price of this horse to other horses, etc.), such a ratio can only be determined approximately in any case.

The second paragraph talks mainly about fungibles, but sheds significant light on the equality of ratios of barter trading and market prices, and its relationship to economic efficiency. The discussion centers around the ratio of barter trading and the ratio of utilities (benefits) derived by the traders. Combining the two equalities which "justice" requires in the two paragraphs, ratio of barter trade = ratio of prices = ratio of [?]-utilities. The mystery square [?] may be profitably replaced by the term "marginal," as this is clearly the concept Ibn Rushd referred to when discussing the benefits derived from various goods, but lacked the proper language to express it in terms of marginal benefit or utility, writing as he did centuries before the invention of differential calculus.

Considering benefit/utility in the marginal sense, it stands to reason that the ratio at which a barter trade takes place roughly equates the two parties' ratios of marginal utilities of the traded objects (with perfect equality if the goods are perfectly divisible), provided that they have access to many other trading partners. The trade is conducive to economic efficiency if the trading ratio was equal to the ratio of marginal utilities over the entire economy. The latter is ensured in turn by equating the ratio of marginal utilities to the ratio of market prices. This is the condition for Pareto Efficiency in the market. By referring to the first and second welfare theorems of economics, it can be concluded that "justice" dictates that "just" prices and trading ratios are those which maximize allocative efficiency. This does not mean that equality considerations are ignored, for they can be easily addressed ex post through Islamic re-allocative mechanisms such as *Zakah* (thus, the common conjunction of the verses of *Zakah* and *Sadaqah* with the verses of *ribā* in *Al-Rum*, *'Al-`Imran*, and *Al-Baqarah*, can be understood in this light, in addition to the direct contrast between the two terms "*ribā*" and "*Zakah*," both of which lexically mean "increase").

Now, we can also understand the Prophet's (peace be upon him) order to Bilal not to trade dates of low quality for dates of high quality at a mutually agreeable ratio. The second paragraph from Ibn Rushd above clearly states that "it is not necessary for a person" (in this case Bilal) to engage in this exchange. Thus, if he does engage in trading dates for dates, the Hadith says, he should trade in the same quantities. Otherwise, if he considers them sufficiently different to warrant a trading ratio other than one, then he should be forced to "mark to market" what this ratio should be. Thus, he should sell the one type of dates, and collect its price, presumably getting the fair market price for his goods. At this point, he is not obliged to buy from any particular seller, and thus if he uses the proceeds to buy the other type of dates, he will also get the fair market price in the second trade. The net result is, again, the equality of the ratio of [marginal] utilities of the traders to the ratio of market prices, Pareto efficiency, and the maximization of a certain notion of social welfare. Ex-post re-allocations of wealth can then address other notions of social welfare (especially equality) outside the marketplace.

Before moving to *ribā al-nasī'a*, it is useful to highlight the two conclusions derived from the analysis of Ibn Rushd's writings:

1. The objective served by the prohibition of *ribā*—justice—is obtained by fairly compensating each party for the value of its goods as determined by the marketplace. This fair compensation is equivalent to the notion of Pareto efficiency familiar to students of welfare economics. Issues of "fairness" which incorporate equality are not ignored in this context; they are only excluded from the marketplace and handled ex post by re-allocative mechanisms. Further proof for this conclusion is the well-known prohibition in the following Hadith, narrated by Muslim and others (cf. Sakhr, 1995) on the authority of Jabir (my translation):

   The messenger of God (peace be upon him) said: "Let not a city-dweller sell on behalf of an incoming Bedouin. Leave the people so that God may make them benefit from one another."

   The explanation of this Hadith is thus (cf. Al-Shawkani, n.d., vol. 5, p. 164): A Bedouin coming to the market may not know the current market conditions. The prohibition here applies to a city-dweller who knows the market conditions, and asks the Bedouin to allow him to sell on his behalf (thus helping the Bedouin to earn a higher profit). While most discussions of this Hadith refer to the case of a shortage in the market, and the city-dweller helping the incoming Bedouin to keep supply low and prices high, the Hadith in itself is quite symmetric, and "benefiting from one another" is a fixed-sum game in which one person's relative loss is another's gain. The Hadith, indeed, forbids interventions into market conditions that may reduce efficiency (by fostering monopoly as indicated by commentators, or in any other way).

2. The second point is the pre-commitment mechanism recommended in the Hadith of Bilal and its link to the analysis of Ibn Rushd. For fungibles, the rule is that if the same item is to be traded, it should be in equal quantities; otherwise, the prohibition of *ribā al-faḏl* forces the traders physically to "mark to market" the ratio at which they trade. The need for such a pre-commitment mechanism avoids inefficient trades due to lack of complete information about the fair market prices of the two exchanged goods. We shall see in the next section that a similar argument illustrates the efficiency-enhancing role of pre-commitment mechanisms that allow economic agents to avoid *ribā al-nasī'a*.

IV. Efficiency Gains from the Prohibition of *Ribā*, and the Precommitment Mechanisms Inherent in Islamic Financial Contracts

The informational argument that applied to *ribā al-faḏl* applies by extension to *ribā al-nasī'a*. The dimension of time, however, adds at least another source of inefficiency in the market: the tendency for humans to be dynamically inconsistent. We shall shortly review some of the experimental evidence on so-called "discounting anomalies" exhibited by humans (as well as animals), and which result in such dynamic inconsistency. Before we do that, however, it is productive to reference a few of the verses of the Qur'ān which assert that "man," generally speaking, does indeed exhibit such dynamic inconsistency and asymmetric treatment of potential gains and losses (all translations from Yusuf Ali, 1991):

> *If God were to hasten for men the ill (they have earned) as they would fain hasten on the good, then would their respite be settled at once.*
> *When trouble toucheth a man, he crieth unto us, ... But when we have solved his trouble, he passeth* on *his way as if he had never cried to us for a trouble that touched him. Thus do the deeds of transgressors seem fair in their eyes.* [10:11-12]
>
> *They ask thee to hasten on the evil in preference to the good: ...* [13:6]
>
> *(Inevitably) cometh (to pass) the Command of God: seek ye not then to hasten it…* [16:1]
>
> *The prayer that man should make for good, he maketh for evil; for man is given to haste.* [17:11]
>
> *When distress seizes you at sea, those that ye call upon—besides himself—leave you in the lurch. But when He brings you back safe to land, ye turn away [from Him]. Most ungrateful is man.* [17:67]
>
> *Man is a creature of haste: soon [enough] will I show you My Signs; then ye will not ask Me to hasten them.* [21:37]
>
> *He said: "Oh my people! Why ask ye to hasten on the evil in preference to the good?…."* [27:46]
>
> *They ask thee to hasten on the Punishment (for them):…*
> *They ask thee to hasten on the Punishment…* [29:53-54]
>
> *When trouble touches men, they cry to their Lord, turning back to Him in repentance: but when He gives them a taste of Mercy as from Himself. Behold, some of them pay part-worship to other gods besides their Lord…* [30:33]
>
> *Do they wish (indeed) to hurry our Punishment?* [37:176]
>
> *They say: "Our Lord! Hasten to us our sentence (even) before the Day of Account"* [38:16]
>
> *When some trouble toucheth man, he crieth unto his Lord, turning to Him in repentance: but when He bestoweth a favor upon him from Himself, [man] doth forget what he cried and prayed for before…* [39:8]
>
> *Now, when trouble touches man, he cries to Us; but when We bestow a favor upon him as from Ourselves, he says, "This has been given to me because of a certain knowledge [I have]!" ...* [39:49]
>
> *Taste ye your trial! This is what ye used to ask to be hastened!* [51:14]
>
> *Truly, man was created very impatient.*
> *Fretful when evil touches him;*
> *and niggardly when good reaches him.* [70:19-21]
>
> *Nay, (ye men!) But ye love the fleeting life* [literally: *that which is sooner*] [75:20]
>
> *Woe to those that deal in fraud.*
> *Those who, when they have to receive by measure from men exact full measure,*
> *but when they have to give by measure or weight to men, give less than due.* [83:1-3]

Those verses assert four aspects of human behavior: (1) people are impatient, i.e. they discount the near future too heavily; (2) they treat potential gains and losses asymmetrically; (3) they do not follow through with their plans (to repent or otherwise), and, most surprising of all; (4) they wish to "hasten the evil." While this set of irrational dispositions of mankind may strike economists accustomed to working with models of perfectly rational agents as irrelevant, another body of research in economics and psychology independently reached the same conclusions, under the banner of so-called "discounting anomalies."

A. Experimental Evidence of Hyperbolic Discounting and Dynamic Inconsistency

Perhaps the most comprehensive analysis of discounting anomalies to date is that of Lowenstein and Prelec (1992). They classified anomalous experimental findings on the discounting of future benefits and losses into four categories, and then offered a unifying model that accounts for all four anomalies. The four anomalies stated below can be shown to be in accordance with the positive behavioral assumptions we cited above:

1. **Common difference effects:** Individuals have been observed to determine their “time preference” based not only on the period of time between two choices, but also on the distance between the time a choice is made and the time of the two options. For example, Thaler (1981) found that a person may prefer one apple today to two apples tomorrow, while preferring two apples in 51 days to one apple in 50.

   This observation is in agreement with the behavioral implication of the Qur’ānic verses cited above. In the religious domain, humans are criticized for their preference to enjoy material goods immediately, and postponing costly righteous deeds into the future. When young, they see the advantages of righteous deeds in their old age, but are unwilling to undertake them now, even though the rewards of righteous deeds when they are young are higher. Thus, events deferred one year in the immediate future are discounted much more heavily than ones deferred one year in the distant future are. This is the common difference effect.

2. **Absolute magnitude effects:** Large benefits suffer less discounting than smaller ones. Thus, Thaler (1981) found individuals may on average be indifferent between $15 immediately and $60 in a year; and be on average indifferent between $3000 immediately and $4000 in a year. This result was replicated with different designs. The verses 75:20-21 assert: “Nay, (ye men!) but ye love the fleeting life [that which is sooner] and leave alone the hereafter.” Similarly, verse 76:27 asserts: “as to these, they love the fleeting life [the one that is sooner] and put away behind them a day (that will be) hard.” The behavior depicted in these verses is consistent with high discounting for lower benefits (of this fleeting life), but low discounting for higher benefits associated with higher pursuits. Other things being equal, such behavioral distortions would make the individuals invest an excessive amount of effort to obtain material benefits as soon as possible, but delay working for higher payoffs to later times.

3. **Asymmetry between gains and losses:** Individuals were observed to discount losses less severely than they discounted gains. An extreme case was found in Thaler (1981), where several subjects exhibited negative discounting of losses, preferring an immediate loss to a later loss of equal value. This “anomaly” is in perfect agreement with Qur’ānic assertions about irrational human behavior quoted above. Verse 10:11 explicitly disparages humans for different treatment of gains and losses. The extreme form of this anomaly, where individuals prefer immediate loss to later loss of equal value corresponds to the verses which refer to “hastening the evil” and “hastening the punishment” (vv. 13:6, 27:46, 29:53-54, 37:176, 38:16, 51:14). Such behavior gives rise to dynamically inconsistent behavior, which is precisely the implication that the cited verses carry. Implicit, thus, is an understanding that dynamic consistency is normatively desirable, as contrasted with the positively verifiable dynamically inconsistent behavior.

4. **Asymmetry of delays and speedups:** Subjects were found in Lowenstein (1988) to discount delays more heavily speedups. Thus, the compensation they demanded to accept a delay of consumption was two to four times the amount they were willing to sacrifice in order to speed-up consumption over the same period. This asymmetry to be similar to many preference reversals (cf. Tversky, Slovic, and Kahneman, 1990) where individuals demand more compensation for an object if they own it than they are willing to pay if they don’t. This is the behavior described in verse 83:3 as well as others. When individuals are in possession of an object, even the infinite “Treasures of the Mercy of God,” they “hold back for fear of spending them” (17:100). Thus, they always demand more for what they hold than what they truly think it is worth. On the other hand, when people do not possess an object, and when asked how much of what they have they are willing to exchange for the object, they will always be willing to pay less than what they have. The two attitudes are opposite sides of the same coin, and are characterized by the fear of not being sufficiently compensated for one’s possessions. When applied to delays and speedups, one may interpret a delay as giving up the time value of the goods whose delivery is being delayed, and speedups as obtaining that time value. Asymmetric pricing of that “time value” depending on whether one “has it” or not is yet another manifestation of preference reversals.

Lowenstein and Prelec (1992) then provide an objective function such that consumers who maximize it will exhibit behavior in accordance with the four "anomalies" listed above. They thus replace the standard Samuelsonian preferences over $n+1$ consumption bundles $\{x_0,\ldots,x_n\}$ to be consumed at time periods $t=0,\ldots,n$. The standard preferences would be represented by a concave function $u(.)$ and a discount factor $\delta \in (0,1)$, where the consumer would maximize:

$$U(x_0,\ldots,x_n)=\sum_{t=0}^{n}\delta^t u(x_t)$$

Instead, the value function of Lowenstein and Prelec (1992) over $n+1$ consumption bundles $\{x_0,\ldots,x_n\}$ to be consumed at time periods $\{t_0,\ldots,t_n\}$ will take the form:

$$U(x_0,t_0;\ldots;x_n,t_n)=\sum_{i=0}^{n}\phi(t_i)\upsilon(x_i)$$

where $\nu(x)$ is a "value function," and $\phi(t)$ is a "discount function." For those preferences to admit the four sets of anomalous discounting behavior, the value and discount functions must satisfy the following five conditions (cf. Lowenstein and Prelec, 1992, pp. 578, 580, 582-584):

- **R0**. All choices are defined as deviations from a "reference point." Thus, the arguments x_i in the above objective function are interpreted as "prospects" (following Kahneman and Tversky, 1979), or deviations from some anticipated status quo plan.
- **D1**. The discount function is a generalized hyperbola:
$$\phi(t)=(1+\alpha t)^{-\beta/\alpha};\alpha,\beta>0$$
- **V1**. The value function is steeper for losses than it is for gains:
$$\nu(x)<-\nu(-x)$$
- **V2**. The value function is more elastic for losses than for gains:
$$d\log(\nu(x))/d\log(x)|_{x=y>0}<d\log(\nu(x))/dx|_{x=-y<0}$$
- **V3**. The value function is more elastic for more extreme outcomes:
$$d\log(\nu(x))/d\log(x)|_{y}<d\log(\nu(x))/dx|_{z};0<y<z\,||\,z<y<0$$

B. Model

Now, consider an individual who fits the description provided in the cited verses and the experimental evidence. Let this individual's horizon be divided into three periods: t=1,2,3. In periods 1 and 2, the person receives no profits from his investment project but, in period 3, receives profits \$A\$. Assume further that this individual wishes to maximize a utility function in extra consumption prospects:

$$U(c_1,c_2,c_3)=u(c_1)+\phi(1)u(c_2)+\phi(2)u(c_3)$$

Since the person has no profits in periods 1 and 2, he wishes to finance some of his business costs in those two periods to free-up funds for extra consumption during those two periods. In a loan-based environment, he faces a banking sector with three interest rates:

(A.0) $R^b < R^s < R^l$

where R^l is the periodic interest rate on long-term loans (2 periods), R^s is the periodic interest rate on short-term loans, and R^b is the interest rate the agent would receive if he deposits savings in the bank.

The agent must first decide whether to acquire a short-term loan or a long-term loan. A short-term loan taken in either period 1 or 2 will be repaid in the following period with interest at $(1+R^s)L_{short}$, and a long-term loan made in period 1 is due in period 3 at $(1+R^l)^2 L_{long}$.

Theorem 1: *Under* **(A.0)***, an individual will choose to take two short-term loans in periods 1 and 2 rather than one long-term loan in period 1.*

Proof: If the agent selects the long-term loan, he would solve the problem:

$$\max_{L,S_1,S_2}\{u(L-S_1)+\phi(1)u((1+R^b)S_1-S_2)+\phi(2)u(A+(1+R^b)S_2-(1+R^l)L)\}$$

where S_1 and S_2 are the amounts he saves in periods 1 and 2, respectively, and on which he earns interest rate R^b. He takes a loan L in period 1, and pays it off at compounded long-term interest $(1+R^l)^2 L$ in period 3.

If the agent selects instead to choose two short-term loans, then he solves the problem:

$$\max_{L_1,L_2}\{u(L_1)+\phi(1)u(L_2-(1+R^s)L_1)+\phi(2)u(A-(1+R^s)L_2)\}$$

where L_1 and L_2 are the loans he takes in periods 1 and 2, respectively, and on each of which he pays interest rate R^s.

We now prove that the agent can do at least as well with two short-term loans as he can with one long-term loan. Toward that end, let L^*, S_1^* and S_2^* be the optimal choices the agent can make when taking a long-term loan. Notice that it is quite feasible for the agent to set:

$$L_1 = L^* - S_1^*,$$

and

$$L_2-(1+R^s)L_1=(1+R^b)S_1^*-S_2^*.$$

In other words, the agent can match the first and second period consumption that the optimal long-term loan plan can achieve. We now show that under (A.0), he will have higher consumption in the third period (and therefore higher utility in that period and overall) if he takes two short-term loans.

We solve for the two levels of c_3 under the scenarios of optimal long-term loan, and the feasible short-term loan that matches the first two periods of consumption, denoted c_3^L and c_3^S, respectively (by substituting for L_2 and L_1 from above):

$$c_3^L = A+(1+R^b)S_2-(1+R^L)^2 L,$$

$$c_3^S = A-(1+R^b)(1+R^s)S_1^*+(1+R^s)S_2^*-(1+R^s)^2L^*+(1+R^s)^2S_1^*.$$

Since $R^s > R^b$ by **(A.0)**, we get:

$$c_3^s > A+(1+R^s)S_2^*-(1+R^s)^2L^*.$$

By (A.0), $(1+R^s)\ S_2^* > (1+R^b)\ S_2^*$, and $(1+R^s)^2\ L^* < (1+R^L)^2\ L^*$. Thus, $c_3^S > c_3^L$. This proves that a feasible plan of two short-term loans can provide more lifetime utility to the agent, and therefore the agent can always do better under the short-term-loans scenario.

For the next result, the following assumption must be made:

(A.1) In the consumption levels chosen by the consumer under either scenario, $u'(.)>0$ and $u''(.)<0$ both exist.

This assumption (positive but diminishing marginal utility of consumption) is standard in traditional economic analysis. Now that we know from Theorem 1 that the agent will choose to take two short-term loans, we prove the next result:

Theorem 2: *Under* **(A.1)***, the agent's borrowing in the second period will be more (less) than originally planned, depending on whether* $\phi(2)/\phi(1) > (<) \phi(1)$.

Proof: In period 1, the agent chooses L_1* and L_2* to solve the two first order conditions:

$$u'(L_1) = \phi(1)(1+R^s)u'(L_2 - (1+R^s)L_1),$$

and

$$\phi(1)u'(L_2 - (1+R^s)L_1) = \phi(2)(1+R^s)u'(A - L_2(1+R^s)).$$

In period 1, the agent follows through with his plan, thus borrowing the amount L_1* which solves the two above equations. However, in period 2, instead of following through with the L_2*, he takes L_1* as given, and chooses $L_2^{\#}$ to solve the new first order condition:

$$u'(L_2^{\#} - (1+R^s)L_1^*) = \phi(1)(1+R^s)u'(A - L_2(1+R^s)).$$

To compare the $L_2^{\#}$ and L_2* resulting from solving the last two equations, we rewrite the middle equation as follows:

$$u'(L_2 - (1+R^s)L_1^*) = \frac{\phi(2)}{\phi(1)}(1+R^s)u'(A - L_2(1+R^s)).$$

If $\phi(2)/\phi(1) < \phi(1)$, the term multiplied against $(1+R^s)\, u'(A-L_2(1+R^s))$ on the right hand side is smaller for the re-written second equation than it is in the third. Notice, moreover, that the derivative term on the left-hand-side is decreasing in L_2, while the one on the right-hand-side is increasing in L_2. Thus, to keep the equality, it follows that the L_2 solving the re-written second equation is smaller than that solving the third. In other words, the person will borrow more in period 2 than he originally planned in period 1.

Conversely, if $\phi(2)/\phi(1) > \phi(1)$, the person will borrow less than he had originally planned.

Notes:

- If we replace **(A.1)** by an assumption that $u(.)$is convex in the relevant range under all scenarios, we reach the mirror-image result of more borrowing than planned if $\phi(2)/\phi(1)<\phi(1)$$, and vice versa. If we mix the concave and convex regions, we can get any combination of results. The illustration in Theorem 2 of the concave u case was motivated by the familiarity of the diminishing marginal utility/risk aversion model in mainstream economic theory.
- The usual economic discounting model $\phi(1)=\beta$, $\phi(2) = \beta^2$, would render $\phi(2)/\phi(1)= \phi(1)$, and result in no dynamic inconsistency of behavior (the ex post and ex ante F.O.C.s for the second period become identical). However, allowing for more general (and more realistic) discount functions, we get dynamically inconsistent behavior where the agent chooses to deviate in period 2 from the plan he made in period 1.

The most popular solution for dynamically inconsistent agents, who are aware of this shortcoming, is to induce some sort of pre-commitment mechanism to make sure that they will follow through with their plans. In the following subsection, we consider the same agent's problem if he is restricted to a class of Islamic financial instruments.

C. Islamic Financial Contracts and Pre-commitment

We now consider the types of financial contracts available to our hypothetical agent, which fall in two categories:

1. **Debt-based contracts:** Perhaps one should defend the use of "debt-based" in the title summarizing this type of contracts. The contracts considered here include cost-plus financing of purchases (*murābaha*), leasing (*ijāra*), etc. Such contracts are "debt" or "liability" (*dayn*)-based in the sense that the seller or financial institution's compensation in such transactions is established as a liability on the buyer or client (*thabit fi al-dhimmah*). In this sense, while those contracts are explicitly not loans, they are debt-based since one party's compensation is a liability on another.

   While those contracts would, in principle, be able to mimic precisely the short and long-term loans the agent could obtain in the interest-based market, there is a significant difference that renders the results of Theorems 1 and 2 inapplicable. While assumption **(A.0)** is quite reasonable for standard market conditions, where the term-structure of interest rates is upward sloping, it need not apply here. The implicit "interest" rates on short- and long-term *murābaha* or lease are not simply a function of time and aggregate anticipated market conditions. Instead, such implicit rates (which Islamic banks operating in the U.S. are legally required to disclose to their clients) will be linked to the specific physical object being financed, used as collateral.

   Longer-term financing will typically be associated with more valuable assets with lower depreciation rates (e.g. buildings, machinery, etc.). Thus, it is quite conceivable that the implicit "long-term interest rate" facing our agent can be lower than its short-term alternatives generated by financing smaller and more perishable items. If that is the case, then the agent will not be tempted to engage in two short-term financing contracts instead of one long-term contract, thus avoiding the potential for dynamically inconsistent behavior. However, such results are by no means guaranteed in this context, especially if debt-based Islamic instruments mimic conventional ones, as discussed below.

2. **Equity-based contracts:** Since the agent will only begin to collect profits in the third period, equity-based contracts (e.g. silent partnership *mudāraba*, or full partnership *mushāraka*, etc.) only allow the agent to receive sums of money in periods 1 and 2 in exchange for a share in his profits to be realized in period 3. The agent in this case will engage in an agreement with the financial intermediary for their share in his firm's expenses in periods 1 and 2, and the share they get in his profits in period 3.

   In this context, the agent's productive activity is viewed as a single firm, and the partner (whether silent or active) has a right to the capital of the firm and its stream of profits (in this case materializing only in period 3). Thus, the agent does not have the right freely to alter his financial flows in period 2 and obligations in period 3 without the agreement of his partners. Insofar as those partners do not suffer from the same dynamic inconsistency as the agent, this eliminates the potential for efficiency losses due to dynamic inconsistency.

D. The Choice of Equity-based Contracts and Pre-commitment

An easy solution may be obtained if we can claim that the implicit interest rate in long-term equity financing is lower than both short-term and long-term interest rates. There are many theoretical and empirical justifications one can give for such an assumption. The higher control and availability of information to the partner as compared with a lender can be sufficiently large to justify such an assumption. It would then be routine to prove the converse of Theorem 1, and to conclude that equity financing will be optimal for all agents, Islamically constrained, or otherwise. While such a conclusion may be ideologically pleasing, it contradicts the observed behavior of agents (Islamically constrained or otherwise) as well as Islamic financial organizations.

A more realistic assumption would be obtained by augmenting (A.0) as follows:

$$R^b \cong R_I^b < R^s \cong R_I^s = R_{eI}^1 < R^1 \cong R_{dI}^1,$$

where R^b, R^s and R^l are, as before, the deposit, short-term borrowing, and long-term borrowing interest rates. The debt-based Islamic counterparts of the above listed three interest rates, labeled $R^b{}_I$, $R^s{}_I$ and $R^l{}_{dI}$ are obtained through different legal contracts, but tend empirically to be very close to their non-Islamic counterparts.

The only distinct new rate of return in this equation is $R^l{}_{eI}$, which is the long-term "interest rate" implicitly calculated from an equity-based Islamic financial contract. The increased control and information availability makes the rate of return required for such contracts lower than long-term interest rates on significantly riskier loans. On the other hand, the Islamic financial institution does not distinguish between the annualized equity-based rate of return it collects on short-term versus long-term investments, thus making $R^s{}_I = R^l{}_{eI}$. Theorem 1 still applies in this case, with the individuals now (virtually) indifferent between seeking short-term debt-based financing (Islamically or otherwise) and a long-term equity-based financing from a financial point of view. We add to this the non-financial considerations of entrepreneurs, and we can still explain the current preference of debt-based financing by Islamic economic agents. Moore (1997) cites a recent survey of 222 companies in 6 manufacturing sectors of Saudi Arabia, where 83.4% of respondents rejected *mushāraka* contracts and 78% rejected *muḏāraba* contracts, in preference of sole-ownership. However, as we have seen, firms thus restricting themselves to debt-based financing methods will, in general, be subject to efficiency-reducing dynamically inconsistent behavior.

One prescriptive approach, which has been advocated in much of the Islamic economic literature, is to advocate equity-based financing methods as "more truly Islamic," thus forcing the more devout firm owners to choose $R^l{}_{eI}$, which will be to their advantage in our model. Another solution is to allow Islamic financial institutions to endogenize the dynamically inconsistent behavior of their debt-based clients, thus charging $R^l{}_{eI} > R^s{}_I > R^s$. If the loss due to dynamic inconsistency outweighs the Muslim firms' aversion to external control, this can induce them to prefer the time-consistent plan of seeking long-term equity-based financing. However, it is understandable why Islamic banks will shy away from such a pricing scheme, in their efforts to mimic conventional banks which compete for a portion of their clientele (cf. El-Gamal, 1998).

The first prescriptive approach would yield the socially optimal choice of $R^l{}_{eI} \cong R^s$, which is tantamount to the optimal choice under R^s together with a pre-commitment mechanism which disallows agents from breaking their own plans. This prescription is often justified in the literature based on one of two assumptions:

1. Anything which is similar to conventional banking *ribā* must be less Islamic. Juristically, such an argument can be based on the principle of *sadd al-dhara'i`* (closing potential avenues for circumvention of the law).
2. A vast portion of the Islamic economic literature is devoted to macroeconomic models which illustrate the superiority of an equity-based economy to one which is debt-based, in terms of stability, growth potential, equal access to capital markets for rich and poor entrepreneurs, etc.

In this sense, this paper can add a small contribution to the latter literature by noting that the pre-commitment inherent in equity-financing can also be welfare enhancing on a project-by-project basis, if entrepreneurs are feared to exhibit dynamically inconsistent behavior.

V. Conclusion

We have seen that the prohibition of *ribā* can be explained in terms of efficiency-enhancing enforcement of economic-agents' pre-commitment. While the argument of Ibn Rushd, if taken to its logical extreme, can severely enlarge the scope of forbidden *ribā* (cf. Al-Zuhayly, 1997, vol. 5, pp. 3724-3725), it highlights the purpose of the prohibition and encourages agents to adopt its spirit of marking the ratio at which they trade in barter to the ratio of market prices. Similarly, while it is difficult to argue on purely juristic grounds that equity-based financing is "more Islamic" than debt-based financing when the latter meets all the conditions postulated by jurists, the economic logic of pre-commitment can support the position long adopted by Islamic economists that equity-based financing is preferred to its debt-based counterparts.

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[1] The opinion of 'Ibn Kaysan that "the reason (*al-maqsūd*) for the prohibition of *ribā* is kindness toward people" (i.e. by not charging an increase) was reported and debunked [*far^c fi Madhahib al-^culama' fi bayan ^cillat al-ribā fi al-ajnas al-arba^ca* vol. 9], since this logic would extend incorrectly to profit-making and the explicit permission to trade different genuses in different quantities, as well as trading non-fungibles (e.g. camels) in different quantities.

[2] The text that appears in vol. 3 pp. 183-184 (*bidayat*) appears verbatim in vol. 3 pp. 258-9 (footnote on "*al-farq al-tisuna wa al-mi'a bayna qa^cidat ma yadkhulhu ribā al-fadl wa bayna qa^cidat ma la yadkhulhu ribā al-fadl*") (R24). In fact, stronger economic arguments for enlarging the scope of *ribā* were made elsewhere by Al-Hasan and Ibn Jubayr, as reported in [ibid.] (R31), and rejected due to disagreement with texts permitting trading in different quantities for different genuses. In this regard, Al-Hasan's reported opinion equates the reason for prohibiting *ribā* when trading in different quantities to trading items of different value, while Ibn Jubayr went as far as requiring equality of [marginal?] utilities (*manfa^ca*) of traded goods. Those arguments are indeed juristically stronger versions of the argument of Ibn Rushd on which this paper is based, but they share the same economic logic, as discussed below.

Islamic Banking and the Conduct of Monetary Policy

Lessons from the Islamic Republic of Iran

Ramin Cooper Maysami[*]

ABSTRACT

Following its Islamic revolution of 1979, the Islamic Republic of Iran has undergone a comprehensive reform of its once traditionally interest-based banking system to conform to interest-free banking principles. This article begins with a review of the stated duties of the banking system under the Iranian Islamic banking laws; it then surveys authorized banking facilities and means and methods of providing credit in the country. Various instruments of monetary policy as employed in the I.R. Iran are also discussed. These include those instruments common to both traditional and Islamic systems, and those instruments of monetary policy unique to an interest-free system. The paper concludes with a discussion of common modes of bank financing in the Iranian model, exploring ways in which the central bank may use these modes of financing to conduct economic policy.

I. INTRODUCTION

Islamic banking prohibits the payment of a predetermined interest. This leads to a seemingly valid question as far as monetary policy is concerned: how would the monetary authorities exert control over the banking system without the interest mechanism?

> "With the elimination of interest from all banking operations, one of the most basic policy instruments is out of the domain of the monetary and credit authorities. In the traditional banking system, any change in interest rates by the central bank, more or less, would lead to a similar change in the market rates of interest in general and the banks' rates of interest in particular. In the absence of interest, the monetary authority, in addition to classical instruments of monetary policy must rely on a few distinct but inter-related instruments such as the minimum expected rate of profit, profit ratios, and profit margins to influence the economy."[1]

This article aims to address the means of monetary policy available to the central bank in the absence of the interest rate mechanism. The paper begins with a brief introduction to the concept of Islamic banking and presents the Islamic alternative—the profit-and-loss-sharing scheme. Various instruments of monetary policy are then discussed, including those instruments common to both traditional and Islamic systems, and those instruments of monetary policy unique to an interest-free system. The paper concludes with a discussion of common modes of bank financing with which the central bank in an Islamic system may supplement monetary policy tools in conducting economic policy.

II. BANK REGULATIONS IN IRAN[2]

In the Islamic Republic of Iran, the *Law for Usury-Free Banking* was passed by the parliament in August 1983, defining the objective of the banking system as "the establishment of a monetary and credit system based on rightness and justice as delineated by Islamic jurisprudence for the purpose of regulating the sound circulation of money and credit to enhance the health and growth of the country's economy."[3] Additional objectives of the banking system are stated as the employment of appropriate monetary and credit mechanisms to achieve the government's economic goals, policies, and plans; the creation of facilities necessary for the public extension of cooperation and *Quard al-Hassana*; the attraction and absorption of surplus funds, reserves, savings and demand deposits; the maintenance of the currency value along with equilibrium in the balance of payments; and the facilitation of commercial exchanges.

The law goes further to define the duties of the banking system as a whole to include such traditional functions as issuance of notes and coins, regulation, control and guidance of the circulation of money and credit, performance of all banking operations in foreign exchange and local currency, and the implementation of monetary

[*] Assistant Professor, Nanyang Business School, Singapore.

and credit policies. In addition, the banking system is made responsible for the opening of various *Quard al-Hassana* accounts, acceptance of term investment deposits, and the distribution of loans and credits free of interest charges.

A. Authorized Banking Facilities

To promote the activities of various productive, commercial and services sectors, banks may provide a portion of the capital and/or resources required by these sectors on a partnership basis. They may directly invest in productive and development projects or activities as long as the evaluation of the project indicates no loss. Banks, however, are not allowed to invest in the production of luxury and non-essential consumer goods. In addition, to provide facilities required for the expansion of commercial activities, banks may put the necessary financial resources at the disposal of the customers on the basis of *Muzara'a*. They, however, may not enter into a *Muzara'a* contract with the private sector for imports.

In promoting the expansion of industry, mining, and agriculture, banks are empowered to purchase movable properties and to sell them to customers on a secured basis and on installment terms. Banks may additionally purchase either movable or immovable properties and place them at the disposal of the client in accordance with hire-purchase arrangements. Similarly, for the purpose of providing facilities necessary for the expansion of housing activities, banks may be involved in the construction of low-priced residential units for sale on installment or hire-purchase.

Provision of working capital needed by the productive units is allowed through banks' purchases of raw materials and spare parts needed by productive units and their resale to the said units on credit, and on the basis of forward purchases of the said units' easy-to-sell products. Finally, banks are obliged to provide a portion of their resources as *Quard al-Hassana* to applicants. The procedures for enforcement of this requirement are determined by the central bank of Iran—Banke Markazi—and must be approved by the Council of Ministers.

Banks may engage in authorized banking operations with state-owned institutions, government-affiliated organizations, and public corporations. In its dealings with other banks, Banke Markazi is not authorized to engage in banking operations that involve usury, nor are banks to do so among themselves. Any funds received as commissions and fees constitute a bank's income and cannot be divided among the depositors. Exemption from commercial tax, and/or tax exemptions granted by law to factories and productive enterprises also apply to banks when they act as agents in matters of import or ownership.

B. Mobilization of Financial Resources

General liabilities of a bank comprise *Quard al-Hassana* with no accrued returns, and Term Investment Deposits. Banks are authorized to accept two types of term investment deposits: short-term investment deposits, which enable the depositors to use their funds as they wish; and long-term investment deposits, which based on the stipulated incentives for such deposits must be placed with the bank for at least one year. These deposits, over which the bank enjoys the power of attorney, must be used in joint ventures, *Muzara'a*, hire-purchases, installment transactions, *muḏāraba*, *Musqat*, direct investment, forward dealings, or *Jo'ala* transactions.[4]

Accrued profits resulting from a bank's credit operations may be divided between depositors and the bank in proportion to duration and amount of term investment deposits, and with due observance of the bank's share of resources in total funds utilized for such operations. However, banks may not announce or pay any pre-determined sum as profit to any term investment deposits. For the acceptance of the term investment deposits, banks may receive attorney's fees from the depositors' share of the profits, based on maximum and minimum rates dictated by the Currency and Credit Council. To attract such current and saving deposits, banks may in turn offer incentives such as non-fixed prizes and bonuses in cash or in kind, discounted commissions or fees, and priority in use of banking facilities.

C. Methods for Provision of Credit Facilities

Provision of credit facilities out of the deposits received by banks can be based on one of the following methods: partnership (civil and legal), direct investment, *muḏāraba*, installment sales, hire-purchase, sales on credit, forward delivery transactions, *Quard al-Hassana*, *Jo'ala*, *Muzara'a*, and *Musqat*. Moreover, credit facilities must be provided in such a manner that the principal amount as well as any expected profit be returnable within a specific period of time. The determination of the minimum and maximum rates of profit and/or of the expected rate of return on the credit facilities provided by banks is a matter of government policy. The determination of the period over which banks provide credit facilities and the details of the return of the principal together with any profits are similarly approved.

Banks must supervise the proper performance of the concluded contracts with regard to both the procedures of utilization and the return of credit facilities provided. The provision of facilities is contingent upon a sum of money entitled "Advance Deposit," the determination of which depends on sufficient security to safeguard the interest of the bank and the satisfactory performance of the respective contracts. When dealing with properties that, in the opinion of the bank, have limited, exclusive, or sub-economical utilization, the bank can grant facilities after taking additional security.

Finally, the joint provision of credit facilities by two or more bank to individuals or to legal entities is authorized under any one of different types of facilities. The administration of such facilities would be undertaken by one bank as chosen by the participating banks. During the term of the contract, banks must arrange for the annual insurance of properties and/or the securities obtained in respect thereof, for an amount at least equivalent to the outstanding balances due from the provision of such facilities.

III. The Central Bank and the Conduct of Monetary Policy

Monetary authorities operating under the Islamic banking system must continue to have regulatory powers over the banking system and financial operations in the economy. In order to ascertain the allocation of resources in conformity with the priorities of the society, and to direct monetary policy toward specific areas of activities and other policy objectives, the central bank should retain control of high-powered money and the money-creating ability of banks. Under an Islamic banking system, where interest as a classical instrument is removed from the banking system, such objectives may be achieved both through general instruments of monetary policy as known in traditional banking, and certain other instruments applicable to profit-and-loss-sharing activities.

A. Islamic Banking and Traditional Instruments of Monetary Policy

Imposing reserve requirement against private bank deposits and various other liabilities does not violate the requirements of Islamic banking. The central bank could impose such an obligation on banks in order to execute its control over monetary expansion through the absorption of banks' resources, which could otherwise be used for the expansion of credit. In Iran, the required reserve ratio of "no less than 10 and no more than 30%," in effect since 1972, remained effective even after the metamorphosis of the traditional banking system in 1980. Some Iranian economists have even proposed a 100% reserve requirement ratio against demand deposits of the private sector, hoping that fluctuations of the rate of profit in the usury-free banking operations would not weaken the payment system.[5]

Open-market operations may be considered the most important monetary policy instrument in countries with a well-developed financial market. This instrument, however, cannot be used effectively in countries where financial markets are still undergoing development unless some adjustments are made in its execution. In Iran, to conform to Islamic banking principles and to avoid pre-determined interest payments, investment deposits may only be utilized through Islamic contracts, after deducting required reserves. It is nevertheless compulsory for banks to hold government securities against certain liabilities. The problem is that while the charging and payment of interest among government entities is not considered *usury* and is permitted, any financial contract between government and the public must be based on profit-and-loss-sharing principles. As such, the public can finance only profitable government projects, and in the case of private banks only this form of financing is possible.

Under an Islamic banking system, the central bank remains the lender of last resort and should be able to provide any required liquidity in case the need arises and banks find themselves in need of liquidity. Nevertheless, discount rate policy is not broadly applicable in Islamic banking as it is in the traditional banking system. Discounting true bills, issued based on a real transaction, however, is permissible under the *sharīʿa*; this instrument is applicable in an Islamic banking system with certain qualifications. Since any changes in the terms and conditions of extending such facility would have an impact on the monetary conditions of the economy, it is used as an instrument of monetary policy under Iran's Islamic system of banking.

Imposing credit ceilings is another effective instrument in the execution of monetary policy and in directing credit to desired areas. In Iran, Banke Markazi imposes ceilings on the growth of credit and limits facilities extended to the whole or certain sectors of the economy, in order to prevent the total credit, and thus the money supply, from exceeding the target level. Additionally, to abide by the priorities set in the economic plan, the central bank uses this instrument in allotting credit and facilities to different sectors of the economy. Although this instrument could be quite effective in controlling liquidity and allocation of credit according to priorities set, it has proven difficult in Iran to supervise banks to ensure their observance of the regulations. In fact, lack of appropriate supervision could leave the goal of the policy-maker unachieved.

B. Instruments of Monetary and Credit Policy Unique to Islamic Banking

Under the banking laws of Iran, several methods may be, and are, used in providing credit facilities. They are divided into two broad categories: first, the instruments that implement the policies of Banke Markazi by increasing and decreasing the volume of savings, primarily aiming to increase *Quard al-Hassana* deposits. These monetary policy instruments include prizes and rewards granted in relation to interest-free deposits, discounts, or the exemption of holders of these accounts from banking charges and/or commission fees, and required reserve ratios.

Adjustments in reserve ratios complement the instrument of commission fees for managing the deposits through regulation of the volume of deposits. For example, as the profit paid to investment depositors is determined after making allowances for the required reserves on such deposits, the higher the reserve ratios on investment deposits, the lower the profit payable to the depositor. This would clearly decrease the willingness of depositors to place funds in such accounts. Of course, the lower the reserve ratios, the higher the profit payable to depositors and the higher the volume of investment accounts.

Granting prizes and other advantages for attracting *Quard al-Hassana* deposits can be a very flexible instrument for absorption of savings. It is accepted, however, that the speed and effectiveness of these instruments in drawing savings might be slower than that of the interest rate mechanism. Moreover, changes in the rate of interest and its effect on deposits may be more definite and can be calculated, while changes in the amounts of interest-free deposits are not foreseeable and the evaluation of its effects on depositors is difficult.

The second category of Islamic monetary policy instruments used in Iran is that which influences the volume of credit facilities: determining the minimum and/or maximum ratios of profit for banks with respect to *murābaẖa* and *mushāraka* transactions; determining the minimum rate of expected return (profit) for *muḏāraba*, *mushāraka*, Direct Investment, *Muzara'a* and *Musqat* transactions; and determining the minimum and maximum margins of profit as a proportion of the cost of goods transacted by the bank in installment sales and hire-purchase transactions.

The "profit ratio" is the bank's share of actual profits derived from transactions on credit facilities extended by the bank. Such ratios differ depending on the field of activity and according to the priority set by monetary authorities, and are determined, as a rule, before the extension of credit. As an instrument of monetary policy, the increase or decrease in the profit ratio would influence the demand for utilizing this kind of facility.

The "minimum expected rate of return" or the yield is the expected profit during a specified period derived from credit facilities extended, and is forecasted and computed prior to actual extension of credit. The minimum expected rate of return could help determine the best form of investment if banks sort their various investment potentials according to this criterion. The demand for credit facilities is also effectively categorized upon examining these ratios. The yield, of course, varies for different types of economic activities, and as a monetary policy instrument is considered a proper means for evaluating and selecting suitable investments in Iran.

It is possible to imagine that increasing the rate of expected return would decrease the potential propensity to invest. However, a number of investment projects that need to use the banks' credit facilities but because of high costs and low efficiency do not have good return prospects, may have no option except to correct their planning and to increase efficiency. Therefore, when a project is selected according to the minimum expected rate of return, in addition to implementing monetary policy by Banke Markazi, the economic efficiency of the Iranian society may also be increased following the improved efficiency of the economic units that demand banking facilities.

Finally, the "margin of profit" is the profit resulting from transactions involving banking facilities as a proportion of the price of goods or services thereof. Since, according to Iran's banking laws, the profit of banks in these types of transactions is directly added to the final price of goods, changes in the profit margin would influence the demand for these credit facilities and its expansionary or contractionary effects would help achieve the goals of monetary policy.

The role of these three instruments in implementing monetary policy encompasses credit rationing. Determining the expected rate of profit or banks' profit margin in various contracts, for example, would impact the distribution of credit and facilities among various sectors of the economy. Neither general economic growth nor sectoral growth would be achieved were the cost of funds to the client to exceed the nominal return in the economy in general, or in particular sectors. Determining the rates would require a thorough understanding of the economy in general and its various sectors. Otherwise, allocation of resources among different sectors of the economy should be left to market mechanisms.

Moreover, since a project could be financed through various methods, in determining the profit margin, Banke Markazi should verify that the minimum cost of funds for the borrower is such that the profitability of the project is the same under all modes of financing. A project in the commerce and services sector, for example, may be financed either through *muḏāraba* or Civil Partnership, and discrepancies in the profitability between the two modes of financing would promote one over the other.

Another important issue—the impact of changes in the central bank's instruments on monetary parameters and the economy in general, as well as the way and the extent to which these instruments should be used in implementing monetary policy—must be carefully considered. Specifically, in determining the expected minimum rate of profit or the banks' percentage share of the profit, Banke Markazi should consider costs associated with each different type of contract and within different sectors of the economy. This is particularly important when there are certain other non-bank charges such as registration and specific tax charges. It is therefore useful to examine the common modes of bank financing operation in Iran.

1. Installment Sale and Hire-purchases

In a country like Iran where some sectors of the economy face limits in credit expansion, assigning different minimum expected rates of profit to various sectors based on the marginal rate of return of capital in each sector could be the remedy. Determination of the minimum and maximum rate of profit in an installment sale contract would be justified only if there was good reason to believe that the equilibrium rate is somewhere between these two limits. If even at the maximum rate assigned to a sector, the demand for financial facilities exceeds the supply of funds, the result would be a misallocation of resources along with reduced profitability of banks which itself is to the disadvantage of depositors. Therefore, in the Iranian system of credit rationing, the rate applied to each sector is determined in accordance with the profitability of that sector and regardless of the rate in other sectors.

Machinery and tools may also be financed through hire-purchase contracts. If the minimum and maximum rate of profit of a bank is the same for either of the two types of contracts, and if the amount of down payment for hire-purchase contracts is higher than the down payment in installment sale contracts, the latter would be favored. Even under equal conditions, the desire for ownership might make installment sale contracts more appealing to clients.

From a policy perspective, as long as there is an excess demand for bank facilities in a particular sector, with an increase in the minimum expected rate of profit, and accordingly the maximum rate, more profitable projects would be financed and implemented without having any impact on the total credit extended to the sector. When Banke Markazi intends to extend the volume of credit in a sector, a credit ceiling and the minimum expected rate instruments are used simultaneously. Variation in the amount of down payment would also have an impact on the allocation of credit. For instance, an increase in the amount of down payment would direct the credit toward clients with better financial positions, and thus, would narrow the number of applicants for such facilities.

2. *Muḏāraba*

Muḏāraba is a mode of financing that, according to Iran's Islamic banking principles, is applicable only to commerce. The central bank may influence *muḏāraba* contracts either by imposing a different minimum expected rate of return or by varying the banks' share from profits. Banke Markazi of Iran currently specifies only the minimum expected rate of profit and leaves it to banks to determine their share from accrued profit. As *muḏāraba* contracts are regarded as the preferred source of financing for commercial activities in Iran, the minimum expected rate of profit of banks in such contracts is regarded as the base rate for all commercial activities and relevant rates in other modes of financing are determined accordingly

Although in a system based on credit rationing, the expected rate of return should be used for optimum allocation of resources in each sector, to avoid an increasing rate of inflation the cost of facilities may be fixed at a lower level than equilibrium rate of profit. Since the cost of bank facilities are not pre-determined for the client and will be determined and paid only after the completion of the project, it should not be considered a cost and, thus, not be reflected in the price. Consequently, an increase in the expected rate of profits by banks should not cause an increase in prices.

Upon identifying the equilibrium rate of profits, Banke Markazi, may and does use both instruments foreseen in this mode of financing, given their differing impacts on financial conditions. With the fixed share of profit for banks, an increase in the minimum expected rate of profit would imply only the implementation of those projects with higher rate of return. The demand for funds in commerce sector will fall as a result. On the other hand, given the minimum expected rate of profit, increases in the profit share of banks results in a reduction in the client's share of the profit as a percentage of the capital. When and if the rate of unemployment is high and the opportunity cost of the labor force is low, an increase in the banks' share of profit may not cause a reduction in demand for funds. Otherwise, it will reduce the activities of and the demand for financial facilities in commercial sector.

3. Civil Partnership

Quite often, Civil Partnership contracts rank second among facilities extended by Iranian banks—up to 18% of total facilities of commercial and specialized bank have been, at times, extended through this mode of financing. According to Iranian laws, banks are allowed to participate in Civil Partnerships in productive, commercial, and services activities. For this mode of financing, the Money and Credit Council determines the minimum and/or maximum share of profit for banks. Regulations limit the maximum participation of banks in each partnership contract to 80% of total required capital, with the client providing at least 20%.

IV. Discussion and Conclusions

Following the substitution of Islamic banking system for traditional banking and the elimination of interest as a monetary policy instrument, practical issues surrounding the central bank's responsibility for monetary policy need careful examination. While in principle the central bank may continue to play the same role in regulating banking and financial transactions, there are certain issues that should be considered. For example, could the central bank conduct effective open-market operations with securities not paying explicit interest? Or should Islamic banks have the same pattern of reserve requirements as those of other banks?

In addition, if the economy suffers from imbalances in different sectors and credit rationing is used to correct them, it would be necessary to use other instruments in addition to the general instruments of monetary policy. Coordination among these instruments is more complicated than simply setting the rate of interest under traditional banking. Moreover, although implementation of credit ceilings is not a requirement in Islamic banking, it is not in contradiction with it either, and in certain cases it could play a vital role in money and credit control.

In using instruments such as the minimum expected rate of profit and the share of banks' profit, it is important to try to determine the minimum cost of funds to clients in different sectors of the economy. It is obvious that a sectoral approach to the economy stems from certain biases toward various economic sectors. In the case where the rate of profitability is low in the favored sector, either a subsidy should be paid to its products, or it should be provided with cheap financial facilities. In the latter case, the cost of funds should be determined according to the marginal profitability (rate of return) in the sector.

In the application of different instruments available to monetary authorities, credit ceilings determine the volume of private investment financed by the banking system on the one hand, and control the growth of liquidity on the other. The expected rate of profit in different contracts and share of banks from profits should only be used for efficient allocation of resources within the sectors in order to prevent further inefficiencies. In cases where banks are faced with scarce or excess resources, the central bank could use other instruments to absorb or free bank reserves.

Another constraint on the successful implementation of an Islamic banking system, and in conducting monetary policy under such a system, is the lack of appropriate non-interest-based investments for financing budget deficits, especially since the government may account for a major component of demand for credit. In Iran, financial transactions between the public sector agencies, private enterprises, and nationalized banks take place on the basis of a fixed rate of return, which indeed is considered interest. The Iranian government may borrow from the nationalized banking system without violating the interest-free banking principle for the stated reason that such amounts are ultimately posted to government revenues on one hand and its expenditures on the other and, consequently, have no bearing whatsoever on the government resources.

The more reasonable solution to this problem requires work on certain inter-related fronts, including greater emphasis on fiscal policy based on Islamic precepts, which require the government to justify and rationalize all its expenditures, and on ensuring appropriate tax structures so as to discourage tax evasion. This should go hand-in-hand with steps aimed at resolving technical difficulties in developing and putting into operation new financial instruments designed specifically for an Islamic type financial system. Only then may government borrowing take place at a non-fixed rate of return basis.

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[1] Maysami, Ramin Cooper. "Islamic Banking." SES Journal 25(8) (August 1997). pp. 54-59.

[2] For a complete introduction to the banking law of Iran, see Maysami, Ramin Cooper, H. Golriz, and S. A. Hedayati. "Pragmatic Interest-Free Banking: Metamorphosis of the Iranian Financial System." Journal of International Banking Law 12(3) (March 1997). pp. 1-6.

[3] "The Law of Usury-Free Banking." Objectives and Duties of the Banking System in the Islamic Republic of Iran. Chapter 1, Article 1, Clause 1.

[4] As specified in the glossary to "The Law of Usury-Free Banking," *Jo'ala* is the undertaking by one party to pay a specified amount of money to another party in return for rendering a specified service in accordance with the terms of the

contract. *Musqat* is a contract between the owner of an orchard or garden with another party for the purpose of gathering the harvest of the orchard or garden and dividing it, in a specified ratio, between the two parties. *Muzara'a* is a contract wherein the bank turns over a specified plot of land for a specified period of time to another party for the purpose of farming the land and dividing the harvest between the two parties at a specified ratio. *Muḏāraba* is a contract wherein the bank undertakes to provide the cash capital and the other party undertakes to use the capital for commercial purposes and divide the profits at a specified ratio between the two parties at the end of the term of the contract.

[5] Khan, Mohsin S. "Islamic Interest-Free Banking: A Theoretical Analysis." International Monetary Fund draft, August 1985.

Islamic Finance and Beyond

Premises and Promises of Islamic Economics

M. Nejatullah Siddiqi*

ABSTRACT

Some distinctive features of Islamic banking are reaffirmed. A close linkage between the real economy and finance obviously holds in sharing-based financing modes but also in fixed-return modes such as *murābaha*. Islamic finance can meet all the transaction needs of the market and do so more efficiently than conventional finance because it focuses on productivity rather than creditworthiness. By aligning entrepreneurs' payment obligations with revenue accrual, Islamic finance reduces instability in financial markets. The paper notes that exchange-rate fluctuations hurt developing countries, hence the need for regulation framed and enforced by an international agency. Although the prohibition of interest can help cure the ills of contemporary finance, much more must be done to create a safer, saner financial world. Islamic economics incorporates altruism along with self-interest: the institution of *waqf* is a witness to the reality of individual behavior with a social purpose. The scope of morally inspired economic behavior, common today as well as in the past, needs to be broadened.

I. INTRODUCTION

This paper seeks to concentrate on two issues before concluding with some observations relating to Islamic economics: Firstly, a reaffirmation of some distinctive features of Islamic banking and finance that can contribute to human felicity. And secondly, there are some worrisome aspects of modern finance, especially globalized finance, which call for attention.

II. DISTINCTIVE FEATURES OF ISLAMIC FINANCE

Islamic finance ensures a closer linkage between real economy and finance, the former dictating and the latter following. The linkage is obvious in sharing-based modes of investment and financial services. When two parties, the financier and the entrepreneur, agree that an opportunity for creating additional value exists, they come together to realize the gain and share it. Since economic activities are, by definition, value-creating activities, sharing as a basis of finance is inconceivable without economic activity. In the uncertain world in which these activities have to be conducted, they do sometimes fail to create additional value. There is nothing to share. Sometimes part of the existing wealth may be destroyed—the losses borne by capital, the entrepreneurial efforts gone unrewarded.

This linkage between real economic activity directed toward creation of additional wealth and financial transactions continues in case of non-sharing Islamic modes of finance such as *murābaha* (cost-plus), *salam* and *istisnā*ᶜ (prepaid orders) and *ijāra* (leasing). These deals, which are being used by contemporary Islamic banks to secure predetermined returns on their investments, are possible only when some real economic activity is involved. There have to be some goods and services to be objects of *murābaha*, *salam*, *istisnā*ᶜ, and *ijāra*. The demand and supply of these goods and services whose exchange is "financed" through the above mentioned contracts ensures that financial activity is the servant not the master of real economic activity.

Prohibition of "interest" has closed the door on exchange of more money for less money, even when a period of time intervenes. Stratagems (*Hiyal*) securing the same goal by bringing in a commodity in a nominal way e.g. *ina*, *tawarruq* or *bay*ᶜ *al-wafa* are rejected as impermissible.

There remains the gray area of exchange between different monies, i.e. selling one currency for another. Islamic economic research in this area has yet to catch up with the times. I do not have any opinions to pronounce save noting that it is a necessary economic activity facilitating exchange of goods and services across borders. Fear of making financial transactions "profitable" without there being any link whatsoever with exchange of real goods

* Professor of Economics, Center for Research in Islamic Economics, King Abdulaziz University, Jeddah, Saudi Arabia.

and services makes many Muslim scholars opt for the strictest interpretation of the relevant rules. But that carries the danger of restricting what may be really necessary. The challenge of finding the golden mean remains.

III. The Viability of Islamic Finance

It has been demonstrated that all market activities can be financed by using the various Islamic modes, such as *mushāraka*, *muḏāraba*, *murābaẖa*, *salam*, *istiṣnāᶜ*, and *ijāra*. No stratagems are needed. Financing consumption needs that fall outside the market (there being no prospective income to pay from out of) requires humanitarian solutions in the voluntary-cooperative sector or under a state sponsored safety net. Financing government deficits has also been shown to be quite feasible.[1] How far it is desirable to run deficits, how long and what for, are however issues far beyond the scope of "finance."

We have been arguing that interest-free Islamic modes of finance can replace the conventional interest based finance with certain added advantages. By synchronizing entrepreneurial payment obligations and accrual of revenues, sharing-based modes of finance remove a major source of instability from freely functioning markets.[2] Also by linking financial intermediaries' returns to the actual revenue of the fund users, allocation of funds to invest is redirected to projects expected to produce more value than their alternatives.

Even though the predominance of non-sharing modes of finance in the current practice of Islamic banking dilutes these advantages, the Islamic system would score far better than any system that permits exchange of more money for less money. Part of the reason is the vast opportunities of exchange that this permission opens bypassing the real economy which is focussed on exchange of goods and services with one another, money serving as a means of such exchange. Exchange of money for money degenerates into a game of chance in which people indulge to try their luck, little benefit flowing to the production of goods and services which exchange is supposed to promote. Prohibition of interest is directed at restoring money to its essential functions, which certainly do not include a means for gambling.

IV. Beyond an Interest-free Economy

We now turn to the worrisome aspects of contemporary financial markets. As already noted, prohibition of interest would go a long way in improving the situation. You exchange money either for goods and services, or for money or for debt. In the Islamic framework we have no problems with the first, the second, exchange of money for money is severely constrained, and the third is almost eliminated. Islamic law allows cash for debt only at par,[3] which leaves no room for a "market" in which debt could be sold for cash. It also allows exchange of debt for debt at par and with further restrictions. Again the possibility of a "market" for debt is slender. There would, of course, be a market for common stock, *ijāra* (lease) certificate,[4] and financial papers based on *salam* or *istiṣnāᶜ*.[5] But, despite their presence, the scope for speculation in an Islamic framework would be far less than witnessed at the present.

The disturbing features of contemporary finance, which would remain unaffected by the prohibition of interest, restrains on the money market and the demise of the market for debt, are the following.

1. The possibility of massive capital movements into and out of a country, which has destabilizing, effects, especially for small economies.
2. Wide exchange rate fluctuation, to the great disadvantage of small developing countries dependent on foreign trade.
3. Social, cultural and political aspects of financial globalization and multinational corporations (MNCs) dominating the market. This is especially worrisome to developing countries in Africa and Asia that do not share the sociocultural background of the regions where the MNCs are based. These countries also lack sophisticated bureaucracies, mature politicians and efficient media, which could be a guard against the possible undesirable role of MNCs.

We now take up these issues one by one. In an Islamic framework the influx of foreign capital in a country would hardly be in the form of loans, as they would earn no returns. Foreign capital would come either in partnership with local capital and/or enterprise, in which case it would commit itself for medium or long run, or as price paid for common stock, in which case it would be short term. It could also come through a *murābaẖa* contract in which case the date for its possible exit with returns is determined from now. Capital invested in financial papers based on *ijāra*, *salam*, or *istiṣnāᶜ* can, however, make an exit at will. In sum, we have two kinds of foreign capital, the long-term partnership and *murābaẖa* based capital which is subject to a predetermined schedule so far as its withdrawal is concerned, and the short-term capital invested in the market for common stock and other financial papers. It is the second kind which calls for attention as it can leave the country at will. The usual solution is to impose some kind of discipline so that the destabilizing effects of withdrawals of foreign capital are minimized.

Some kind of regulation is necessary. Several ideas, including those of James Tobin are relevant.[6] The crucial thing, however, is to shift the focus from ad hoc individual initiatives and policies to some kind of international understanding. There is a need for an international agency, maybe part of the UN system, to be set up to engineer the needed regulation and protect the small and the weak from actions emanating from profit-driven investment decisions (and speculation) oblivious of the social political and ethical dimensions of such decisions. The conscience of the world community must take charge where the market fails to give due weight to mankind's larger interests (i.e. interest other than enrichment of capital owners).

The post World War II fixed exchange rate regime collapsed in 1971 because of the inability of the United States of America to continue honoring its commitment to a certain gold value of the dollar. A return to gold standard now seems neither feasible nor desirable. But the type of exchange rate fluctuations experienced by Southeast Asian economies in 1997-98 is simply a killer. It demonstrated for all not only the dangers of freely floating exchange rates but also much more that needs correction, so succinctly indicated in the following quote from the Human Development Report 1999.

> "When the market goes too far in dominating social and political outcomes, the opportunities and rewards of globalization spread unequally and inequitably—concentrating power and wealth in a select group of people, nations and corporations, marginalizing the others. When the market gets out of hand, the instabilities show up in boom and bust economies as in the financial crisis in East Asia and its worldwide repercussions, cutting global output by an estimated $2 trillion in 1998-2000. When the profit motives of market players get out of hand, they challenge people's ethics—and sacrifice respect for justice and human rights."[7]

Some degree of exchange rate stability must be ensured if the small and the weak have to coexist on planet earth with the big and the strong—as they must. It is generally recognized that this necessitates some regulation of capital flows, but the timing and modalities of such regulation are not clear. In the absence of an agency especially designed for this purpose, most favor the IMF and the World Bank to take up this role.

If taken up in earnest there is a need to set limits within which only supply and demand are allowed to determine exchange rates. That in its turn calls for manipulating supply or demand, as the case may be, when needed. Only an agency with almost unlimited resources (in respective currencies) can play this role (of the "lender" of last resort). Does this mean the power to create money? Maybe yes.

It can now be seen how difficult it would be for the IMF and the World Bank, under their current constitutions, to take up this task. A new international understanding is necessary.

The clock of globalized finance cannot be turned back. It need not be. It is good even for small developing countries that international financial giants—banks, mutual funds, investment companies—can find it profitable to pour in resources to exploit the vast opportunities for wealth creation these countries in Africa and Asia offer. But there are some problems—psychological, cultural, and political.

Smart briefcase holding (mostly Western) representatives of the MNCs, stepping out of five star hotels remind onlookers of the colonial days. How to change that perception? Employing local boys helps. Broadening the vision of MNCs to include the social dimension in their profit making activities will help more.[8]

This goes hand in hand with encouraging tourism and helping local entrepreneurs to invest in developing resorts, which could attract foreign tourists and earn hard currencies. Add dish antennae, casinos, and nightclubs, and you have a scenario ripe for breeding misgivings leading to anger among the "natives." They visualize a cultural onslaught and feel being targeted with hegemonic designs of the western culture and fear losing their age-old traditions.

Sovereign states are supposed to take care of themselves. Those who feel the need enter into alliances for defending their boundaries, even enlist foreign cooperation in maintaining internal security. Vulnerability to the manipulations of MNCs and financial giants is however a new kind of danger, which the traditional modes of "defense" fail to handle. Primitive administrative structures, inexperienced political elite, largely illiterate electorate—that is not a position very helpful in dealing with the new danger. Protection is needed which can come only in the form of counseling and, if needed, intervention, by some international agency, preferably working under the UN system.

These observations are offered here with two ends in view.

First, it is to reassure all concerned that the Islamic economists share the anxiety justifiably caused by the current happenings in the financial markets in particular and in the economic aspect of living in general. They too share the search of a better way for managing our affairs.

Second, it is to shake out of their naivete those sympathizers of Islamic economics who might presume that abolition of interest takes care of all the current problems in finance and economics. There is a need to go beyond that necessary but not sufficient step in an Islamic reconstruction of man's economy.

V. PREMISES AND PROMISES OF ISLAMIC ECONOMICS

More than any thing else, Islamic banking and finance, a sub-culture of Islamic economics, has been a quest for justice and morality into "the ordinary business of life." Justice and morality cannot, however, be all encapsulated into laws and regulations, especially when it comes to protecting the small and weak from the big and strong. Some behavioral changes are called for. Justice and morality have to penetrate the behavior of all economic agents, including the decision-makers at the national and international level, so that all can live together in peace and harmony. Has Islamic economics something to offer in making this possible?

At the heart of the Islamic economic culture lies care for others as a force tempering man's innate selfishness. In sharp contrast to neoclassical economics, which dominated the scene during the twentieth century, Islamic economics brings the social dimension of living into focus, thus downsizing individualism. It also recognizes morality as a potential motor of action and overseer of self-interest. The former, the social dimension, is compulsory; economic analysis can ignore it only to its peril. The latter, ethical action, is a potentiality in the realization of which civilizations have had different records. But no human society has been devoid of the moral dimension. Thus, ignoring it can never be justified.

As regards, Islamic economics the moral dimension is its raison d'être. As the literature shows, the last fifty years have shown several attempts to analyze morally informed human behavior in production, consumption, and exchange.[9]

Nothing captures the distinguishing features of Islamic economics noted above i.e. a care for others, as does the institution of *waqf* (charitable endowments). Unlike the *Zakat* levy and the prohibition of interest, there is no legal force behind *waqf*. No Muslim is under compulsion to create a *waqf* under any circumstances whatsoever. And yet this institution emerged right during the days of the Prophet (peace be upon him), and continued to grow through out Islamic history. This giving away of private property for social purposes must have had ripple effects on the economies in which it took place, but the phenomenon has yet to attract the attention of analysts other than historians.

The other pillar of capitalism, along with private property, is free enterprise. Here social and moral dimension shows up into priorities in production and consumption and self imposed limits on profit making. The literature of *h̲isba*[10] (accountability) partly captures this, as do the economic writing of Ibn Taymiyyah, al Ghazzali, Muhammad Ibn al Hasan al Shayhani and Abu Yusuf—in the reverse chronological order.[11] Recent attempts to study Muslim economic agents under influence of Islamic norms and values have been very few,[12] reflecting the continued domination of neoclassical economics. But we do have enough evidence on the reality of ethical economic behavior[13] in the contemporary societies in East and West to justify attempts to broaden its scope and capture new areas. That is the need of the hour.

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[5] Ibid., Chapters 6 and 7.

[6] Tobin, James. "Financial Globalization: Can National Currencies Survive?" in Annual World Bank Conference on Development Economics, 1998. Washington: The World Bank, 1999. pp. 63-75.

[7] The United Nations Development Program. Human Development Report 1999. New Delhi: Oxford University Press, 1999. p. 2.

[8] "Multinational corporations influence the lives and welfare of billions of people, yet their accountability is limited to their shareholders, with their influence on national and international policy kept behind the scenes. If they were brought into the structure of global governance their position would become more transparent and their social responsibility subject to greater public accountability." Human Development Report 1999. New Delhi: Oxford University Press, 1999. p. 12.

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Experimental Tests of the *Homo Economicus*

The Implications for the Research on Islamic Economics

Abdullah Yavas*

ABSTRACT

The purpose of this study is twofold. One is to discuss recent experimental tests of the neoclassical theory and identify those behavioral assumptions of the theory that perform well and those that perform poorly in experiments. The second is to discuss the implications of these experimental results for the future research on Islamic economics. The conclusion of economic experiments is that human beings are neither as selfish and rational as the *homo economicus* nor as cooperative and norm-oriented as the *homo sociologicus* or *homo Islamicus*. Both norms and incentives are important determinants of our behavior.

I. INTRODUCTION

One of the most persistent debates in the social sciences has been between *homo economicus* and *homo sociologicus*. While the former is driven by rationality and outcome, the latter is guided by social norms. The former strives to maximize self-interests, whereas the latter's behavior is prescribed by a set of rules and standards. The former follows the norms only when they serve self-interests and the latter uses rationality and self-interest maximization only when they are within the boundaries set by the norms.

The research in economics today is predominantly based on the neoclassical theory. The primary axioms of the neoclassical theory are those of the *homo economicus*: individuals act so as to maximize utility, represented as a function of income, consumption, wealth and leisure. In doing so, individuals make "rational" and "selfish" decisions. Economists have developed elaborate mathematical models using *homo economicus* to address a wide array of issues; from economic growth to monetary policy, from firm behavior to consumer behavior, from international trade to urban planning, and from marriage to suicide. They even attempted to explain religious inclinations and practices with rationality and self-interest maximization (the utility function here obviously does not include the expected benefits in the hereafter).

A major issue for the study of Islamic economics is whether to utilize the existing rich models of Neoclassical economics or build new models of economic behavior that captures "Islamic values." That is, should we simply examine how the *homo economicus* would behave in an economy governed by Islamic rules or regulations or should we also change the axioms of *homo economicus* and develop a *homo Islamicus*? Unfortunately, majority of academic research in Islamic economics hitherto took a third, an easier, route. Instead of developing formal models of *homo Islamicus* or utilizing the existing formal models of *homo economicus*, they offered informal speculations of how the Islamic values of individuals would differentiate them from *homo economicus* and how this would ensure that various problems of the neoclassical model would not arise in an Islamic economy (see Kuran, 1983, for a criticism of the research in Islamic economics).[1]

Are the axioms of rationality and selfishness the driving forces of human beings' behavior? This question has recently been debated by mainstream economists themselves. The motivation for the debate is the results that were obtained in laboratory economics experiments where subjects were asked to make economic decisions. The laboratory economic experiments in the last three decades have revealed that the axioms of rationality and self-interest maximization alone are not sufficient to explain subjects' behavior. In fact, in many cases these axioms are violated by the subjects in experiments. As a result, some economists have begun to modify the existing economic models in order to be able to explain the subjects' behavior in experiments (e.g., Bolton and Ockenfels, 1997).

The purpose of this study is twofold. One is to discuss recent experimental tests of the neoclassical theory and identify those behavioral assumptions of the theory that perform well and those that perform poorly in experiments. The second is to discuss the implications of these experimental results for the future research on Islamic economics. It is also hoped that this study will encourage Islamic economists to consider the experimental approach as a method of testing their behavioral assumptions and theories.

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* Associate Professor of Business Administration, Pennsylvania State University, University Park, Penn.

It will be shown that the results of various experiments have seriously challenged some of the behavioral assumptions of the neoclassical theory. Subjects in experiments often fail to take “rational” actions, and they care considerably about “fairness” and “equity” even when doing so is against their self-interests. Subjects also tend to be more “cooperative” than the theory predicts. These results are observed especially in experimental markets where there are a few players, such as in two-person bargaining games or public good games with few players. As we move to market experiments with a large number of participants, we observe less cooperative and more selfish behavior. The experimental results also show that monetary incentives play a crucial role in determining individuals’ behavior. For any given environment, a change in incentives almost always leads to a change in behavior in the direction predicted by the theory. Unfortunately, this last point is often neglected or downplayed in studies on Islamic economics and in their policy recommendations. Players in the models of Islamic economics are somehow immune to any monetary temptations and strictly follow the “prescribed” strategy regardless of any incentives to follow a different strategy.

The main conclusion of this paper is that while some of the behavioral assumptions of the neoclassical theory need to be modified, its assumptions regarding incentives should be taken more seriously by the researchers in Islamic economics. It will be a mistake to assume that *Homo Islamicus* is immune to any temptations created by monetary incentives to break the norms or to act selfishly against the interests of the society. As we have witnessed with a number of rulings in recent years, such as the rulings on interest-bearing mortgage loans, option trading, forward contracts and insurance, monetary incentives induce Muslims to search for excuses, exemptions, or new interpretations of norms and rulings to justify their behavior. More importantly, the Qur’ān and Sunna specify a set of rules of conduct for social and economic interactions and call for the state to implement these rules and punish those who violate them. The state is even asked to enforce the *zakah* payments on each wealthy individual and to penalize those who evade them. Obviously, if norms were enough to ensure the desired behavior in an Islamic society, there would not be a need to prescribe any punishments, and *Zakah* payments would be left to the individuals’ conscience.

The purpose of this paper is not to offer a critique of the research on Islamic economics. Neither is it to evaluate how successful an Islamic economic system would be in such macro issues as inflation, unemployment, income distribution, or growth. Rather, the purpose is purely practical; it is to utilize the recent experimental studies to provide some guidance and evidence on human behavior, thus on the micro foundations of a tenable economic model.

The next section of the paper briefly describes the experimental methodology and its advantages. Section III reports some of the major findings of laboratory experiments that are relevant for the researchers in Islamic economics. Section IV discusses the implications of these experimental findings for future research. Section V offers some concluding remarks.

II. Experimental Methodology

A. Brief Description

The purpose of economic theories is to explain the activities of individuals and markets. Economists have developed massive and mathematically sophisticated theoretical models of agents and markets, but the testing of these models has lagged behind the theory. The theory has typically been tested using field data, data from “natural” markets. The evaluation of a theory or policy by using laboratory experiments is a recent development.[2] Despite this late start, experimental methods have become increasingly widespread in the last twenty years.

The first step in testing a theory in an experimental lab is to construct the environment for the theory. Suppose we want to test if the competitive market price takes place at the intersection of supply and demand functions. We establish a market by dividing the subjects into two groups, buyers and sellers, and assigning a unit cost to each seller and a unit value to each buyer. The seller’s earning from each unit sold will be the difference between the selling price and the seller’s cost of the unit while the buyer’s earning from each unit purchased will be the difference between the buyer’s value of the unit and the purchase price. Since we assign the cost and value figures to the sellers and buyers, we know exactly what the supply and demand in the market are. By allowing the buyers and sellers trade with each other, we observe whether or not the transaction prices are taking at the intersection of the demand and supply. We can also test how transaction prices differ across different trading rules, such as sealed-bid auctions, double oral auctions, etc.

Once the environment is carefully designed and theoretical predictions are ascertained, the experimenter recruits subjects for the experiment. It is important to conduct an unbiased recruitment of the subjects and make it clear to the subjects how their cash earnings will depend on the strategies they choose during the experiment. If an experiment does not offer the subjects performance-based rewards, then the subjects may not have any incentive to pay attention to their strategies, and the results of such an experiment will be questionable.

After the experiment is conducted, the data from the experiment is analyzed using the appropriate statistical techniques. If necessary, further sessions are run to replicate the data or to test the implications of a change in the market environment.

The next section discusses the advantages and limitations of laboratory experiments and why the experimental methodology has become so popular with researchers in economics and finance.

B. Advantages and Limitations of Experimental Methods

A primary advantage of laboratory experiments is that they allow the researcher to have control over the data. The researcher can manipulate laboratory conditions to induce changes in any of the variables while holding the other variables constant. This enables the researcher to evaluate and compare alternative theories and policies. If we want to test the implications of a change in the demand curve, for instance, we can run a new session where the buyers are assigned a new set of values for the traded good and compare the prices in the new session with the prices of the original session. Similarly, we can conduct sessions with different number of sellers to investigate price formation under different market structures (monopoly, duopoly, oligopoly, etc.). With field data, on the other hand, we often observe only the transaction prices in the market without knowing the underlying demand and supply curves. Thus, it can become a challenge even to estimate the demand and supply curves.[3] Even if econometricians manage to clearly identify the effects of desired variables from the rest of the factors, they do not have the ability to control the environment in which the data was generated.

Another advantage of the experimental approach is that in cases where collection and verification of field data is expensive, it can serve as a less costly alternative to generating the desired data. The experimental method also offers more reliable data, because the field data is usually collected not by the researcher for scientific purposes, but by businesses and/or government agents for their own purposes. The experimental data, on the other hand, is generated for a specific purpose using the desired set of variables.

The main advantage of experimental methodology, however, is that its data are replicable. Field data are generated from events that occurred at a specific time in a specific place. Due to the constantly changing nature of these settings, it is very difficult for other researchers to replicate a field data set, therefore making it difficult to verify the accuracy of the data and the accuracy of the findings. Since laboratory data are generated in controlled laboratory conditions, it is easier to reproduce the experiment and replicate the results.

In addition to the above advantages, laboratory methodology is sometimes the only feasible way to test a theory. This happens when data from existing markets cannot be collected, because it is impossible to find markets that match the assumptions of our theory, or the data is available but not in a form that would enable us to differentiate among alternative theories. This problem is particularly manifested in individual choice problems and game theoretical analysis. These models are either impossible or very difficult to evaluate with field data. Such problems, however, can be, and frequently have been, tested by laboratory experiments.

In spite of its advantages, some critics raise concerns about the experimental approach. One typical criticism is that experiments often use undergraduate or MBA students as subjects whereas relevant decision-makers in the economy are more sophisticated players. This criticism was tested in some experiments where the same game was played by a set of undergraduate students and a set of decision-makers such as corporate managers (as an example, see DeJong et al., 1988). The behaviors of the two groups were not significantly different. Furthermore, even if this criticism were true, it is a criticism of the choice of subject pools in experiments, not the experimental approach itself.

Another common criticism of the experimental approach is that real-life economic environments are much more complex than the laboratory environments. However, since the laboratory environment is designed to test a theory, this is a reservation about the theory not the experimental approach. Furthermore, if the theory fails to work in a simple experimental environment, then it less likely to work in a more complicated environment.

The major limitation of experiments is that some environments are technically very difficult to construct. Many macroeconomic policies, for example, rely on intertemporal trade. How do we test if subjects recognize that government spending today may create inflation or increase taxes in the future or how do we test if the subjects care about the welfare of future generations? Although numerous elegant approaches have been developed, we have not been quite successful at testing some of the economic issues in laboratory experiments.

III. What Do Experiments Tell Us about Human Behavior?

Experimental research has been applied to a large number of areas in economics in the past three decades. It is impossible to offer a detailed discussion of all the results obtained by the experimentalists in this article. Instead, a brief summary of the major experimental results is provided.

A. Market Experiments

In experiments with a large number of traders competitive market predictions have been observed in a rich variety of circumstances. Even with as few as five to six buyers and sellers, price converges to the competitive equilibrium level. An exception is the games where the buyers had to pay a search cost to learn the prices set by the sellers. It is common to have the prices in such games of costly information to differ from the prices predicted by the theory (e.g., Abrams, Sefton, and Yavas, 1999; Roth et al., 1991).

B. Ultimatum Bargaining Experiments

There is a widespread violation of the theory in games that involve a few players. A striking example is the ultimatum bargaining game. In this game, two players negotiate over the division of a pot of money. One player, say Player 1, proposes to the other player, say Player 2, a division of the pot. Player 2 then either accepts or rejects Player 1's offer, and the game ends. If Player 2 accepts Player 1's proposal, then they divide the pot according to the proposal. If Player 2 rejects Player 1's proposal, then each player receives zero. The two players play this game only once. This game has a unique equilibrium[4]: since a rejection by Player 2 gives zero amount to each player, Player 2 will accept any proposal by Player 1 as long as the proposal gives Player 2 a positive amount. Given this "rational" reaction by Player 2, the best strategy for Player 1 is to offer Player 2 the smallest possible amount (say a penny) and keep the rest of the pot to himself.

The observed behavior in ultimatum game experiments, however, differs from the theoretical prediction profoundly. A typical outcome of such ultimatum game experiments is that Player 1 offers an equal split of the pot and Player 2 accepts. Furthermore, some proposals (those that give Player 2 a small portion of the pot) are rejected by Player 2 (Guth et al., 1982; Kahneman et al., 1986).

C. Dictator Game Experiments

The results of the ultimatum game experiments took many economists by surprise. They began to question whether Player 1 was offering a significant portion of the pot to Player 2 because of a fear that Player 2 would penalize Player 1 by rejecting Player 1's proposal if it were not a "fair" proposal. To test this, a dictatorship game experiment was designed whereby Player 2 no longer had the choice of rejecting Player 1's proposal. Thus, the pot would be divided according to Player 1's proposal. The unique equilibrium is for Player 1 to keep all the pot to himself and give zero to Player 2. In experiments conducted by Forsythe et al. (1994), about 20% of the dictators took the whole pot, but the remaining 80% gave something to Player 2. In fact, around 20% of dictators went as far as splitting the pot equally.

D. Prisoner's Dilemma Experiments

Consider the following prisoner's dilemma game where Player A and Player B choose simultaneously and independently between strategy Y and Z.

Figure 1. Prisoner's Dilemma Game

		Player B	
		Y	Z
Player A	Y	350, 350	1000, 0
	Z	0, 1000	800, 800

The first payoff in each cell is Player A's payoff while the second payoff is Player B's payoff. For instance, if Player A chooses Y and Player B chooses Z, then Player A earns 1000 points while Player B earns 0 points. When players play this game only once (or a finite number of times) the unique equilibrium is for both players to choose Y. This is due to the fact that it is dominant strategy for each player to play Y; a player earns more by playing Y regardless of what they expect the other player to do. Note that both players would be better off if they both choose the strategy Z instead. However, this is not an equilibrium because it is better for a player to play Y even when they expect the other player to play Z.[5]

When Cooper et al. (1996) ran an experiment with this exact game, however, they found a significant amount of cooperative play, i.e., strategy Z. The percentage of Z choices in their experiments ranged from 20% to 43%. Another common feature of prisoner's dilemma experiments is that once a cooperative pattern of behavior is established in early rounds, it tends to persist. Therefore, the initial rounds can become critical.

E. Public Good Experiments

Even though the provision of a public good (e.g., national defense, fire and police protection, or spraying of swamps near a town) is in everyone's interests, each individual has an incentive to "free-ride" on others' contributions. This leads to under-provision of public goods. To test for the free-rider hypothesis, consider the following experiment. There are 20 subjects, and each subject is given 10 "tokens" which they can allocate between a private fund and a group fund. Each token invested in the private fund earns the contributor $1 while each token invested in the group fund earns $0.25 to each member of the group, including the contributor.

If each player invests all 10 tokens in the group fund, then each player earns $50 (20x10x$0.25). However, note that when everybody else contributes all of their tokens to the group fund, then a player can earn even more by switching all of their tokens to the private fund and free-ride on others' contributions to the group account. Such a strategy would earn him/her $57.5 (19x10x$0.25 = $47.5 from the group fund plus 10x$1=$10 from the private fund). Since each player has such an incentive to free ride, the unique equilibrium of this game is where no tokens are contributed to the group fund, all tokens are invested in the private fund, and each player ends up earning $10 only.[6]

Various variations of free-riding problem have been tested in experiments. Contrary to the theoretical prediction that players would contribute zero tokens to the group fund, almost every experiment found positive levels of contributions (even as high as 80% of the total tokens) to the group fund (see, for example, Isaac, Walker, and Thomas, 1984).

F. Bilateral Trade and Coordination Experiments

In a recent experiment, Yavas, Miceli, and Sirmans (1998) assigned the subjects the roles of buyers and sellers and paired each buyer with a seller. The buyer and the seller in each pair then negotiated the price of a unit through computers. If the negotiations resulted in an agreement, then the seller's earning from each unit sold would be the difference between the negotiated price and the cost of the unit, while the buyer's earning from each unit purchased will be the difference between the value of the unit and the negotiated price. If the two sides failed to reach an agreement, then they would each earn zero. The seller's cost of the unit and the buyer's value of the unit were randomly drawn by the computer. Each seller knew its cost but did not know the buyer's value. Similarly, each buyer knew its value but did not know the seller's cost. However, all the subjects were informed that the seller's cost could be any integer number between 601 and 700 and the buyer's value could be any integer number between 751 and 850. That is, each subject's cost/value was a private information drawn from a publicly known distribution. Note that since the lowest possible value for the buyer was greater than the highest possible cost for the seller there was always a positive gain to reach an agreement.

Although an agreement was in the interests of both sides in each pair, we observed many disagreements. On average, 10% of negotiations failed to reach an agreement. The disagreement rate was as high as 50% in some of the sessions. Disagreements were due to the fact that each side tried to obtain a bigger part of the surplus. They could have split the surplus equally, but they did not know what the surplus was. Additionally, they had no incentives to believe any attempts by the other player to reveal his or her value.

The source of inefficiency in the above game is the asymmetric information that players have about their values and costs. Another potential source of inefficiency is the risk of the strategy leading to the efficient outcome. The following coordination game used in Cooper et al. (1992) and Sefton and Yavas (1996b) illustrates such a case.

FIGURE 2. PAYOFF MATRIX FOR THE COORDINATION GAME

		Player B	
		Y	Z
Player A	Y	960, 960	960, 0
	Z	0, 960	1200, 1200

There are two equilibria in this game[7]: one where both players choose Y and the other where both players choose Z. Obviously, the (Z,Z) equilibrium Pareto dominates the (Y,Y) equilibrium, i.e., (Z,Z) is preferred by both players. However, most subjects (as high as 100% of them in some experimental sessions) choose strategy Y. The reason is simple: Y is a safer strategy than Z. Playing Y ensures a payoff of 960 while the payoff from Z will be either 0 or 1200 depending on the choice of the other player.

IV. DISCUSSION OF RESULTS

This section discusses the implications of the experimental results reported in the previous section. As will be seen, some factors other than "rationality" and "self-interest maximization" are important determinants of subjects' behavior in experiments.

1. Market experiments report that competitive market predictions are commonly observed. Prices generally take place around the intersection of supply and demand. It is also found that information structure plays a critical role. Players are less likely to play the predicted strategies when they have to incur a cost to obtain price information and process that information to update their expectations of price distribution in the market.

Market experiments involve interactions among many buyers and sellers. Competition among players in such settings yields the predicted equilibrium outcome. However, when the number of players is reduced to two or three and the actions of a player have direct consequences for the other player(s), i.e., when things get "personal," then observed behavior diverges from the predicted behavior.[8] Below are some examples of such outcomes.

2. Two observations about the ultimatum games raise questions about the rationality and selfishness axioms: one is the fact that some of the Player 2 types were rejecting the offer they received from Player 1 types, and the other is the fact that many Player 1 types were offering half of the pot to Player 2 types. A rational Player 2 would never reject any positive offer, and given this, a rational Player 1 would offer the smallest possible amount to Player 2. A plausible explanation for the observed behavior is that players care about the "fairness" of the outcome. That is, in additional to penalizing himself, Player 2 is penalizing Player 1 because he does not believe Player 1's proposal is fair. Similarly, Player 1 is offering more than he should because he is afraid of being rejected by Player 2 and/or also wants to have a fair division of the pot.

The result that Player 1 proposes a smaller amount in the dictator game than in the ultimatum game indicates that the possibility of rejection by Player 2 increases Player 1's offer. In other words, players become more "altruistic" when they have incentives to do so. However, the fear of rejection is obviously not the whole story because most proposers in the dictatorship game gave a positive amount to the other players. This behavior points to the fact that players can be altruistic and opt for an "equitable" distribution even when it is against their self-interests.

Finally, a further dictator game by Hoffman et al. (1991) suggests that dictator's (Player 1's) altruism also depends on whether or not the dictator's offer could be observed be the experimenter. Dictators were less generous when their offers could not be observed by the experimenter. In other words, players behave more selfishly when they can remain anonymous (this may explain why people living in smaller towns are more cooperative and helpful to others than people living in big cities). Thus, the institutional setting and the social pressure have an influence on how altruistic players are.

3. Prisoner's dilemma experiments show that subjects tend to be cooperative even in circumstances where it is against their self-interests. That is, subjects do not necessarily play the self-interest maximizing strategy.

Another observation in Prisoner's dilemma games is "reciprocity"; subjects are cooperative to those who have been cooperative to them in earlier rounds of an experiment and strike back at those who have been uncooperative. As part of this observation, once a cooperative pattern of behavior is established in early rounds, it tends to persist in later rounds of the experiment. Therefore, the initial rounds can become critical. One question to raise here is what determines the level of cooperation in initial rounds. Could, for instance, the religious/ethical values or cultural background of the subjects be a deciding factor?

The rejection of "unfair" offers in the ultimatum games and the "reciprocity" in the prisoner's dilemma games point to the fact that we sometimes make choices with our emotions rather than with our reason. Both irrational anger and unselfish sympathy occur commonly across all cultures.

4. Free Riding is observed. Public good experiments indicate that players can act selfishly and prefer strategies that maximize their self-interests rather than the joint interests of the group. This point needs to be stressed. Most Islamic economists would argue that a Muslim would not act against the interests of the society even when doing so would serve their self interests. In most cases the behavior of a Muslim would not be significantly different from that of a non-Muslim. This public good experiment was conducted in a predominantly Muslim class at the International Black Sea University in Tbilisi, Georgia in the Spring of 1998 and obtained even a smaller amount of contribution to the group fund than the amounts reported in earlier public good experiments.[9]

5. Substantial numbers of disagreements in bilateral negotiation games indicate that inefficient outcomes arise. Inefficiencies are also observed in some coordination games where players opt for the safer strategy even when there is an alternative, but riskier, outcome that makes both of them better off.

6. The assumption of "rational" behavior has been seriously challenged. In experiments involving individual choices (i.e., experiments where the strategies of a player do not have any impact on other players' earnings, therefore altruism, fairness and equity issues are irrelevant), subjects repeatedly make inconsistent choices (see chapter 8 of Davis and Holt, 1992, for a summary of these experiments). Similar challenge to rationality was observed in experiments involving multiple-stage games. In such games, a subject makes a choice, then their opponent responds, then the subject responds to the opponent's response, and so on. The notion of subgame perfect equilibrium in such games requires that each subject figure out what the optimal chain of responses in later stages of the game will be to its initial strategy, and accordingly chooses the optimal initial strategy. Various experiments (e.g., Sefton and Yavas, 1996a) have shown that the subjects often fail to reason the optimal chain of responses, especially as the chain gets longer.

7. There has been a very limited investigation of how subjects' religious, national, ethnical or cultural backgrounds affect their behavior. Roth et al. (1991) conducted the same ultimatum bargaining and market experiments in Israel, Yugoslavia, USA, and Japan and did not find significant differences across these countries. Guttman (1997), on the other hand, found more cooperative play in prisoner's dilemma games among the Chinese students than among the Israeli and American students. Ben-Ner and Putterman (1997) observed that subjects with more religious education gave more to the other player in dictatorship games. It has been argued by almost every study on Islamic economics that a Muslim consumer or firm would put the interests of the community above his/her individual interests (e.g., Bendjilali and Taher, 1990; Choudhury, 1986b). Experimental methodology offers us a chance to test this and other hypotheses of Islamic economists.

V. Conclusion

In addition to the behavior observed in laboratory experiments, there are numerous real life observations that shed doubts on the universality of selfishness and rationality postulates of neoclassical theory. We tip the waiters in restaurants when we are out of town (restaurants that we do not expect to visit again in the future), we do not litter in the park even when there is nobody around to observe us, we spend the time and effort to vote in the elections even though a single vote would not make a difference, and we donate to the public radio and TV even though the provision of their programs do not hinge on our individual donation. These acts are difficult to reconcile with selfishness.

Credit cards provide us with convenience in shopping. Yet, many people refuse to own any credit cards or they cancel their credit cards because they cannot refrain from overspending when they own a credit card. Why could not they follow the same spending pattern and enjoy the convenience of credit cards? Similarly, many people cancel their cable subscription because they cannot help watching too much TV when they have cable. Why could not they spend the same amount of time watching TV and enjoy the benefits of cable? It is a well-known mathematical result that unconstrained optimization yields a better result than a constrained optimization. However, the examples of credit cards and cable TV show that this rule is violated by (or perhaps it does not apply to) some people, making it difficult to reconcile such behavior with rationality. Another example of irrational behavior is the fact that millions of people start using addictive drugs even though it is common knowledge that it will most likely ruin their lives.[10]

Although the subjects in experiments are more cooperative than the theory predicts, selfish behavior is also commonly observed in various experiments. Selfish behavior was pervasive, for instance, in the public good experiments and in many of the coordination game experiments. Furthermore, the observation that subjects are not as selfish as the *homo economicus* does not mean that norms alone will induce players to be unselfish and cooperative. This is true for Muslims as well as for non-Muslim players. If norms alone could be sufficient to generate the desired outcome, there would be no need for an Islamic criminal law or for the Islamic state to enforce the payment of *Zakah*. The Qur'ān and Sunna recognize that incentives play a crucial role in our behavior and establish the incentives/penalties to encourage/discourage certain types of behavior. Unfortunately, many of the studies in Islamic economics fail to recognize the role of incentives and argue that norms and values would be sufficient to obtain the desired outcomes in an Islamic society.

To summarize, the results of economic experiments show us that human beings are neither as selfish and rational as the *homo economicus* nor as cooperative and norm-oriented as the *homo sociologicus* or *homo Islamicus.* Both norms and incentives are important determinants of our behavior.

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[1] It should be noted that a large number of recent studies in Islamic economics offer rigorous formal models of their arguments. A nice example is Choudhury's Contributions to Economic Theory.

[2] The first attempt is attributed to Chamberlin (1948), who used his students as subjects in an experiment in which he simulated a market by inducing the supply and demand schedules and attempted to obtain equilibrium price and quantity. Other early attempts include Tucker (1950) and Smith (1962).

[3] The observed prices in equilibrium are points on both the demand and supply curves. However, if prices are not taking place at the equilibrium points, then we may fail to identify if an observed price is a point on the demand curve or on the supply curve.

[4] The notion of equilibrium used here is that of subgame perfect Nash equilibrium.

[5] When a player expects the other player to play Z, s/he earns 1000 by playing Y and only 800 by playing Z.

[6] Note that the free-rider problem is a variation of the prisoner's dilemma game. Both have an outcome that each player prefers, yet both give incentives to each player to follow a strategy that leads to an undesired outcome.

[7] The two equilibria here are pure strategy Nash equilibria.

[8] This is in some way parallel to Kuran's (1983) argument that norms become less effective as the size of the society grows.

[9] These were very "cooperating" students as well (they resorted to numerous methods of "helping" each other during the exams).

[10] One can also argue that it is irrational for a person who believes in heaven and hell to commit any sins because the pleasure/benefit of the sin will be enjoyed for a finite period of time in this life, while the punishment in the hereafter can be for an infinite period of time. Yet, believers in heaven and hell commit sins on a frequent basis.

PART II

THE *SHARĪ*

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Introduction

Frank E. Vogel[*]

It is a privilege to introduce the *sharīʿa* section of this volume of papers from the Third Harvard University Forum on Islamic Finance. The papers in this section demonstrate how vital it is for the future of Islamic finance that strenuous efforts continue in research and scholarship on the relevant Islamic laws and their applications. The articles to follow, in the manner of true scholarship, not only make their own contributions but also reveal how wide are the gaps remaining to be filled by further research. They usefully demonstrate the breadth and difficulty of the tasks before us. Each of these articles confronts the difficulty of translating legal ideas between two strikingly divergent contexts chronologically and ideologically, those of modern finance and of the classical or medieval Islamic law. Carrying out these translations or comparisons as faithfully as possible demands extensive consideration not just of the two systems of commercial law doctrine, but also of the complex settings of economics, society, and politics that are the essential background to the doctrines. Since our understanding of the teachings of Islamic law in finance and commerce is inevitably shaped by modern attitudes and practices, we must compensate for this tendency with as much comparative awareness and sensitivity as we can muster. As such, comparisons demand ideally the skills not just of legal practitioners or comparative legal scholars, but, as here, also of economists, financiers, economic historians, and legal historians.

These papers are serious contributions to this burgeoning body of research. They also exemplify two of the major levels at which this research is conducted: one, research at the level of principles, of basic legal or economic precepts; and second, research at the level of techniques, both normative and institutional, for putting these precepts or principles into practice. I shall discuss the articles roughly in the same order: first, those that focus on principles and, second, those that deal with the practice.

In his article "Property Rights in Islam," Abdel-Hameed M. Bashir directs our attention to the Islamic construction of "property" or *māl*, which is certainly among the most basic notions of the Islamic law of finance and economics. Investigating the Islamic law relevant to commerce, one quickly discovers that many of its most characteristic conceptions are implicit in its notion of property. The extent to which property law is vital to the laws of commerce comes as a surprise to those accustomed to Western law and finance. In conventional modern practices, property notions play little formative role; they do not shape, but are shaped by, other crucial factors such as the free agreement of the parties, the structure of economic institutions, and government regulation and taxation. In his article, Bashir returns to revealed texts to elicit Islamic moral and legal tenets concerning property, and to show how fertile these notions are for exposing the Islamic economic, legal, and regulatory regime. Indeed, their profundity is revealed in the difficulty, faced also by medieval Islamic legal scholars and administrators, of determining by which of many possible means these tenets should be enforced: by moral precept, by laws of commerce, by private institutions within the market, or by government regulation? The article pursues the most basic question: in what respects does the Islamic ideal of property dictate approaches different from those in contemporary Western economies? For example, among the tenets Bashir identifies are: "If the property owner proves his inability to use *al-māl* property, he forfeits his ownership rights," and "any property acquired through unjustifiable means, like *gharar* (speculation) . . . is proscribed and forbidden." He also declares that "the government is expected to keep its intervention in the market to a minimum, confined to the enforcement of property rights." Given the problem of reconciling such statements, the article points up the vital importance of work to give further functional definition to property rights and to work out in practical terms how these rights may be effectively implemented in actual markets and economies. Illumination for this task might be derived from research by legal and economic historians into how these precepts were enforced or inculcated in past Islamic societies. Such research would also help us to fully appreciate the meanings given to these revealed precepts by classical *fiqh* scholars.

In "Toward the Revival of *Awqāf*: A Few *Fiqhī* Issues to Reconsider," Monzer Kahf illuminates for us the crucial importance for contemporary Muslim societies and economies of *waqf* (Islamic charitable foundation or trust) funds and of the Islamic rules that govern them. The *waqf* institution, a pervasive and basic economic institution in past Muslim societies, is often overlooked today as we focus on rules and practices for private financial

[*] Custodian of the Two Holy Mosques Assistant Professor of Islamic Law and Director of the Islamic Legal Studies Program, Harvard Law School, Cambridge, Mass.

institutions and transactions. Kahf's article perceptively evokes how the greater sophistication and flexibility of modern financial transactions may enable implementations of *waqf* norms and institutions that achieve, even better than those in the past, the purposes underlying medieval laws of *waqf*. For example, while past scholars often limited *waqf* to real estate, since only a corpus composed of real estate assured perpetuity of the corpus, Kahf points out that modern artificial legal persons may offer a useful alternative, since they also exist in perpetuity. Similarly, while various pressing policy concerns may have kept many jurists in the past from embracing the notion of a non-perpetual or time-limited *waqf*, nowadays convenient and flexible financial or legal arrangements alleviate many of their concerns and offer new approaches. Kahf offers a critique of governmental nationalization and regulation of *awqāf*, now the near-universal practice among contemporary Muslim states, arguing that this is a modern development only, and that *awqāf* and their administration properly belong to the private sphere. *Awqāf*, Kahf argues, properly form a "third sector" providing by private means many public services that we nowadays associate mainly with government. *Awqāf* performed a crucial role in past Muslim societies, and were an essential element in their characteristic decentralization and privatization of public functions. Kahf also criticizes a modern trend of disapproval of the estate-planning and charitable roles of the family *waqf*, and argues for its revitalization. Again, this highly suggestive and perceptive article opens for the reader the crucial importance in contemporary Islamic society of development of *waqf* law and practice. In this, once more, a deeper study of medieval Islamic practices would also be helpful.

Thirdly, Gohar Bilal's article, "Business Organizations under Islamic Law: A Brief Overview," shows the vital importance to the advance of Islamic finance and economics of a profound consideration not just of laws but also of the institutions that implement those laws. No law can be understood without knowing something of the institutions through which the formulators of the law, such as the *fuqahā'* of classical times, foresaw its implementation. In some cases, such as business organizations or other private consensual institutions, these institutions are themselves described in laws making them more readily studied. But even then, much more needs to be done than merely to learn and recite the rules from the classical textbooks. First, as Bilal shows us, we must ask what are the economic and moral, as well as legal, precepts that motivated the structuring of these institutions in just this way and no other? The need then arises for ways to make judgments as to which of these precepts are fundamental and relatively fixed, and which may be readily altered to adapt to different times and places. A further question is to identify the key connections between such precepts and other basic principles of the Islamic law of commerce and finance. Still another set of fundamental questions is how these institutions have operated in practice. What can we learn from economic and legal historical study of the workings of these institutions at times when they operated directly and exclusively under the aegis of the *fiqh* and under the supervision of scholars and Islamic courts? Finally, Bilal's article demonstrates the need to improve our ability to use terms in comparative law with full awareness of their precise meanings, or, if the definitions had varying or imprecise meanings, of the need to make clear in what exact sense we are using them. Only with such precision can we identify or differentiate legal institutions in different legal systems, or can we adopt a single term (whether from English or Arabic) to refer to two apparently comparable institutions in the two systems.

The remaining papers proceed at the level of the actual application of Islamic economic or legal principles in modern contexts.

Shaikh Abdul Hamid, in "Investing in Equities: Some Issues from the Islamic Perspective," analyzes how doctrines laid down by scholars and *sharīᶜa* boards to govern Muslims' investments in equities of non-Islamically run companies are applied in practice. He analyzes the Dow Jones Islamic Market Index (DJIM), and shows that, based on information supplied by Dow Jones itself, serious questions arise as to whether the relevant permissive doctrines governing investment in equities have been correctly applied. His exposition suggests the extent to which investments corresponding to these strictures exist in practice, and the degree of economic sacrifice, if any, involved in adhering to those strictures.

Nizam Yaquby, in "Requirements to be Fulfilled When Conventional Banks Set Up Islamic Banks, Windows, or Funds," opens up another important area of practical research, by examining the widespread practice by which conventional banks seek to share the marketing advantages of Islamic banks by creating divisions that claim to pursue Islamic rules in finance and banking. Yaquby mentions grounds for skepticism over whether these operations are precisely Islamic, and some of the resulting divergence of opinion among Islamic scholars on the propriety of such claims of Islamicity. He valuably lays down standards that such operations ought to be held to meet if they are to be accepted as Islamically sound.

Michael J.T. McMillen's article, "A *Rahn-ᶜAdl* Collateral Security Structure for Project and Secured Financings," is the longest and most detailed paper in the section. It describes the first-ever implementation under Saudi and (therefore) Islamic law of the collateral security aspects of a project-finance transaction. This particular financing was a most significant event, since, before this transaction, complex financial transactions in Saudi Arabia reflected more the law of England or the United States than local Islamic law, and, accordingly, had only uncertain prospects of enforcement if they were ever to be litigated before Saudi courts. As McMillen describes, an immense effort of applied comparative law, exerted by Western-trained and *sharīʿa*-trained lawyers and jurists, went into formulating this complex transaction. The article is significant not only for local Saudi practice but for Islamic finance generally. Besides adding to the arsenal of Islamic financing tools, it also shows the complexity of the tasks awaiting us if we seek to elaborate not just the basic structuring of a transaction on Islamic legal models (*murābaha*, *mudāraba*, etc.), but also try to subject all of a transaction's terms and provisions to the manifold other rules of Islamic law. Many of these collateral rules are also profoundly shaped by fundamental rules about *ribā*, *gharar*, and *māl*, and may deserve as much respect as accorded the rules governing the basic financial terms of the transaction.

Together, these articles are a useful indicator of the moving edge of writing by scholars and practitioners about Islamic financial theory and practice today.

Property Rights in Islam

Abdel-Hameed M. Bashir*

ABSTRACT

Ownership rights in Islam originate from the concept of *khilafah* (stewardship), which is a constituent of the Islamic faith. The *sharīᶜa* clearly and explicitly defines property rights and the institutions that safeguard them. Meanwhile, there exist certain ethical and legal obligations that govern the acquisition of private ownership. The use of whatever is owned is restricted by the prohibition of *ribā* and the legal obligation of paying *zakat*. These moral limits are meant to achieve two vital objectives: restoring *al-ᶜadl* and promoting *al-ih̲sān*. *Al-ᶜadl* and *al-ih̲sān* are both necessary and sufficient conditions for restoring equitable income distribution. The paper further argues that the Islamic law of contracts and obligations acknowledges economic freedom. Nonetheless, the government is expected to play an active role by providing the institutional infrastructure that facilitates the efficient allocation of resources.

I. INTRODUCTION

For centuries Islam has influenced (in varying degrees and intensity) the structures and the political developments of societies in the Middle East, India, and Southeast Asia. Even today, Islamic tradition leaves its imprint on the thinking and the lifestyle of a large number of people. In the past few years, an interesting and widespread development appeared in the field of Islamic law and finance. The outgrowth of modern banking on the basis of the *sharīᶜa* renewed an old debate on economics and culture, especially religious culture (Berger, 1994). Although the idea of enforcing religious discipline in business is not new, few would argue that culture actually determines economic behavior in today's industrial societies.[1] What makes this development interesting is the fact that Islam does not separate between markets and sanctuaries, nor does it separate between morals and economic rationality. Indeed, economic and financial practices in Islam are not bound primarily by the marketplace. *Fiqh* (jurisprudence) and the *sharīᶜa* in general form the background against which all attempts in finance and business find guidance and legitimacy. Hence, the reliance of Islamic finance on law is inevitable since Islamic law gives any financial practice its legitimacy and significance (Saleh, 1986).

Serious attempts have been made in explaining the principles, concepts, and viability of the Islamic concept of economics. Considerable effort has been devoted specifically to Islamic banking and finance. These efforts have clearly demonstrated that the financial system of Islam is no longer a theoretical myth but an existing reality.

However, an important issue that has received little attention in the current literature, despite its relevance, is the issue of property rights in Islam. What makes this issue particularly relevant and appealing is that economists have recognized that market transactions are exceptionally productive in reconciling private desires with public purposes.[2] One central component of the legal foundation of the market relates to property rights over objects and circumstances. Effective and properly defined property rights are deemed essential in providing the preconditions for economic growth.

Thus, Islam, like Christianity and Judaism, acknowledges private ownership of assets insofar as this is in conformity with the Islamic law. In fact, the Qur'ān (the foremost source of Islamic Law) contains various rules and provisions which curtail to a certain extent the rights of ownership (Rodinson, 1986). For example, the Qur'ānic prohibition of usury (*ribā*) and the *sharīᶜa*'s prohibition of speculation (*gharar*) constitute two landmarks of the Islamic legal system. Both create a constraining factor on the technique of contracting (Saleh, 1988).[3] Yet, certain institutions, like *al-h̲isba*, are deemed necessary to define and safeguard ownership rights (Bashir, 1998).

The objective of this paper is to give an overview of the ownership rights in Islam, the acceptable means for acquiring wealth, and the Islamic restrictions on private and public property. Section II below discusses the concept of ownership in Islam and sketches, in concrete terms, the Islamic requisites on property acquisition. Section III discusses the sources of ownership from an Islamic perspective. The obligations and restrictions placed by the *sharīᶜa* on ownership rights are summarized in section IV. The institutions required to enforce and protect property rights are discussed in section V. An appreciation of these rules and institutions is essential in

* Assistant Professor, Department of Applied Economics, Grambling State University, Grambling, La.

understanding the Islamic perspective on economics. Section VI focuses on the impact of institutions on economic development, and Section VII concludes the study.

II. PROPERTY RIGHTS IN ISLAM

Ownership rights in Islam originate from the concept of *khilafah* (stewardship) which is a constituent of the Islamic faith. Generally speaking, ownership is regarded as depending less upon the independent activity of men than upon God's will (Rodinson, 1978). That is, God's ultimate ownership of property supersedes that of the individual. The Qur'ān and the Sunna (teachings of the Prophet), clearly and explicitly stated that God is the sole owner of wealth and that people, as vicegerents of God, are merely trustees or custodians.[4] In practice, however, nothing prevents the owner of private property from legitimately causing his property to fructify in the capitalist manner. The individual claims to *al-māl* (which denotes all the resources made subservient to man) are recognized and safeguarded by law.[5] Yet, the use of whatever is owned is restricted by the prohibition of *ribā* (usury) and the legal obligation to give *zakat* (alms).[6] The Qur'ān (57:7) explicitly states: "Believe in God and His messenger, and spend of that whereof He made you trustee." By implication, the ownership of *al-māl* is understood to be a trust and its disposal is considered to be a test of faith since the owner has to use it in accordance with God's revealed wisdom. The Qur'ān (6:165) states: "It is He who hath made you (His) vicegerents (or stewards), inheritors of the earth. He hath raised you in ranks, some above others; that He may try you in the gifts he hath given you." Hence, a person entrusted with wealth can achieve the highest degree of virtue (*falāh̲*) by spending out of his wealth within the boundaries prescribed by the *sharīᶜa*, Qur'ān (2:261).

Meanwhile, the objectives of the *sharīᶜa* are said to pertain to this world and to the life *hereafter*. It is, therefore, no surprise that the concept of stewardship brings the idea of accountability. Accountability indicates that we can neither evade responsibility for our actions, nor the motives behind them. Therefore, the repercussion of every human action is two fold: its effect in this life ("this worldliness") and its effect in the life hereafter ("other worldliness"). That is, the belief in the hereafter, which extends the life horizon beyond physical death, elicits an intertemporal behavior (Bashir, 1998). As Kuran (1989) writes, "In the terminology of modern economics, he is to bring into his calculus the negative and the positive externalities of his actions." Most important, the pattern of eternal reward and punishment exemplified in the Qur'ān motivates compliance with the dictates and prohibitions of the *sharīᶜa*. For example, when someone decides to pursue a business venture, he must take into consideration not only his expected profits (the worldly benefits) but also the eternal rewards he might get from benefiting the community. Perhaps, the most indispensable goal of the *sharīᶜa* is realizing the economic well being of the society through full and efficient utilization of resources. Al-Ghazzali, a great Islamic jurist, wrote, "The very objective of the *sharīᶜa* is to promote the welfare of the people which lies on safeguarding their faith, their life, their intellect, their posterity and their property. Whatever ensures the safeguard of these five serves the public interest and is desirable."[7]

In so doing, the *sharīᶜa* explicitly specifies a set of rules and principles that regulate the legitimate sources of acquiring *al-māl* (property), its growth, and its disposal. These moral limits, which will be discussed in detail below, are meant to achieve two vital objectives: restoring *al-ᶜadl* (socioeconomic justice) and promoting *al-ih̲sān* (mutual benevolence) (Qur'ān 16:90). *Al-ᶜadl* and *al-ih̲sān* are meant to articulate the notion that people should have equal opportunities, not necessarily equal riches.[8] More specifically, by emphasizing *al-ᶜadl*, the *sharīᶜa* intends to eliminate all forms of economic inequality, injustice, exploitation, oppression, and wrongdoing, whereby a person either deprives others of their rights or does not fulfil his obligations toward them. The principle of *al-ᶜadl* forbids gross inequalities in the distribution of goods and indicates that the ownership of wealth has social as well as economic dimensions.[9] *Al-ih̲sān*, on the other hand, is a reassurance that *al-māl* is to be used to maximize the welfare of the community (*Ummah*). Restoring both *al-ᶜadl* and *al-ih̲sān* are necessary and sufficient conditions for equitable distribution of income.

Other precepts specified by the *sharīᶜa*, to restore *al-ᶜadl* and *al-ih̲sān*, include the proscription of both avarice and wasteful spending (*Israf*) (Qur'ān 17:27). *Israf* or extravagant spending is prohibited because it entails consumption beyond the average standard for society and, therefore, violates the principle of equality (Kuran, 1989). Hence, people are encouraged to be modest and utilize the available resources to attain both the mundane and the spiritual objectives of the *sharīᶜa*. Another important injunction required for the restoration of *al-ᶜadl* and *al-ih̲sān*, is the proscription of hoarding (*kanz*). Hoarding is prohibited due to its negative externality on wealth and income distribution. In today's economic thinking, hoarding can be harmful because it limits the productive capacity of resources and leads to the concentration of wealth in the hands of few. Chapra (1985) writes, "Islam provides an economic system that makes it absolutely imperative to use God-given resources for fulfilling the essential needs of all human beings and providing them with decent living conditions."

III. Sources of Ownership in Islam

A. Private Ownership

To reach a conclusion on the position of Islam on private property, it is necessary to make a thorough examination of the manner in which Islamic law (the *sharīʿa*) specifies the privileges, the usage, and the disposal of owning property. As a prelude, it is important to note that the Islamic concept of ownership rights is commensurate with work effort. Work, in all its forms, is considered to be a perfectly legitimate vehicle for acquiring property in so far as it is in conformity with certain moral requisites. There are numerous injunctions in the Islamic law urging the followers of Islam to engage in productive activities and pursue legitimate monetary gains to improve their economic well being. For example, the *sharīʿa* dictates that it is a divine duty for all persons to work and use their abilities to gain a just reward from their work effort.[10] Consequently, the individual can acquire property, including the means of production, through a host of legitimate means. Though traditional Islamic sources of private ownership were profoundly influenced by the circumstances of the earlier days of Islam, the following sources are still relevant and safeguarded by law in many Islamic countries.

1. Physical and Mental Work

Since Islam seeks to promote the economic well being of each person within the framework of its moral norms, it urges man to engage in productive activity and to utilize all the resources he is entitled to, circumscribed by the limits set by the *sharīʿa*. Accordingly, ownership is considered a fair return when the job is done with care and devotion. The Qur'ān (9:105) states: "And say: work; soon will God observe your work and His Apostle, and the Believers." This high admiration for work is a clear enticement to innovation and novelty. Hence, wage-labor is seen as something perfectly normal, and individuals are encouraged to invest in their human capital development. Indeed, intellectual property rights are acknowledged and safeguarded by the *sharīʿa*.

2. Landed Property

According to the Islamic theory of landed property, development and fructification of what one possesses binds ownership. Property can be acquired through developing and utilizing arable fertile (farming) land with no previous claim of ownership.[11] However, the right someone has acquired to a piece of land is not lost merely through non-use; it vanishes only if someone else brings that land under cultivation.[12] The purpose of such law is to benefit the general public by bringing life to the virgin land and to ensure the continuity of utilization.[13] No privately owned natural resource is to be left unused. Meanwhile, the concept of sharecropping is acknowledged by most Islamic schools of thought as a justifiable mode of acquiring property rights.

3. Mining and Minerals

Extraction of minerals (*al-rekaaz*) is another accepted means by which one may legitimately claim ownership rights.[14] Here the extractor is assured of four fifth of the yield, provided that these minerals are extracted through individual efforts. The public treasury (*bayt al-māl*) claims the other fifth.

4. Inheritance and Bequest

Islamic jurists agree that property rights can be transferred through inheritance and bequest. The *sharīʿa* has a detailed set of rules and regulations concerning the intergenerational transfer of asset ownership from parents to children. In principle, the ownership rights of the entire inherited wealth can go to one heir. However, only one third of the property can be willed away as a bequest.[15] A closely related source of ownership acknowledged by the *sharīʿa* is the right of *Ash-Shufe'ah* (preemption). The right of *Ash-Shufe'ah* gives the neighbor and/or the partner the right to acquire the property of his neighbor or partner when the latter intends to sell it. The Prophet was quoted as giving a verdict regarding *Shufe'ah* in every undivided joint object (property). But if the limits are defined and the shares are identified, there is no preemption. *Waqf* is also a legitimate means of acquiring the benefits of ownership.[16]

5. Trade and Commerce

Trade and commerce are praised sources of acquiring ownership rights. In fact, the Sunna has stated that trade is a superior way of earning one's livelihood: "If you profit by doing what is permitted, thy deed is *jihad* [that is, it is identified with holy war or any vigorous effort undertaken for God's cause] and, if thou usest it for thy family and kindred, this will be a *sadaqa* [that is, a pious work of charity]; and truly, a *dirham* [drachma, silver coin] lawfully gained from trade is worth more than ten *dirhams* gained in any way." It is important to note that the *sharīʿa* forbids the fixed or predetermined return on financial transactions (interest), but not the uncertain rate of return represented by profits. The Qur'ān (2:275) states that trade is permitted and usury is forbidden. Therefore, economic activity, the search for profit, and consequently, production for the market, are looked upon favorably.

To avoid unlawful gains and usurious transactions, the *sharīᶜa* has specified detailed contractual laws that govern trade and commerce. All types of contracts, such as *ijāra* (hire), *ijāra wa iktina* (hire-purchase), *murābaha* (markup), *mushāraka* (partnership), and *mudāraba* (profit sharing), are permitted so long as the ethics of contracting are observed. Faithfulness to contractual obligations is certainly stressed in the *sharīᶜa*.[17] It is worthy to mention here that, no specific wording is recommended as *the* way to make contracts. Any consensual transaction between two trading partners is considered a binding contractual agreement. However, the contracting parties should have perfect knowledge of the countervalues intended to be exchanged as a result of their transaction (Saleh, 1988). This freedom of contracting provides the parties involved with the flexibility to make a virtually open-ended menu of financial transactions and instruments (Khan and Mirakhor, 1987).

B. Public Ownership

The state, in the Islamic system, is a form of collectivity that derives its authority from the concept of *Khilafa* (vicegerency). Bound by the moral teachings of Islam, the state has a number of duties to perform. These include activities such as defending the territorial integrity of the state, maintaining law and order, propagation of good and suppression of evil, assurance of at least a basic minimum standard of living for all its citizens, and prevention of gross inequalities in income and wealth distribution. To fulfill its obligations, the State must generate sufficient funds. Ironically, Islam envisages a variety of property rights that accrue to the state.

1. Public Farming

It is quite true that, in the early stages of the Islamic State, revenues came mainly from agricultural production. Expropriations "for the public good" were numerous at the time and immense areas of cultivable land were placed at the disposal of the State. It was indispensable that this land be exploited so as to meet the costs of the machinery of State and to generate revenues for the treasury (*bayt al-māl*). Part of the revenue was used to provide help for the needy and the poor.

2. Public Utility

Although the *sharīᶜa* advocates sharing rather than excluding, it restricts and regulates public ownership.[18] For example, property may be expropriated for public utility such as pasturage, mining, and water sources. Moreover, designated public farming land cannot be used for private purposes unless a special arrangement is made (e.g., share cropping). This emphasizes the fact that production for the public interest gives the State the power to limit the property rights of individuals. However, individuals affected by regulations that allow taking land use options from owners must be compensated.

3. Other Public Resources

A variety of other sources of public revenue are also available to the Islamic State. These include the *zakat* (a wealth and property tax to be recovered from Muslims), *kharāj* (land tax on agricultural land surrendered to Muslims without any resistance), *jizya* (poll tax on non-Muslims residing in Muslim territories), *ushoor* (custom duties) and *rekaaz* (mines and treasure-trove). *Ghaninmah* (spoils of war), and *fai'* (booty surrendered by the enemy without actual fighting), are other occasional sources. Each one of the above-mentioned sources is subject to a separate fund account. For instance, *Diwan Al-Zakat*, with its dual role of collecting and distributing the *zakat*, and *Diwan al-Kharāj*, for collecting taxes, were public institutions utilized in the past that were designated for administering public revenues. Religious institutions, public endowments (*awqāf*), and the natural resources buried underneath the earth may also generate revenue to finance public projects that benefit the general public. All revenues accruing from these sources are considered public and the State should disburse them according to a certain set of rules.

Meanwhile, the State is expected to seek other ways to generate enough revenue to pay for its civic and defense expenses. In fact, the *sharīᶜa* provides broad guidelines according to which the State may perform its functions. The permissibility of dynamic interpretations (*ijtihad*) provides wider latitude to find solutions to newly emerging problems. Utilizing the principles of *qiyas* (analogical deduction) and *al-masalih-al-mursalah* (judgment based on public welfare), jurists have concluded that the state should be active in promoting overall economic activity by fully utilizing the economy's productive resources.

IV. THE NORMS GOVERNING PROPERTY RIGHTS

Ownership and acquisition in Islam are bound by a set of normative obligations laid down by the *sharīᶜa*. These obligations comprise the moral and the religious doctrines that guide and govern ownership in Islam. Since the Islamic economic regulations are closely related to moral standards, these norms should be looked at as regulations rather than restrictions. From an economic perspective, one would expect these principles to enhance economic performance by restoring both equity and efficiency. Nonetheless, since these principles should be obeyed under all temporal and spatial conditions, the following restrictions should be taken as axiomatic.

A. Prohibition of *Ribā* (Usury)

The central restriction of the Islamic economic system is the prohibition of *ribā* (interest) in financial transactions. According to the Islamic value system, *ribā* represents a source of unjustified advantage, and those who deal with *ribā* wage war against God and His Apostle (Qur'ān 2:279). Obviously, the prohibition of interest applies to all types of loans, whether or not notes or debentures secure them. The *sharīᶜa* has acknowledged instead the usage of the unspecified rate of return (profit) as a mechanism for allocating resources. The Qur'ān (2:275) states: "But God hath permitted trade and forbidden usury." A system based on profit-and-risk sharing is believed to be more equitable than a system based on interest and usury.

B. Prevention of *Gharar* (Chance)

Starting from the notion of protecting the weak against exploitation, the *sharīᶜa* has prohibited any transaction entailing uncertainty, speculation, or risk (*gharar*). The *sharīᶜa* prohibits any gain that may result from chance or from undetermined causes. A certain game of chance that received an enormous degree of prohibition is *maysir* (gambling). Above all, any selling in which there is an element of uncertainty is prohibited (Rodinson, 1978). If the subject matter of the contract is not in existence or even present at the time of contracting, the transaction is regarded void.

C. Repudiation of Monopoly

There is a general principle in Islam that wealth should not be monopolized in the hands of a few individuals, since this will create social imbalance. The *sharīᶜa* prohibits monopoly and exclusive possession of *al-māl* because monopoly, along with interest, are believed to be the primary vehicles for financial exploitation and wealth concentration. By denouncing monopoly, the *sharīᶜa* mandates that *al-māl* should be distributed in a way that does not confine it to a few wealthy people in society.[19] Therefore, the private owner should adhere to the requirements of the *sharīᶜa* when acquiring, disposing, spending, transferring, or exchanging property.[20] The Qur'ān (57:7) states: "And spend (in charity) out of the (substance) whereof He has made you heirs."

D. Prohibition of Unjustified Means

Any property acquired through unjustifiable means, like *gharar* (speculation), *maysir* (gambling), bribing, stealing, cheating, or illegal trading is proscribed and forbidden.[21] Certain commercial practices are, however, prohibited (deemed *ḫarām*) by the *sharīᶜa* as well. These include the production and marketing of intoxicants, as well as the hoarding and cornering of stocks with the intention of creating artificial scarcity and profiteering. Interest-based transactions, bribery, theft, robbery, breach of trust, and the use of fraudulent weights and measures do not satisfy the definition of *al-māl* and, therefore, are not worthy of ownership. Any contract involving these products is not binding and, hence, should not be honored or enforced.

E. Legal Obligation of *Zakat* (Alms)

Zakat occupies a unique position in the Islamic economic system. The *sharīᶜa* assigns to the state a clear-cut duty to organize a system of *zakat* collection and disbursement. The Qur'ān (9:103) states: "Take alms of their wealth, wherewith thou mayst purify them and mayst make them grow…" According to Islamic teaching, payment of *zakat* purifies one's soul, as well as leads to increase in material welfare in this world and growth of religious merit in the next. Those who fail to discharge this obligation are warned severe chastisement in the hereafter. Therefore, the property owner is deemed responsible for the payment of *zakat* when *al-māl* reaches the necessary limit of *al-nisab* (the minimum quantity of an asset which makes it liable to *zakat*) and has been in his ownership and possession for one full year.[22]

F. Voluntary Spending for Welfare of the Poor (*Sadaqa*)

It is the general philosophy of Islam that human beings should be properly motivated to act rightly on their own, so that the coercive powers of the state are used to the minimum extent necessary (Ahmad, 1989). In the matter of income distribution particularly, Islam emphasizes the virtue of *infaq*, that is, voluntary spending for the welfare of the poor. The Qur'ān (3:92) proclaims that in no case will man attain piety unless he spends freely from his wealth in the way of God for the needy and the poor. The repeated exhortations on this matter in the Qur'ān and the Sunna (the traditions of the Prophet) are meant to promote a culture and a way of living where people care for each other and where the disparities in income and wealth are minimized.

G. Efficient Use of Property

By condemning hoarding and extravagant spending, the *sharīᶜa* encourages and promotes efficient use of property. The owner is required to use his wealth in ways that benefit him while not hurting the general interest of society. Any inefficient use of property is in violation of the objectives (*maqāsid*) of the *sharīᶜa*.[23] If the property owner proves his inability to use *al-māl* properly, he forfeits his ownership rights. Under such conditions, the community (State) is fully justified in withdrawing the rights of usage of that property[24] in order to protect it from the misuses of its owner.[25] Imam Al-Shafe'i (a renowned jurist) is of the opinion that when individuals go beyond the point of moderation in expenditure, even if they are spending on good and lawful things, their property should be placed under the custody of the State.[26] This is because Islam attaches great importance to protecting people from harm. The Prophet is reported to have said "to cause harm to others is not allowed in Islam."

H. Fulfilling Necessary Interests

According to the Islamic jurists, five necessary (*daruri*) interests need to be fulfilled. These comprise the *deen* (religion), the *nafs* (life or self), *nasl* (family or progeny), *māl* (property), and *ᶜaql* (intellect or reason). One major liability of the property owner is to fulfill his *daruri* (necessity) obligations, since these obligations constitute basic religious duties on par with the annual payment of *zakat*.[27] The Qur'ān (2:177) states: "It is not righteousness that ye turn your faces to the east and the west; but righteousness is to believe in God and the Last Day and the Angels and the Scripture and the Prophets; and spend of your substance, out of love of Him, for your kin, for orphans, for the needy, for the wayfarer, for those who ask, and for the ransom of slaves, to be steadfast in prayer, and practice regular charity; to fulfill the contracts."

I. Investment of *al-Māl*

It has been argued that the Islamic prohibition of hoarding wealth entails continuous investment of *al-māl* in legitimate (*halal*) enterprises. The *sharīᶜa* encourages Muslims to invest their funds sensibly and neither gamble them away, nor otherwise waste them (Qur'ān 6:141). Given the absence of interest, it can be seen that uninvested money will be entirely eaten up by the *zakat* over time. Hence the *zakat* is expected to have a stimulating effect on investment. Both the wealth (property) owner and the State are obliged to devise permissible investment strategies to reproduce *al-māl*.

V. PROPERTY RIGHTS INSTITUTIONS

The enforcement of property rights can only begin with the establishment of legal as well as economic institutions. This is important because legal and economic institutions are inextricably linked and complementary to each other. Certainly, the promulgation of written laws delineating individual rights and responsibilities will compel participants to abide by these laws. Conversely, the lack of a well-defined legal system specifying the domain and limitations of property rights would undermine any efforts to encourage individuals to enter into long-term contracts. Not only does the *sharīᶜa* acknowledge ownership rights, but it also requires establishing institutions that will regulate, codify, and enforce property rights. Indeed, the Islamic system already has built-in institutional infrastructure to enforce and protect individual rights.

A. Legal Institutions

In the Islamic legal system, there exist comprehensive clauses specifying the rights and responsibilities of property owners. Several times, the Qur'ān makes explicit reference to institutional authority to uphold justice, collect the *zakat*, and oversee contractual agreements. In fact, the *sharīᶜa* places a great emphasis on contracts, and the Qur'ān (4:1) instructs the believers to faithfully fulfill all contractual obligations. With regard to documenting and recording debts to protect individual rights, the Qur'ān states: "O you who believe, when you contract a debt for a determined period, record it in writing and let a scribe justly record it in writing." Implementing and enforcing the

Islamic law of contract is, therefore, expected to accomplish two things. First, it will foster compliance with long run contractual agreements. Second, the existence of monitoring institutions and/or written provisions will minimize the moral hazard problem associated with long-term agreements. Hence, applying the *sharīᶜa* is both a necessary and sufficient condition for initiating property rights institutions.[28]

Historically, the Islamic legal institutions used to protect property rights include the *fiqh* (jurisprudence) institutions, the judiciary system, the *shura* (consultation) institutions, and the *ẖisba.*[29] To ensure their integrity, these institutions were given total independence from the government (State). Under an independent judiciary system, the court system will be effective in enforcing contractual agreements, settling disputes, and specifying punishments. The strict punishments prescribed by the *sharīᶜa* for violating property rights (e.g., stealing, burglarizing, and using force to confiscate) would safeguard properties of all individuals. In fact, the independence of the *fiqh* institutions were the catalyst in allowing the Islamic jurists to freely interpret relevant and applicable *sharīᶜa* rules and perform *ijtihad*.[30] The *shura* institutions, on the other hand, are needed to enact regulations and secure compliance and accountability. Meanwhile, the State is expected to give due regard to *shura* and *ijma* (consensus of jurists) in formulating its policies in various spheres (Ahmad, 1989). Furthermore, the institution of *al-ẖisba* is meant to monitor the behavior of market participants and set the standards for fostering ethical and moral behavior.

B. Market Institutions

In endorsing economic freedom and allowing maximum scope to market forces, the *sharīᶜa* acknowledges the market mechanism as a vehicle for the determination of commodity prices. Full and unlimited access to the market, by all buyers and sellers, is advocated as a prerequisite for the free working of a liberal economy. Moreover, full disclosure of the quality of goods being offered for sale and noninterference with suppliers before entrance into the market is required. Above all, specific norms of behavior have to be observed by all market participants if the interests of all parties are to be safeguarded (Ahmad, 1989). For example, the parties entering any sale-purchase transaction have free consent (*khiyar*) in reaching an agreement. However, once the transaction is completed, fulfillment of all terms of the contract is required. In addition, the *sharīᶜa* prescribes certain norms to enhance the market behavior. Adulteration, hoarding, and cornering of stocks with a view to creating artificial scarcity and profiteering, collusion among buyers or sellers to hurt the interest of one party, and bidding up prices without the intention to purchase are all severely condemned (Ahmad, 1989). Strict adherence to correct weights and measures is also emphasized.

Historically, independent regulatory agencies were established to monitor trading practices and other fraudulent market behaviors. These medieval Islamic institutions included *al-ẖisba*, *diwan al-azimmah*, and the Real Estate Registry. Currently, *sharīᶜa* committees affiliated with Islamic banks are established for the same purpose. Meanwhile, the State is enjoined to institute whatever arrangements are needed to regulate the market. Certainly, this can be interpreted as part of its duty of propagating good and suppressing evil (*amr bil maruf wa-n-nahi anil munkar*). The Qur'ān (22:41) states: "They are those who, if we establish them in the land, establish regular prayer and give regular charity, enjoin right and forbid wrong…" Moreover, Islam also allows a considerable flexibility in using human reasoning to find solutions to new problems. The only constraint is that the objectives (*maqāṣid*) of the *sharīᶜa* should be met.

C. Financial Institutions

Credit and commerce were in widespread use in the Islamic world at least three or four centuries before comparable levels of economic activity were recorded in medieval Europe. Although no Islamic institutions evolved into the kind of credit and banking institutions which were seminal in the economic growth of Europe, a variety of credit institutions which could both facilitate trade and provide a framework for credit were founded in the earliest Islamic periods. In fact buying and selling on credit was an accepted and apparently widespread commercial practice, whether the merchant was trading with his own capital or with that entrusted to him by an associate (Udovitch, 1975). Moreover, Islamic jurisprudence has not identified the firm as a legal entity whose obligations are separate from its owners, (Gamble and Karin, 1990). Yet, many early Islamic legal writers assumed that credit dealings were indispensable to successful and profitable trading.

Indeed, contemporary banks, firms, and other financial institutions are encouraged to use credit insofar as they satisfy the injunctions (*maqāṣid*) of mobilizing assets via various modes of profit-sharing arrangements. Surely, the freedom of contracts allowed under the Islamic law provides a flexibility that makes possible a virtually open-ended menu of various forms of financial transactions and instruments[31] (Khan and Mirakhor, 1989). Under the provisions of these profit-sharing arrangements, a good number of different types of trading companies (*sharikāt*) were known to Islamic jurisprudence (Gambling and Karim, 1985). According to Islamic jurisprudence, *sharikāt* can be of two kinds: *sharikāt al-milk* (non-contractual) and *sharikāt al-uqud* (contractual). The latter are also divided into four categories: *sharikāt al mufawadah*, *al-ᶜīnan*, *al-abdan*, and *al-wujuh* (Chapra, 1985). These are companies based on delegation, guarantee, labor, and reputation. The equity-based system also entails the creation of new institutions, new markets, and new instruments to eliminate the possibility of dealing with *ribā*. For instance, joint stock companies and large-scale financial markets are needed to foster financial development so long as they conform to the *sharīᶜa*.

D. Monetary Institutions

Certainly, contemporary monetary and fiscal policy institutions were not identified in classical Islamic jurisprudence. However, their conformity to the *sharīᶜa* can be judged through *qiyas* and *al-masaleh al-murssala*. For example, the avoidance of inflationary and deflationary pressures requires the coordination of monetary and fiscal policy to restore macroeconomic stability. Monetary stability is very important because inflation and unemployment are believed to have serious consequences on property rights. Like other taxes, inflation is unpopular, erodes the value of the property, and redistributes incomes unequally. Indeed, reducing the level of inflation is consistent with the *maqāṣid* of the *sharīᶜa*, and so the government has an incentive to prevent it. Hence, macroeconomic stability should be the top priority of the Islamic State.[32] Consequently, an autonomous monetary authority (central bank) is needed to develop appropriate financial instruments that are permissible under Islamic law. Beside its role of regulating the banking system freely and diligently, the central bank should issue and control high-powered money. This requires the central bank to be an independent institution. An independent central bank would constrain the government from using inflationary debt financing to balance its budget. Recent evidence has shown that greater independence of the central bank is associated with lower inflation rates (Cukierman, 1994).

E. Political Institutions

Legal and market institutions should also be accompanied by political institutions. The institutions of *as-shura* (mutual consultation) should be established. *As-shura* is needed to reach consensus in matters where there is no clear injunction from the Qur'ān or Sunna. A*s-shura* institutions could be formed to deal with legislative as well as executive matters. Al-Awa (1980) writes, "It is more compatible with the Islamic method of legislation to leave matters to be brought before *As-Shura* unspecified and undefined, establishing only the principles and general rules, and leaving details to be worked out by Muslims in adapting the law of Islam to particular time and place." The institutions of *as-shura* will implement the constitutional changes, safeguard the transition of power, and warrant political stability. *As-shura* institutions are also needed to regulate and protect ownership rights, to check government performance, and enforce the rule of law.

VI. INSTITUTIONS AND ECONOMIC DEVELOPMENT

The Islamic perspective of development seeks to improve the social, cultural, economic, and ethical condition of man (as vicegerent on earth) under the guiding principles of the *sharīᶜa*. As Ahmad (1981) writes, "[D]evelopment would mean moral, spiritual and material development of the individual and society leading to maximum socioeconomic welfare and the ultimate good of mankind." Hence, the legal, economic, and political institutions comprise the infrastructure needed to maintain sustained and balanced development. The impact of these institutions on growth and development can be analyzed in terms of their effects on income and wealth distribution, resource allocation, saving and investment, and monetary stability.

The institution of *zakat* for example, is expected to play an important role in income distribution and resource allocation. First, the *zakat* serves as a safety net designed to provide for the relief of poverty and other forms of social security. Its redistribution effect is expected to increase the aggregate demand in the economy. Second, as a tax, the *zakat* is expected to have a strong stimulating effect on investment and productivity. By discouraging property owners from holding idle assets, the *zakat* will create incentives for wealth owners to ensure the maximum turnover of their net capital (Gamble and Karim, 1990). Together with the proscription of extravagant spending, the *zakat* is expected to reduce the transaction demand for money. Moreover, the stimulating effect of the *zakat*, together with the ban on interest, is expected to reduce the precautionary demand for money. Finally, the redistribution effects of *zakat* are expected to have a positive impact on the level of aggregate savings.

Equivalently, the market institutions, especially Islamic banks, can make useful contributions to growth and development. Given the high degree of thrift practiced by farmers and peasants, expanding the interest-free banks in the rural areas will help transform the rural economies. The Islamic banks could use their profit-and-loss sharing schemes to finance productive sectors like agriculture and small-scale industries (microcredit schemes). Islamic banks would make a significant contribution to growth and development if they were able to attract foreign capital through cooperation and partnership (i.e., foreign direct investment). They could also be the vehicles for transferring technology.

Growth and development will also be impacted by monetary institutions that assure price stability. It is well documented in the literature that managing the rate of growth of the money supply is a prerequisite for stable prices. Research has also shown the depleting effects of inflation on economic growth. Hence, price stability is expected to have a significant positive effect on economic growth. An independent central bank would be in place to manage the money supply, issue and maintain the value of the currency, and sustain the public's confidence in the payment system. Moreover, as a regulatory agency, the central bank can serve as a catalyst in guaranteeing transparency, accountability, disclosure, and openness.

Meanwhile, the Islamic State has an indispensable role to play in the economy. First, it should design policies that protect economic freedom and provide perfect information to the market. Second, it should strive for sustained and balanced growth, higher standards of living, and equitable distribution of income. Third, the government should invest in human capital to increase productivity, assist entrepreneurs in acquiring managerial skills, and acquire new knowledge. Finally, fiscal and monetary policy should be coordinated to attain economic stability and curb inflation.

VII. CONCLUSION

The paper analyzes the bearing of Islamic teachings on defining and enforcing property rights. It is strongly argued that the *sharīʿa* acknowledges and specifically defines ownership rights. Moreover, Islamic law is explicit about the institutional framework needed to protect the rights and privileges of property owners. The paper further argues that Islam permits economic freedom and free markets provided that these institutions do not violate certain guidelines regulating the means by which ownership is attained. Meanwhile, the government of the Islamic State is expected to promote market-oriented policies to facilitate efficient allocation of resources.[33] However, the government is expected to keep its intervention in the market to a minimum, confined to the enforcement of property rights. Hence, all economic and social institutions which improve income distribution, restore social justice, and conform to the requirements of the *sharīʿa* should be established. The institution of *al-ḫisba* plays an important role in monitoring and enforcing ethical and legal restrictions. Furthermore, it is argued that establishing these institutions will promote economic development. There is much to learn, and much room for improvement.

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[1] The Christian Church in Europe made consistent and well-documented attempts to enforce canon law in business affairs, for centuries (Gambling and Karim, 1990).

[2] For example, when property rights to land are properly enforced, land users must pay for what they use and therefore will economize on their use. Equally, land owners searching for high bids have a strong incentive to find those with highly valued uses now (for revenue) and in the future (to protect current asset value) (see Stroup, 1997).

[3] *Ribā* can be defined as an unlawful gain derived from quantitative inequality of the countervalues in any transaction purporting to the effect of exchange of two or more species. *Gharar* in sale transactions, on the other hand, causes the buyer to suffer damage (*ghubn*) and is the result of a want of knowledge (*jahl*) that affects either the price or the subject matter (see Saleh, 1986).

[4] See Qur'ān (20:6).

[5] The concept of *al-māl* in Islam denotes all the resources that God made subservient to man on land, in the sea, and beneath the surface of the earth. *Al-māl* is also defined as anything (property) that can be owned and has value, including the rights and benefits of ownership. It can be classified as *ḫalāl* (lawful) if owned through legitimate means, or *ḫarām* (unlawful) if acquired through unjustifiable means.

[6] Neoclassical economists tend to regard institutions as constraints on market activity, and from this perspective it follows that property rights embody protection against the arbitrary and capricious alteration in such institutions. However, a correct understanding of institutions sees them as both liberating and constraining economic agents (see Bromely, 1997).

[7] Al-Ghazali. *Al-Mustasfa* 1. pp. 130-40.

[8] Justice and equity are such indispensable ingredients of the Islamic faith that an ideal Muslim society, where these norms have not been actualized, is inconceivable.

[9] See Kuran (1989) for a similar argument.

[10] The Qur'ān (62:10) states: "And when the prayer is ended, then disperse in the land and seek of God's bounty, and remember God much, that ye may be successful."

[11] The Prophet Muhammad disapproved of leaving productive assets (land) idle and urged those who owned land to cultivate it or leave it to those who could do so.

[12] The Prophet (peace be upon him) explained the principle of ownership of such land, "Land belongs to God and the human beings, too. Whoever rehabilitates barren land becomes its owner." He also said, "There is no right of ownership to be claimed on the land if the owner does not reasonably exploit it after three years of possession."

[13] During the decadence of the Roman Empire, the owners of agricultural domains were threatened with forfeiture of their property if they neglected to cultivate it (see Rodinson, 1978, pp. 172).

[14] *Al-reikaaz* are treasures buried during the pre-Islamic period. The extractor should declare it first before claiming its ownership. A similar practice was common during the Roman Empire: one was allowed to exploit a mine he had discovered, whether the owner of the land consented or not, and only one-tenth of the product was due to be paid to this owner (Rodinson, 1978).

[15] The Prophet (peace be upon him) told his companion Sa'ad, when the latter asked about the Will, "The third, and the third is too much."

[16] *Waqf* is a public endowment where the benefactor has the right to reap the benefit from the asset but not the right to sell or exchange it.

[17] The Qur'ān (2: 275) says, "But God hath permitted trade and forbidden usury," while Qur'ān (5:1) says, "O ye who believe! Fulfill (all) obligations."

[18] The right of ownership is limited by certain considerations, such as the right of everyone to life. One dying of hunger is justified in taking, at the expense of the legitimate owner, the minimum of food needed to remain alive. Meanwhile, some primary products, such as water and grass, are not subject to appropriation. See Rodinson (1978, Ch. 2).

[19] Although people differ in their wealth, Islam always recommends an equitable income distribution. Qur'ān (59:7) states, "... in order that it may not (merely) make a circuit between the wealthy among you."

[20] There is a consensus among Muslim jurists that ownership cannot be established without the authorization of the *sharīᶜa* because all rights, including the right to own, originate in the *sharīᶜa*.

[21] Islam does not allow the arbitrary expropriation of private property. The Qur'ān (2:188) says, "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."

[22] The *zakat* is an important component of social insurance or a provident fund for the community. It is the right of the less fortunate members of the community on the property of the rich. If the rich fail to pay zakat, the government is responsible for enforcing it. When the proceeds from zakat are insufficient, the government has the right to levy more taxes on the wealthy for budgetary purposes.

[23] The Prophet was quoted as saying, "No harm and no harming." The jurists said there should be laws and regulations to curb mischief before it occurs.

[24] The Qur'ān (4:5) says, "To those weak of understanding, make over your property which God has made a means of support for you."

[25] It was narrated that the Prophet (peace be upon him) told one of his companions that he might fully water his fields and must leave the water to flow to his neighbor to benefit from it. The Prophet was also quoted as saying, "People are partners in three things: water, pasture, and salt," indicating that water is common property.

[26] The owner can regain the title to his/her property when showing willingness to refrain from *Israf*, or extravagant spending. During the decadence of the Roman Empire, the owners of agricultural domains were threatened with forfeiture of their property if they neglected to cultivate it (Rodinson, 1978).

[27] There are other unspecified rights on *al-māl*, over and above zakat, especially during the time of emergencies and disasters. The Prophet (peace be upon him) was quoted as saying, "There are obligations on *al-māl* other than zakat."

[28] Islamic law places a great deal of emphasis on contracts and the necessity for participants to remain faithful to the terms specified in them, so much so that faithfulness to the terms of contracts is considered a distinguishing characteristic of a Muslim. The Prophet was quoted as saying, "Muslims are bound by their stipulations." When the Prophet was asked about the believer, he replied, "A believer is one with whom the people can trust their persons and possessions."

[29] The institution of *al-h̲isba* is based on the Islamic duty of enjoining the right and preventing the wrong. The *muh̲tasib*, who oversees the *h̲isba*, is a market monitor or regulator delegated by the authorities to oversee trading practices (e.g., weights and measures).

[30] *Ijtihad* is the jurist's use of reasoning to find solutions to new problems while keeping in full view the intent and spirit of the *sharīᶜa*. Methods of *ijtihad* include *qiyas* (analogical deduction), *istihsan* (preference of one *qiyas* over another or even abandonment of *qiyas* for some strong reason), and *al-masalih-mursalah* (judgment on the basis of public welfare).

[31] The Islamic financing mechanisms include *mud̲āraba*, *mushāraka*, *murābah̲a*, *ijāra*, *ijāra wa iktina*, *Bayᶜ Mo'ajal*, *Salam*, and *Quard Hassan*.

[32] Recently, some economists have suggested that zakat could be used as a stabilizing device to reduce inflationary pressures (Ahmad, 1983).

[33] The Prophet (peace be upon him) allowed sharecropping while implicitly acknowledging the efficiency of private enterprise. Public property should be privatized or managed privately through profit-sharing arrangements.

Business Organizations under Islamic Law
A Brief Overview

Gohar Bilal*

Abstract

The concept of partnership is uniquely dealt with in Islamic law. Under the *sharīʿa*, there is no single definition that covers the different types of partnerships. The definition of each is based on the conditions and rules that govern the relationship. Understanding business partnerships is very important in today's environment. Individuals form associations, corporations, and firms that generate profit through specific businesses. There are partnerships in capital, labor, services, and work. In other cases, one partner nominates the other as his/her agent or trustee. Although Islamic law does not directly address the concept of business/commercial corporations, it does discuss in detail the different kinds of partnerships, based on factors such as responsibility, restrictions, and division of work and profit. The subject is important because it is implicated in the development of business vehicles—i.e., platforms that allow efficient development and structuring of Islamic financial products in the areas of venture capital, project finance, joint ventures, and asset-backed securities.

I. Introduction

Organizational vehicles set boundaries for designing financial products. However, conventional and Islamic financial products face different issues when developed under existing regulatory frameworks established for corporations. Islamic finance professionals are currently examining products such as tradable instruments (other than stocks), partnership structures, and others. At the same time, it is becoming equally important to review various shells or organizational structures that would support the development of such new products efficiently.

Why must we do this? Currently, when designing Islamic financial instruments, we work within a shell that caters most often to conventional finance, which caters to a different market and presents a different concept from Islamic finance. For efficient structuring of Islamic financial products, it is necessary to review the structure of companies or corporations that would form an optimum platform for designing these instruments. This would require:

1. assessing the financial needs of the beneficiaries of Islamic finance;
2. understanding the organizational structures that are approved under Islamic law;
3. in-depth review of the financial services companies existing in today's market;
4. evaluation of similarities and differences between conventional business institution(s) and those that generally classify as Islamic business organizations;
5. determining key components for structuring corporation(s) that would conform to Islamic law and would also operate within the conventional legal system; and
6. most importantly, structuring companies to meet regulatory approval.

The objective of this paper is to suggest a process of developing an optimum organizational structure that can offer completely integrated Islamic financial institutions serving both borrowers and investors. An optimum organizational structure can be determined by screening for the following criteria: legal considerations; the *sharīʿa*; and tax considerations. Here we focus on the first two.

II. Conventional Legal Definition of a Corporation

In the existing environment, the most popular business vehicle is the "corporation," an artificial person or legal entity created by or under the authority of the laws of a state. A corporation: is an association of persons created by statute as a legal entity; is treated by law as a person that can sue and be sued; is distinct from the

* Visiting Research Scholar, Harvard Islamic Finance Information Program, Cambridge, Mass.

individuals who comprise it (shareholders); survives death of its investors, as shares can usually be transferred; and has a personality and existence distinct from that of its several members. The purpose of a corporation is either to carry out a business for profit or to provide a service.

As an artificial person, a corporation needs some form of *ᶜaql* (brain) to carry out business. This brain or decision-making power can be lodged in an individual, or in a group of individuals, such as the board of directors. In either case, these groups act as agents of the company.

As a legal person, a corporation can own property in its name. It can transact business, incur liabilities, and engage in litigation to protect its interest and observe legal duties and restrictions. Also, it has all rights and privileges of an individual, subject to limitations imposed by law or constraints from its nature as an artificial person. Different forms of corporations under conventional law are identified in Table 1.

TABLE 1. MAJORITY FORMS OF CORPORATIONS EXISTING UNDER CONVENTIONAL LAW

Financial Institutions	Companies	Investment Schemes
banks	charities; unincorporated associations	real-estate investment trusts (REITs)
credit unions	firms	investment trust companies
offshore trusts	cooperatives	open-ended investment schemes
investment banks	partnerships	collective investment schemes
cooperatives	limited partnerships	various types of funds
	public limited companies	
	private limited companies	

III. APPROACH

The search for the most appropriate vehicle for developing Islamic financial products could proceed in the following manner:

1. Establish objectives.
2. Research and identify the range of corporate structures.
3. Screen each option by the above criterion.
4. Narrow the range by eliminating inappropriate structures.
5. Review results; subject the remaining corporate structures to further screening; and finally select the optimum structure (structure selected in second tier).
6. Apply the above criterion on second-tier-selected structures.
7. Identify steps to establish the vehicle.
8. Identify internal and external corporate framework.
9. Develop legal and *sharīᶜa* documentation.
10. Implement (set up) the corporate vehicle.

IV. Corporations under Islamic Law

In Islamic law, (classical *fiqh*[1] discussions) the corporate form of a business organization as a separate legal entity does not appear directly. Strictly speaking, Islamic business organizations do not have legal personality; they do not exist independently of those who invest in them. The OIC Fiqh Academy accepts the concept of a legal or fictitious personality (*Shakhsiyah i'itbariyah*) and so do Muslim scholars (*fuqahā'*). The scholars have approved the corporate form on the basis of *fiqh* principles of *qiyas* (analogy) and *istihsan*, or *masaliha mursalah* (public interest). This, however, does not mean acceptance of any modern business corporation within the framework of Islamic law.

The closest approximation to corporate legal entities found in Islam have been *bayt al-māl* (public treasury), mosque property, *waqf* (trusts), and *Muwafada*.[2] However, it must be noted that institutions such as *bayt al-māl* and *awqāf* are essentially non-economic organizations, and their features are somewhat distant from those of business-oriented corporations. An example from the Shafi'i school[3] close to the concept of a legal person is a joint stock company.[4] According to this school, in the case where more than one person runs a business in common with others and mixes his/her property with those of others, *Zakah* is not levied on each business partner individually, and instead is payable on their joint stock.

The only type of business organization historically found in an Islamic economy and discussed in detail by Islamic law are "partnerships." We will review the different forms of business partnerships under the Hanafi school of Islamic jurisprudence and the laws applicable to these entities when conducting commercial activities.

V. Comparison between Islamic and Conventional Forms of Business Partnerships

A. Partnerships under Conventional Law

According to the definition given in English law, a partnership is the relation that subsists between persons carrying on a business in common and with a view of profit. The partnership business may be owned by two or more persons who are not organized as a corporation. American law gives a similar definition: a partnership is a voluntary contract between two or more competent persons to devote some combination of their money, effects, labor, and skills in pursuit of lawful commerce or business, with the understanding that there shall be a proportional sharing of profits and losses between them. Persons who enter into a partnership to conduct business are collectively called a "firm," and the name under which they operate their business is called the "firm name."

Lawyers accept the idea of a firm. However, to analyze the underlying legal relationship between the partners, it is imperative to understand the exact nature of the partnership. A firm for the lawyer may be an association of persons, a partnership, a limited partnership, or a corporation. In law, partnership and corporation are two separate concepts, although the distinction is rapidly fading. A corporation is assigned a legal personality, whereas a partnership is not.[5]

A partnership is a contractual agreement. However, no statute requires that a partnership agreement be in writing. In general, the following matters are dealt with in almost all types of partnerships:[6]

1. nature and place of business;
2. provision of capital;
3. ascertainment and division of profits;
4. management of the partnership business;
5. indemnity against liability in the firm's business;
6. remuneration;
7. duration of partnership;
8. death or retirement of a partner;
9. restrictions on a (retiring) partner's carrying on a competing business; and
10. reference of disputes to arbitration.

All partners are allowed (although not required) to share equally in the capital and profits of the business. They must contribute equally toward capital losses sustained by the firm. In English law, if the capital is not contributed equally, a stipulation to pay interest on capital is allowed. In this case, provision is often made for payment of interest on capital before net profits are divided.[7] However, a partner is entitled to the interest on capital only after the ascertainment of profits. In the absence of any agreement, express or implied, profits are divided equally because of the inference that the moneyed partner is considered equivalent in skill or knowledge to the other partner. But if the partners divide the profits equally, they must likewise divide the losses. Losses include not only liabilities to third parties, but also losses of capital. If any partner is insolvent and unable to contribute the required share of lost capital, the solvent partners are not liable to compensate for the insolvent one's deficiency.[8]

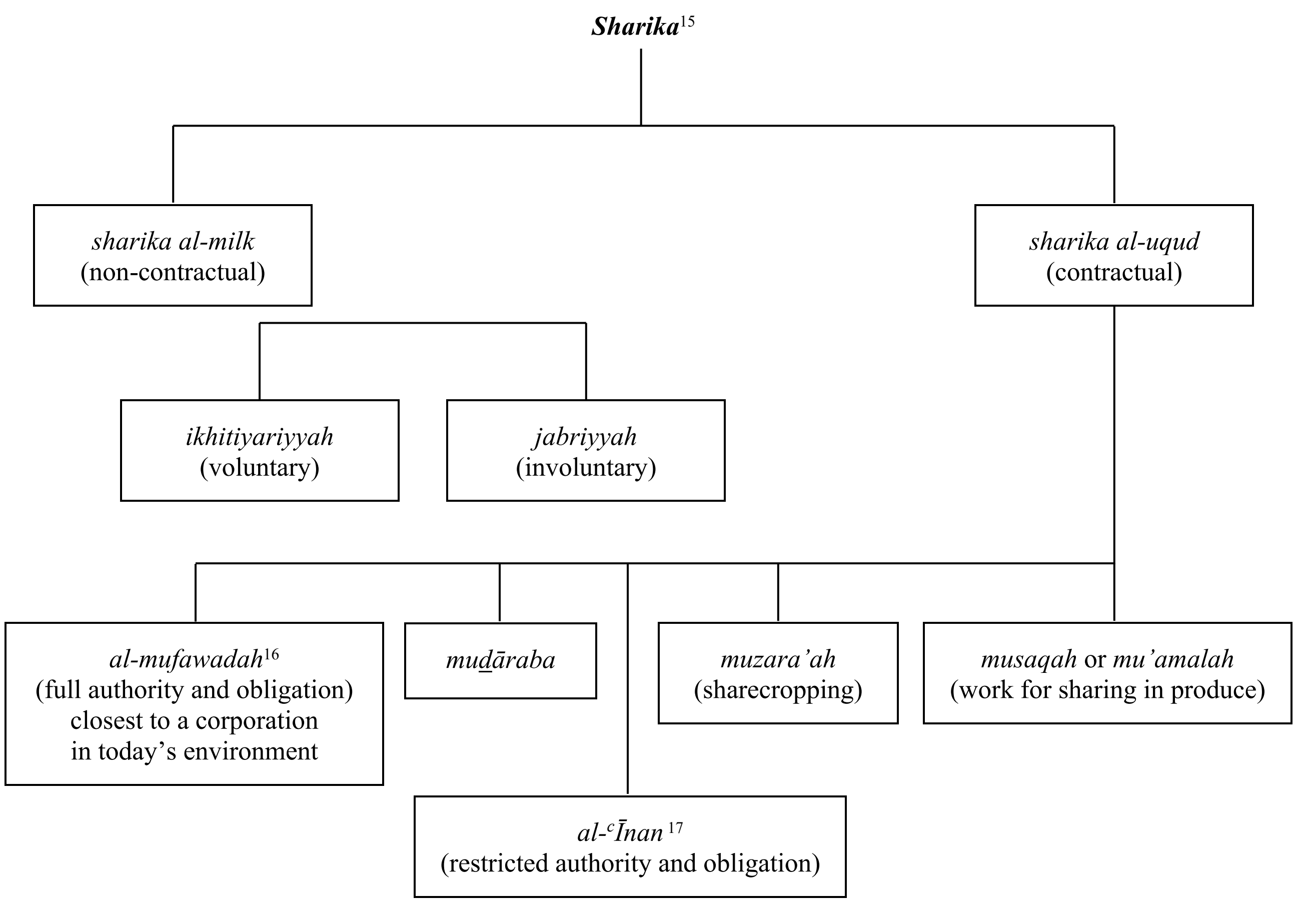
Under English law, there is no necessary connection between the proportion in which the capital is contributed and that of profit and loss. Prima facie, it may appear that the partners share profits and bear losses equally, notwithstanding that the capital contributed by each may not be equal. In other words, the profits and losses are not shared in proportion to the capital contributed by each partner. On the other hand, there is an inference that losses are to be borne in the same proportion in which profits are shared. Therefore, an agreement to share profits in certain proportions is, under English law,[9] prima facie evidence that it is intended that losses be borne in the same proportions and not equally.

Unless definite terms are stated, the general rule is that the partnership lasts only during the will of the partners.[10] Where no fixed term for the duration of the partnership has been agreed upon, any partner may terminate the partnership at any time by giving notice of his/her intention to do so to all other partners.[11] Subject to any agreement between the partners, every partnership is dissolved, as regards all the partners, by the death of any partner.[12]

B. Partnerships under Islamic Law

The term *sharika* or *shirka* [13] is used in Islamic law to define partnership.[14] *Sharika* may be of two kinds: *sharikat al milk* (non-contractual), and *sharikat al uqud* or *shirka al aqd* (contractual). Figure 1 summarizes the taxonomy of *sharika*.

FIGURE 1. TAXONOMY OF *SHARIKA*



VI. ISLAMIC LEGAL DEFINITION OF PARTNERSHIP

The literal meaning of *sharika*, as provided by the jurists, is used in two ways:

A. Mixing or *Ikhtilat*

This implies the mixing the respective shares of capital. Some jurists describe *Ikhtilat* as the attribute of a property that is found in a mixed or mingled state; that is, the mixing of capital shares in such a way as to make individual shares indistinguishable. This means participation: when partners participate, they bring about the mingling of wealth (*khalt*), and hold the resulting wealth jointly.

B. The Contract of Partnership

The second meaning of *sharika* is the contract of partnership itself because it is the cause of *khalt*. Thus the phrase "*sharikat al aqd*" explains it further. A contract defines the type of union and its legal effects. The emphasis is on the relationship that exists between two (or more) partnerships.[18] *Sharikat al Aqd* is an "agreement between two or more persons for common participation in capital and profits."[19] The Hanafi school divides partnerships into two categories, as shown in Table 2.

TABLE 2. CATEGORIES OF PARTNERSHIPS UNDER HANAFI LAW

Category	Forms of Partnership	
Work from both sides	*sharikat al-ᶜīnan* • *amwāl* – capital • *ᶜamal* – work • *wujuh* – creditworthiness	*sharikat al-ᶜīnan* • *amwāl* – capital • *ᶜamal* – work • *wujuh* – creditworthiness
Work from one side only	*muḏāraba*, *muzara'ah*, *musaqah*	

Under business partnerships, the primary structures that must be reviewed include: *sharikat al-ᶜīnan* (*ᶜīnan* partnership through wealth); Mufawadah by way of *amwāl* (Mufawadah partnership through wealth); and *muḏāraba*, which is explained in several books and, as such, will not be discussed in this paper.

VII. *SHARIKAT AL-ᶜĪNAN*

A. Contracts

Four contracts can operate on a partnership basis. However, it is not necessary that all four exist together. These contracts are *amanah* (trust); *wakala* (agency); *kafāla* (surety); and *ijāra* (hire). Every contract contains the contract of agency. The surety contract does not operate in the second category of partnership (*muḏāraba*, *Muzara'ah*, and *Musaqah*). The contract of hire does not play any role in the first category.

The *ᶜīnan* contract can be of two types: general or special. General *ᶜīnan*, also called simply "*ᶜīnan*," is based on an agency agreement, whereas the special *ᶜīnan* contract, also called *ᶜīnan khāss*, is based on both agency and surety.

B. Fundamental Rules for *ᶜĪnan* Partnership

ᶜĪnan is a contract without complete equality: the sharing of capital on the condition of trading and dividing profits between them. The single element (*rukn*) of an *ᶜīnan* (like all other contracts) is the form (*sighah*) of offer (*ijab*) and acceptance (*qubul*). For *ᶜīnan khāss*, the contract of *kafāla* (surety) must be mentioned, otherwise the contract is general *ᶜīnan*.

For each type of *ᶜīnan* (*amwāl*, *ᶜamal*, and *wujuh*), the contract permits participation from all partners in wealth (capital), work, and creditworthiness in any proportion so as to share the profits in an agreed ratio.

For *sharikat al-ᶜīnan* based on *amwāl*, capital should be gold or money and cannot be immovable property, merchandise, or goods.[20] In *sharikat al-amwāl*, the capital becomes the joint property of the partners, in equal or unequal shares. It must be declared between the shareholders as a proportion, such as a third for each; it may not be specified as a particular amount, for if a fixed amount of profit is given, the partnership is void (*batil*).

In an *ᶜīnan* contract where individuals have contributed equal amounts of capital, it is lawful for profits to be divided in differing proportions, provided the person receiving the greater share of the profit is more skilled and bears more responsibility. The right of profit is according to the stipulation stated at the time of making the contract of partnership alone; it is not in accordance to the work done. The entitlement of profit is on the basis of *ḏamān* (liability for bearing loss).[21] In the *ᶜīnan* contract, wealth is a basis for entitlement of profit, along with the corresponding liability for bearing the loss.

Partners are *ameen* (agents) of one another in general *ᶜīnan*. The partnership's property in the possession of each of them is like a thing entrusted. If this property is destroyed without fault or neglect, one partner is not responsible for the share of the other.

A partnership is dissolved by the revocation of one of the partners, but the other partners must know of its dissolution. When one wishes to dissolve a partnership, the dissolution is not effected until all partners learn of it.

A partner does not possess the authority to take loans in an *ᶜīnan* contract. The bearing of loss always follows the ratio of capital contribution. However, a contract stipulation for unequal ratios of sharing in loss is valid.

In an *ᶜīnan khāss* contract, which also is based on *kafāla*, one partner is a surety for the other. Thus, the liabilities created in this type of partnership are joint and several. Whatever debt or liability incurred by one partner will have recourse on the other partners as well.

VIII. Fundamental Rules for Mufawadah Partnership

Mufawadah is the stipulation of complete equality in wealth or capital, profit and work. This is one of the absolute conditions for the contract. The stipulation of complete equality is for working with one's own wealth or labor, or creditworthiness so that each partner is a surety to the other partner. Under Mufawadah, partners have equal interests and are sureties for one another. Also, there are contracts of *Wakala* and *kafāla* between each partner. Finally, the mufawadah contract requires that the partners meet on equal terms of profit and loss.

IX. Liability of Partners under Islamic Law

Under Islamic law, there is no assumption in the contract that liabilities will never exceed assets. The liability of a partner for the debts of a partnership is unlimited; Islamic law does not legitimize the concept of limited liability.[22]

X. Conclusion

The above conceptual discussion, though brief, highlights the forms of vehicles that have historically been accepted under Islamic law. Having compared these forms with the vehicles existing under conventional law, it appears that the concept of juristic person for commercial business must first be researched in detail. The model developed must not only be *sharīᶜa*-compliant, but it needs to work efficiently within present regulatory frameworks. Although the concept of limited liability has been reviewed by the *sharīᶜa*, the issue itself is still debated among scholars, who must provide a detailed review of this issue and rulings.

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[1] The term "*fiqh*" literally means "understanding" and "discernment." In law, it is defined as the knowledge of legal rules pertaining to conduct, which have been derived from specific evidence. See Nyazee, Imran Ahsan Khan. Outlines of Islamic Jurisprudence. Islamabad: Advanced Legal Studies Institute, 1998. p. 29.

[2] The Hanafi *Muwafada* partnership constitutes the single exception and is the closest approximation found in Islamic law to a corporate entity.

[3] Usmani, M. Taqi. "The Principle of Limited Liability from the *Sharīᶜa* Viewpoint." Journal of Islamic Banking and Finance.

[4] A joint stock company is an assemblage of individuals formed to start and operate a business organization. It generally shares the same characteristics as a corporation, but does not provide limited liability. Joint stock companies are not common nowadays because it has become easier to form limited-liability corporations under state authorization.

[5] In certain jurisdictions (such as Scotland), even partnerships have been assigned a legal personality. Some forms of partnerships have been assigned personality in French law, and hence in Egyptian law. The Uniform Partnership Act in the United States has preferred the entity concept and assigned legal personality even to partnerships.

[6] Details as per English law. However, similar details would also be necessary under American law.

[7] Under English law, in the absence of such a stipulation, interest on capital is not allowed for the partnership.

[8] The amount available after the insolvent partners have made their proper contributions is divided according to the amount of the capital standing to the credit of each partner (not including the insolvent partner who has failed to bear his share of the loss).

[9] Partnership Act of 1890.

[10] Under English law, the partnership may be continued after the expiration of the agreed term. Where a partnership, entered for a fixed term, is continued after its term has expired, then without any express new agreement, the rights and duties of the partners remain the same as they were at the expiration of the terms, so far as is consistent with the incidents of a partnership at will.

[11] A provision that the partnership is to be terminated by "mutual agreement only" will prevent termination at the instance of a single partner.

[12] It is usual and desirable, therefore, to make provision for continuing the firm, notwithstanding the death of one or more of the partners, by stating that the business is not to be wound up, but instead the surviving partner or partners is to continue or carry it on.

[13] In Urdu, the word *shirkat*, literally meaning "participation," is used.

[14] Most often, in Arab countries, the same term is used to refer to both partnerships and corporations. To distinguish between the legal forms, additional terms are used. For example, a company or corporation is called *sharikat al-musāhama***.** Saudi law uses the term *niẓām* (institutions) for corporations.

[15] This diagram shows the Hanafi and the Hanbali division of partnership. The Maliki division of partnership in inheritance, partnership in booty, and partnership in sales comes in the purview of partnership by right of property.

[16] This form is only accepted by the Hanafi school. The three other major schools do not support this form.

[17] This is the only form of partnership that enjoys the *Ijma* (consensus of opinion) from all schools.

[18] Hanafi jurists go into great detail to emphasize the relationship and the legal effects that flow from it.

[19] Majallah. Note that this definition has been designed for the partnership form called *sharikat al-amwāl*.

[20] Labor and creditworthiness are not included here. If only they are contributed, they are discussed as a different partnership (*sharikat al-ᶜīnan* based on labor or creditworthiness).

[21] The Prophet Muhammad (peace be upon him) has said, "Revenue is based upon the corresponding liability." Here, it means taking the risk associated with trade and business.

[22] Limited liability is payment of debts of partnership from the entire assets of the partnership, including profits or from whatever is left. Creditors do not have access to the personal wealth of the partners or the wealth that has not been contributed toward the capital of partnerships. Limited liability derives from the concept of the juristic person. However, under Islamic law, the concept of juristic person is known only in cases other than those of commercial entities. For commercial dealings by Muslims in today's environment, where the corporate world is more complex, limited liability from the *sharīᶜa*'s point of view is still a debated issue.

Investing in Equities

Some Issues from the Islamic Perspective

Shaikh Abdul Hamid*

ABSTRACT

If the *sharīʿa*'s prohibition on interest were taken literally, one would have to pluck all feathers in an attempt to find Islamically acceptable stocks because most publicly traded firms engage in paying and/or receiving interest, whether on short-term or on long-term debt. *Sharīʿa* boards have broadened the scope of *ḫalāl* investment by defining allowable levels of debt, receivables, and interest income an investable company may have. This study draws on the principles laid down by some *sharīʿa* boards and explores how they could be put into practice. It also analyzes the relative performance of companies with varying levels of debt. This will show the extent to which investors gain or lose by not investing in companies with high debt levels. Other issues discussed include permissible and impermissible businesses and speculative stocks.

I. INTRODUCTION

The *sharīʿa* lays down principles to govern economic and financial operations and decision-making. One of its cardinal economic principles is that of profit-and-loss sharing in ownership, which at the same time prohibits interest-bearing debt as a means of financing. Given the widespread use of interest-bearing debt by companies around the world, Islamic investors would be interested in finding companies that do not use debt. Even if companies do not use long-term debt, they rely heavily on bank borrowing to meet their working-capital requirements. In other words, publicly traded companies, with few exceptions, engage in paying interest. Many companies, even if they do not have interest-bearing loans, may invest their idle cash in short-term interest-bearing instruments. If the prohibition of interest were taken literally, one would have to turn over every stone in an effort to find Islamically investable stocks.

Sharīʿa boards have come to the aid and have broadened the scope for Muslims to invest in equities, by defining allowable levels of debt, receivables, and interest-income a company may have. This paper draws on some of the principles and explores empirically how such principles may be put into practice. Among other issues, the performance of companies based on varying levels of debt in their capital structure is also explored.

II. THE DOW JONES ISLAMIC MARKET INDEX

Dow Jones recently created the Dow Jones Islamic Market Index (DJIM). The DJIM is a subset of the Dow Jones Global Index (DJGI) family. Of the more than 2,700 stocks in the DJGI, over 2,000 are excluded, leaving the DJIM with about 600 stocks from 30 countries, with a total market capitalization of nearly $7.5 trillion. The exclusion criteria are drawn from *sharīʿa* laws. The purpose of the DJIM is "to provide a definitive standard for measuring stock market performance for Islamic investors on a global basis following both Dow Jones' well-established index methodology and the Islamic investment guidelines established by the index's *Sharīʿa* Supervisory Board. The methodology used to construct and maintain the index aims to produce an investable index in which all constituent stocks are readily accessible and well traded."

DJIM investable stocks are selected from DJGI stocks by applying two types of screens. First, a company's primary business must be Islamically acceptable; second, certain financial ratios must be acceptable. Appendix 1 lists the businesses and industries that are deemed inconsistent with the *sharīʿa* by the DJIM's *Sharīʿa* Supervisory Board. These include alcohol, tobacco, pork- and poultry-related products; financial services; defense; and entertainment.

After companies in the DJGI are filtered based on primary business activities, the remaining stocks are filtered to ensure that they adhere to certain financial ratios, listed in Appendix 2. These ratios seek to identify companies with unacceptable levels of debt or impure interest income. Companies are to be excluded if:

* Assistant Professor of Finance, New Hampshire College, Manchester, N.H.

1. total debt as a proportion of total assets is 33% or more;
2. accounts receivable as a proportion of total assets is 47% or more; or
3. non-operating interest income as a proportion of operating income is 9% or more.

It is to be noted that *sharīᶜa* scholars have not unconditionally endorsed the use of debt. In their *fatāwā* (pronouncements), they declare:

> "It must be stated emphatically at this point that the above mentioned formula is one that applies to investors interested in companies offering shares on international market on which Muslims have no control. It should in no way be understood as an endorsement of the practice, by Muslim owned businesses, of interest based borrowing."

III. The Use of Debt by Companies

It may appear to a layman investor that very few companies are debt free. Fortunately, that is not the case. A screening of about 7,000 companies in a database (found online at http://www.hoovers.com) produced 1,777 companies with no long-term debt. Over 3,800 of them have debt-to-asset ratio of 33% or less. In other words, the universe of companies with an acceptable level of debt is large. However, that does not mean that this group does not contain any members with short-term interest-bearing debt, for even if companies do not use long-term debt, they rely on bank borrowing to meet their working-capital needs. In other words, dealing in interest is pervasive. Companies may also invest idle cash in short-term instruments that earn interest. If the prohibition of interest were taken literally, then it would be very difficult to find Islamically investable companies. At least for the present, *sharīᶜa* boards, like the one of the DJIM, have enabled practicing Muslims to invest in wide range of equities by raising the allowable level of debt.

Appendix 2 shows how Dow Jones has defined total debt: the sum of short-term debt, the current portion of long-term debt, and long-term debt. Total debt can also be expressed as the sum of current and long-term liabilities, which equals total liabilities. In other words, the way in which total debt is defined can lead one to consider it to be total liabilities, interest-bearing plus non-interest-bearing. If the intent is that non-interest-bearing debt is not to be included in total debt, it can be made unambiguous.

First, we use the definition of total debt as being all liabilities, and find the ratio of total debt to total assets for selected companies in the DJIM. Then we define total debt as interest-bearing debt, and recalculate the ratio of total debt to total assets for the same companies.

About 100 of the 600 stocks in the DJIM are listed on the Web page of Dow Jones. Based on that list, one can conduct some research to determine to what extent the listed stocks meet the financial-ratio filters mentioned above. Appendix 3 lists two types of ratios for 28 U.S. stocks in the DJIM. Only five of these had ratios of total debt to total assets of less than 33%—the level deemed acceptable by the DJIM's *Sharīᶜa* Supervisory Board. Twenty-three out of 28—or 82%—had debt levels higher than that approved by the Board. All companies had acceptable ratios of accounts receivable to total assets.

Accounts payable—a component of total liabilities—is non-interest-bearing. If accounts payable is excluded from total liabilities, and only interest-bearing debt is compared to total assets, we find that nine of the 28 companies have debt-to-asset ratios of less than 33%; 19 had unacceptable levels of debt.

The DJIM component companies listed on the Dow Jones Web page feature data presumably current as of December 31, 1998. The debt and accounts-receivable ratios are calculated from balance sheets as of the same date for nearly all the companies. To provide a more up-to-date analysis, Appendix 4 provides the debt ratios for the 28 U.S. companies from balance sheets for the quarter ending March 31, 1999. The numbers do not change: five companies had total-liabilities-to-asset ratios of less than 33%; nine companies had interest-bearing-debt-to-asset ratios under 33%; and all had acceptable ratios of accounts receivable to total assets.

Of the 72 non-U.S. DJIM companies listed in the Dow Jones web page, the balance sheets of 27 of them were available. Only three firms had ratios of total liabilities to total assets of less than 33% (Appendix 5). If accounts receivable is excluded from total liabilities, the number increases to nine. Thus, out of a sample of 28 U.S. and 27 non-U.S. companies, only 18 had acceptable levels of debt; the remaining 37 had unacceptable levels of debt. However, all these companies met the accounts receivable criterion of Dow Jones' *Sharīᶜa* Supervisory Board.

Assume that the term "total debt" in Appendix 2 refers only to interest-bearing debt. Appendix 6 shows the resulting ratios of total debt to total assets for the 28 U.S. companies. Only one firm (Caterpillar) now has an unacceptable ratio of more than 33%. As shown in the last two rows of the table, even in 1996 and 1997, Caterpillar had a debt ratio of more than 33%.

The total interest-bearing debt to total assets ratios of Caterpillar as of June 1998, September 1998, December 1998, March 1999, and June 1999 were also calculated. The ratio increased slightly from 0.49 to 0.52 over this period. Clearly, Caterpillar should not have been in the DJIM.

However, discerning interest-bearing debt of a company from published balance sheets is not a simple matter. Appendix 7 seeks to make that point using liabilities figures for Pfizer as of December 31, 1998. The following items in the balance sheet are presumably non-interest-bearing:

- accounts payable
- dividends payable
- income taxes payable
- accrued compensation
- post-retirement benefit obligations

The following items are presumably interest bearing:

- short-term borrowing and current portion of long-term debt
- long-term debt

But the following items may or may not be interest-bearing:

- other current liabilities ($1,431 million)
- other non-current liabilities ($1,217 million)

The amounts are significant enough for the items to contain at least some interest-bearing portion, given that non-interest-bearing items are given above rather exhaustively. Therefore, to be on the safe side, one would include other liabilities (current and non-current) as part of interest-bearing debt. With this definition of total debt, the total debt to total assets ratio is recalculated for the 28 U.S. companies. The ratios are shown in the last column of Appendix 6. Now we have eight companies (emboldened in the appendix) with debt ratios over 33%. In other words, they would be Islamically non-investable.

Appendix 8 shows the number of companies in the Hoovers database in various debt ranges. It also shows average and median 5-year growth rates of revenues, earnings, and prices for companies that have grown by at least 15%. The purpose of this chart is to explore the relationship, if any, between debt level and corporate performance. No relationship can be discerned from the appendix. Companies with higher debt do not appear to exhibit higher growth rates.

Though no salient pattern can be identified, companies with no long-term debt have comparatively high 5-year growth rates. Out of the 1,777 companies with no long-term debt, 86 had 5-year growth rates of 15% or more. The average 5-year revenue, earnings, and price growth rates of these firms are between 31% and 35%. The growth rates are somewhat lower as the level of debt increases, but no clear pattern can be discerned after that. This implies that investors do not necessarily lose if they invest in companies that have no long-term debt. Companies that use debt do not exhibit clearly superior performance.

Companies that have no long-term debt are from various industries, so diversification can be achieved by investing in them. Some, such as Microsoft and Cisco, are large firms, while many others are small growth companies. Some are profitable enough to not require debt; their retained earnings can finance their growth. Some may be risky, which may not allow them to raise debt capital. Many (in the high-tech sector) do not have enough tangible assets to support the use of debt. Examples are software companies, whose assets are largely human resources.

Appendix 8 also shows that there is no visible relationship between debt level and market value. There may be a pattern between debt level and asset size (although this aspect is not explored in this study). Corporations with greater assets are likely to have more debt.

IV. Permissible Business

Sharīᶜa supervisory boards identify companies that are permissible for investing purposes. A company is deemed permissible if its primary business is Islamically acceptable. However, some uncertainty can arise when considering a firm such as Amazon.com, whose primary business is selling books, but may also have significant sales of prohibited CDs and videos. Should some proportion of impermissible to permissible be spelled out, or should such companies be avoided altogether? *Sharīʿa* boards must resolve this issue.

V. Speculation

Islam prohibits speculation. It also prohibits a risk-free or a pre-fixed rate of return, even if some risk is involved; and it does not allow excessive risk-taking. Hence, speculative stocks—those of highly risky companies, of companies whose prospects are uncertain, or of companies about which sufficient information is not available—are unacceptable. Investing in such stocks would border on gambling. Examples of such stocks are those of Internet-related and biotechnology firms.

The process of trading may also be speculative. For example, very short-term investing, such as day trading (investing to realize profits within minutes or hours), would possibly fall under speculation. However, it is not clear whether it would be speculative (and thus prohibited) to invest in stocks that are highly risky in the short-run (because of high volatility) but may not be so in the long run. *Sharīʿa* boards have a responsibility to throw light on this and other questions.

VI. Changing financial ratios

Companies change their capital structure over time as their prospects change. Sometimes, the capital structure can change dramatically within a short period. Hence, investors need to continually monitor the debt levels of stocks in their portfolios. They also need to monitor the level of interest income (and the levels of other ratios that *sharīʿa* boards have deemed relevant) to ensure that they are acceptable.

VII. Conclusion

Islam lays down certain economic principles. It is unambiguous about the prohibition of interest. Taken literally, that would mean that companies that deal in interest would be unacceptable for investing. However, *sharīʿa* boards have given pronouncements that allow Muslims to invest in companies that have some debt. For those Muslims who wish to adhere to the prohibition of debt in the strictest sense, even then hundreds of companies are available that have no long-term debt. Many of these have attractive histories of performance and have generated handsome returns. However, firms in general do borrow from banks to finance working-capital needs. Furthermore, many firms invest idle cash in short-term interest-bearing instruments. Therefore, strictly speaking, it would be very hard, if not impossible, to find companies that do not engage in interest at all. One compromise could be to consider the payment of taxes as coming from interest income or from income that a company earns using debt capital.

Investments in Islamic index funds have to be made with care, as these funds may not strictly adhere to guidelines laid down by *sharīʿa* boards. It also must be borne in mind that the screening of companies done by an index fund is based on historical data: a company's ratios may have changed in the meantime, and publicly available information may not reflect the change(s). One solution is for *sharīʿa* boards to prescribe acceptable levels of ratios. Investors need to continually monitor the financial ratios that *sharīʿa* boards have prescribed for companies to be investable to ensure that these ratios are within acceptable levels, since ratios can change suddenly.

The determination of interest-bearing debt is not a trivial exercise. To be accurate, the debt figures must be found by examining the liabilities items in the balance sheets contained in annual reports. Such reports are often available on the Internet.

APPENDIX 1. ACCEPTABLE INDUSTRIES

The following businesses are deemed inconsistent with the *sharīᶜa* by the *Sharīᶜa* Supervisory Board of the Dow Jones Islamic Market Index. Companies whose primary business is in these areas are not suitable for Islamic investment purposes and are excluded.

1. alcohol
2. tobacco
3. pork- and poultry-related products
4. financial services (banking, insurance, etc.)
5. defense/weapons
6. entertainment (hotels, casino/gambling, films, pornography, music, etc.)

The following industry-group codes and definitions of the DJGI cover the above businesses.

- I/DST distillers and brewers
- I/TOB tobacco
- I/OFD other food (note: pork- and poultry-related products are excluded from this group)
- I/BAK banks, including major international banks (BAN) and regional banks (BAR)
- I/INS insurance companies, including full-line insurance companies (INF); life-insurance companies (INL); and property- and casualty-insurance companies (INP)
- I/FIS diversified financial companies
- I/SCR securities brokers
- I/SAL savings-and-loan associations
- I/ARO aerospace and defense companies
- I/ENT entertainment and leisure, including casinos (CNO); restaurants (RES); and recreational products and services (REC), which includes entertainment and movies (MOV) and other recreational products and services (REQ)
- I/LOD lodging if engaged in gambling operations

Companies classified in other industry groups may also be excluded if they are deemed to have material ownership or revenues from the above prohibited business activities.

Source: http://indexes.dowjones.com

APPENDIX 2. ACCEPTABLE FINANCIAL RATIOS

These ratios screen out companies with unacceptable levels of debt or impure interest income. A company is to be excluded if any of the following are true:

1. (total debt ÷ total assets) ≥ 33%
   total debt = short-term debt + current portion of long-term debt + long-term debt

2. (accounts receivable ÷ total assets) ≥ 47%
   accounts receivable = current receivables + long-term receivables

3. (non-operating interest income ÷ operating income) ≥ 9%
   If a company has positive non-operating interest income but negative net income, it is excluded. However, a company with negative net income and no non-operating interest income may be included.

Source: http://indexes.dowjones.com

APPENDIX 3. DEBT RATIOS OF SOME U.S. STOCKS IN THE DJIM: DECEMBER 31, 1998

Company	Total Assets (TA)	Total Liabilities (TL)	Accounts Receivable (AR)	TL/TA	(TL-AP)/TA	AR/TA
3M	14,153	8,217	2,666	58.06%	51.93%	18.84%
Abbott Labs.	13,216,213	7,502,552	1,950,058	56.77%	48.77%	14.76%
Allied Signal	15,560	10,263	1,933	65.96%	56.81%	12.42%
AT&T	59,550	34,028	8,652	57.14%	46.69%	14.53%
Caterpillar	25,128	19,997	7,176	79.58%	65.42%	28.56%
Chevron	36,540,000	19,506,000	2,813,000	53.38%	47.44%	7.70%
Cisco Systems	8,916,705	1,810,087	1,297,867	20.30%	17.51%	14.56%
Compaq Computer	23,051,000	11,700,000	6,998,000	50.76%	32.38%	30.36%
Coca Cola	825,228	89,442	75,305	10.84%	1.41%	9.13%
Dell Computer	6,877,000	4,556,000	2,094,000	66.25%	31.39%	30.45%
Dow Jones	1,491,322	918,982	236,928	61.62%	56.53%	15.89%
DuPont	38,536	24,582	4,201	63.79%	58.78%	10.90%
Exxon	92,630	48,880	9,512	52.77%	37.84%	10.27%
Gateway	2,890,380	1,546,005	558,851	53.49%	28.64%	19.33%
Goodyear Tire	10,589,300	6,843,500	1,770,700	64.63%	53.94%	16.72%
Hewlett Packard	33,673	16,754	7,752	49.75%	40.24%	23.02%
Intel	31,471	8,094	3527	25.72%	21.77%	11.21%
Johnson & Johnson	26,211	12,621	3,661	48.15%	41.05%	13.97%
Lucent Technologies	23,811	20,424	6,939	85.78%	77.67%	29.14%
Merck	31,853,400	19,051,600	3,374,100	59.81%	48.25%	10.59%
Microsoft	22,357,000	5,730,000	1,460,000	25.63%	22.23%	6.53%
Oracle	5,819,011	2,861,453	1,857,480	49.17%	45.05%	31.92%
Pfizer	18,302,000	9,492,000	2,914,000	51.86%	46.56%	15.92%
Procter & Gamble	30,966,000	18,730,000	2,781,000	60.49%	53.86%	8.98%
Sun Microsystems	5,711,062	2,197,434	1,845,765	38.48%	29.80%	32.32%
Tellabs	1,627,591	250,999	480,620	15.42%	11.55%	29.53%
Union Carbide	7,291	4,842	993	66.41%	62.79%	13.62%
United Technologies	18,375,000	13,161,000	3,993,000	71.62%	59.45%	21.73%

APPENDIX 4. DEBT RATIOS OF SOME U.S. STOCKS IN THE DJIM: MARCH 31, 1999

Company	Total Assets (TA)	Total Liabilities (TL)	Accounts Receivable (AR)	TL/TA	(TL-AP)/TA	AR/TA
3M	14,153	8,217	2,666	58.06%	51.93%	18.84%
Abbott Labs.	13,216,213	7,502,552	1,950,058	56.77%	48.77%	14.76%
Allied Signal	15,560	10,263	1,933	65.96%	56.81%	12.42%
AT&T	59,550	34,028	8,652	57.14%	46.69%	14.53%
Caterpillar	25,128	19,997	7,176	79.58%	65.42%	28.56%
Chevron	36,540,000	19,506,000	2,813,000	53.38%	47.44%	7.70%
Cisco Systems	8,916,705	1,810,087	1,297,867	20.30%	17.51%	14.56%
Compaq Computer	23,051,000	11,700,000	6,998,000	50.76%	32.38%	30.36%
Coca Cola	825,228	89,442	75,305	10.84%	1.41%	9.13%
Dell Computer	6,877,000	4,556,000	2,094,000	66.25%	31.39%	30.45%
Dow Jones	1,491,322	918,982	236,928	61.62%	56.53%	15.89%
DuPont	38,536	24,582	4,201	63.79%	58.78%	10.90%
Exxon	92,630	48,880	9,512	52.77%	37.84%	10.27%
Gateway	2,890,380	1,546,005	558,851	53.49%	28.64%	19.33%
Goodyear Tire	10,589,300	6,843,500	1,770,700	64.63%	53.94%	16.72%
Hewlett Packard	33,673	16,754	7,752	49.75%	40.24%	23.02%
Intel	31,471	8,094	3527	25.72%	21.77%	11.21%
Johnson & Johnson	26,211	12,621	3,661	48.15%	41.05%	13.97%
Lucent Technologies	23,811	20,424	6,939	85.78%	77.67%	29.14%
Merck	31,853,400	19,051,600	3,374,100	59.81%	48.25%	10.59%
Microsoft	22,357,000	5,730,000	1,460,000	25.63%	22.23%	6.53%
Oracle	5,819,011	2,861,453	1,857,480	49.17%	45.05%	31.92%
Pfizer	18,302,000	9,492,000	2,914,000	51.86%	46.56%	15.92%
Procter & Gamble	30,966,000	18,730,000	2,781,000	60.49%	53.86%	8.98%
Sun Microsystems	5,711,062	2,197,434	1,845,765	38.48%	29.80%	32.32%
Tellabs	1,627,591	250,999	480,620	15.42%	11.55%	29.53%
Union Carbide	7,291	4,842	993	66.41%	62.79%	13.62%
United Technologies	18,375,000	13,161,000	3,993,000	71.62%	59.45%	21.73%

APPENDIX 5. DEBT RATIOS OF SOME NON-U.S. STOCKS IN THE DJIM: DECEMBER 31, 1998

Country	Company	Total Assets (TA)	Total Liabilities (TL)	Accounts Receivable (AR)	TL/TA	AR/TA
Australia	Howard Smith	1,320,507	722,608	25,594	54.72%	1.94%
Belgium	Petrofina	9,635	5,654	1,581	58.68%	16.41%
Canada	Alcan Aluminum	9,901	4,382	1,401	44.26%	14.15%
	Barrick Gold	4,578,000	1,042,000	62,000	22.76%	1.35%
	Magna Intl.	8,620,700	3,675,300	1,801,900	42.63%	20.90%
Chile	Gener	1,375,813	639,904	24,390	46.51%	1.77%
Finland	Rauma	6,846	3,894	1,683	56.88%	24.58%
France	Alcatel Alsthom	251,772	207,818	22,959	82.54%	9.12%
Greece	Hellenic Telecom	1,554,757	581,819	203,033	37.42%	13.06%
Hong Kong	Hong Kong Telecomm.	54,177	17,231	3,775	31.81%	6.97%
Ireland	Waterford Wedgwood	480,400	321,700	93,100	66.97%	19.38%
Japan	Canon	2,720,597	1,572,519	412,375	57.80%	15.16%
	Honda Motor	4,815,265	3,207,351	422,642	66.61%	8.78%
	Toyota Motor	13,854,335	7,832,459	1,169,982	56.53%	8.44%
Netherlands	Akzo Nobel	26,358	22,348	6,222	84.79%	23.61%
	Royal Dutch Petroleum	66,040	33,064	8,332	50.07%	12.62%
New Zealand	Fletcher Challenge Energy	3,421	1,859	255	54.34%	7.45%
Norway	Norsk Hydro	115,336	69,619	17,321	60.36%	15.02%
Portugal	Portugal Telecom	1,000,343	599,101	139,344	59.89%	13.93%
Spain	ENDESA	4,371,525	2,859,137	239,429	65.40%	5.48%
	Repsol	2,858,955	1,853,520	299,510	64.83%	10.48%
Sweden	Astra AB	62,280	16,265	6,851	26.12%	11.00%
Switzerland	Nestle	56,441	32,845	10,991	58.19%	19.47%
Taiwan	Taiwan Semiconductor	123,173,526	40,857,285	8,805,902	33.17%	7.15%
United Kingdom	British Petroleum	32,877	18,765	6,947	57.08%	21.13%
	Shell Transport & Trading	45,821	21,666	8,304	47.28%	18.12%
	Unilever	19,247	11,831	4,176	61.47%	21.70%

APPENDIX 6. INTEREST-BEARING DEBT TO TOTAL ASSET RATIOS FOR 28 U.S. COMPANIES IN THE DJIM

Company	Short-term Debt	Long-term Debt	Assets	Debts ÷ Assets	Other Current Liabilities	Other Liabilities	(Debts + Others) ÷ Assets
3M	1,492	1,614	14,153	0.22	1,278	2,217	**0.47**
Abbott Labs.	2,011	1,476	15,560	0.22	0	1,075	0.29
Allied Signal	1,759	1,340	13,216	0.23	0	1,091	0.32
AT&T	1,171	5,556	59,550	0.11	5,478	3,322	0.26
Caterpillar	3,048	9,404	25,128	**0.50**	1,339	2,648	**0.65**
Chevron	3,165	4,128	36,540	0.20	265	2,560	0.28
Cisco Systems	0	0	8,917	0.00	0	0	0.00
Compaq Computer	0	0	23,051	0.00	5,104	0	0.22
Coca Cola	4,462	687	19,145	0.27	0	991	0.32
Dell Computer	0	512	6,877	0.07	0	349	0.13
Dow Jones	0	150	1,491	0.10	153	34	0.23
DuPont	6,629	4,495	38,536	0.29	0	7,640	**0.49**
Exxon	4,248	4,530	92,630	0.09	1,339	24,938	**0.38**
Gateway	11	3	2,890	0.00	117	113	0.08
Goodyear Tire	789	1,187	10,589	0.19	352	176	0.24
Hewlett Packard	1,245	2,063	33,673	0.10	0	1,218	0.13
Intel	159	702	31,471	0.03	0	0	0.03
Johnson & Johnson	2,747	1,269	26,211	0.15	0	874	0.19
Lucent Technologies	2,231	2,409	26,720	0.17	3,459	1,969	**0.38**
Merck	624	3,221	31,853	0.12	0	0	0.12
Microsoft	0	0	14,387	0.00	0	809	0.06
Oracle	3	304	5,819	0.05	0	57	0.06
Pfizer	2,729	527	18,302	0.18	3,492	1,773	**0.47**
Procter & Gamble	2,281	5,765	30,966	0.26	0	3,287	**0.37**
Sun Microsystems	47	0	5,711	0.01	17	0	0.01
Tellabs	0	3	1,628	0.00	0	0	0.00
Union Carbide	426	1,796	7,291	0.30	780	1,576	**0.63**
United Technologies	612	1,575	18,375	0.12	0	1,961	0.23
Caterpillar – 1997 (3)	1,626	6,942	20,756	**0.41**	1,395	2,756	**0.61**
Caterpillar – 1996 (4)	2,372	5,087	18,728	**0.40**	1,228	3,067	**0.63**

APPENDIX 7. PFIZER, INC., LIABILITIES: DECEMBER 31, 1998

Current Liabilities	
Short-term borrowing + current portion of long-term debt	$2,729
Accounts payable	971
Dividends payable	285
Income taxes payable	1,162
Accrued compensation	614
Other current liabilities	1,431
Total current liabilities	*$7,192*
Long-term Liabilities	
Long-term debt	527
Post-retirement benefit obligations	359
Deferred taxes on income	197
Other non-current liabilities	1,217
Total long-term liabilities	*$2,300*
Total liabilities	**$9,492**

APPENDIX 8. NUMBER OF COMPANIES IN VARIOUS DEBT RANGES

Debt Range	# of firms	# of firms with growth* > 15%	5-Yr. Revenue Growth#		5-Yr. Earnings Growth#		5-Yr. Price Growth#		Market Value#	
			Average	Median	Average	Median	Average	Median	Average	Median
0.00-0.00	1777	86	31.30%	29.00%	32.47%	27.73%	34.82%	34.08%	9649.62	523.00
0.01-0.10	731	33	27.54%	24.33%	33.86%	33.04%	30.78%	30.12%	6891.00	536.00
0.11-0.20	415	22	27.20%	22.43%	26.65%	24.73%	32.49%	31.14%	13456.45	1170.00
0.21-0.30	361	23	26.18%	23.96%	27.67%	21.92%	31.45%	30.12%	13738.48	1017.00
0.31-0.40	337	24	31.62%	24.59%	28.88%	24.39%	33.71%	32.40%	4962.65	1469.50
0.41-0.50	277	13	25.97%	25.22%	33.08%	23.70%	31.08%	31.32%	1360.67	733.50
0.51-0.60	240	22	29.96%	24.64%	32.37%	32.43%	29.88%	25.92%	1746.41	932.50
0.61-0.70	258	16	28.83%	23.28%	28.21%	25.19%	31.15%	29.40%	1452.38	364.50
0.71-0.80	181	9	34.17%	29.68%	25.45%	21.14%	40.73%	39.00%	7788.88	575.00
0.81-0.90	230	11	27.68%	27.26%	24.92%	18.68%	25.72%	23.04%	490.44	621.00
0.91-1.00	192	6	23.98%	22.22%	39.78%	32.39%	36.88%	31.02%	718.40	772.00
1.01-1.20	232	11	39.80%	25.34%	41.59%	29.74%	29.30%	26.52%	2420.31	958.00
1.21-1.40	192	9	31.74%	31.00%	26.54%	18.90%	26.29%	28.44%	1544.78	286.00
1.41-1.60	130	5	39.43%	41.35%	21.02%	19.67%	25.27%	24.48%	37755.00	791.50
1.61-1.80	116	2	20.98%	20.98%	20.25%	20.25%	25.80%	25.80%	3904.50	3904.50
1.81-2.00	97	3	34.68%	36.48%	27.42%	27.52%	31.96%	35.52%	18075.67	412.00
2.01-3.00	275	8	28.69%	29.84%	22.41%	22.67%	36.54%	38.82%	16085.83	5017.50

* Revenues, earnings, and prices all grew by at least 15%.
# Data pertain only to firms that grew by at least 15%.

Toward the Revival of *Awqāf*

A Few Fiqhī *Issues to Reconsider*

Monzer Kahf*

ABSTRACT

The recent interest in *awqāf* marks a reversal of a trend of neglect of and even attacks on them that continued for almost a century in most Muslim countries. Rediscovering *awqāf* and attempting to enhance their role in social and economic development requires attention to several important issues in the *fiqh* of *waqf*, of which six are: 1) the principle of perpetuity versus temporality, 2) *waqf* of usufructs and financial rights, 3) public *waqf* versus posterity or private *waqf*, 4) *waqf* management, 5) the ownership of *waqf* and its legal entity, 6) and the special conditions of the *waqf* founder (*al wāqif*). This paper presents a few examples where there is a dire need to revise classical *fiqh* in areas that help promote the establishment of new *awqāf* and improve the benefits derived from existing ones. Many Muslim communities are rich in their inherited *awqāf* properties, if only their capital benefit ratios can be improved.

I. THE PRINCIPLE OF PERPETUITY VERSUS TEMPORALITY IN *WAQF*

When Al-Shafi'i in his "*Al-Umm*" mentioned that the Prophet (peace be upon him) invented the *waqf*, a concept with no precedent in all other nations, he was not aware that Egyptians, Greeks, and Romans had certain types or versions of *waqf*. Al-Shafi'i was certainly correct in his assertion if we look at some of the unique characteristics and scope of the Islamic *waqf*. One of the major points in this regard is the principle of perpetuity. Perpetuity in *waqf* means that once a property is dedicated as a *waqf* it remains so until the Day of Judgment— no one can change it later.[1] In contrast with perpetuity, some kinds of *waqf* are also recognized as temporal.

Perpetuity requires three conditions:

The property made *waqf* must be suitable for perpetuity either by nature, by its legal status, or by its accounting treatment. Land is the only property that is perpetual by nature. Perpetuity of a property is acquired by legal organization or legal status through equities in common stock perpetual companies. Accounting procedures may turn a given property into a perpetuity through the application of the principle of provision for capital consumption or provision for amortization.

The second condition relates to the will of the *waqf* founder. A perpetual *waqf* requires an explicit or implicit expression of will on the part of the founder to make it so. This condition was not fully elaborated in the classical *fiqh*. In fact, the Maliki School has the only group of jurists who explicitly accept temporality in *waqf* by virtue of the will of the founder. Even Malikis themselves do not accept temporality in a *waqf* for a mosque and they say that even if a *wāqif* (founder) decreed that his/her *waqf* for a mosque is temporal, the *waqf* is considered perpetual and the temporality condition is nullified.

This seems to grossly infringe on the desire and property rights of the founder without any legal or *sharīʿa* support for such a position. As expressed by the late Zarqa, everything in *waqf* is subject to *Ijtihad* and there is no single ruling in it that gained unanimity except that the *waqf* purpose must be benevolent (*Birr*). Apparently all schools of *fiqh*, including the Malikis (with respect to temporality in mosque *waqf*), did not anticipate cases in which there are real needs for temporal *waqf* in general as well as in mosques specifically.[2] It may be interesting to note that the Malikis, who rejected temporality in mosque's *waqf*, accepted it if the founder is a lessee of a structure and he/she made his/her usufruct, owned by virtue of the lease contract into *waqf* as a mosque. However, it must be noted here that temporality in a *waqf* by a lessee is caused by the nature of the property not by the will of the founder.

It must also be noted that the perpetuity in *waqf* remains the rule and temporality the exception. Hence we go along with the majority of jurists who consider the *waqf* as essentially perpetual, and we believe that temporality in *waqf* requires an explicit expression in the founder's will.

The third condition for perpetuity is that the objective of *waqf* must be perpetual. Here, jurists talk about non-existence of the assigned beneficiary at the beginning, in the middle, or at the end of a *waqf* and they treat these

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* Formerly of the Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia.

cases in ways that finally fall under either annulling the *waqf* that has a non-existent objective or transforming it into the general objective of supporting the poor and needy on the assumption that there is always need for such an objective.

The importance of the principle of perpetuity in the *sharīʿa* should be looked at in the light of the need, in all societies, to establish revenues/services-generating permanent assets devoted to social objectives. In other words, the perpetuity in *waqf* provides for capital accumulation in the third sector that, over time, builds necessary infrastructure for providing social services on a non-for-profit basis. Hence, perpetuity in *waqf* accounts for the accumulation of assets in the non-profit sector which is a first and necessary step for the growth of this sector in contrast with the profit-motivated sector and the government sector built on authority and law enforcement.

The principle of perpetuity is protected in the *sharīʿa* by a series of rulings. Some of these relate to the prohibition of the disposition of the *waqf* asset through sale and other contracts and some relate to the transfer of *waqf* revenues from one objective to another in the event that the assigned objective cease to exist, so that the property remains in the domain of *waqf*.

However, little attention is given to the importance of temporality in *waqf*. In this regard, we must notice that all jurists, without exception, approve of the temporality of *waqf* if it comes from the nature of certain assets made into *waqf*. Regardless of the justification given by different schools of jurists, *waqf* of buildings, trees, horses, books, swords, slaves, etc. is accepted. They did not consider this *waqf* as non-perpetual on the claim that this is a *waqf* for the lifetime of the asset itself, i.e., in such kinds of property, perpetuity is given a non-perpetual meaning! The Malikis accept temporal *waqf* by the will of the founder. They also accept the *waqf* of usufructs, which may very often be temporal too.

The truth remains that all these properties only make a temporal *waqf* especially in that *waqf* is an object that relates to lives of societies and communities, and perpetuity in it cannot be measured in terms of life of horses or durability of trees and rugs. Recognizing this dilemma, Ibn Arafa, a Maliki, defines perpetuity of *waqf* in terms of "as longs as the property lasts." Many *fuqahā'* mention that *waqf* of mobile assets is a mere exception from the rule because it was done at the time of the Prophet (peace be upon him).

It is worth noticing that the accounting idea of forming provisions for capital consumption, which lead to accounting perpetuity, is a new one, early jurists were not aware of it. Temporality, which is decreed by the will of the founder, is not permitted by the majority of jurists, the Malikis are an exception, while temporality caused by the life span of those mobile assets that are considered by jurists for *waqf* is approved without calling it temporality.

Contemporary experiences of Muslim societies and communities indicate that temporality by will of the founder and by nature of certain objectives is part of social life as all societies need it as much as they need perpetuity and glorify it.

Contemporary Muslim jurists should reconsider this principle in terms of the basic distinction between *waqf* and ordinary *sadaqah*. If one looks at the sayings of the Prophet (peace be upon him) about *waqf*, one important characteristic can be derived. A *waqf* is made distinct from ordinary *sadaqah* by the repetitiveness of the benefits that come out of it. Therefore, any form of *sadaqah* that makes repeated payments to service its objective is a *sadaqah jariah* (running *sadaqah*): a *waqf*.

This "running" feature of *waqf* can be manifested in different forms. It may be shown in terms of pledging the income/usufruct of an asset for a period of time at the end of which the asset and its income/usufruct return to the founder. It may also be shown in terms of distributing both its income and parts of its asset over repeated installments to the beneficiaries. Hence, temporality comes from depletion of the asset. It may be manifested in terms of a perpetual asset that produces a repetitive flow of income or services, or in terms of a right granted to the beneficiary to receive periodically, at repeated intervals or when needed, a flow of mobile objects/usufructs. All are *waqf* and there is no need for excluding any of them from being a *waqf* without valid rationale or support from an original text.[3]

II. *WAQF* OF USUFRUCT AND FINANCIAL RIGHTS

Waqf of usufruct is known in the Maliki School but not the other schools of jurists. Contemporary life has many forms of usufructs that can be made into *waqf*, such as driving a car on a toll way or passing through a tunnel or bridge that has fees on it. Similar to that is the use of a parking lot given a *waqf* for two hours for the Eid prayers twice a year. These kinds of *waqf* need to be recognized by the contemporary *fiqh* as well as by the laws of *awqāf* in the Muslim countries and communities.

Most laws of *awqāf*, including those in Algeria, Jordan, Sudan, and India do not make any reference to the *waqf* of *manafi'* (usufruct). The recently proposed law of *waqf* in Kuwait recognizes both temporality and usufruct in *waqf*. It is still lingering between the government and parliamentary committees.

Financial rights are also not usually recognized in *waqf* by jurists and laws. Modern life has many kinds of these rights, some of which were known in the past but were not of much financial value. For instance, although authorship rights are non-transferable (because transferring them makes a lie) the right to publish and financially exploit the product of an author has become an important business in our days. The same was not known in the past. Patents and other rights related to the product of talents are also an important new dimension in contemporary life. These rights are not dealt with in our classical *fiqh*, so is the *waqf* of objects that have a repetitive character such as newspapers, magazines, and other periodicals. The products of film companies, educational software programs, and many other intangible properties are similar. All such rights and objects must be covered in the *awqāf* principle.

Under the existing *fiqh* and laws of *awqāf* in most Muslim countries and communities, one cannot, for instance, make a *waqf* of ten years' subscription to the *American Economic Review* to the benefit of a university library. It is true that civil laws in all these countries consider such an act a donation, but the laws of *awqāf* must give it privileges similar to those granted to other types of *awqāf*.

To complete the story of the *waqf* of rights and usufruct, it is worth while to mention the publication of classical works in *fiqh* and other subjects that is being done these days all over the world without any recognition of the financial right of the author by the publishers. There are many indications that Muslim writers throughout Islamic history were motivated by the Islamic tradition that prevents and prohibits withholding knowledge from others. They were thus always keen to make all their intellectual products available to users. This is equivalent to making their intellectual property a *waqf* to students, scholars, and other non-commercial users. The publishers of these works profiteer themselves from the share that is otherwise given to authors. This is an area where the laws of *awqāf* in the Muslim countries and communities must interfere to protect the right of writers important in the heritage from being exploited financially by publishers. This can be done, for instance, by stipulating that a percentage of the copies published must be given for free to libraries, mosques, schools, and other learning institutes This, to a large extent, fulfills the main desire of the authors by making their works accessible to those who seek knowledge.

III. Public and Private *Waqf*

From the point of view of the nature of the objectives of *waqf*, *waqf* may be divided into public and private. Public *waqf* is that which serves an objective of interest to the whole society or part of it. Its examples are *awqāf* for mosques, schools, orphanages, scientific research, the poor and needy, travelers, etc.

Private *waqf* is a *waqf* in which the beneficiaries are either specific persons or persons characterized by certain relations to the founder or any other specific person. The most common type of this *waqf* is *waqf* for the descendants of the founder. That is why this kind of *waqf* is usually called family or posterity *waqf*.

Posterity *waqf* is a pure invention of Muslims. It was created when the companions of the Prophet (peace be upon him), started making *awqāf en masse* following the footsteps of the second *khalifa*, 'Umar Bin Al-Khattab, and they added clauses in their *waqf* documents to the effect that the first or major beneficiary of the *waqf* should be the descendants of the founder.

The private *waqf* always spills over to the public since the private *waqf* have a clause assigning either a fraction of the revenues to a public cause or converting all of the private *waqf* to a public cause should the assigned beneficiaries cease to exist. Al-Shafi'i in his "*Al-Umm*" gave two empirical examples of private *waqf*, one of them was for his own son Abu al-Hassan, who was born to him in Egypt. In both, the *waqf* goes to the poor and the needy after its private objective ceases to exist.

In several Muslim countries, private *waqf* came under heavy attack from some disciples of the orientalists who criticized this type of *waqf* in the late 1800s. Several Muslim countries enacted laws that liquidate existing private *waqf* and prevented establishing new ones. This happened in both Egypt and Syria. Lebanon limited the private *waqf* to two generations only, after which a private *waqf* is subjected to liquidation to the benefit of the beneficiaries. These attacks were rightly justified by the huge amount of corruption that dominated the handling of *awqāf* all over the Muslim world but there was no reason for any discrimination between private and public *awqāf* on the basis of corruption. The fact is that the management of both types of *awqāf* was corrupt and most *awqāf* properties were either already stolen or very much abused. The solution could not be found in eliminating such a benevolent institution but in redesigning the approach to its management, as will be discussed later.

The private *waqf* in fact serves an important social objective as well as encourages economic growth. Properties left to posterity help provide additional income to descendants of the founder. They also help keep them off social welfare and *Zakah* recipient lists while, at the same time, such properties provide for a mechanism of capital accumulation through generations which is an important way for growth and development. This fact that was only recognized in the west, especially in the United States, over the past few decades where the use of family trusts under different variants became very common and were granted several tax privileges. Moreover, it is known in Islamic *fiqh* that any *waqf* whose beneficiaries cease to exist turns into a *waqf* for the poor and the needy as this is considered a primary objective of the institution of *awqāf* itself. Hence, both *fiqh* and laws in Muslim countries should have dealt with the problems of corruption, fragmentation of beneficiaries and cost of locating beneficiaries in relation to the revenues in a more dynamic way that allows for the promotion of private *waqf* and for turning it into a *waqf* for the poor and needy over time instead of looking at it negatively.

IV. The Management of *Awqāf*

A careful study of the Islamic *awqāf* and its *fiqh* as developed throughout centuries and a deep look into *sharīʿa* rulings on *awqāf* and the different *fatāwā* in its regard in different Muslim cities and countries all point to the idea that Islamic *awqāf* is certainly not an invitation to the authority of the government to dominate the area of benevolent activities in society. To the contrary, from its beginning the establishment of *awqāf* was a clear representation of creating a third sector related to philanthropies that is kept away from both the profit-motivated behavior of individuals and the authority-dominated action of the government. ʻUmar Bin Al-Khattab, during his reign as a khalifa, wrote the document of his famous *waqf*, which is considered the main source of *fiqh* on the issue. He appointed himself a manager, and after him a person from his family not his successor in *khilafa*. In the other *waqf* which was done at the time of the Prophet (peace be upon him) by ʻUthman, the *waqf* of the well of "*Ruma*" which supplies drinking water to al-Madina was also not put under the command of the government. It was managed virtually by the community with no government interference. The late Abu Zahrah mentions that many rulers and rich persons used to make *awqāf* in order to have their wealth escape potential persecution and confiscation by newcomers to power, and there was no mention in any book of *fatāwā* and *nawazil* of any single *waqf* in which the founder nominates the government as a manager of his/her *waqf*.

It seems that the first attempt by the government to manipulate *awqāf* took place during the period of the *Mamaliks*, at the time of Al-Zahir Bebars in Cairo. This attempt was received with extreme negativity and rejection by the *fuqahā'* and other Muslim scholars. It was withdrawn. The miraculous change came in our era where we find *awqāf* properties in almost every Muslim country run and managed by a branch of the government. Hence, instead of having a strong third sector independent of both the profit-making motivation and the power of the government, we end up with *awqāf* that works under the shadow of a corrupt and inefficient public sector.

This change began with the Ottoman *awqāf* law which was enacted around the middle part of the nineteenth century and which came as a drastic response to the dominant corruption in the management of *awqāf* as a result of abuse, neglect, and mistrust that enveloped a great majority of *awqāf* managers (*nuzzar*).

Yet, the Ottoman *awqāf* law was only a first step because it did not transfer all *awqāf* management to the hands of government. Nor did it eliminate the private *awqāf*. During the first half of the twentieth century *awqāf* laws were issued in almost all Muslim countries. These laws established a branch of government, called "Ministry of *Awqāf*" or General Directorate of *Awqāf* to manage *awqāf* properties like other branches of the public sector.

The government is a bad manager of economic enterprises. It is also a bad manager of benevolent projects. *Awqāf* properties, whether used directly for their objective or investment whose revenues are utilized in supporting the objective designated for them, are merely properties that belong to economic/benevolent activities in the society in which government represents a failing manager.

Several reform attempts started taking place in some Muslim countries to reform the management of *awqāf*. In Sudan, starting from 1987, a new organization was found under the name of the Public Corporation of *Awqāf*. 1993 witnessed the reorganization of the Ministry of *Awqāf* in Kuwait whereby a General Secretariat of *Awqāf* was created as an autonomous, though governmental, body to manage the *awqāf* in Kuwait. Qatar also remodeled its Ministry of *Awqāf* along similar lines.

Unfortunately, all these reforms could not touch the real problem; solutions suggested were only cosmetics and represent mere change of hands—a kind of intergeneration struggle, rather than a change in the concept of management.

In the Islamic legal system, *awqāf* represents an early version of the concept of corporation that was invented throughout the last three centuries and matured in the third quarter of the nineteenth century. In a way, economic corporations are no more than funds utilized to generate profit to their owners whereas *awqāf* properties are funds utilized for the benefit of their beneficiaries. There are numerous indications, at least from existing or surviving *awqāf* documents, that founders tended to always nominate a manager for their *awqāf* from their own vicinity or that of the property itself. Once we decide to respect the conditions of founders and avoid the government as a *nazir*, it can be established, on the basis of the surviving documents, that the intention of founders has always been in the direction of appointing local managers rather than the central government or its local branch.

Hence, in fulfillment of the will of the founders, in respect of the distinctive nature of the third sector or the non-profit sector of *awqāf*, in recognition of the tremendous failure of governments in managing economic and benevolent enterprises, and in realization of the need for distinguishing the style of management of *awqāf* from that of profit-motivated private-interest-seeking enterprises, the *awqāf* management should be run by local people who relate to the beneficiaries of *awqāf* as well as to the community in which *awqāf* properties represent an infrastructure capital for social work and social interests.

The management that is needed for *awqāf* is similar to that of economic corporations. It also involves, however, finding a way to elect a management board that relates to the beneficiaries and locality of the *awqāf* property. A new proposal recently submitted in the context of a study on the reform of *awqāf* in Saudi Arabia was based on the concept of creating *awqāf* management units that are selected from among concerned individuals and civil society organizations in the area where *awqāf* properties exist.

V. The Ownership of *Awqāf* and Its Legal Entity

The differences of opinion among Muslim scholars on who owns *awqāf* property are well known. These opinions may be grouped in three. Does a *waqf* remains with the ownership of the founder and is it inherited from her/him by legal heirs? This is the view of Malik and many others. Does a *waqf* become owned by the beneficiaries? The leader of this opinion is Abu Hanifah among others. Is a *waqf* is owned by God, the Almighty? Abu Yusuf, Al-Hassan, and Al-Shafi'i among others subscribe to this view.

These differences reveal an interesting fact. Ownership of *awqāf* was a question that puzzled Muslim scholars at a time when the concept of legal entity or legal personality, outside of natural persons, was not developed. Contemporary *awqāf* laws in Muslim countries and communities quickly assign a legal personality to *awqāf* and consider *awqāf* properties owned by that legal entity.

In fact, there are many *awqāf*-type properties that fall outside *awqāf* laws in all Muslim countries, simply because they come under the acts on non-profit organizations, be they educational, charitable, social, or otherwise. The laws of organizations in Muslim countries assign to an organization a legal entity that allows it to own both mobile and immobile properties. Many of these properties are certainly given to the organization on the basis of forming permanent capital to be used for servicing the objective of the organization, say a school building or land, or as a permanent source of income to the organization, as investments that generate revenues. These properties are no more than *awqāf*.

The concept of legal entity or corporation is a western one, which was developed in Western Europe and the United States over the last few centuries. A legal entity has its independent financial status. It also has the right to litigate and to be represented as well as represent others. There are many voices among legal scholars that call for a legal entity to be covered by criminal laws so that it can be put under guardianship, fined, and eliminated. Contemporary Muslim jurists usually accept this new concept of legal entity or corporation and include it in their studies and rulings.

It has always been argued that the concept of *waqf* comes very close to the manifestation of a legal entity as it has separate and independent financial personality (*thimmah*) of its own, not intermingled completely with that of its manager. The manager (*nazir*) is only a representative of the *waqf*. The relationships between them are very well elaborated in *fiqh*.

On the other hand, it is rarely questioned whether the concept of corporation and its legal entity does really suit the exact size of *awqāf*. The management of a corporation, with proper authorization from its constituency, the general assembly, can dispose of the assets of the corporation through sale, gifting, and other ownership transferring transactions. It can also liquidate the corporation and do away with all of its properties. The managers of *awqāf* are very restricted. In *awqāf*, properties are not considered owned by any human entity, individually or in groups, be it natural or judiciary. They cannot even give any of the *waqf* income to any philanthropic objective outside the assigned one. We have seen that many scholars consider God the owner of *awqāf*, and no one dares attribute to Him such kinds of transactions.

Thus, *awqāf* properties require a special kind of judiciary person, or an amended legal entity unlike other persons. The properties are either not to be disposed of by the owners, or the legal entity of *awqāf* should somehow be allowed to conduct certain contracts and legal actions only—those which relate to investment of assets and distribution of income and usufructs. However, it should not be allowed to take up other kinds of contracts and legal actions that infringe on the principle of perpetuity, continuous growth and further accumulation of *awqāf* properties, and the distribution prescribed by the founder.

The managers of *awqāf* are thus not similar to the managers of corporations in the scope of their authority. The dilemma referred to above of *awqāf* properties under the authority of judiciary entities that take the names of non-profit organizations is exemplary. *Awqāf* under non-profit organizations can be liquidated, sold, and disposed of by actions within the scope of the proper authority of the management of these organization.

As a result of this confusion involving *awqāf*, corporations, and the place of *awqāf* as judiciary entities, the *awqāf* properties of Muslim communities in many countries live under continuous threat of mishandling of not only their usufruct or income. Properties of *awqāf*, including mosques, schools, and other properties assigned for community use by Muslims in the United States, Canada, most European countries, and South Africa, for example, are subject to all kinds of ownership-transferring contracts by the management, as well as to litigation by others for actions of the managers. The management of such properties can mortgage them or use them for loans. This exposes these properties to be repossessed by lenders, and managers can sell these properties and make other transactions that dispose of them. These properties can be liquidated by legal action due to the neglect of the managers. The corporations in whose form the organizations that own these properties appear are always vulnerable to litigation that threaten the public character of *awqāf* itself these countries.

VI. Special Conditions of the *Waqf* Founder

Classical *fiqh* adopted a slogan that became very famous over time: "The conditions of the *wāqif* are similar to the texts of the Legislator." This indicates the value attached to the conditions of the *waqf* founder in *fiqh*.

Yet we find that the *fuqahā'* very often deviate from the spirit of this slogan and violate or disrespect conditions of the *wāqif*, as seen here already. There are many other examples of the same, as can be seen by a quick glance at the two Majallahs: Majallat al-Ahkam al-Adliyah of the Hanafis, and Majallat al-Ahkam al-Shar'iyah of the Hanbalis. For instance, the prevailing view in the classical *fiqh*, especially in the Maliki and the Hanbali, is that the *wāqif* is not permitted to make himself a beneficiary of the *waqf*. This is based on the presumption that making oneself a beneficiary contradicts the benevolent character of *waqf*, as if the Prophet (peace be upon him) did not consider making *Birr* to oneself a priority in the actions of *Birr*.

Another area where the conditions of the *wāqif* are not respected is the *wāqif*'s right to terminate the *waqf* and retrieve its property to themselves if they found that such a reversal is needed. This right is not accepted by any jurist except Abu Hanifah, with the provision that the *waqf* did not, in the meanwhile, gain perpetuity through a judicial action.

A third situation where the conditions of the *waqf* founder are not respected is where the objective of the *waqf* comes to an end at a certain point of time and the *wāqif* makes her/his *waqf* in such a way that its principal ceases to exist at the same time. An easy example of this is the supporting of orphans until they reach maturity.

In contemporary life filled with uncertainty and unpredictability about the future and where family and tribal mutual financial solidarity is lax, these three types of conditions become of great importance to the *waqf* founder. Many a *wāqif* would be encouraged to make *waqf* if they were assured that should they need the *waqf* funds at the time of retirement, old age, sickness or otherwise, they can be a prime beneficiary of their own *waqf*, or they can rehearse the action and come back to own and use the *waqf* assets and/or income. Additionally, allowing a *waqf* to end after fulfilling its objective encourages making *waqf* because it is a lower sacrifice to the *wāqif*. For instance, a $1000 ten-year annuity with the depletion of its principal requires half the amount of principal for a perpetuity at an expected rate of return of 7%.

Contemporary *fiqh* and laws of *awqāf* in Muslim countries and communities must re-address the issue of special conditions set by the *waqf* founder and recognize the implications of the new reality of uncertainty and unpredictability about future income and future financial needs. This is especially true of three areas: the condition of benefiting the *wāqif* from their *waqf* and its income, the right to reverse the decision of making *waqf*, and the right to make a *waqf* that lapses with the lapse of its objective.

Practices in some Muslim countries accept the condition of self-beneficiary as in actual new *waqf* documents created in both Jordan and Saudi Arabia. The proposed new Act of *Awqāf* in Kuwait allows for the *wāqif* to reverse her/his decision on creating a *waqf*.

Finally, it should be noted that a balance between perpetuity and benevolent objectives for the public of a *waqf* on the one hand, and the special desires and conditions of the *wāqif* and the *wāqif*'s right to select a path that is most appreciated from their point of view on the other, must be drawn. This is to preserve the unique character of perpetuity in the Islamic *waqf* as a mechanism for providing a third non-profit benevolent sector in the economy and in the society at large with permanent and ever-increasing income-generating assets.

VII. CONCLUSION

It is clear that there is indeed a dire need to revise the classical *fiqh* in areas that help promote the establishment of new *awqāf* and improving the benefits derived from existing ones. It should be noted that Muslim societies and communities in many areas of the world are rich in their inherited *awqāf* properties. What remains to be done is improve their capital benefit ratios.

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[1] That is perhaps why many Muslim jurists argued that a *waqf* property is owned by God, the Almighty.

[2] All Muslim communities today may need, one way or another, a temporary mosque for a certain period of time, either because of the mobility of Muslim communities in the Americas and Europe or because of the long period needed for building mosques, whether for collection of donations or for construction.

[3] In a similar case regarding *ijāra*, Ibn Taymiyyah considers as a valid *ijāra* renting an asset that produces repeated mobile objects rather than usufruct. The example he gives is renting a well for its water and hiring a nursing woman for the milk she provides to a newborn baby.

A *Rahn-ᶜAdl* Collateral Security Structure for Project and Secured Financings

Michael J.T. McMillen*

ABSTRACT

This paper summarizes the principal elements, development, and implementation of the *rahn-ᶜadl* collateral security structure for the Saudi Chevron petrochemical project financing. The structure was developed with particular sensitivity to the requirements of the Hanbali school of Islamic jurisprudence. The paper describes: (a) the primary transactional participants; (b) the primary loan and *rahn* documentation; and (c) institutional requirements of the project participants. Three economic and financial trends in Saudi Arabia promoting and supporting the financing are identified. General legal considerations influencing development of the structure are discussed, and then the development and substantive elements of the *rahn-ᶜadl* structure are detailed. The structural model was developed from *sharīᶜa* precepts, with English law adaptations added to the *sharīᶜa* model (opposite to the approach usually taken). The developmental process is described, from early models to the final models for the petrochemical project. Major issues and related Saudi Arabian law are discussed in detail. Finally, the paper notes how the *rahn-ᶜadl* structure has been refined in subsequent financings and where the structure is being used in other types of financings.

I. SUMMARY

This paper summarizes the principal elements, development, and implementation of the *rahn-ᶜadl* collateral security structure for the Saudi Chevron petrochemical project financing, which was the first limited recourse project financing in Saudi Arabia. The structure was developed with particular sensitivity to the requirements of the Hanbali school of Islamic jurisprudence, but has been used (with modifications) in a variety of Middle Eastern project, structured, and other limited recourse financings. The paper describes: (a) the primary transactional participants (Saudi Chevron Petrochemical Company and its equity participants; the international, regional and local banks providing financing; and the offshore and onshore *ᶜadlān*); (b) the primary loan and *rahn* documentation; and (c) institutional requirements of the project participants, including collateral security and other credit requirements of the banks, as well as sponsor needs to reduce borrowing costs and limit recourse to the project assets in accordance with the principles of a limited recourse project financing. Economic and financial trends in Saudi Arabia promoting and supporting the financing are identified as: (i) industrial diversification; (ii) access to a broader financial base by involvement of Saudi Arabian investors, internationalization of the financing process, and the use of project financing techniques; and (iii) reduction of the governmental role in the provision of financing. General legal considerations influencing development of the structure are: (A) the primacy of the *sharīᶜa*; (B) the absence of statutory or other published law in respect of collateral security; and (C) the *sharīᶜa* precept that the agreement of the parties is binding absent a prohibition in the *sharīᶜa*. The development and substantive elements of the *rahn-ᶜadl* structure are detailed. In general, the structure needed to satisfy the credit policies of the banks, the operating and financing parameters of the developers, and both *sharīᶜa* precepts and English legal principles. The structural model was developed from *sharīᶜa* precepts, with English law adaptations added to the *sharīᶜa* model (the opposite approach to that usually taken). The scientific method for development of the *rahn-ᶜadl* model was the assembly of a group of Islamic scholars, *sharīᶜa* advisors, lawyers practicing in Saudi Arabia, and Saudi Arabian jurists. The interactive developmental process is described as it moved from early models (involving the *rahn* of a camel, land, and equipment) to the final models for the petrochemical project. Exemplary major issues and related Saudi Arabian law are discussed, including that pertaining to: (1) location of assets and choices of governing law; (2) revocability of powers of attorney and principal-agent relations; (3) *sharīᶜa* precepts applicable to an *ᶜadl*; (4) substantive law relating to a *rahn* and the nature, rights, and responsibilities of an *ᶜadl* (particularly concepts of possession, revocability, after-acquired property, subsequent advances, and actual notice to third parties); (5) the documentation used in the Saudi Chevron project financing; (6) the jurisdictional ambits of the major Saudi Arabian enforcement entities; (7) the extent of examination of underlying documentation by each such Saudi Arabian

* Partner, King & Spalding, New York, N.Y.

enforcement entity; and (8) enforcement of foreign judgments and arbitral awards in Saudi Arabia. Finally, the paper notes how the *rahn-ᶜadl* structure has been refined in subsequent financings and where the structure is being used in other types of financings, including general secured lending transactions, project financings, and financial products in the capital markets.

II. INTRODUCTION[1]

The essential participants in any financing of a large scale industrial or infrastructure project are one or more equity investors (often the sponsors of the project) and the availability of debt financing, or an Islamically acceptable alternative to the debt portion of the financing.[2] The determination by a lender as to whether to participate in a given industrial or infrastructure loan centers on the project economics and, particularly in a limited recourse project financing, the collateral package that is made available to secure the loan. Project sponsors and their affiliates have a strong aversion to guaranteeing a project loan or otherwise incurring a balance sheet liability in respect of a project. This is particularly true of companies that may have to reflect the guarantee liability on, or consolidate project debt onto, a parent company balance sheet under generally accepted accounting principles. Thus, in addition to careful tax and ownership structuring, project sponsors and their parent companies also have a strong interest in providing the lenders with a strong collateral security package. In addition, they want the collateral for the project to be, and to be limited to, the assets comprising the project and the cash flows from operation of the project.

In fact, these needs and preferences of the equity and the debt provide the core of the definition of "project financing": financing of an economic unit in which the lenders look initially to the cash flows from operation of that economic unit for repayment of the project loan and to those cash flows and the other assets comprising the project and the economic unit as collateral for the loan.[3] It is an "off balance sheet" method of financing. Collateral security is the essence of a project financing.

This paper presents a case study for the first limited recourse project financing in Saudi Arabia, the Saudi Chevron petrochemical project in late 1998. In particular, it focuses on the development of the *rahn-ᶜadl* collateral security structure for that financing. This collateral security structure has been used as a model for, and has found a much broader implementation in, other secured financings throughout the Middle East.

III. THE SAUDI CHEVRON TRANSACTION: PARTICIPANTS; STRUCTURE; INSTITUTIONAL REQUIREMENTS

A. Participants and General Structure

The Saudi Chevron petrochemical project is a benzene and cyclohexane project located in Madinat Al-Jubail Al-Sinaiyah, The Kingdom of Saudi Arabia. The project company, which owns and operates the project, is Saudi Chevron Petrochemical Company, a Saudi Arabian limited liability company (the Project Company). Equity in the Project Company is held by a Chevron Corporation affiliate (Chevron) and Saudi Industrial Venture Capital Group (SIVCG). Loans for the project are made to the Project Company by a consortium of international, regional and local banks (the Banks) led by Chase Investment Bank Limited, Gulf International Bank B.S.C., The Industrial Bank of Japan Limited, United Saudi Bank, and The Saudi Investment Bank as Arrangers. Additional loans, not governed by the agreements discussed in this paper, were made to the Project Company by Saudi Industrial Development Fund (SIDF).

In summary, construction and long-term multi-tranche loans are made by the Banks to the Project Company pursuant to a Facilities Agreement (the Facilities Agreement) and certain related documents and are evidenced by promissory notes (the Notes) (collectively, the Financing Agreements). Such loans are secured by essentially all the cash flows from the operation of the project, all the assets comprising the project,[4] and all assets owned or held by the Project Company pursuant to a numerous mortgage (*rahn*) (the Mortgage (*Rahn*)) and pledge (*rahn*) and assignment agreements (the Pledge [*Rahn*] Agreements) (collectively, the Security Documents). The primary categories of assets of the Project Company include various contracts (including feedstock and other input and off-take agreements), the site lease for the land on which the project is built, other real property rights and interests, approvals and licenses, and intellectual property rights (including technology rights and licenses) (collectively, the Project Documents), cash, bank accounts, accounts receivable, immovables, the assets comprising the project itself, computers, office equipment and other personal property (collectively, with the Project Documents, the Collateral or the *Marhūn*).

In addition, certain loans are made to the Project Company by SIDF pursuant to a loan agreement (the SIDF Loan Agreement) and those documents are secured by a mortgage and pledge of certain assets of the Project Company pursuant to the SIDF Mortgage and Pledge.[5]

Two entities act as *ᶜadlān* for the transaction, one for assets of the Project Company that are located outside Saudi Arabia (the Offshore Security Agent), and one for the assets of the Project Company that are located within Saudi Arabia (the Onshore Security Agent). Collectively, the Offshore Security Agent and the Onshore Security Agent are referred to as the Security Agents. The offshore assets of the Project Company are principally cash receipts from offshore sales of benzene and cyclohexane. The onshore assets are principally the project itself and all related rights, titles, and interests.

B. Institutional Requirements

Financing for the project is provided by a group of international, regional, and local Banks. In accordance with their credit policies, the Banks have particular expectations as to the type of collateral and the nature of the collateral security interests that secure the loans. The international Banks, and some of the regional Banks, are intimately familiar with a variety of collateral security systems in different countries. They are accustomed to advanced statutory collateral security systems in which there are precise, but easily understood and implemented, systems for recordation of mortgages, pledges, and other security interests. Many of those Banks have precise requirements as to the nature of the security interest that is permissible in a lending transaction, particularly a project financing, involving that Bank—namely, perfection of the security interest must be obtainable and the priority of the security interest must rank ahead of all competing creditors, a first prior protected security interest, and the security interest must cover all the assets comprising the project and those of the Project Company. Obviously the requirements are more stringent in a project financing because the Banks do not have recourse to the sponsors or any other parties or assets.

Some regional Banks and most local Banks in Saudi Arabia have a somewhat different view of collateral security, particularly in light of the absence of a recordation system in the Kingdom and due to the absence of a Saudi Arabian statute pertaining to collateral security. While many attempts have been made over the years to achieve recordation and some type of perfection of a security interest in Saudi Arabia, most have been unsuccessful, for both legal and political reasons. For example, as discussed below, "possession" of an asset is necessary for perfection of a security interest under the *sharīᶜa* (unlike American and English systems in which recordation of the nature and extent of the security interest is the touchstone for perfection, without regard to any concept of actual physical possession). Actual possession is a difficult concept to achieve for many types of assets (consider intellectual property rights) and for an operating plant. Thus, local Saudi Arabian banks have focused more on lending transactions involving recourse to a third party, such as a guarantee by a parent company or individual shareholders in the project company or its parent. To each of the Banks, maximization of an effective collateral security interest was and is essential.

Chevron and SIVCG, like most project equity participants, desired a true limited recourse financing, with recourse limited to the Project Company and its cash flows and other assets. Neither wanted to put the credit of its affiliates or shareholders behind the financing obligations. Thus, both equity participants desired to provide to the Banks the strongest possible collateral security package—a project financing will not be undertaken by the lenders without an adequate collateral security package.

A sound security structure decreases transactional risks, with a resultant decrease in financing costs for project financing in the relevant jurisdiction. Such a cost decrease is desirable to all project sponsors and developers because of the direct effect on profitability. It is also desirable to the financing Banks because of enhanced project economics and increased ability of the Project Company to repay financing obligations.

IV. The Economic and Financing Environment

The economic and financing environment in Saudi Arabia prior to, and at the time of consummation of, the Saudi Chevron financing involved a focus on diversification of the industrial base in the Kingdom. There was a trend toward accessing a broader financing base, with greater involvement of Saudi Arabian investors, internationalization of the financing process, and the use of project financing techniques rather than personal and corporate guarantees. Concurrently, the government and local businesses were considering and attempting to implement methods of reducing the role of government in the provision of financing.

In the initial stages, industrial diversification proceeded most rapidly in the petrochemicals industry, particularly where affiliates of Saudi Arabian Basic Industries Corporation (SABIC) were involved. Among the early petrochemical projects which obtained financing were expansions by Saudi Yanbu Petrochemical Company (Yanpet), a joint venture between SABIC and Mobil Yanbu Petrochemical Company, Saudi Petrochemical Company (Sadaf), United Jubail Fertilizer Company, a joint venture among SABIC and five SABIC companies, Al-Jubail Petrochemical Company (Kemya), and Eastern Petrochemical Company (Sharq). Financings by these and other companies involved some degree of recourse to project sponsors or their affiliates. They also involved some element of collateral security for the financiers of such projects. However, these projects did not fall within the "limited recourse project financing" concept that is being considered in this paper and none of those projects involved the use of the type of collateral security structure that was developed for the Saudi Chevron petrochemical project.

These projects illustrate broader involvement of Saudi Arabian investors, with each involving significant or exclusively Saudi Arabian equity, and some involving joint stock companies that may eventually seek stock exchange listings. In addition, Saudi Chevron and many SABIC projects, such as Yanpet, involve a combination of local, regional, and international lenders. Notably, 1998 also saw the first international lending transaction in the electricity sector when Saudi Consolidated Electric Company in the Eastern Province executed a "dedicated receivables" financing for its Ghazlan II project.

The health and liquidity of local and regional banks was a significant factor in industrial and infrastructure finance in Saudi Arabia in that period. Local banks reported profits in each of the years preceding the Saudi Chevron financing. Those banks experienced substantial liquidity and low loan-to-asset ratios. Profits were based more on investment income than interest, and loan growth had been low. This encouraged banks to increase lending to all economic sectors. To spread risks and increase the borrowing base, banks sought to join regional and international lending groups, particularly for large projects such as Saudi Chevron, Ghazlan II, and Yanpet.

Governmental evaluations were ongoing regarding restructuring of the electricity sector, with initial consideration given to financing the Shoaiba project as an independent power project using a build-own-operate (BOO) structure. Privatization of the telecommunications sector, Saudi Arabian Airlines, and port operations, maintenance, and management were all being actively considered. A public offering of SABIC shares was also being considered at the time. Regarding capital markets development, in April 1998 the Saudi Arabian Monetary Agency (SAMA) issued a new binding draft of the Investment Business Regulations which regulate, among other things, the distribution of securities and the management of mutual funds. Accession to the World Trade Organization was also a frequently considered topic, together with its effects on brokerage, insurance and commercial banking activities, as well as export/import markets.

Each of these developments, and others, worked to expand the capital markets, permitting greater access to foreign funds and a strengthening of the economy over the longer term. The aim was to free up Saudi Arabian capital, allowing it be spread over a broader risk base within the economy. This, in turn, would have the effect of a reduced burden on government and an allocation of risks to those willing and most able to bear them. It was anticipated that increased foreign equity investment would result in further technology transfer into the industrial sector. As completed financings illustrate, the time frame for implementation of individual projects was reduced as businessmen sought to avoid additional costs of delays and other inefficiencies in implementing their projects. Privatization, where determined appropriate, would allow governmental risk sharing with the private sector, cost reduction, and governmental management of the pace and depth of movement of functions to the private sector.

The Saudi Chevron petrochemical project financing exemplifies all of the foregoing trends and developments: extensive local equity (SIVCG, one of the two equity participants); international equity (Chevron affiliate); local (Al Bank Al Saudi Al Fransi, The Saudi British Bank, United Saudi Bank), regional (Gulf International Bank), and international (Chase Manhattan Bank) lenders; loans by SIDF; limited recourse financing techniques; and industrial diversification in the petrochemical industry. As noted in this paper, the structural implications of that financing are even broader.

V. The Legal Environment: General Considerations

The fundamental and paramount body of law in The Kingdom of Saudi Arabia is the *sharīᶜa* as construed by the Hanbali school of Islamic jurisprudence. Certain matters are dealt with "statutorily," by Royal Decrees with respect to that matter. Where such a statutory body of law has been promulgated, such law is ultimately subject to, and may not conflict with, the provisions of the *sharīᶜa*. Unlike other Middle Eastern countries, there is no statutory body of law in Saudi Arabia with respect to collateral security, mortgages and pledges, recordation of security interests or related matters.[6] Thus, financiers and legal practitioners must look directly to the *sharīᶜa* in structuring and applying legal principles relating to collateral security matters. This, in addition to the factors discussed immediately below, render it difficult to provide definitive advice as to how collateral security arrangements similar to those contemplated by the Security Documents can be effected or would be interpreted by adjudicative bodies in Saudi Arabia. It is noteworthy, however, that under the *sharīᶜa*, absent a prohibition in the *sharīᶜa*, the agreement of the parties will control.

In addition, under the principles of law applicable in Saudi Arabia, previous decisions of Saudi Arabian courts and other adjudicative authorities are not considered to establish binding precedents for the decision of later cases, and the principle of *stare decisis* (binding precedent) is not accepted in Saudi Arabia. Also, Royal Decrees, ministerial decisions and resolutions, departmental circulars and other governmental pronouncements having the force of law, and the decisions of the various courts and adjudicatory authorities of Saudi Arabia, are not generally or consistently collected in a central place and are not necessarily available to the public.

Specific legal principles affecting the collateral security structure are discussed in detail in Section 6 of this paper, entitled "Exemplary Major Issues and Resolutions."

VI. Development of the Collateral Security Structure

A. General Approach

The challenge that was presented to the lawyers by both the Banks and the Project Company was to develop a collateral security structure that met the project financing and related credit requirements of all the Banks and was satisfactory to the Project Company. A structure had to be developed that met the traditional requirements of New York and English financings but was consistent with the *sharīᶜa*. In developing such structures in other jurisdictions, lawyers and financiers begin with the New York or English (i.e., Western) model as the base structure. They then attempt to implement that model within the framework of the host country's laws by adding to such model a variety of procedures and structures from the host country's practice. Those host country practices often have to be modified to fit the pre-existing Western model. This often has the effect of jeopardizing the effectiveness of the host country procedure or structure, which, in turn, weakens the entire collateral security structure.

The approach taken for the Saudi Chevron financing was the opposite: The determination was made to build the base model structure from the point of view of the host legal system, the *sharīᶜa*. Thereafter, additions and modifications would be made to incorporate procedures and structures from the Western model more familiar to the international Banks.

The adoption of this approach was the direct result of discussions with the various *sharīᶜa* advisors, Saudi Arabian lawyers and, in particular, Saudi Arabian jurists. Through those discussions, it became apparent that the Western conception that there was greater certainty in using Western collateral security structures was incorrect where legal interpretation might be had in Saudi Arabia. For example, Saudi Arabian jurists are accustomed to thinking in terms of *sharīᶜa* precepts and to operating within the *sharīᶜa* system. Our discussions revealed that they did not consistently interpret Western legal language and structures. Greater consistency and predictability was obtained in their interpretations of *sharīᶜa* precepts. In addition, it was thought to be a much more advisable course because there is greater flexibility in the New York and English legal systems as regards collateral security and there is greater certainty as to the implementation of certain relevant legal structures (particularly Western elements of the structure) in those offshore jurisdictions. In addition, and in light of the necessity of asset possession under Islamic law but not New York or English law, we anticipated that we would be able to move certain of the assets (such as cash from offshore product sales) to an offshore jurisdiction, using those assets as "first-line" collateral, and then feed cash back into the onshore jurisdiction for use in conjunction with the assets comprising the "second-line" or "ultimate" collateral.

When a project experiences difficulties, calls on collateral are often sequential and predictable. Lenders rarely foreclose on all the collateral, although they almost always have the right to do so. Rather, they attempt to minimize their intrusion into the operations of the borrower and they proceed against the assets in a definable sequence (beginning, in most cases, with cash and other liquid assets). To give effect to those realities, the Financing Agreements and Security Documents were structured to allocate cash to problem areas without resorting to the more drastic step of calling upon other assets. The security interest in the cash is held, in the first instance, in an offshore jurisdiction with which the international Banks are familiar and which meets the credit requirements of those international Banks. This satisfies the Banks' standards for first-line calls on collateral and as to the nature and extent of the security interest itself. In the Saudi Chevron transaction, England was chosen as such a jurisdiction (New York would have worked equally as well).

The remaining task was to demonstrate to the Banks that a satisfactory security interest could be obtained under the *sharīᶜa* in Saudi Arabia. As anticipated, it was not an easy task to convince the Banks that such a security interest was satisfactory under their Western-focused credit policies. There was a perception that collateral security is difficult to obtain under the *sharīᶜa* and even more difficult to obtain in Saudi Arabia and that the nature of the security interest is uncertain. The perception was strongest among those unfamiliar with the *sharīᶜa* (which was most of the people involved in the transaction). Few completed project financings have joined Islamic and American/European security concepts, and it was our challenge to effect that joinder.

B. Scientific Method

The structure was developed from first principles under relevant *sharīᶜa* precepts, particularly under the Hanbali school of Islamic jurisprudence predominant in Saudi Arabia. Our first task was to achieve both a comprehensive understanding of the relevant *sharīᶜa* principles and a precise understanding of how those principles compared, point by point, with similar Western concepts. We enlisted a group of legal scholars and *sharīᶜa* advisors to supplement the team of lawyers. We provided the scholars, advisors, and lawyers with a detailed description of how a transaction would be structured under a Western model, including descriptions of the importance and legal effect of each structural element. They, in turn, provided a similar description of how a transaction would be structured under the *sharīᶜa*, with similar explanatory materials. There was considerable back and forth in arriving at a comparative outline of the two different structures and in achieving a basic understanding of that model.

We then began to probe the legal principles pertaining to each element of the structure in the context of a construction and long-term financing for an operating plant. We began with a series of general questions: How do you get a security interest under the *sharīᶜa* with respect to a given type of collateral? What is the nature of the security interest? What degree of certainty can we have with respect to any given security interest? What is necessary to retain that security interest? How is the security interest enforced? What are the respective rights and responsibilities of each of the involved parties? Why was a given element present? Why was it structured as suggested? What if the facts changed in this way or that way? What is the Islamic equivalent of a given Western element, if any? What is the Western equivalent of any given Islamic element? Would a different procedure or technique under the *sharīᶜa* better serve the requirements of the project participants? As we moved from the general to the specific, the list of questions ran into the thousands and the process was repeated a number of times as the answers, and the model, were refined.

As an example, we examined each category of assets (*marhūn*) comprising a project or held by a project company and relevant *sharīᶜa* precepts for granting a *rahn* (mortgage and pledge) or assignment with respect to each such category. Categories included: real estate interests (site leases, easements); immovable property (the plant); movable property (computers, equipment); cash (from sales, investments, and insurance); bank accounts; contracts; accounts receivable; intellectual property; technology licenses; and permits. Certain types of property fall into multiple categories and were appropriately analyzed.

As the model developed, we expanded our participant list from transactional lawyers, legal scholars, and *sharīᶜa* consultants to include judges from the Board of Grievances of The Kingdom of Saudi Arabia. We wanted to achieve an understanding of how *sharīᶜa* precepts pertaining to each element of the structure (and the developing documentation) might be applied in specific factual situations. And, as noted above, our discussions were leading us to the conclusion that greater certainty and predictability would be achieved if our structure was *sharīᶜa*-based.

Given the complexities of a project financing of a large industrial project, we began with a much simpler analogy. We posited a simple loan from one person to another that was secured by a *rahn* of a camel. Our questions were retailored to this analogy. Can a *rahn* be granted with respect to the camel? What are the necessary elements of a valid and enforceable *rahn*? Who is responsible for feeding the camel? Who is responsible for caring for the camel? Who is responsible for the security of the camel? Can the camel be milked? Can the milk be sold? Who is entitled to the cash received from the sale of the milk and how should that cash be applied? What are the respective rights and obligations with respect to care of the camel during the period of the *rahn*? What are the rights and responsibilities of the parties if the camel becomes ill? Can a subsequent loan be made that is also secured by the camel? Will that security interest come into effect automatically or will other steps have to be taken to ensure the effectiveness of the new security interest? What if the camel delivers a calf? Does the creditor automatically obtain a *rahn* over the calf? How and when can the *rahn* be enforced?

We then repeated the process on a comparative basis for a loan secured by land and equipment. As the understanding of the precepts and their application developed, we expanded the inquiry to include other types of *marhūn*.

This list of detailed questions became lengthy, and the conversations even more intricate. The discussions were penetrating, fascinating, and enlightening for all persons involved. Despite the intellectual rigor of the undertaking, humor permeated the entire process. As the model got refined in accordance with *sharīᶜa* precepts, we achieved a more precise understanding of the type of structural bridges that would have to be constructed to the relevant Western concepts so as to maintain familiarity to the international Banks and ensure the effectiveness of the entire collateral security structure.

As discussed below, the primary bridge between the *sharīᶜa* structure and the Western concepts familiar to the international Banks was the incorporation into the collateral security structure of an *ᶜadl*. American and European financings usually involve a trustee that holds collateral on behalf of lenders. The *sharīᶜa* does not provide for trustees, at least in a Western sense. However, the *sharīᶜa* has long experience with a similar concept, the *ᶜadl*. In brief, an *ᶜadl* is a trusted and honorable person selected by both the lender and the borrower, a type of "trustee-arbitrator" having certain fiduciary responsibilities to both parties. In addition to providing the necessary structural bridge, incorporation of the *ᶜadl* into the structure also solved or minimized numerous difficult issues under Saudi Arabian law, some of which are discussed in the next section of this paper.

VII. Exemplary Major Issues and Resolutions

The structure that was developed involved the grant of a *rahn* with respect to the *marhūn* to one or more *ᶜadlān*. A *rahn* is a type of mortgage (with respect to real property) and pledge (with respect to personal property) of property (*marhūn*) meeting certain requirements. The *ᶜadlān* are the Onshore Security Agent and the Offshore Security Agent.

Implementing the structure involved addressing a variety of legal and financial issues, some of which are noted in this paper. This paper first discusses certain Saudi Arabian legal principles bearing on choices as to governing law and the location of assets. Then, we consider the issue of "certainty" of a grant of a *rahn* (and with respect to the taking of various actions by the holder of the security interest). Resolution of these issues led to incorporation of the *ᶜadl* into the collateral security structure. Thereafter, we outline various factors pertaining to the nature of a *rahn* with respect to different categories of collateral. Next, we focus on issues pertaining to enforcement aspects of the Saudi Arabian legal system, in particular jurisdictional issues and document review issues arising with respect to different courts and adjudicatory authorities and issues pertaining to enforcement of foreign court judgments and arbitral awards in Saudi Arabia.

A. Location of Assets; Governing Law

One of the initial structural determinations was to use both an offshore and an onshore security agent. A security interest in the cash proceeds from the sale of benzene and cyclohexane produced by the project would be deposited in the first instance in an English bank account held with the Offshore Security Agent pursuant to English law and a security interest would be taken in that bank account. As and when needed, cash would then be transferred to an onshore bank account held by the Onshore Security Agent pursuant to Saudi Arabian law. Similarly, in light of Saudi Arabian and *sharīᶜa* possession concepts, certain other assets (such as executed original copies of certain contracts and negotiable instruments) were also located in England with the Offshore Security Agent, and a security interest was obtained in those assets pursuant to English law.

Concurrently, decisions were taken as to what law should govern the various documents to the transaction. It was determined that, to the extent possible and practicable, English law would govern the Facilities Agreement and certain other Financing Agreements and those collateral security agreements that pertained to assets located in England (most notably, the cash receipts account). The remaining documents would be governed by Saudi Arabian law. As a result, two separate sets of documents were constructed, each harmonious with the other. This structure resulted in careful drafting as to procedures for contemporaneous operation under each set of documents and cooperation between the two *ᶜadlān*, particularly as regards cash movements and any possible exercise of remedies.

B. Certainty: Powers of Attorney; Agency; The *ᶜAdl*

Characterization of a given grant of rights (such as in respect of collateral) is somewhat uncertain under Saudi Arabian law. For example, various security arrangements may be characterized as "powers of attorney" given by the Project Company to the Banks, with the Banks (and the Security Agents) being characterized as mere "agents" of the Project Company.

Many, if not most, judges in Saudi Arabia take the position that such powers of attorney and most agency arrangements are revocable at will by either party under the *sharīᶜa* and other Saudi Arabian law.[7] If so, the Project Company would be in a position to revoke the power of attorney and the agency arrangement, and thus the security interest given to the Banks, at the will of the Project Company. To the extent that the Banks derive their rights indirectly, through a security agreement, rather than directly, as a party to a contract, the Project Company may therefore be able to terminate the rights of the Banks. However, even under construction of relevant *sharīᶜa* precepts by jurists applying the Hanbali school of Islamic jurisprudence, the use of a *rahn-ᶜadl* structure confers a degree of irrevocability not otherwise found.

Further, there is an exception to the irrevocability rule under certain schools of Islamic jurisprudence. That exception is that grants of agency power, and powers of attorney, when coupled with an interest of third parties, are irrevocable when such irrevocability is relied upon by the third party. There is some debate among jurists in the

Hanbali school as to the extent to which such an exception exists in Saudi Arabia. In any event, jurists of the Hanbali school would likely give the narrowest reading to the exception to revocability.[8]

Notwithstanding the strict mandates of the law, however, there is a trend in Saudi Arabian legal practice toward a recognition of irrevocability in certain situations. For example, the Saudi Arabian courts have recently indicated that an agency relationship or a power of attorney may not be revocable if there is a specified term for the existence of the agency relationship or the duration of the power of attorney. In addition, the SAMA Committee (as hereinafter defined) attempts to interpret contracts in accordance with the expressed agreement of the parties, even where there is a seeming conflict with the *sharīᶜa*.[9]

In addition, under Saudi Arabian agency law, the principal (i.e., the Project Company) is always entitled to act whether or not the agent (i.e., the Security Agents and the Banks) is also entitled to act. The actions and directions of the principal will supersede those of the agent: a most undesirable outcome in a project financing.

Saudi Arabian law, however, acknowledges a type of mortgage/pledge arrangement, *al-rahn*, which is of particular relevance to this financing. *Al-rahn* is making a designated property a security for a debt, which may be partially or totally recovered from such property or the price thereof.[10] In a *rahn*, the definite property that is made a security for a debt, *al-marhūn*, may be deposited with a type of trustee-arbitrator, a trusted person mutually agreed upon by the parties, *al-ᶜadl*.[11] This device is similar in some ways to a bailment arrangement under New York or English law. The practice in Saudi Arabia is that either or both of the *rahn* documents and the *marhūn* may be deposited with the *ᶜadl*.[12] The nature of the *rahn*, and the rights and powers of an *ᶜadl*, with respect to the exercise of contractual rights under third party contracts that are the subject of a pledge is not well developed.

However, it is established that the *marhūn*, and/or the *rahn* documents, may be placed with the *ᶜadl* and may not be removed from the *ᶜadl*'s possession without the agreement of both the mortgagor/pledgor and the mortgagee/pledgee,[13] and possession may not be returned to the mortgagor/pledgor without the consent of both such parties in interest. The *ᶜadl* may not sell the property given as security without the consent of both such parties in interest, although that consent may be provided in the *rahn* documents that are executed at the commencement of the *rahn* transaction, and such consent will not be treated as a revocable power of attorney.[14] There are various other requirements that must be met in connection with a valid *rahn* with an *ᶜadl*.

The implications of the foregoing for the Saudi Chevron project financing were considerable. First, the structure included two *ᶜadlān*, one offshore and one onshore. Irrevocable grants were made to the *ᶜadlān*, and the Project Company, as mortgagor/pledgor, explicitly and irrevocably authorized the *ᶜadlān* to do various things and take various actions from time to time on the occurrence of specific conditions (such as sales of the items of collateral upon the occurrence of an event of default and the exercise of other remedies in connection with an event of default). These authorizations were substantially more specific and detailed than would have been the case in a document governed by New York or English law where there is a substantial body of determinable interpretive precedent and the principle of *stare decisis* is applicable. The nuances of these doctrines under the *sharīᶜa* were also addressed in detailed drafting.

The use of recitals to an agreement governed by New York or English law has diminished greatly in recent years. In some cases, the recitals continue to provide some evidence of the legal consideration for the agreements embodied therein. Although there is no equivalent body of law with respect to legal consideration under the *sharīᶜa*, the use of detailed recitals is important for other reasons. This is particularly true in a financing such as the Saudi Chevron transaction. Thus, detailed recitals, and substantive provisions of the agreements, were constructed to make it clear that an agency relationship is not contemplated and that the rights afforded the Security Agents, on behalf of the Banks, are irrevocable and coupled with an interest. The nature of the interest, as well as the reliance of the Banks and the Security Agents on the *rahn* and their irrevocability, was addressed in detail.

To render even greater certainty to the structure, the Banks, directly in certain documents, and through the Security Agents in other documents, became parties to agreements that they might have to enforce in the exercise of their rights under those agreements or under any of the Security Agreements. This resulted in the Banks becoming direct parties to more documents than would have been the case in a transaction governed by New York or English law and the Security Agents becoming direct parties to certain other undertakings and guarantees that may otherwise have been unilaterally executed by the Project Company or other grantor. Such a structural modification allows the Banks, directly, to enforce the Security Agreements should it be determined that they are unable to act through the Security Agents with respect to a given matter.

Another device that was used included having the Security Agents become "parties" to various underlying Project Documents. This was accomplished by virtue of having the parties to the Project Documents execute relatively standard "direct agreements" or "acknowledgments and consents" (the Consents). In the usual case, these Consents contain an acknowledgment by the third party that the Project Company has granted a security interest in the referenced contract to which the Consent relates. They also contain a consent to the pledge of the referenced

Project Document. In Saudi Arabia, however, the Consents contained an explicit acknowledgment by the Project Company and the third parties that the Security Agents will have the irrevocable right to enforce the underlying Project Document upon certain events (such as an event of default under the Financing Agreements). Most of the other requirements for such direct enforcement are included in standard consents of this type. These arrangements were designed to effect an "amendment" to each of the underlying Project Documents with respect to which a Consent was or is executed, making the Security Agents direct "parties" to those agreements, to a limited extent. This element of the structure helped alleviate certain of the revocability issues and other Saudi Arabian legal limitations pertaining to collateral assignments of contracts: the Security Agents will be able to enforce the various Project Documents in their own right upon the occurrence of events of default under the Financing Agreements, without having to proceed under the various collateral assignments.

Specific substantive issues arising under the *sharīᶜa*, and which would not be addressed in detail in a document governed by New York or English law, were also the subject of precise drafting. For example, the Security Documents expressly delineate the rights and powers of the *ᶜadlān* in a variety of situations, including a power and right of occupation, use and operation of the *marhūn* upon the occurrence of an event of default and as to the application of the proceeds of occupation, use and operation to satisfaction of the outstanding indebtedness.[15] The Security Documents specify that the parties intend the grants of rights and powers to the Security Agents to be coupled with an interest, that they be irrevocable, and that such grants and the irrevocability have been relied upon by the Banks in entering into the transaction. Grants of powers and rights to the Security Agents are structured to be exclusive of powers and rights in the Project Company during the continuance of an event of default, with significantly more separation of rights than would otherwise be the case. The general language which is found in New York and English security agreements will likely be unavailing in Saudi Arabia, which interprets such grants literally based on express language.

In light of recent Saudi Arabian court decisions, the duration of the grant of a security interest was expressly stated as a quantifiable measurement of time. This should provide for irrevocability in the event of recharacterization as a power of attorney. For example, the term was set as some period of years beyond the term of the debt (to allow for enforcement upon default), with an earlier termination if all obligations of the Project Company under the Financing Agreements and the Security Documents are paid and performed in full.

C. *Rahn* Principles in Saudi Arabia

The land on which the Saudi Chevron project is constructed is owned by the Royal Commission for Jubail and Yanbu of The Kingdom of Saudi Arabia (the Royal Commission). The land is leased to the Project Company pursuant to a type of land lease agreement (the Site Lease). In the traditional structure, such leasehold interest of the Project Company would then be mortgaged to the Onshore Security Agent pursuant to a leasehold mortgage agreement to secure the obligations of the Project Company under the various Financing Agreements, in particular the Facilities Agreement and the Notes.

Under Saudi Arabian law, a mortgage of real property is treated, in most respects, identically with the treatment of a pledge of personal property.[16] Real property may be made the subject of a mortgage and used as collateral to secure indebtedness.[17] Personal property may also be made the subject of a pledge and used as collateral to secure indebtedness.[18] Increases in the value of the *marhūn*, additions to such property, and products from the operation of a project are automatically subject to the *rahn* under *sharīᶜa* precepts as applied by some schools of Islamic jurisprudence; under such precepts as applied by other schools, they may be made subject to the *rahn* by some definitive action or agreement; in each case, interpretations and applications of these precepts vary.[19]

The indebtedness may be totally or partially recovered from the *marhūn*,[20] and the entirety of the *marhūn* will remain subject to the *rahn* until payment in full of the indebtedness.[21] The *marhūn* must be something that can be validly sold. As such, it must (i) be in existence at the time of the execution of the contract of *rahn*, (ii) have a quantifiable value, and (iii) be saleable and deliverable.[22] Accordingly, a *rahn* of "after acquired" (including "subsequently constructed") property is invalid.[23] The "benefits" of a property may not be mortgaged or pledged separately from such property. Thus, rent generated by, or the sales proceeds of products produced by, a property may not be mortgaged or pledged without a corresponding *rahn* of such underlying property.[24] Uncertain sums may not be mortgaged or pledged.[25] An existing *rahn* may not be valid with respect to future advances or loans in the view of some Islamic jurists, particularly in Saudi Arabia.[26] Finally, assets that are "borrowed" for use by a borrower may not be mortgaged or pledged.[27]

Under the *sharīᶜa*, the mortgagee/pledgee is responsible for all expenses incurred in connection with the preservation of the *rahn*, such as the erection of the fence around the property, the wages and fees of the Security Agents, the wages of the guard posted at the property, the cost of erection of the signs and the like.[28] The mortgagor/pledgor is responsible for all expenses in connection with the improvement and maintenance of the *marhūn*, including repairs and operation and maintenance expenses.[29] Any agreement modifying these allocations is void. If either the mortgagor/pledgor or the mortgagee/pledgee should of their own accord pay the expenses that are rightly paid by the other such party, such payment is in the nature of a gift and no subsequent claim may be made for such amounts.[30]

Under the *sharīʿa*, a *rahn* is, by definition, possessory. The Qur'ān refers to the idea of mortgages as "mortgages with possession" (*fa rihānun maqbūḏa*). Thus, in order for the security interest purported to be created by a *rahn* agreement to be perfected (i.e. to be enforceable against third-party creditors), the mortgagee/pledgee must have "possession" of the *marhūn*. If the mortgagee/pledgee ceases to have "possession" of the *marhūn*, such mortgagee/pledgee will be treated as an ordinary creditor, and would have the same rights as other creditors in the collection of their debts, *i.e.* a *pro rata* share in the proceeds of the sale of those properties of the debtor that have not been mortgaged or pledged.

In the absence of a clear practical definition of what constitutes "possession," most jurists in Saudi Arabia appear to have taken the position that what is required is actual physical possession by the mortgagee/pledgee of the *marhūn*. However, a principle of the *sharīʿa* is that "possession is in accordance with the nature of the property to be possessed" (*qulu shay'in yuqbadhu bi hasabihi*), and in many instances physical possession is an impossibility.

Perfection of a *rahn* on real property or a real property interest in Saudi Arabia would be normally effected by (a) the preparation of a *rahn* agreement (in the form of a deed) and (b) the recordation of such *rahn* agreement on the title deed evidencing ownership of the relevant real property or real property interest.

Recordation of the *rahn* agreement has been deemed in Saudi Arabia to be a type of "constructive possession" of the *marhūn*.[31] Since 1981, Saudi Arabian Public Notaries have refused to record mortgages of real property in the name of banks as mortgagees on the grounds that such mortgages secure an indebtedness which is most likely related to a transaction which is interest-based and therefore inconsistent with the *sharīʿa*.[32] Thus, recordation of the Mortgage (*Rahn*), as a substitute for, and determinative indictor of, possession by the mortgagee is not presently available in Saudi Arabia for commercial banks as mortgagees.[33] Recordation is available to a very limited and identifiable group of lenders, including SIDF. Other indicators of "possession" include "bills of possession," fencing, signs, the presence of an employee or agent of the Onshore Security Agent exercising dominion and control, and similar factors.[34]

Provided that a mortgagee/pledgee has possession of the *marhūn*, such mortgagee/pledgee has priority, under the *sharīʿa*, over all other creditors of the debtor in the collection of the secured amounts owed to such mortgagee/pledgee from the value of the *marhūn*. The *marhūn* may not be separately mortgaged or pledged to another mortgagee/pledgee (unless such other mortgagee/pledgee is a partner of the original mortgagee/pledgee and the *marhūn* is mortgaged or pledged to them jointly) because, if such property is mortgaged or pledged to the second mortgagee/pledgee with the consent of the first mortgagee/pledgee, the first *rahn* becomes void.[35]

Neither the mortgagor/pledgor nor the mortgagee/pledgee may sell the collateral without the consent of the other.[36] If the secured debt becomes due and the debtor/mortgagor/pledgor does not satisfy the debt obligation, the mortgagee/pledgee will not obtain title to the *marhūn*.[37] Rather, a judicially directed sale of the *marhūn*, initiated at the request of the mortgagee/pledgee, would take place.[38] The mortgagee/pledgee would have priority with respect to those sale proceeds in satisfaction of the secured amounts owed to such mortgagee/pledgee by the debtor/mortgagor/pledgor. In the event that the proceeds from the sale of the *marhūn* are less than the amount of the debt secured by the *rahn*, the mortgagee/pledgee has the right to share with other creditors in the value of the debtor's remaining property.

Prior to a judicially directed sale of the *marhūn*, it may be necessary for the banks to hold such property. The rights of the banks to occupy, use, and operate such property are unclear in Saudi Arabia due to lack of precedent. In current practice, banks avoid exercising their rights to occupy, use, and operate property in Saudi Arabia. Rather, banks are inclined to sell the *marhūn* and apply the proceeds of such sale to the indebtedness due the Banks. However, the *sharīʿa*[39] and other elements of Saudi Arabian law[40] contemplate that banks may hold the property for some time prior to a sale, whereupon they will have responsibility for the safekeeping of the *marhūn* during such period, and that the banks may apply the proceeds from the *marhūn* to the reduction of their indebtedness. These principles, while existent in Saudi Arabia, are largely undeveloped.

Although there is no prescribed form of *rahn* in Saudi Arabia, there are, based on general principles of the *sharīʿa*, various requirements under Saudi Arabian law regarding specificity of the description of the *marhūn* and the indebtedness secured thereby. The *rahn* agreement must include an accurate designation and description of the *marhūn*. In the case of a *rahn* of real property, the location and description of the real property, as specified in the deed pertaining thereto, should be included. A *rahn* of real property may also specify that it covers fixed assets located on the land, such as buildings and immovables (fixtures).[41] The *rahn* will not be valid to the extent that it covers property that does not exist at the time of the execution of the *rahn* agreement. Despite the validity issue, the practice of SIDF in Saudi Arabia is to include "after acquired" property within the scope of the *rahn*.

The *rahn* agreement must also identify the debt being secured thereby. There does appear to be agreement that a reference to the loan agreement pursuant to which the secured debt is incurred is necessary and that the exact amount of the debt is required to be specified in the agreement.[42] There should be separate detailed specifications of amounts constituting each element of indebtedness, i.e., principal, interest, and other amounts. In the event that the *rahn* agreements are reviewed for compliance with the *sharīᶜa* and are determined to secure interest, the practice in Saudi Arabia is that such agreements would be unenforceable only as and to the extent that they secure interest; the remainder of the provisions would remain enforceable.

The *rahn* agreement should also include the terms under which it may be exercised and the remedies of the mortgagee/pledgee to occupy, use, and operate the *marhūn*, and to sell such assets, and, in each case, to apply the proceeds thereof to pay off the debt secured. All other customary remedies should also be set forth in greater detail than would be the case where New York or English law is applicable.

It is important to note that Saudi Arabian law is somewhat less developed as it pertains to pledges of certain personal property, such as contract rights and permits, than it is with respect to immovables, land, and other tangible assets. For example, it is unclear whether and to what extent contract rights and permits are "saleable" under the *sharīᶜa* as applied in Saudi Arabia and thus whether they can be subject to a pledge. In addition, it is more likely that a pledge of contract rights or permits would be characterized as a power of attorney or agency relationship and thus terminable by either party at will.

A final issue under Saudi Arabian law relates to the ability of the banks to exercise remedies upon the occurrence of an event of default that is not a payment event of default. The weight of authority under Islamic jurisprudence, and in Saudi Arabia, appears to be that a party would be entitled to exercise remedies for non-payment defaults. It is less certain, however, that the banks would be entitled to accelerate the loans and exercise the full panoply of remedies in such a situation; a Saudi Arabian court or other adjudicatory authority, in applying equitable principles, may limit the available remedies.

D. *Rahn* Documentation in the Saudi Chevron Project

As noted above, in order to address the applicable *sharīᶜa* precepts, the collateral security structure was developed by dividing the available collateral into different categories. The general categories of collateral and the related *rahn* and assignment agreement were as set forth in the following table.

TABLE 1. CATEGORIES OF COLLATERAL AND AGREEMENTS

Type of Collateral	Agreement
General	Onshore Master Security Agreement
General	Onshore Common Agreement
General	Deed of Possession
General	Security Trust Deed
General	Offshore Security Deed
General	Announcement and Notification
General	Sign Language
Immovables, Real Property Interests, and Related Contracts	Onshore Mortgage (*Rahn*) Agreement

Type of Collateral	Agreement
Accounts	Onshore Pledge (*Rahn*) and Assignment of Accounts
Accounts	Offshore Accounts Assignment
Accounts	Offshore Accounts Trust Deed
Contracts	Consents
Contracts	Onshore Pledge (*Rahn*) and Assignment of Contracts
Proceeds, Available Receipts, and Accounts Receivable	Onshore Pledge (*Rahn*) and Assignment of Proceeds, Available Receipts and Accounts Receivable
Intellectual Property	Onshore Pledge (*Rahn*) and Assignment of Intellectual Property
Approvals and Permits	Onshore Pledge (*Rahn*) and Assignment of Approvals
General Personal Property	Onshore Pledge (*Rahn*) and Assignment of Personal Property
Equipment	Onshore Pledge (*Rahn*) and Assignment of Equipment
General Intangibles, Chattel Paper, Documents, and Instruments	Onshore Pledge (*Rahn*) and Assignment of General Intangibles, Chattel Paper, Documents, and Instruments
Technology Licenses	Onshore Pledge (*Rahn*) and Assignment of Technology Licenses
Technology Licenses	Offshore Assignment of Technology Rights
Letters of Credit and Performance Bonds	Onshore Pledge (*Rahn*) and Assignment of Letters of Credit and Performance Bonds
Letters of Credit and Performance Bonds	Offshore Assignment of Letters of Credit and Performance Bonds

Each type of Collateral was independently analyzed with respect to all relevant factors, such as the nature of possession of that type of Collateral. In the recitals and in the relevant substantive provisions, each Security Document addresses each necessary element of a permissible *rahn* with respect to each category of Collateral. Those elements include marketability, value, and deliverability. A Bill of Possession was drafted to address possession issues with respect of each type of Collateral.

The Onshore Master Security Agreement and the Common Agreement were designed to unify all the Collateral and all rights and remedies in respect of each type of Collateral. This allows the Security Agents, among other things, to proceed against the entire Collateral package, if necessary, and to coordinate rights and actions in respect of each type of Collateral with all other rights and actions in respect of all other types of Collateral. In addition, separate Security Documents were drafted with respect to each individual type of Collateral.[43] Among other things, this allows the Security Agents to proceed on a more limited basis where such an approach is appropriate. The Security Agents could then proceed in respect of only a portion of the Collateral and minimize interference with the ongoing operation of the project. As discussed in a later section, such differentiation also allows the Security Agents greater flexibility in choosing an enforcement entity in any given situation. Each of the

Security Documents incorporated elements intended to insure that the relevant grants were irrevocable. The structure was designed so that the *Marhūn* could be placed in the possession (for *sharīᶜa* purposes) of the Security Agents.

Each of the Security Documents incorporated traditional representations, warranties, covenants, and events of default for a limited recourse project financing. These were then tailored specifically to incorporate *sharīᶜa* requirements. Particular attention was paid to keeping the *Marhūn* free of competing liens, maintaining the liens of the Security Documents, including in respect of after-acquired or after-constructed property and in respect of loans made after the date of execution of the Security Documents (i.e., subsequent advances under the Financing Agreements), placing possession of the *Marhūn* with the Security Agents, minimizing costs payable by the Security Agents as *ᶜadlān* and bailees of the Banks, preventing the Project Company from incurring indebtedness other than pursuant to the Financing Agreements and the SIDF Loan Agreement, and bankruptcy proofing the Project Company.

The Mortgage (*Rahn*) was drafted in conventional form for recordation in Saudi Arabia, notwithstanding that it cannot be so notarized and recorded under current practice. Substantive modifications were made to the Mortgage (*Rahn*) and to each of the Pledge (*Rahn*) Agreements to incorporate and harmonize with other elements of the collateral security structure. The types of modifications that were considered for the Mortgage (*Rahn*) included: (a) requirements that the Project Company (and the Royal Commission) make a notation on the Site Lease providing adequate notice of the mortgagee rights of the Onshore Security Agent; (b) recognition, in the Site Lease, of the fact that the site is mortgaged in connection with the financing; (c) obtaining the agreement of the Royal Commission to make a notation on its deed pertaining to the mortgaged property to the effect that such property is subject to the Mortgage (*Rahn*) in favor of the Onshore Security Agent;[44] and (d) obtaining a Consent from the Royal Commission that contained an agreement that the Royal Commission would not obtain a replacement deed for, or enter into any other lease with respect to, the mortgaged property without the consent of the Onshore Security Agent.

Various structural elements address the issue of providing adequate actual notice to competing creditors of the existence of the *rahn* in favor of the Security Agents for the benefit of the Banks. For example, notices and signs were posted and are to be maintained on the site and certain items of Collateral to provide public notice of the *rahn* on the project and other assets of the Project Company. In addition, to provide notice, it is appropriate to publish a notice of *rahn* in the *Official Gazette* (the *Umm Al-Qura*). It is not clear, however, that the *Official Gazette* would agree to publish such a notice. However, other notices were provided by virtue of “tombstone” announcements in various financial publications, including those directed at potentially competing creditors, in order to give actual notice of the existence of the security interests.

Each of the Security Documents is structured such that it is updated and amended (i) through the advance request, on each drawdown to reflect construction completed, and property acquired, since the date of the most recent previous update, and (ii) periodically throughout the term of the financing to reflect any property acquired by the Project Company since the most recent previous update. The property descriptions are detailed. For example, the Mortgage (*Rahn*) includes a precise description of the real property itself, the Site Lease, and all “fixtures” and other items of property that might, under Saudi Arabian law, be considered “immovable” property. The descriptions are subject to periodic updating. Each of the Security Documents also described with particularity the indebtedness secured thereby. Additionally, a mechanism was included in the advance request and at periodic intervals to update each of the Security Documents to reflect continuing drawdowns and an increasing amount of indebtedness.

The remedies provisions of each of the Security Documents expressly permit the Security Agents to possess, use, and operate the *Marhūn*, including as an operating entity, and to utilize the proceeds of operation to repay indebtedness and other amounts due under the Financing Agreements. Other customary remedies, including power of sale, were included in each of the Security Documents in greater specificity than would be the case under New York or English law. Given the lack of clarity in Saudi Arabian law, each of the Security Documents clearly and unequivocally indicates that the Onshore Security Agent is entitled to exercise remedies, including remedies other than judicial sale, upon the occurrence of events of default which are not payment events of default. The Security Documents stipulate that non-payment remedies are integral to the transaction, that the failure to perform with respect to non-monetary matters is likely to have a material adverse effect on the nature of the Collateral (indicating the limited recourse nature of the financing), and that the existence of such non-payment events of default was relied upon by the Banks in entering into the transaction.

Because of the provisions of the *sharīᶜa* requiring that the Banks maintain responsibility for expenses relating to preservation of the *rahn*, among other reasons, the Facilities Agreement contains covenants to require the Project Company, as part of the project design, to include features that maximize the value, utility, useful life and secure status of the Collateral. These provisions have the ancillary effect of minimizing the cost exposure of the Banks. For example, the Project Company is required to erect a fence and the pertinent notices of existence of the *rahn* in the construction contract and is required to at all times maintain a security force, acceptable to the Banks, which security force acts under the direction of the Onshore Security Agent if an event of default has occurred. Other documentary provisions were fashioned to require that the expenses in connection with the "possessory" interest of the Banks be included in various other agreements. In certain instances, the Project Company is able to act as agent for the performance by the Security Agents of their responsibilities in respect of the Collateral. In addition, traditional reimbursement obligations with respect to these expenses were included in the Facilities Agreement.[45]

Each of the Security Documents also contains provisions that lay the basis for asserting the jurisdiction of the different Enforcement Entities (as hereinafter defined) in Saudi Arabia. And each Security Document affords the Security Agents, on behalf of the Banks, the widest possible latitude in choosing an Enforcement Entity.

E. Jurisdiction of Enforcement Entities

Considerations of choice of forum are critical in every financing and in every jurisdiction in the world. Different enforcement entities have different areas of expertise and different sensitivities to issues. Each enforcement entity has a different array of remedies that it can apply, particularly in a jurisdiction such as Saudi Arabia. Rights to appeal from each Enforcement Entity (as hereinafter defined) are different. And, given varying dockets and procedures, the dispute resolution period can and does vary dramatically from one Enforcement Entity to another.

There are a number of different courts, committees, offices, and boards (collectively, Enforcement Entities) that might have jurisdiction over a matter in Saudi Arabia in which a Bank could be involved. Three of these Enforcement Entities were of particular relevance in the context of the Saudi Chevron financing: the Banking Disputes Settlement Committee (the SAMA Committee) of the Saudi Arabian Monetary Agency (SAMA); the Office of the Settlement of Negotiable Instruments Disputes, also known as the Negotiable Instruments Offices (the NIO), which is under the jurisdiction of the Ministry of Commerce;[46] and the Board of Grievances (*Qiwan Al-Mazal'im*) under The Board of Grievances Law (the Board of Grievances). In summary:

1. the SAMA Committee has jurisdiction over matters and disputes involving banks and their customers—that is, "settling" disputes between banks and their customers "in accordance with the agreements concluded between them." Under the regulations constituting the SAMA Committee, all disputes between banks, including foreign banks, and their customers (other than those involving negotiable instruments) are to be referred in the first instance to the SAMA Committee;[47]
2. the NIO has jurisdiction over actions, matters, and disputes involving negotiable instruments (such as the promissory notes used in the Saudi Chevron financing of this type), and in the context of such disputes, the NIO has jurisdiction superior to that of the SAMA Committee;[48] and
3. the Board of Grievances has jurisdiction over commercial disputes (by implication, other than banking disputes and negotiable instruments disputes), including the enforcement of foreign judgments and bankruptcy matters.[49]

The jurisdiction of the various Enforcement Entities is, in certain respects, unclear and arguably overlapping. Numerous questions arise as to which Enforcement Entity would have jurisdiction in various matters involving one of the financing banks. For example, although the Board of Grievances has jurisdiction with respect to enforcement of foreign judgments and awards generally, the SAMA Committee has jurisdiction with respect to all matters involving banks (other than in respect of negotiable instruments). Does this mean that the SAMA Committee should assert jurisdiction with respect to a foreign award obtained by a bank? Would this be true despite the express provisions of the various official pronouncements regarding enforcement of foreign awards, particularly those rendered in foreign arbitrations? In the bankruptcy context, although the Board of Grievances generally has jurisdiction, if there is a bank creditor should the SAMA Committee take jurisdiction? Which Enforcement Entity has jurisdiction where the foreign judgment or award is in on a negotiable instrument? These are questions of first instance in Saudi Arabia, which will be determined by each Enforcement Entity, and it is not possible to determine in advance the decision which will be made.

Given the foregoing situation and issues, among others, it was important to structure the transaction, particularly the collateral security package, in a manner that would afford the Banks the Enforcement Entity of their choice in any given situation and to raise these jurisdictional issues with such Enforcement Entity.

F. Examination of Underlying Documentation under the *Sharīᶜa*

Creditors involved in disputes to be resolved through the SAMA Committee or the NIO are afforded certain advantages over creditors who pursue their claims before the Board of Grievances. Although the SAMA Committee is in theory obliged to apply the *sharīᶜa* and its precepts, including the prohibition on interest, to banking disputes, in practice the SAMA Committee has generally shown a willingness to force a recalcitrant debtor to honor the terms of the agreement creating the indebtedness, regardless of whether the agreement requires the payment of monies in the nature of interest or is otherwise variant from the principles of Saudi Arabian law. The SAMA Committee does examine the various underlying documents and will make inquiry as to whether these arrangements are in accordance with Saudi Arabian law, but makes all reasonable efforts to respect the agreement of the parties even in the face of conflicts with the *sharīᶜa*.

It is noteworthy that review by the SAMA Committee is comprised of a legal review and an accounting review. The accountants of the SAMA Committee perform independent determinations, based on their calculations, of the amount of interest payable in respect of a given dispute. Interest is payable only to the date of commencement of the action with the SAMA Committee. Thus, no interest is payable in respect of periods after such date and no interest is payable in respect of overdue amounts. In practice, it is the author's understanding that most actions before the SAMA Committee take from six months to one year.

Remedies available to the SAMA Committee include (i) prohibition of the debtor from leaving Saudi Arabia and (ii) putting the debtor on a "notice list" which is circulated to banks in Saudi Arabia. The second alternative can be a very effective remedy, as banks in Saudi Arabia will decline to conduct banking business with the debtor so listed.

Where the SAMA Committee, acting as a mediating body, is unable to bring about a settlement of a dispute, its implementing regulations require that the matter be submitted to the court of competent jurisdiction (i.e., the Board of Grievances) for a *de novo* hearing. Notwithstanding the express requirements of such implementing regulations, however, under present practice the Board of Grievances will generally decline to hear cases that fall under the jurisdiction of the SAMA Committee.[50]

In resolving actions, matters, and disputes within its jurisdiction, the NIO will generally enforce a debt obligation as evidenced by a negotiable instrument without looking to the substance of the transaction giving rise to such instrument, including whether such indebtedness includes amounts in the nature of interest.[51] The NIO will, however, consider general defenses such as whether or not a debt was actually incurred or a negotiable instrument properly formed. Thus, the NIO does not undertake an inquiry into whether the documents underlying a negotiable instrument comply with the *sharīᶜa* and certain other principles of Saudi Arabian law.[52] Actions before the NIO are resolved in less time that those before the SAMA Committee.

The Board of Grievances will undertake a fulsome examination of any matter presented to it, and this examination will include a rigorous inquiry into matters of public policy (including the compliance of all documentation with the *sharīᶜa* and other principles of Saudi Arabian law). Thus, if a foreign judgment or award is obtained and enforcement is sought in Saudi Arabia, the Board of Grievances may examine the underlying documentation and make what is essentially a *de novo* determination as to whether the documentation underlying the judgment complies with the *sharīᶜa* and Saudi Arabian law. In the context of considering the position of the Board of Grievances, it should be noted that the Board of Grievances generally does not recognize provisions of agreements with respect to choice of foreign law or submission to the jurisdiction of foreign courts. Actions before the Board of Grievances often take from two to ten years, although the author has been informed by Saudi Arabian legal practitioners that actions for enforcement of foreign judgments are likely to take approximately one year if the order or award, on its face, does not contravene the *sharīᶜa* or Saudi Arabian law.

G. Enforcement of Foreign Judgments and Awards; Arbitration

As noted above, large industrial and infrastructure projects are increasingly international in scope. Thus, they frequently involve the law of two or more countries. A critical set of legal and financial issues involve the enforcement of a foreign (e.g., American, English or French) arbitral award or court judgment against the project company or its assets in the country in which the project is located (in this case, Saudi Arabia). The court with jurisdiction over applications seeking enforcement of foreign judgments is the Board of Grievances. There is an unresolved jurisdictional issue where the foreign judgment or arbitral award is obtained by a bank because of the jurisdiction of the SAMA Committee over disputes involving banks. The author is aware of only one case where a foreign bank has sought to enforce in Saudi Arabia a decision of a foreign court or arbitral body.[53]

There is little precedent for the recognition and enforcement of foreign judgments by the Saudi Arabian courts.[54] Indeed, other than a small number of 1989 cases involving judgments of courts in member states of the Arab League, the author is aware of no instance where the Board of Grievances has afforded final recognition and enforced a judgment of a foreign court or foreign arbitral award. The author has been informed of a single recent case in which a bank sought enforcement of a foreign judgment or award.[55] In that case, the Board of Grievances reportedly declined to exercise jurisdiction because of the involvement of a bank. Presumably, enforcement would be sought from the SAMA Committee in such an instance.[56]

Nevertheless, Saudi Arabian law does give the Board of Grievances the power to issue a judgment recognizing a foreign judgment for enforcement in Saudi Arabia if the state of origin would afford reciprocal recognition to the judgments of the Saudi Arabian courts and provided that nothing in the foreign judgment contravenes the *sharīʿa*.[57] In the only recent cases of which the author is aware which sought enforcement of decisions of the courts of England, the Board of Grievances declined to enforce the judgments because no showing had been made that the English courts would afford reciprocal treatment to a Saudi Arabian court decision.[58] As noted above, the Board of Grievances is said to have recently declined to exercise jurisdiction in the case of a foreign court judgment or arbitral award obtained by a bank.

In 1994 Saudi Arabia filed an instrument of accession to the New York Convention on the Recognition and Enforcement of Arbitral Awards of 1958 (the New York Convention). The authorizing decree incorporates the requisite reciprocity requirement and specifies that jurisdiction over actions seeking enforcement of foreign arbitral awards shall lie with the Board of Grievances.[59]

To date, the Board of Grievances has not issued procedural rules for actions seeking enforcement of international arbitration awards. The author understands from Saudi Arabian legal practitioners that have consulted Board of Grievances officials that no such rules will be issued in the near future. This being the case, it appears that an application for the recognition of a foreign arbitral award would be submitted and would proceed in accordance with the procedures specified for applications in respect of the recognition of foreign judicial awards.

The author also understands that only one application seeking recognition of a foreign arbitral award under the New York Convention has been filed to date. In that case, the Board of Grievances declined to exercise jurisdiction because the foreign court judgment or award was obtained by a bank. Presumably, the bank must then make application to the SAMA Committee for enforcement of the judgment or award. Since any such application to the Board of Grievances would be quite rare at this point in time, it would be reasonable to anticipate that the Board of Grievances would consider such an application, as well as any objections filed with respect to the application, carefully and deliberately. *De novo* Board of Grievances proceedings normally last from two to ten years, with the long duration being in large part due to *sharīʿa* rules of procedure which allow a defendant considerable ability to delay the final resolution of the proceeding. The author understands from Saudi Arabian legal practitioners that a proceeding before the Board of Grievances to enforce an arbitral award which, on its face does not contravene the *sharīʿa* or other Saudi Arabian law, should take approximately one year.

Assuming that it can be demonstrated to the Board of Grievances that the party against whom enforcement is being sought has been afforded the requisite due process (such as appropriate summons and opportunity to defend), then a foreign default judgment should, at least in theory, be as enforceable as a contested judgment.

However, officials of the Board of Grievances also indicated that they would review arbitral awards brought for enforcement under the New York Convention to ensure compliance with the *sharīʿa*, on public policy grounds. Although it is clear that decisions which are contrary to the *sharīʿa* will not be enforced on public policy grounds, it is unclear how broadly the Board of Grievances will review an award or the legal basis for the issuance of the award to ensure compliance with the *sharīʿa*. For example, it is possible that the Board of Grievances would decline to recognize an award if it is based upon underlying contractual commitments which would not be enforceable under the *sharīʿa*, such as where the underlying contractual commitment is prohibited, or *muharam*, under Islamic jurisprudence. Similarly, it also possible that the Board of Grievances would decline to recognize an award of damages where the damages are of a type which would not be available under the *sharīʿa*,[60] or where an element of an award would not be available under the *sharīʿa*. For example, generally speaking, in judicial proceedings in Saudi Arabia, the courts will only award actual, proven, out of pocket damages. Damages which are deemed by Saudi Arabian jurists to be speculative in nature, such as lost profits, are generally not available under the *sharīʿa* as interpreted in Saudi Arabia. Recognition of an award containing an element deemed to be speculative may therefore be declined.

From conversations with Saudi Arabian jurists, it is the author's understanding that the wording of the judgment or award may be critical. Many jurists believe that the Board of Grievances will not look beyond the face of the award, particularly in the case of an arbitral award. If the award, on its face, does not contravene the *sharīʿa* or other Saudi Arabian law, it is felt that the Board of Grievances will not look beyond the award to substantive documentary provisions, although it will examine jurisdictional matters.

The fact that a foreign judicial decision contains an element that violates the *sharīʿa* may not necessarily be fatal to the enforcement of the decision, however. For example, the party seeking recognition of the decision in

Saudi Arabia could, as a part of its recognition application, expressly disclaim any right to recovery based upon the contravening element. For example, the party could disclaim any right to recover the interest component of the award. Furthermore, in the event that the recognition of an English arbitral award or judicial decision in Saudi Arabia is the only means by which the Banks could obtain satisfaction with respect to claims under the Facilities Agreement, it might be possible to fashion the claims, and thus hopefully the decision, in such a way as to maximize the probability of the decision being recognized by the Board of Grievances.

H. Dispute Resolution in the Saudi Chevron Financing

Decisions were taken in the Saudi Chevron financing, as they are in any international financing, as to whether arbitration should be a mandatory or permissible remedy. Numerous transactions have been structured to allow the financing banks the choice of remedies, court actions, or arbitration, as well as the choice of forum. In some instances, the remedies vary with the nature of the dispute—providing for court resolution as a possibility in some disputes and mandatory arbitration with respect to other types of disputes. The provisions of the Security Documents and the Financing Agreements for the Saudi Chevron transaction contain complicated and carefully negotiated remedies provisions incorporating a variety of mechanisms for dispute resolution. On the whole, they allow the Banks, at times through the Security Agents, maximum flexibility as to choice of forum in Saudi Arabia (and outside Saudi Arabia, where appropriate) and the provisions include Enforcement Entity, court, and arbitral board options, although the range of options varies with the type and subject matter of the dispute.

VIII. Development of the *Rahn* and ᶜ*Adl* Concepts in Financings

The Saudi Chevron structure is now the basis for a wide variety of project financings and other secured lending transactions in Saudi Arabia. Lending transactions of all types are incorporating the possessory concepts relating to a *rahn* of a *marhūn*, even where additional collateral is available to secure the loan. Various business groups, as well as banks, are considering ways in which to use the *rahn-ᶜadl* structure to promote residential housing finance. The *rahn-ᶜadl* structure has been implemented in the collateralization of large equipment leases and fleet leases. Proposals are being discussed for the establishment of a private security interest recordation system to achieve the broadest possible notice. As lender comfort increases, there should be decreased reliance on personal and corporate guarantees and greater use of secured financing techniques. This would allow individuals and companies to deploy assets over a wider investment base and banks to make loans of longer tenor, increasing capital investment throughout the economy.

The ᶜ*adl* structure is also being implemented in a wide variety of transactions. These range from employee stock participation programs to securitizations to debt instrument issuances to project financings. The increased certainty and stability of ᶜ*adl* arrangements will insure that its use becomes commonplace in capital market transactions as well.

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[1] The development of the collateral security structure entailed study of many written sources and discussions with *sharīᶜa* advisors, Saudi Arabian judges, and lawyers practicing in Saudi Arabia. Many of the written sources are available only in Arabic. The most widely available summary of *sharīᶜa* precepts in English is the *Majalat Al-Ahkam Al-Adliyah*, a summary of certain principles of the *sharīᶜa* as applied by the Hanafi school of Islamic jurisprudence in the former Ottoman Empire and countries that were formerly part thereof; it was officially adopted in the Ottoman Empire. The *Majalat Al-Ahkam Al-Shar'iyah* is a summary of certain principles of the *sharīᶜa* as applied by the Hanbali school of Islamic jurisprudence in the Kingdom of Saudi Arabia. It has not been officially adopted in Saudi Arabia. It is not as detailed as the *Majalat Al-Ahkam Al-Adliyah.* English-language translations of relevant portions of the *Majalat Al-Ahkam Al-Shar'iyah* were prepared for the author expressly for the development of the collateral security structure for the Saudi Chevron transaction.

Throughout this paper, footnote references are made to the *Majalat Al-Ahkam Al-Adliyah*, most often without further reference to the *Majalat Al-Ahkam Al-Shar'iyah*. In many instances, no corresponding provision can be found in the *Majalat Al-Ahkam Al-Shar'iyah*. In many instances, the cited principle is interpreted or applied differently, or with modifications, by Saudi Arabian jurists applying principles of the Hanbali school of Islamic jurisprudence. Many such differences or modifications were made known to the author orally in discussions, and no specific reference is made in this paper to the variations from the *Majalat Al-Ahkam Al-Adliyah*. Although not all such differences are discussed in this paper, the various documents for the Saudi Chevron financing included adaptations to give effect to those differences.

Each of the *Majalat Al-Ahkam Al-Shar'iyah* and the *Majalat Al-Ahkam Al-Adliyah* use a single Arabic word ("*al-rahn*") for security interests in both real and personal property, without distinction, and that convention is followed in this paper. However, in certain instances, an English-language term is used. In partial conformity with the *Majalat Al-Ahkam Al-Shar'iyah* and the *Majalat Al-Ahkam Al-Adliyah*, only the English terms "mortgage" and "pledge" are used. The term "mortgage" refers to security interests in real property and other immovable property (essentially "fixtures" under New York and English law), while the term "pledge" refers to all security interests in personal property, including contract rights, cash, accounts, movable assets, permits, and intellectual property.

[2] Although not discussed in this paper, Islamic alternatives to the debt portion of the financing have been developed and implemented. One such alternative was developed by the author in conjunction with three Saudi Arabian banks and was implemented in the financing of an electricity-generating project (including transmission equipment) in Saudi Arabia. That project involved the use of an undisclosed *mushāraka* comprised of the project sponsor and the financing banks. The *mushāraka* shares and project assets were sold over time, pursuant to a *murābaha*, from the financing banks to the project sponsor. The obligation under the *murābaha* could be secured in essentially the same manner as discussed in this paper.

Because the Saudi Chevron project financing involved debt financing, this paper makes reference to a debt portion of the financing.

[3] The definition cited is of a "pure" project financing; recourse is limited to only such cash flows and other assets. Such a structure is sometimes referred to as "non-recourse project financing," although most practitioners refer to such a structure as a "limited recourse project financing" because there is recourse to project company assets. In many project financings, there is additional limited recourse to assets outside those of the relevant economic unit—such as where a parent company provides a limited completion guarantee during the construction period.

[4] As is customary in project financings, the Project Company is a single-purpose entity and has few assets other than such cash flows and the assets comprising the project itself.

[5] Very difficult issues arose in connection with the intercreditor arrangements between the Banks and SIDF. These issues were successfully resolved, in some cases with unique arrangements and provisions. Those issues and the means of their resolution are not discussed in this paper.

[6] A unique exception in Saudi Arabia is in the area of ship mortgages, which is governed by the Commercial Court Regulations (Royal Decree No. M27 of 1931), the Ship Mortgage Regulations (which came into force on June 17, 1955), and the Regulations for Ports and Harbors (Royal Decree No. M27 of July 14, 1974), and the Regulations for Ports, Harbors and Lighthouses dated 19/6/1394 (Resolution No. 934 of the Council of Ministers).

[7] Under the *sharīᶜa* it is unlikely that a mortgage or pledge would constitute a nominate contract of assignment (*hawala*). The Islamic contract of *hawala*, which means literally to "turn over," contemplates a situation where a creditor, A, assigns to his own creditor, C, a debt that is owed to A by B. In order for this contract to be effective as a contract of *hawala*, the amount owed to A by B must exactly equal the amount owed by A to C. Furthermore, A must be indebted to C and B must be indebted to A at the time the contract of *hawala* is concluded. The contract of *hawala* may not relate to future indebtedness, a particularly thorny issue in an ongoing funding regime for a project financing.

It is unclear under the *sharīᶜa* whether other rights ancillary to the right to receive payment (for example, the right to accelerate payment upon the occurrence of a specified default, or the right to claim under a tax indemnification provision) are in fact "turned over" to the assignee. With respect to ancillary rights, it can be argued that A may only grant to C the power to act as A's agent in enforcing them, again subject to the various conditions applicable to contracts of agency.

A contract of assignment that does not meet the narrow conditions of the nominate contract of *hawala* will, generally speaking, be considered a contract of *wakala*, or agency. In other words, in the present case, under the various Security Documents, the Project Company would be considered to have granted the Security Agents what is effectively a power of attorney empowering the Security Agents to exercise all or certain of the borrower's (i.e., the Project Company's) rights under the various Project Documents being assigned.

The characterization of a mortgage or pledge (*rahn*) as a contract of *wakala* has several implications. *First,* under the *sharīᶜa* as applied in Saudi Arabia, contracts of agency are generally considered cancelable at will by either the principal or the agent. (An exception is noted in the text of this paper.) *Second,* where a principal grants to an agent the power to exercise certain of the principal's rights, the principal retains the power to exercise such rights in its own name independently of the power in the agent, and the actions of the principal would be superior to those of the agent (which would be unacceptable to the Banks in any financing). *Third,* a Saudi Arabian court or other adjudicatory authority might construe the grant of the power of agency pursuant to a mortgage or pledge narrowly, finding that the Security Agent has only such powers as are expressly granted thereunder.

[8] Notably, where a power of attorney or agency relationship is revoked contrary to the terms of the documents granting such power and one of the parties is thereby harmed, an appeal can be made to the Saudi Arabian courts for relief, as an equitable matter, to make the harmed person whole.

[9] Interpretation issues are discussed in Sections VII.E and, especially, VII.F of this paper. The SAMA Committee (officially, the Banking Disputes Settlement Committee of the Saudi Arabian Monetary Agency) is the enforcement entity in Saudi Arabia that is most likely to have jurisdiction in a dispute pertaining to a financing such as the Saudi Chevron project financing. However, as discussed in Sections VII.E and VII.F of this paper, it is not the only entity that may have jurisdiction.

[10] See, for example, Articles 940-944 and 1008-1017 of the *Majalat al-Ahkam Al-Shar'iyah* and Articles 701-761 of the *Majalat Al-Ahkam Al-Adliyah*.

[11] The *marhūn* may also be held by the mortgagee or pledgee, and the ᶜ*adl* many be one of the mortgagees or pledgees.

[12] The *rahn* structure has found considerable use in financings of residential property, for example.

[13] If the parties so agree, only the consent of the mortgagee/pledgee will be required.

[14] There are various instances in which consents must or may be obtained in connection with the application of *sharīᶜa* precepts relating to the *rahn*. In many of those instances, the consent may be obtained at the time of entering into the *rahn*.

[15] The rights of banks to use and operate property that is mortgaged or pledged as collateral, and to apply the proceeds derived from such use and operation to indebtedness secured thereby, is unclear under Saudi Arabian law. The practice in Saudi Arabia is for Banks to sell the property granted as collateral rather than to operate such property and apply such proceeds. However, the *sharīᶜa*, the *Majalat Al-Ahkam Al-Adliyah*, the *Majalat Al-Ahkam Al-Shar'iyah*, and the Saudi Arabian Banking Control Law do contemplate such use and operation and the application of such proceeds. For example, a camel provided as security must be fed and cared for and may be milked. The milk may be sold and the proceeds of such sale may be applied to the reduction of the secured debt. Similarly with regard to the fruit of trees on land with respect to which a *rahn* has been granted.

[16] Because the term "*rahn*" encompasses both mortgages and pledges, and because mortgages of real property and pledges of personal property are treated identically for most purposes under the *sharīᶜa*, and a *rahn* encompasses both mortgages and pledges, the outline of legal principles in this section makes reference to principles applicable to both types of property, except where otherwise noted by use of the term "mortgage" or "pledge."

[17] Consider, for example, the examples cited in Articles 711, 723, and 724 of the *Majalat Al-Ahkam Al-Adliyah*. SIDF takes a mortgage on leasehold interests. Similarly, in practice, other real property interests may be subjected to a mortgage.

[18] Consider, for example, the examples cited in Articles 711 and 714 of the *Majalat Al-Ahkam Al-Adliyah*. As noted in this paper, certain types of personal property rights may not be pledged: they must be assigned. Assignment agreements (often incorporated into the Pledge (*Rahn*) Agreement) were used for granting rights in such property in the Saudi Chevron financing. In Saudi Arabia, intellectual property is subject to a special set of rules, which are not discussed in this paper.

[19] Consider, for example, Article 711 of the *Majalat Al-Ahkam Al-Adliyah* with respect to the *rahn* of a piece of land as including all trees growing thereon and the fruits of such trees, and Article 715 of the *Majalat Al-Ahkam Al-Adliyah* as to increases arising out of the pledge or mortgage.

[20] Consider, for example, the examples of pledges that are cited in Articles 711, 712, 723, and 724 of the *Majalat Al-Ahkam Al-Adliyah*.

[21] Article 731 of the *Majalat Al-Ahkam Al-Adliyah*.

[22] Article 709 of the *Majalat Al-Ahkam Al-Adliyah.* Also consider Article 710 of the *Majalat Al-Ahkam Al-Adliyah*.

[23] Article 713 of the *Majalat Al-Ahkam Al-Adliyah*. This precept, as applied in Saudi Arabia, is critical to many aspects of a project financing structure. In the usual case, the Financing Agreements are executed before there is any real collateral (other than Project Documents). Thus, essentially all of the *Marhūn* is "after-acquired" or "after-constructed." In the Saudi Chevron financing, various structural modifications were made to continually update the *Marhūn* and include all Project Company assets therein. Some of those modifications are discussed in this paper.

[24] This element of Saudi Arabian law presented interesting issues at the time that SIDF entered the financing structure (which was some time after the Banks had undertaken their financing obligations). SIDF, for example, was interested in taking a mortgage in the property but in leaving the revenue from operations to the Banks as collateral security.

[25] Consider, for example, Article 709 of the *Majalat Al-Ahkam Al-Adliyah*.

[26] But, consider Article 714 of the *Majalat Al-Ahkam Al-Adliyah*.

[27] But, consider Articles 726-728, 735, and 736 of the *Majalat Al-Ahkam Al-Adliyah*.

[28] Article 723 of the *Majalat Al-Ahkam Al-Adliyah*.

[29] Article 724 of the *Majalat Al-Ahkam Al-Adliyah*.

[30] Article 725 of the *Majalat Al-Ahkam Al-Adliyah*.

[31] It is to be noted that "constructive possession" is a concept that is not incorporated in the *sharīᶜa*. The term is used here solely as an analogy that is familiar to United States and English lawyers and financiers, and further discussion of the principle is provided in this paper.

Recordation of real property in Saudi Arabia is effected by the Public Notaries according to the system of personal recording (in the name of the owners of the real property) since there is no separate record and number for each parcel of real property. In recording a *rahn* of real property, the Public Notaries inscribe the full text of the *rahn* agreement on the title deed for the particular property and deliver such deed to the mortgagee. Because of the present lack of recordation in Saudi Arabia, an owner of mortgaged real property (the debtor/mortgagor) is not precluded from obtaining a replacement deed (in lieu of the one claimed lost). Thus, such debtor/mortgagor is capable of disposing of such property, by sale or by other property-transferring dispositions, without the consent or knowledge of the mortgagee if the mortgagee is not in possession of such property. Even where there is recordation, Public Notaries require that an annotation be inscribed indicating that the mortgagee has possession of the mortgaged property, and are often very strict in this respect. It is not clear that Public Notaries would be amenable to undertaking not to issue replacement deeds for a particular parcel of land.

[32] See, Supreme Judiciary Council Decision No. 291, dated 25/10/1401 A.H. (August 25, 1981).

[33] There is some difference of opinion as to whether recordation of a mortgage is merely evidence of the existence of the mortgage or goes to the validity of the mortgage itself. The weight of authority in Saudi Arabia, particularly given the present practice in which recordation is not available, is that recordation speaks only as evidence of the existence of the mortgage.

[34] Local banks in Saudi Arabia have utilized a number of techniques to obtain recordation in the face of the unwillingness of Public Notaries to record. For example, banks have used nominee individuals or companies as mortgagees. More recently, Saudi Public Notaries have refused to record mortgages in favor of any individual or company other than government-owned lending agencies, on the grounds that such individuals or companies are likely to be acting only as nominees for local banks engaged in lending transactions inconsistent with the *sharīʿa*.

Prior to the absolute prohibition on recordation (other than for SIDF and similar entities), another alternative device to obtain adequate collateralization was the transfer of title to the mortgaged real property to a nominee individual (such as a bank officer) or company (such as a company formed by certain shareholders of the bank). The borrower would sell the real property to the nominee individual or company at a nominal price and transfer the title deed to such nominee. The bank would then provide contractually (usually through a trusteeship agreement), and through control over the relevant individual or company, that the property so held is held for the benefit of the bank and for the proceeds of any sale to be paid to the bank, while the borrower would sign a letter granting the nominee-trustee the right to arrange the sale of the security on first demand.

This solution was not wholly satisfactory to most local banks, as disputes have arisen upon the death of a nominee or disagreements have arisen among shareholders of the nominee company. There have been, however, several examples where banks have successfully used this mechanism to realize value on their real property collateral by arranging for the sale of such property.

[35] Article 744 of the *Majalat Al-Ahkam Al-Adliyah*. This precept and its application gave rise to delicate structural and drafting issues where both the Banks and SIDF took security interests in the same property. In other transactions, SIDF has permitted second mortgages without regard to the extinguishment possibility. The author is unaware of any actions in Saudi Arabia in which the cited principle has been tested.

[36] Article 756 of the *Majalat Al-Ahkam Al-Shar'iyah.*

[37] Obtaining title would be an option available to the Banks in a New York or English financing. Frequently, however, banks are reluctant to take title to a project for reasons pertaining to such matters as lenders' liability or environmental law issues.

[38] Consider Articles 756-761 of the *Majalat Al-Ahkam Al-Adliyah.*

[39] See also *Majalat Al-Ahkam Al-Adliyah* and *Majalat Al-Ahkam Al-Shar'iyah.*

[40] For example, Article 10, paragraph (2), of the Banking Control Law of Saudi Arabia permits a bank to have a direct interest, as shareholder, partner, proprietor, or in another capacity, in a commercial, industrial, agricultural, or other enterprise only if such interest accrues to the bank in settlement of a debt from a third party. The bank must liquidate such interest within two years or such longer period as may be determined by SAMA.

[41] Immovable property under the *sharīʿa* is defined as "any property that is stable and fixed so that it may not be moved or transported without damage." It includes land, buildings, and trees. Also regarded as immovable property is movable property placed, by its owner, on immovable property also owned by such owner for the purpose of serving or exploiting such immovable property. Examples include doors and windows in a building which, even though they are originally movable property, become part of the immovable property in actual use. This is equivalent to the concept of fixtures. It is unclear, however, how fixtures would be treated in the context of the Saudi Chevron project since the Project Company would be erecting facilities on land leased, but not owned, by it.

[42] Precision as to the amounts of interest or costs and expenses is very difficult, if not impossible in many instances. The Security Documents do contain requirements that the Security Documents be "amended" from time to time as such amounts become precisely determinable.

[43] Set-off rights in respect of bank accounts are one type of right applicable to only a given type of collateral. Two sets of set-off rights applied in the Saudi Chevron financing, one set under Saudi Arabian law and one set under English law. The Security Documents were tailored to give effect to the relevant rights in each jurisdiction.

Although there are no specific statutory provisions in Saudi Arabia relating to the set-off of debts, the rights of banks in Saudi Arabia to effect a set-off are broad. A set-off is either compulsory by force of law, as in the case of state debts owed by individuals and debts of individuals owed by the state, or by mutual agreement (*hawala wa idhin bil isteefa*) that is irrevocable. The lender may not exercise the right of set-off unilaterally, absent prior irrevocable consent in an agreement (which consent may be given at the time of execution of the relevant Financing Agreement or Security Document). Absent such an agreement, before setting-off any amounts, the bank has to hold the funds and bring an action in court to allow it to exercise such right of set-off.

[44] The author is not aware of a transaction in which this type of recordation on the deed has been made.

[45] If enforcement is had before the SAMA Committee, for example, these provisions are likely to be respected.

[46] The NIO operates in practice like a court, with hearings being held in a number of different circuit locations in Saudi Arabia. For ease of reference, references to the NIO will be in the singular.

[47] SAMA Committee decisions are final and unappealable.

[48] NIO judgments may be appealed to the Legal Committee of the Ministry of Commerce.

[49] Determinations of the Board of Grievances may be appealed to the Board of Grievances Scrutinization Committee.

[50] The author has been informed that the Minister of the Interior has instructed the Civil Rights Department, the department of the Ministry of the Interior responsible for enforcing judgments of the SAMA Committee, that decisions of the SAMA Committee are to be enforced in the same manner as a decision of a court.

[51] Many transactions are thus structured to provide separate notes for principal, interest, and other costs and expenses. These transactions frequently have a requirement of ongoing provision of such notes.

[52] A judgment issued by the NIO may be enforced through a presentation of the judgment to the Civil Rights Department of the Ministry of the Interior. Saudi Arabian legal practitioners have indicated that, unfortunately, the Civil Rights Department is often somewhat less than diligent in enforcing judgments.

[53] It is likely that, on the basis of Council of Ministers Resolution No. 729/8 (which establishes the jurisdiction of the Board of Grievances to enforce foreign awards) and the animosity with which many Board of Grievances judges view non-Islamic banks, the Board of Grievances will refuse to exercise jurisdiction over the enforcement application submitted by a non-Islamic commercial bank. On the other hand, the Board of Grievances might decide that it is inappropriate for a decision of a foreign arbitral body or court to be referred to a non-judicial body such as the SAMA Committee for enforcement, particularly where jurisdiction over enforcement actions is specifically given to the Board of Grievances.

[54] For a comprehensive analysis of issues arising in respect of enforcement actions, see Kritzalis, A., *Saudi Arabia*, in International Execution against Judgment Debtors (D. Campbell, 1993).

[55] The author is unaware whether this is a foreign court judgment or a foreign arbitral award.

[56] The author has been unable to determine at this time whether the party seeking enforcement of the foreign award has sought enforcement by the SAMA Committee in the referenced case.

[57] Rules of Civil Procedure before the Board of Grievances, Council of Ministers Resolution No. 190 dated 16/11/1409 A.H. (June 20, 1989), Article 6. Additional requirements for the enforcement of foreign judicial awards are set forth in Circular Number 7 of the President of the Board of Grievances, 15/8/1409 A.H. (May 5, 1985).

[58] In these companion cases, the Board of Grievances initially issued a decision recognizing the three English High Court decisions. On appeal, however, the Board of Grievances found that there was no treaty between Saudi Arabia and the United Kingdom allowing for the reciprocal enforcement of judgments and that, on the evidence submitted, no law of the United Kingdom would provide for automatic recognition of a Saudi Arabian judgment. Rather, the Board of Grievances concluded that a judgment creditor seeking to enforce a Saudi Arabian court judgment in England would have to commence a common law action against the English judgment debtor in the English High Court to recover the debt evidenced by the Saudi Arabian judgment; in such new action, the English High Court could accept the Saudi Arabian judgment as proof of the debt. The Board of Grievances therefore held that the enforcement of the three High Court judgments should be denied.

[59] The structure for the Saudi Chevron transaction was designed to allow the banks, through the Onshore Security Agent, to attempt to enforce the foreign award through the SAMA Committee, rather than through the Board of Grievances. This should result in (i) substantially quicker resolution and enforcement, and (ii) avoidance of a *de novo* review of the underlying documentation by the Board of Grievances in the enforcement action.

The respective jurisdictional ambits of the SAMA Committee and the Board of Grievances in this situation are unclear and, to the author's knowledge, except as noted in the text, no actions have been brought by a bank in either forum for enforcement of a foreign arbitral or judicial award to date.

[60] Perhaps the clearest example of an element of an award that would be contrary to the *sharīᶜa* would be where it contains an element of interest. Interest is considered a form of unearned gain, or *ribā*, which is prohibited under the *sharīᶜa* as construed in Saudi Arabia. The Board of Grievances will decline to enforce that part of any foreign award that constitutes an award of interest or amounts in the nature of interest. No pre-judgment interest on damages suffered is therefore recoverable.

Requirements to Be Fulfilled When Conventional Banks Set Up Islamic Banks, Windows, or Funds

Nizam Yaquby[*]

ABSTRACT

Many conventional banks and financial institutions are increasingly becoming interested in Islamic finance and investment. How can these conventional banks and institutions enter this market? Is it possible or not? This paper is an initial attempt to lay down the conditions necessary for conventional institutions to comply with and implement when doing so. The most important of these required conditions are: complete segregation of funds; the existence of a *sharīᶜa* supervisory board; management committed to Islamic financial concepts; safeguarding Muslim investors' funds from negligence, trespass, and fraud; and compliance with the standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

I. INTRODUCTION

This is a modest contributory note that sets out the most important conditions to be fulfilled when conventional banks and financial institutions, the Articles of Association of which do not comply with the tenets of Islamic law (the *sharīᶜa*), set up any Islamic bank, window, or fund. The importance of this issue cannot be overstated, particularly in view of the wide spread of this trend, over the past few years, and the oft-repeated claims by many parties that their transactions and dealings fully comply with the provisions of the *sharīᶜa*. When subjected to scrutiny and examination, this proves otherwise. Little or no research appears to have been conducted on this matter, and therefore this note is a beginning toward this end. It is hoped that specialist research and studies by scholars and academics will follow, for this author is no more than a parasite eating at their banquets.

II. FORMS OF COLLABORATION AND THEIR PERMISSIBILITY

Before delving into the details of these requirements, we have to note that cooperation and overlap between Islamic and conventional financial institutions in managing investments has taken several forms. These include the following:

1. An Islamic financial institution (IFI) offers an investment portfolio, backed by its *sharīᶜa* expertise, but vests management of this portfolio in an external investment manager who undertakes to comply with the IFI's conditions and applies the criteria and standards laid down by the IFI when managing investment. This is permissible under the *sharīᶜa* if the investment manager complies with the Islamic conditions and his or her success has been proven in more than one instance.
2. A conventional financial institution or bank sells and markets an Islamic product, introduced and planned by an IFI through its *sharīᶜa* expertise. This is also sanctioned by the *sharīᶜa* if it has been proved successful in more than one practical example.
3. Alternatively, a conventional financial institution or bank opens an "Islamic window" on its premises, introduces an investment product marketed as "Islamic," such as a fund, or sets up a private Islamic bank or company. This is the subject of the present discussion.

Some scholars believe that this is not permissible, because conventional financial institutions do not comply, in the first place, with the *sharīᶜa* in terms of their incorporation and statutes. If they do not comply with Islamic law in their basic charters, how can they claim to comply with it in their funds, branches, or windows?

In addition, the funds of these conventional financial institutions are drawn from prohibited earnings, so how can they invest unlawful funds in Islamic products? The rationale cited by scholars is that these financial

[*] *Sharīᶜa* Scholar and Advisor, Manama, Bahrain.

institutions or banks are only intent on exploiting practicing Muslim investors and on unfairly competing with Islamic financial institutions.

On the other hand, there is a group of contemporary scholars who permit this type of investment product as long as the *sharīᶜa* conditions laid down for them are satisfied. They argue that dealing, in compliance with the teachings of the *sharīᶜa*, in transactions and their Islamically sound contracts is not confined to a certain group of people. In this view, it is permissible—indeed incumbent—upon whomver can conduct dealings in accordance with the provisions of the *sharīᶜa* to do so. If it is impossible to do so in all contracts, at least one should start with those that are possible. In response to the argument that the source of these funds is unlawful earnings, one may reply that there is nothing to prevent such funds from being purified, cleansed, and subsequently directed to lawful and permissible channels. Jurists say that it is permissible to deal with commingled (mixed) funds—funds that are not purely lawful funds, but rather are mixed, containing both lawful and unlawful money. This is as stated by Ibn Taymiyyah, in his *Collection of* Fatāwā, and by other eminent scholars.

Moreover, the claim that traditional financial institutions desire to unfairly compete with Islamic financial institutions can be refuted by saying that competition is always in favor of the most suitable, efficient, and fittest. This kind of competition may prompt Islamic financial institutions to exercise more diligence and care to introduce better quality products and conduct their activities more efficiently. This is in fact evident in many nations in which competition exists.

On the other hand, conventional financial institutions may gradually convert into full-fledged IFIs if they find this viable and if they have acquired adequate practical experience and *sharīᶜa* practices in this field. There are practical examples to substantiate this argument.

Among scholars and jurists who hold this view are Yusuf Al Qaradawi, Abdul-Sattar Abu Ghuddah, M. Taqi Usmani, Nazih Hammad, Abdullah Al Muslih, and Abdullah bin Sulaiman Al Manea. Economists who also espouse this view include M. Ali Elgari and Monzer Kahf. They all concur that the required conditions, outlined below, necessitate strict compliance.

III. Required Conditions

The most important of these required conditions are: complete segregation of funds; existence of a *sharīᶜa* supervisory board; management that is committed to Islamic financial concepts; safeguarding of Muslim investors' funds from negligence, trespass, and fraud; and compliance with the standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

A. Complete Segregation of Funds

The funds of the Islamic investment product and those of the financial institution in which *sharīᶜa* provisions are not observed must be completely segregated. The funds of investors who are very diligent and anxious to earn lawful income should not be commingled with those of conventional investors who are not observant of the *sharīᶜa*. Therefore, there should be separate accounts, books, and computer programs evidencing this complete segregation of funds. This matter is not difficult or problematic in view of the availability of modern computer systems, assuming that intentions are sincere and the required expertise is available. This compliance should be enshrined and expressly stated in the statutes or the prospectus.

B. *Sharīᶜa* Supervisory Board

There should be a *sharīᶜa* supervisory board for any institutional Islamic investment body, and that Board should consist of trustworthy scholars who are highly qualified to issue *fatāwā* (religious rulings) on financial transactions. In addition, they ought to have considerable experience with knowledge of modern dealings and transactions. The Articles of Association, prospectuses, or statutes (depending on the type of activity) should provide for the existence of a *sharīᶜa* board, whose *fatāwā* and resolutions should be binding upon the financial institution's management. It should be independent and free to give opinions on proposed contracts and transactions. The role of the *sharīᶜa* supervisory board should be concurrent with that of the financial institution itself in the sense that it should be formed from the moment the financial institution is incorporated, and that it should provide continued supervision and permanent checking of contracts, transactions, and procedures. This should be expressly provided for in the Articles of Association or the prospectus.

C. Managerial Commitment

The financial institution's management, which is undertaking such business activities, should be fully convinced of the concept and fully committed and dedicated to it. It should be anxious to implement it and comply with the teachings governing it. Unless the entire management is committed and convinced, the business activities and the enterprise will not be foul free or will not escape irregularities and deviation. Regardless of how strict and stringent *fatāwā* and contracts are, this will not ensure sound practices if there is no one sufficiently sincere and committed to implement the principles. However, there is no harm in starting first with the executive senior management, which implement resolutions and subsequently trains the other members of the administrative team. The general manager himself should act as a springboard and set a good example for all in this respect.

D. Safeguarding Muslim Investors' Funds

It is an established principle in Islamic law that the *mu<u>d</u>ārib* does not guarantee the *mu<u>d</u>āraba* capital for the capital provider. Hence, investment accounts in Islamic financial institutions are not guaranteed by the *mu<u>d</u>ārib*. However, this does not prevent the laying down of a stipulation requiring that the parent conventional financial institution (the original company) guarantee Muslim investors' funds against trespass, negligence, and fraud. Major financial institutions may sometimes shirk their responsibility in this connection by claiming that their Islamic windows, branches, or sections are privately incorporated, among other reasons and excuses. This is wholly unacceptable. Precautions should be taken to guard against this, and a similar policy should be expressly stated in the Articles of Association or the prospectus of the financial institution.

E. Compliance with AAOIFI Standards

The Accounting and Auditing Organization for Islamic Financial Institutions has issued and published a number of accounting and auditing standards that all Islamic financial institutions should comply with and implement. The AAOIFI's activities are considered a fundamental groundwork that underpins Islamic banking activities by keeping them away from individual, personal reasoning. The collective personal reasoning (*ijtihad*) of the AAOIFI is highly important in this vital aspect of Islamic economic life. Therefore, these standards deserve strict adherence. A number of government authorities and central banks in certain countries have circulated these standards and obliged other financial institutions to comply with them. That is why any party wishing to incorporate or set up an Islamic financial institution should be required to conform to these standards in order to avoid confusion, misunderstanding, and ambiguity, and to seek clarity and sound business activities.

IV. CONCLUSION

Islamic investment, with its governing *sharīᶜa* rulings and provisions, is an open area for all those wishing to give it a try, provided that they approach it from its front door. They ought to comply with its provisions and honestly deal with people in their communications and transactions. For those who are intent on fraud, cheating, and misleading, all that can be said is that "he who cheats us is not one from us."

PART III

ISLAMIC FINANCE

Introduction
Mahmoud A. El-Gamal

Emerging Trends and Opportunities in the Islamic Financial Industry
I. Malcolm Burnett

Analyzing the Creditworthiness of Islamic Financial Institutions
Andrew Cunningham

Islamic Finance: Sustaining Success
Koshy Zacharia Karuvelil

Developing the Country Framework for Islamic Finance
Iqbal Ahmad Khan

Designing Islamic Contracts for Financing Infrastructure Development
Mohammed Obaidullah

Islamic Banks: Technology and Global Challenges and Opportunities
Abdullah Sulaiman Al Rajhi

Islamic Convertible Bonds: An Alternative to *Bay^c al-‘Inah* and Discounted *Bay^c al-Dayn* Islamic Bonds for the Global Islamic Capital Market
Saiful Azhar Rosly and Mohd. Azmi Omar

Cross-Border *Ijāra*: A Case Study in the U.S. Taxation of Islamic Finance
Robert W. Toan

The Revitalization of Islamic Profit-and-loss Sharing
Ibrahim Warde

The Islamic Commodity Trust: With Application to Crude Oil Forward Sales
Rudy Yaksick

Introduction

Mahmoud A. El-Gamal *

The field of Islamic finance has attracted considerable attention in recent years, mainly due to the perceived potential for the field to evolve into a large-scale industry. While practitioners and supporters of the field rarely miss an opportunity to mention the size of the industry, it certainly remains miniscule if compared to mainstream areas of finance. I shall refrain from quoting the familiar numbers on industry size and growth rates over the past two decades, since my purpose is not to emphasize the importance of this industry to Muslims or to financial practitioners. Rather, my goal in this introduction is to assist the reader by providing a roadmap, not of the Islamic financial industry, but of the thought processes of individuals involved in this enterprise. In so doing, I shall try to limit my discussion to the papers presented in this section. However, my comments will probably be influenced by some of my hopes for, and misgivings about, the industry as well as the thought processes that drive it.

I. Roadmap Key

I shall organize this introduction by dividing the papers in this section into three main categories:

1. The first category consists of papers that focus on the growth potential of Islamic finance and supporting industries. The papers in this category are all very practical, authored either by practitioners in the area of Islamic finance, or by representatives of institutions that provide (or have the potential to provide) support services for this industry. Within this category, I shall discuss the papers in their order of appearance in the volume. Those papers are the ones authored by Burnett, Cunningham, Karuvelil, Khan, Al Rajhi, and Toan.

2. The second category of papers I consider in this introduction is represented by the lone paper of Warde. This paper is directly linked to the older literature on Islamic banking and finance, dating back to the 1970s and before. This literature—which continues to our day—takes as its premise the idea that financial contracts characterized by "profit-and-loss sharing" are closer to the Islamic financial ideal than debt-based financing contracts. This paper follows in a long line of writings discussing the potential for adapting the western venture capital model to Islamic finance, especially in Islamic countries.

3. The third and last category consists of papers that attempt to provide "Islamic" alternatives to standard financial contracts. There are three papers in this category, one by Obaidullah, one by Rosly and Omar, and one by Yaksick. The first paper discusses legal and operating structures for financing, building, and operating infrastructure projects according to Islamic law. The suggestions are mostly in line with standard procedures recently followed by the Islamic Development Bank, and the author discusses some of the risk allocation considerations one must consider. The other two papers are much more ambitious. Rosly and Omar attempt to synthesize a tradable debt instrument that abides by Islamic law, while Yaksick attempts to synthesize a standard forward contract that agrees with Islamic law.

While the first paper in this last group builds on a solid ground based on recent developments in the area of Islamic finance (the notion of diminishing partnership), the other two papers represent a different trend in what is called "Islamic financial engineering." In those two papers, the authors tackle forbidden contracts (tradable debt, and conventional forwards, respectively). The authors suggest syntheses of existing contracts (guaranteed deposits, and silent partnerships restricted to credit sales, respectively) to get the same financial effect. Perhaps if those papers could be written in the form of an *istiftā'* (request for legal ruling from a jurist), and directed at a specific jurist or institution, those efforts may prove fruitful. However, such a trial-and-error approach (seek *fatwā*, develop

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* Professor (Chair) of Islamic Economics, Finance, and Management and Professor of Economics and Statistics, Rice University, Houston, Tex.

new idea, seek *fatwā* again, etc.) is very unlikely to result in solutions, and may prove to be counterproductive. There is no doubt that the industry, and Muslim society at large, is in dire need of valid legal and financial innovation. However, I think that we have yet to find the appropriate formula for such innovation.

II. Regional and Global Opportunities for the Islamic Financial Industry

We now turn to the first category of papers discussed in the previous section. Some of those papers have a specific regional emphasis, while others are concerned with more universal aspects.

Burnett's paper is regionally focused on the United States market. The author recognizes the remarkable similarity between Islamic lease contracts and conventional leases used in the U.S. Of course, this similarity must be qualified: a number of legal restrictions render most conventional leases Islamically unacceptable, as we shall see when discussing the paper by Toan. That being said, the existence of a large leasing market in the U.S. (by far the largest in the world) does suggest a great potential both for increasing the size of the Islamic lease financing industry in this country, as well as increasing the volume of Islamic lease asset-backed securitization. The latter potential, together with recent developments facilitating investment banking operations in the U.S., suggests that the Islamic financial industry has a great potential in the United States. Realizing this potential will benefit American Muslims (by providing financing and investment vehicles that are accepted under Islamic law), as well as Muslims living elsewhere, who can invest their capital in this growing portion of the largest lease market in the world.

Cunningham makes a number of valid points on the possibility and importance of producing a rating mechanism for Islamic financial institutions. The premise is rather obvious: whether or not an investor's/depositor's capital is guaranteed, an estimate of the probability that the investor/depositor loses any portion of his or her capital can be calculated. At this level of generality, there is very little difference between Islamic and conventional financial institutions. Differences in rating the two types of institutions will appear at higher levels of detail. For instance, as the author points out, social and religious aspects influence customer loyalty in different ways across the Islamic/conventional divide. This in turn may influence the probability of a run on the financial institution, and hence its riskiness to investors/depositors. I think that having risk ratings for Islamic financial institutions can be of great benefit to the industry and its clientele. In this regard, the uniformity and transparency required by Islamic financial institution accounting standards (such as those developed by the Accounting and Auditing Organization for Islamic Financial Institutions) can be further enhanced if rating agencies supplement the dry information provided therein with a variety of opinion surveys and historical analyses of business practices and their effects on short- and long-term riskiness.

The paper by Karuvelil provides a useful basic survey of some of the main instruments used in Islamic finance, as well as a brief history of the industry. The author—directly or indirectly—highlights the regional origins of the industry in the Persian Gulf area, and its continued dependence on that area for funds and expertise. In my opinion, this continued dependence on Gulf-originated money and business models has been a source of weakness for the industry. American and European regulators are happy to accept inflows of funds through the Islamic financial movement. However, regulators in these regions continue to be wary of the intentions and business practices of financial institutions with such strong links to the Islamic movement in the GCC (Gulf Cooperation Council). While the industry in the United States and Europe will probably continue to draw on some of the experiences (and funds) from the GCC veterans, it may be in the best interest of those regions to develop their own indigenous business models that are better suited for their circumstances, and that will carry more local credibility than GCC-imported money and business models.

Khan focuses on regional issues that are perhaps of greatest importance to Islamic nations. He points out correctly that the growth prospects of the Islamic financial industry will be determined by two fundamental factors: (1) the development of central bank regulation of Islamic financial institutions at the national and international levels; and (2) the development of centralized supervisory *sharīʿa* boards. The first development, in turn, requires a greater degree of transparency of the accounting standards and business models adopted by those financial institutions. Indeed, Islamic financial institutions' formal and informal attempts in a number of GCC countries to gain credibility and security by coming under central bank supervision bear testimony to the importance of this factor in the long run. The development of independent *sharīʿa* boards that supervise the operations of all financial institutions is equally important. It is a well-known saying that there are no trade secrets in the financial industry. However, many potential participants in the Islamic financial industry are driven away by the trend of what I shall call—for lack of a better term—proprietary *fatāwā*. To increase their market shares in Muslim countries and beyond, Islamic financial institutions need to lose the exotic label. Inclusion under central bank supervision would add a measure of credibility, and validation of business practices by centralized independent *sharīʿa* boards can level the field for competition as well as add to that credibility. However, in my opinion, Islamic financial institutions will never come of age until they feel that they can compete without the "Islamic" label. I look forward to the day when tomorrow's version of Islamic financial institutions are endorsed by independent *sharīᶜa* boards for the benefit of those who wish to know, but compete successfully without the need for such labels. To draw an analogy, I would compare financial institutions to restaurants. Coming under central bank supervision is equivalent to being inspected by the health department, while being approved by *sharīᶜa* boards would be equivalent to having a seal of approval that meat products are produced in the proper manner. In the end, however, the restaurant (or the Islamic financial institution) will survive in the long term if and only if its products are competitive, along other attributes.

Al Rajhi provides a brief review of the Islamic financial industry's history, followed by some remarks on its future potential. He points out that the industry has only recently begun to move from short-term oriented retail banking to longer-term project financing and other long-term financial endeavors. He properly points out that the industry's effort to move into long-term macroeconomic project financing can be further enhanced by creating partnerships with development-oriented international organizations. This proposal seems very sensible given that most Islamic nations (IDB members, say) are still in the early stages of economic development and qualify for subsidized loans from the IFC and other organizations. Islamic financial institutions can join those organizations both in financing infrastructure projects in Muslim nations, and in structuring the financing in an Islamic way. Whether or not this proposal would succeed depends to a large extent on uncertain political perceptions. In particular, the question will be whether the Islamic financial institutions can increase the chance of such projects to be financed and accepted by host countries, or whether partnerships with international bodies like the World Bank and IMF would rob those institutions of the limited credibility they possess with certain parts of the population of target countries.

The last paper in this category is the one by Toan. It takes us back to one of the topics highlighted in Burnett's paper: namely, the flow of funds from GCC nations into Islamic leased asset-backed securities. In this regard, the author focuses on the tax angle, an often-neglected consideration in this industry. The basic story is this: the IRS divides leases into two types (operating versus financial leases) depending on the degree of effective retention of lessor ownership of the leased object. If lessors are deemed to retain ownership of the leased object, the lease is classified as an operating lease; otherwise, it is deemed a financial lease, which is tantamount to a loan. The author proceeds to give speculative suggestions on how it may be possible to effect lessee ownership for tax purposes, while maintaining lessor ownership to satisfy the strict *ijāra* rules in Islamic law. Unfortunately, the suggestions are not specific enough to bring to the attention of a jurist who may rule on the validity of the author's suggested contract. For instance, Toan correctly points out that the lessor's responsibility for maintenance of the leased property under Islamic law would be construed by the U.S. tax authority as effective and sufficient lessor-ownership. He makes a vague suggestion that it may be possible to hire a sort of intermediary to fulfill that obligation while maintaining the appearance of lessee ownership. While this suggestion is too vague to take to a jurist, it also opens a number of legal Pandora's boxes with respect to how that intermediary is classified: a legal representative (*wakīl*), a guarantor (*kafīl*), an employee (*ajīr*), etc.? Afterward, the question must be asked whether the intermediary can have a different legal status from the Islamic point of view, and another from the American legal view.

However, my contemplation of those specifics might have missed the most important point. We all recognize the interest bias in U.S. tax laws, and recognize that financial leases would allow the lessor and lessee to divide the tax gains between them. The author argues for a contract that is Islamic (i.e., an operating lease) in substance, but that qualifies under U.S. laws as a financial lease (in form). Leaving aside the fact that the possibility of finding such a contract has not been established, the effort seems to validate the worst stereotypes shared by many Muslims in North America as well as U.S. government employees: that Islamic finance is little more than window dressing. The cost of perpetuating this stereotype, and possibly alienating U.S. authorities, is simply too large. The author has therefore left three major questions unanswered: (1) is there a real potential for finding such contracts; (2) what is the magnitude of the tax benefit per $1 invested; and (3) what is the magnitude of the cost due to loss of credibility with the Muslim population and possible alienation of the IRS.

III. Profit-and-loss Sharing

Warde returns to a favorite theme of writers in Islamic economics and finance: the presumption that "profit-and-loss sharing" contracts (e.g., *mudāraba*, *mushāraka*) are closer to the Islamic ideal than debt based Islamic contracts (e.g., *murābaẖa*, *ijāra*). He goes so far as to claim that profit-and-loss sharing was the "raison d'être of modern Islamic finance." There is no compelling evidence, religious, economic, or otherwise, to support such claims as: "*Muḏāraba* and *mushāraka* are at once the most Islamically authentic and the most socially and economically useful forms of Islamic finance…." On the other hand, we can all agree that any successful financial system must include high-risk/high-return investment and financing vehicles as well as low-risk/low-return vehicles. In this regard, the contract Warde chooses as the focus of his paper is the high-risk/high-return venture capital contract. Warde gives a brief introduction to the advantages and disadvantages associated with venture capital financing. Of course, there is nothing particularly Islamic or un-Islamic about those general features. It is well known that the moral hazard problems caused by one-sided asymmetric information are exacerbated in venture capital models, which make them suitable only for a small class of business sectors (cf. Gompers, P. "Optimal Investment, Monitoring, and Staging of Venture Capital." Journal of Finance 50 (1995). pp. 1461-89). Moreover, the problems facing the development of venture capital in Muslim countries need not be tied to the Islamic financial industry, for the major impediments are regulatory. For instance, Egyptian capital market law (currently under revision) put many restrictions that prevented non-banks from operating as venture capitalists. Those impediments, together with the general lack of transparency and reliability of Islamic countries' legal systems, are the reason for the dearth of use of partnership financing. Some of the author's suggestions are worth considering, but I wish the analysis concentrated more on regulatory and legal reforms necessary to make partnership financing a viable industry in Muslim nations.

IV. ISLAMIC FINANCIAL ENGINEERING

Obaidullah, in his paper, spells out a sequential series of widely accepted contracts to facilitate infrastructure financing, building, and operation, in accordance with contemporary Islamic jurisprudence. First, he suggests, a diminishing *mushāraka* is established between the host government and a project company. The project company then hires a construction company through an *ijāra* or *istiṣnā*ᶜ contract (possibly with the assistance of an Islamic financial intermediary). Finally, a project company can be hired, through an *ijāra*, to operate the infrastructure. The paper focuses mainly on the agency problems and risk distribution for the various participating parties in the different stages of the project; most of the prudential aspects associated with these agency problems and risk management issues are not specific to Islamic finance. The proposed model has the advantages of being simple, and using only widely-accepted contracts without attempting to synthesize options that may be questionable from the point of view of Islamic law. Thus, the proposals are very similar to existing agreements for the financing, building, and operation of infrastructure projects in developing countries. In this regard, the paper provides a nice overview of the legal structure, as well as valuable insights into the agency problems and risk allocation properties of various organizational structures that may be attempted in the future.

Rosly and Omar motivate their paper by the fact that the bond structures used in Malaysia are unacceptable to the vast majority of Muslim jurists in other parts of the world. Thus, they attempt to synthesize a type of bond which is devoid of the objectionable *bay*ᶜ *al-*ᶜ*īnah* (same item sale-resale) and *bay*ᶜ *al-dayn* (trading in debts), both of which are rejected by those jurists. Their solution, called an "Islamic convertible bond," has three components: (1) a deposit in which the recipient guarantees the capital (safekeeping with guarantee = *wadī*ᶜ*ah ma*ᶜ*a al-ḏamān*); (2) what they call a *kafāla* (guaranty), whereby a third party would guarantee the conversion of the deposit into stocks; and (3) a *mudāraba* with a third party who trades in the underlying stock. This combination of three contracts in one results in a convertible bond. Unfortunately, the conclusions of this paper cannot be validated without reference to a professional jurist. For instance, there is ample evidence that the target audience (Middle Eastern jurists) would not accept the authors' concept of guaranteed monetary deposit. For instance, Jordanian civil law (item 889) states: "if a deposit is made in monetary or consumable form, and if the depositor allows the recipient to use the deposited items, then the contract is considered a loan contract." Recent juristic rulings seem also to point in this same direction regarding guaranteed deposits (see, e.g., Usmani, M. Taqi. Buhuth fi Qadaya Fiqhīyya Mu`asirah. Damascus: Dar Al-Qalam, 1998. pp. 362-366). Clearly, if this view were upheld, it would nullify the authors' effort.

There are similar questions about the other component contracts, but a more fundamental question must be raised regarding the process of synthesizing a number of contracts to produce a given effect. The authors' own motivation, as the title and the early sections of the paper clearly indicate, is predicated upon most jurists' rejection of same item sale-resale (*bay*ᶜ *al-*ᶜ*īnah*). That contract is synthesized in a much simpler manner (two valid sales), but most jurists reject it as a trick to effect *ribā*, while a minority Shāfiᶜī opinion (permitting the practice) is adopted in Malaysia. I wonder that if the jurists addressed by this paper, and similar efforts in "financial engineering," reject such simple syntheses, why would the authors expect them to accept much more complicated ones if the net effect (a convertible bond) has already been rejected? In my opinion, we need to dig deeper into the economic intent of the existing prohibitions issued by classical and contemporary jurists. If we can show that the substantive allocations of risk, benefit, and liability are sufficiently altered in the synthesized contract, then perhaps we have a chance of successfully arguing that the objectives of the law served by the prohibition of the initial contract will not be violated if the synthesized contract is allowed. If such an illustration can be made decisively, and if it can be explained both in economic and religious terms, then perhaps the jurists can be convinced. In the meantime, the exercise of synthesizing replacements for forbidden contracts does not seem to be particularly productive or promising.

The final paper, by Yaksick, attempts an even more blatant synthesis of a forward contract. One of the first paradoxes students of Islamic finance contemplate is: why are credit sales (goods delivered now, price paid later) allowed, *salam* sales (price paid now, goods delivered later) also allowed, but forwards (price paid later, goods delivered later) forbidden? In fact, the classical jurists explicitly addressed the forward contract (*al-bay^c al-muḏāf*) and forbade it. It is important in this regard to note that both credit sales and *salam* sales are exceptions to general rules, allowed only to serve a specific economic purpose. It might be easiest to try to convince the jurists that contemporary forwards in fact do serve such a purpose. As things stand, jurists today definitely view forwards as forbidden contracts. In his discussion of forwards, Sh. M. Taqi Usmani (Buhuth fi Qadaya Fiqhīyya Mu`asirah. pp. 136-143) first shows that the contract cannot be validated based on *salam*, and then claims that there are two categories of individuals who use such contracts. First are speculators, whose intentions to make profits without a legitimate trade are illegal; then there are hedgers, whom, he argues,

> "need only to hedge their positions due to their intention to effect long-term monopoly. In fact, if they were planning to sell a few days after buying the commodities, they would not need to hedge. In fact, they enter into futures only to engage in long-term monopolies and increase their profit margins…. Therefore, there is no legal objective served by the forward contract, and thus we do not need to consider legal alternatives for this contract…." (ibid., pp. 142-3)

Judging from this quote, the reader can see that the possibility of convincing jurists to consider forwards as valid hedging mechanisms for legal purposes does exist. However, attempts at amateur jurisprudence to synthesize a futures contract can only serve to alienate those jurists and further strengthen their resolve to reject the concept. In contrast, Yakisck's suggested synthesis of a *murābaẖa* and a *salam*, with a third party *muḏārib* to effect the forward sale, is very likely only to give jurists reason to discuss the dubiousness of restricted silent partnerships and the eligibility of a *muḏārib* to conclude credit sales. To convince the jurists, we need to argue with substance rather than legalistic form.

V. Concluding Remarks

Thus, the reader can appreciate at least three trends in the area of Islamic finance, represented in this volume in the three groups I have identified. The first trend is pioneered by Islamic financial practitioners, who aim to foster the growth of Islamic finance as an industry by exploring regional, regulatory, and other practical issues, with minimal innovative additions to the existing set of financial instruments. This group should be credited for the oft-cited growth of this industry over the past two decades. In this regard, the caution with which it approaches new and innovative solutions has been helpful in maintaining the industry's credibility with regulators in various countries, as well as maintaining a loyal clientele.

The second trend is represented by the single paper in our second group (Warde), as well as the first paper of the third group (Obaidullah). These two papers represent academic support for modest re-interpretations of existing contracts within an Islamic financial context. While this line of research has had a modest influence on the way Islamic financial practitioners behave, it has had a significant indirect effect through the establishment of the fact that Islamic finance is not simply a fad, and that it is not fundamentally different from known financial methods. This also adds to the credibility of the industry within the Islamic world and on the international stage. Indeed, this trend is largely responsible for the general view that the main goal of Islamic finance is the selection of conventional financial contracts that are sufficiently close to being acceptable in Islam, and then adding some constraints—if necessary—to make them "Islamic."

Unfortunately, that final view can be a two-edged sword. The dangerous side of this resulting view of Islamic finance is the third trend we considered, which is innovative "Islamic financial engineering." In my opinion, the type of work that falls in this category is predicated on a false premise: that academic and professional financial experts can effect innovations and developments in the field of Islamic finance through legal analysis and synthesis. I am not questioning the possibility and reality of some success in this area. However, any successes that are realized through this approach must be coincidental given the hit-or-miss approach of suggesting legal solutions to legal experts, and hoping that they will agree. I maintain that this approach does not make optimal use of academicians' and professionals' comparative advantage. Instead, I think that a much more productive approach would be to explain—in both legal and economic terms—the economic content of the existing body of Islamic law. Then, it may be possible to convince Islamic jurists directly that certain innovations in financial contracts have benefits that outweigh their costs.

Emerging Trends and Opportunities in the Islamic financial Industry

I. Malcolm Burnett*

ABSTRACT

This paper provides an overview of recent developments in the Islamic financial sector from the perspective of conventional finance. It also highlights new trends emerging in the Islamic financial industry and the resulting impact they have on broadening and deepening the Islamic financial market. HSBC Group's involvement in the Islamic financial industry over the years is reviewed, as is its historical involvement in providing correspondent banking services and the recent establishment of a dedicated Islamic banking and finance group within this multi-national institution. Three specific trends emerging across the Islamic financial industry are discussed: asset securitization, private equity, and banking services for Muslim communities in OECD countries. Also covered is the relevance of these emerging trends to the U.S. market.

I. INTRODUCTION

The Harvard Islamic Finance Information Program should be commended for its role in promoting understanding and cooperation in the Islamic financial sector, because in any market, shortfalls in reliable data can hinder expansion. And while there are far more important measures, one indication of the growing prominence of Islamic finance is the number of conferences now devoted to this $90 billion sector.

II. HSBC AND ISLAMIC FINANCE

What connects the HSBC Group to Islamic finance? The foundation lies in its deep-rooted network in the Muslim world. The HSBC Group, as one of the largest financial services organizations in the world, operates under well-established names in the Asia-Pacific region, the Middle East, Africa, Europe and the Americas, in a total of 79 countries and territories. In particular, the Group has a presence in 20 of the 52 Islamic Development Bank (IDB) member countries, including five of the six Gulf Cooperation Council (GCC) states, Egypt, Malaysia, Indonesia, Turkey, and Pakistan. In some of these countries, HSBC was among the first banks to be founded. Furthermore, critical to HSBC's success has been its respect for customers, host countries, and local customs.

Beside local accommodations, the HSBC Group's global involvement in Islamic finance initially centered on providing support to its participants though the provision of correspondent banking services and on confirming letters of credit for trade-related business. As the Islamic banking sector gained critical mass and as the Group saw a steady increase in demand for Islamically-compatible products and services from its own client base across a number of countries, it decided to form a dedicated business unit focusing on Islamic finance.

HSBC Global Islamic Finance (GIF) was launched in July 1998, under Iqbal Ahmad Khan, and is housed in the Merchant Banking division of HSBC Investment Bank in London. From there, it draws upon the local market expertise of HSBC staff in each region to offer the full spectrum of advisory, financing, and dealing services to its clients, at retail, private, corporate, and institutional levels.

One of HSBC's first initiatives was the establishment of an independent *sharīʿa* advisory committee to ensure that the Group's entire Islamic financial activities comply with Islamic law. The *sharīʿa* advisory committee is the sole reference point for the Group's Islamic efforts. It is comprised of three highly regarded and experienced scholars: Mohamed Ali Elgari of Saudi Arabia, Muhammad Taqi Usmani of Pakistan, and Nizam Yaquby of Bahrain.

The second major step was the establishment of the IDB Member Countries Strategy Forum. Headed by the chairman of the HSBC Investment Bank, this Forum brings together product heads and specialists alongside senior executives from the Group's major subsidiaries and affiliates in the Muslim world. It plays an important role in maximizing synergy and harmonizing Islamic financial activities across the Group's commercial banking franchises. HSBC's focused efforts in Islamic finance ought to have a beneficial impact. Not only do they increase

* President and Chief Executive Officer, HSBC Bank USA, Buffalo, N.Y.

the mainstream relevance and credibility of Islamic banking, they also expand the competitive space available for the sector.

III. Sectoral Growth

Since the inception of the IDB, followed by the formation of institutions such as the Dar Al-Maal Al-Islami Trust, Albaraka Investment & Development Company, Dubai Islamic Bank, and Kuwait Finance House in the 1970s, the gaining momentum, sophistication, and market share of the sector is admirable.

Bahrain, where the Group's presence dates back to 1944 (through the British Bank of the Middle East, now HSBC Bank Middle East), has emerged as the international center for the industry. Other advancements can be attributed to the Central Bank of Malaysia, which has actively promoted an interest-free banking system alongside its conventional counterpart for several years. Moreover, in Saudi Arabia, the most profitable bank, year-on-year over the last few years, has been Al Rajhi Banking and Investment Corporation.

We are now witnessing the establishment of Islamic asset management, insurance, and leasing companies. The creation of a number of Islamic investment funds, especially on the equities side, and the advent of Islamic investment indexes points to a broadening and deepening of the market. The emergence of more participants will continue to provide the competitive spur for ongoing innovation and development.

Noteworthy is the continuing leadership of the IDB and, particularly, its creation, in partnership with DMI, of a $1.5 billion infrastructure fund. This fund will go some way toward meeting the huge infrastructure financing requirements of IDB member countries and increasing the embedded capital of these countries.

Also, the work of the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) deserves highlight. AAOIFI is spearheading efforts to unify accounting and auditing reporting standards and is setting up new fiduciary benchmarks for Islamic financial institutions.

Continued forward movement also depends on attention to the financial infrastructure, especially an Islamic interbank money market, and to reforms of the monetary, fiscal, and legal frameworks of Muslim countries. Concerted support from regulatory authorities within and multilateral collaboration across Muslim countries will be required to achieve an Islamic common market or an "Islamic dinar" that is more than a translation currency.

IV. Islamic Finance in the United States

Three specific trends in Islamic finance signal opportunities and potential in the U.S. market.

A. Asset Securitization and Secondary Markets

Securitization addresses some of the pressing issues currently faced by the Islamic banking industry, such as effective management of short-term liquidity and marketability of medium- to long-term assets. Islamic banks will be able to increase transaction maturities, contribute to a diversified pool of lease assets, and, through securitization, produce a readily tradable yet *sharīʿa*-compliant investment. A well-structured securitization product could also diversify financial risks across different sectors, improve asset/liability matching from the investor's perspective, reduce overall financing costs, and enhance return through cross-border tax benefits. In recent months, two Gulf-based Islamic financial institutions have already implemented such programs. We are likely to also see some securitizations in the Middle East, especially for infrastructure projects.

It is likely, however, that much of the early volume will originate in the United States. The largest leasing market in the world, the U.S. accounts for 40% of the global total and offers investors the broadest range of leased-asset classes and industries. In addition, the U.S. is favored as the dollar remains the currency most widely held by Islamic investors and the preferred vehicle for minimizing currency risks. And while it is the fastest growing market in the world for asset-backed securities, even in the U.S. securitized leases represent a nascent segment. Only in recent years have annual issues have ranged from $3 billion to $5 billion.

B. Private Equity

With the opening of equities as an asset-class, Islamic investors are becoming increasingly sophisticated in the management of their portfolios. The drive toward enhanced yields and the desire to manage their funds more efficiently has led Islamic investors to seek opportunities in private equity.

Although there is a steady increase in both private and retail banking appetite for private equity products, very few currently exist. This will change in the near future: at present, at least one major Islamic bank is beginning to carve out a niche. The HSBC Group earlier this year arranged for Crescent Capital, a subsidiary of First Islamic

Investment Bank, the first conforming acquisition financing. The establishment of a new Islamic investment bank focusing on private equity also bodes well.

The U.S., again, as the largest economy in the world, offers Islamic investors the greatest opportunities in private equity. However, in time the Middle East will generate opportunities for investors, as large family-run businesses broaden the management base of businesses and look to local capital markets as a source of finance.

C. Banking for Muslim Communities in OECD Countries

Islamic banking and finance is spreading quickly in the Muslim world. However, Muslims in Europe and the U.S. have had few options. Until lately, their alternatives had been a handful of credit unions and the Amana Mutual Funds, managed by the Saturna Capital Corporation with the assistance of the North American Islamic Trust. To a large extent, these institutions have been dependent on non-Islamic financial institutions or stem from national Islamic organizations. In some ways, the situation has been reminiscent of the Muslim Pilgrims Saving Cooperation in the Far East or the experience of Egyptian savings banks in the 1960s.

Today, Islam has been identified as the fastest-growing major religion in the U.S., and the Muslim population in America is estimated at six to nine million. On average, it is younger, somewhat better educated, and has a higher median income than the total U.S. population. Moreover, in an increasingly global market, the U.S. cannot ignore one-fifth of the world's entire population and the largest religious group in 30 countries. Nor should American institutions ignore that the value-oriented system of Islamic banking appeals, as well, to those looking to invest in a socially responsible manner. Islamic banking in the U.S. is built around 3 themes: community banking, ethical investment, and affinity marketing.

In recent years, banks such as the United Bank of Kuwait have begun to offer Islamic financial products, starting with home-financing schemes. Multinational banks familiar with Islamic finance are beginning to take closer looks at the U.S. market. However, they face distribution difficulties (with the Muslim population generally scattered across the country); potentially significant revamping of legacy computer systems; and hurdles in complying with secular authorities. It is, no doubt, only a matter of time before a number of these institutions, and perhaps other banks from the Muslim world, begin to offer Islamically-compatible products in the United States.

V. CONCLUSION

The HSBC Group sees tremendous opportunities and challenges in Islamic finance. Several developments will contribute to vigorous and sustained growth of this industry: the maturing of fledgling institutions; the regular entry of additional participants into the marketplace of Islamic finance; the need for more asset diversification and management competence; increasingly complex techniques and structures; and expansion into new markets. The HSBC Group, with its presence throughout the Muslim world and commitment to Islamic finance, is keen to promote the sector's evolution and development.

Analyzing the Creditworthiness of Islamic Financial Institutions

Andrew Cunningham*

ABSTRACT

Several issues are involved in analyzing the financial strength of Islamic financial institutions (IFIs). First, is an international rating agency such as Moody's qualified to analyze IFIs? Second, how does the analysis of IFIs differ from that of *ribā*-based banks? Third, based on the analysis, is it possible to say that IFIs are more or less creditworthy, as a class, than *ribā*-based banks? International agencies are qualified to analyze IFIs because the tools for analyzing them are the same as those used for *ribā*-based banks. Differences lie only in the requirement to understand the structure of certain financial instruments and the cultural/ethical agenda of Islamic bankers. Furthermore, it is not possible to say that the Islamic nature of IFIs makes them more or less creditworthy as a class than *ribā*-based banks. In some respects, it makes them stronger than *ribā*-based banks, but in other cases it can make them weaker.

I. INTRODUCTION

Islamic financial institutions (IFIs) are increasingly involved in international financial markets. This process is being driven not only by the desire and ability of IFIs to extend the range of their activities, but also by the appetite of western banks and investors to do business in what are commonly referred to as "emerging markets" where most IFIs are based.[1]

Credit ratings issued by the international credit agencies are an important feature of the international financial landscape. Banks and investors use these ratings to make lending and business decisions. A credit rating, therefore, is significant in determining a financial institution's ability to operate in international financial markets.

The purpose of this paper is to explain how we at Moody's Investors Service—one of those international rating agencies—analyze Islamic Financial Institutions. The paper addresses three main questions:

1. Is an international agency such as Moody's qualified to analyze IFIs?
2. How does our analysis of IFIs differ from our analysis of conventional (*ribā*) banks?
3. Based on that analysis, is it possible to say that IFIs *as a class* are more or less creditworthy than *ribā*-based banks?

This paper takes as a given the role of international rating agencies in the world financial system. Many people have opinions about the influence of international rating agencies, but it is not the purpose of this paper to provide an *apologia* for our activities. The aim is simply to explain how we do our analysis in respect of Islamic financial institutions.

Moody's publishes credit ratings on nearly 1,000 banks worldwide. Bank analysis is only one part of our business, which includes analysis of companies, securities houses, mutual funds, insurance, and structured instruments. We rate Kuwait Finance House, Al Rajhi Banking and Investment Corporation, four banks in Pakistan, which has a wholly-Islamic banking system, and we have ratings on many banks which offer Islamic windows within an overall context of *ribā*-based activity—for example, we rate all the Saudi Arabian banks, most of which offer Islamic windows. So when, for example, we analyze National Commercial Bank in Saudi Arabia, we assess the role which its Islamic business plays in its overall creditworthiness.

II. WHAT DO WE MEAN BY A CREDIT RATING?

This is not the place for a full explanation of Moody's rating methodology. But it is important to be clear about what a rating is, and what it is not. Simply put, a credit rating is an opinion on the likelihood that an institution will be able to re-pay its debts in full and on time. (Of course this immediately raises the question of whether Islamic depositors do actually expect to be paid in full and on time. After all, Islamic banking theory

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* Vice President and Senior Credit Officer, Moody's Investors' Service, London, England.

requires some classes of depositors to share risk with the bank and to see the value of their deposits reduced if the bank declares a loss. This issue is discussed below.)

When, for example, we assign a rating of Aaa ("triple A") to bonds issued by the German government, or deposits placed with Rabobank, one of the leading Dutch banks, we are saying that there is a very high probability that those bonds, or deposits, will be repaid in full and on time. A country whose bonds are rated lower, or a bank whose deposits are rated lower, has in our opinion a lower probability of being able to discharge those obligations in full and on time.

And that is all a rating is. Our Aaa rating on Rabobank is not a recommendation for people to open accounts there. It does not imply that Rabobank offers the best customer service, has the cleanest, most modern banking halls, or offers the highest rates on savings accounts. It is simply an opinion on its ability to service debt. Clearly many factors go into that opinion—and the quality of customer service, for example, will over the long term have an impact on the standing of the bank—but the only issue *directly* addressed by a rating is creditworthiness.[2]

A credit rating does not address the issue of stock valuation. An equity analyst will express an opinion on whether a bank's shares are likely to increase or decrease in value. We are credit analysts and look only at the bank's ability to repay debt and deposits. It is interesting to discuss whether, over the long term, there should be a correlation between stock price appreciation and creditworthiness, but that lies well beyond the scope of this paper.

III. Are Our Ratings Relevant to Islamic Institutions?

We noted that many Islamic depositors may not expect to receive their deposits back in full and on time, since in some circumstances they are expected to share losses with the institution holding their money. Nevertheless, when rating Islamic banks, our focus remains unchanged. Simply put, "If you put a dollar with this bank, will you get it back?" For those Muslims who feel that that is an irrelevant question, our bank ratings will indeed have little value. We respect that. However, we would suggest that many people who deposit with an Islamic bank are *in practice* very interested in the answer to that question.

It is sometimes suggested that rating agencies should treat Islamic banks as mutual funds rather than as banks. Investors in mutual funds accept that the fund manager has no obligation to repay the sum originally invested, although he does have an obligation to return that sum plus or minus any gains or losses incurred: the obligation lies in liquidity not on a specific return on investment. Moody's mutual fund ratings measure that liquidity and not specific return, so would mutual fund ratings not be a more appropriate method of rating Islamic banks?[3]

Our response again addresses the practicalities of depositors' expectations. Muslim depositors have the opportunity to invest in *sharīʿa*-compliant mutual funds and many do. Yet substantial funds are also placed with Islamic banks, implying that depositors are making a distinction between the two types of institutions. We believe that if an Islamic bank were to require depositors to take a loss, and this was portrayed as an ongoing, albeit exceptional, risk which depositors would have to face, then the bank would cease to be a going concern—it would suffer a run on deposits. Investors in mutual funds accept the possibility of negative asset values and even real losses on encashment. Bank depositors expect a greater degree of security.

The analysis contained in the preceding paragraphs is far from being complete. There is a need for more work on the subject of Islamic banks and mutual funds. Perhaps one way into such work is to look at the "constant net asset value" money market funds in the U.S., in which investors do not expect to see their original investment/deposit written down below par, even though they are aware that their money is being invested in a fund. In cases where the net asset value has indeed fallen below par, parent banks and guarantors have stepped in to make up the difference.

IV. A Credit Rating Does Not Take a View on What Is *Ḫarām* or *Ḫalāl*

We at Moody's do not take a view on what does or does not constitute Islamic finance. It is no part of our analysis to opine on whether an IFI conforms to the *sharīʿa*, or whether a certain Islamic instrument—*murābaḫa* for example—is *ḫarām* or *ḫalāl*. Nor would we take a view on whether the way in which a certain instrument is employed in a specific situation is *ḫarām* or *ḫalāl*. Firstly, we are not qualified to do that—we are credit analysts not Islamic scholars. Secondly, it is for Muslims to define and shape Islamic finance according to their beliefs and requirements. We do have opinions on what would make banks more creditworthy—that is our business, but we do not have opinions on what would make them more "Islamic"—that is the business of Muslim scholars.

We do however take an interest in whether an IFI is perceived *by other Muslims* as being compliant with the *sharīʿa*. Suppose an IFI were to get a reputation for investing clients' funds in areas which were subject to some doubt over *sharīᶜa* compatibility. This could result in depositors withdrawing their savings from that bank and placing them in another bank that had a reputation for more stringent *sharīᶜa* compliance. If the loss of deposits was large, the bank might come under severe strain, and have difficulty repaying deposits when due. As a result, its creditworthiness would be impaired. Conversely, the bank that had a reputation for stringently applying *sharīᶜa* rules would have little difficulty attracting deposits from Muslims, a fact that would strengthen its balance sheet and so enhance its creditworthiness.

V. Are We Qualified to Analyze Islamic Financial Institutions?

We believe that we are qualified to express opinions on the creditworthiness of IFIs. We recognize that specialized knowledge and understanding is needed in order to do that analysis, but the process of acquiring that knowledge and understanding is no different from the process required to analyze banking systems throughout the world. For example, Brazilian banks cannot be understood unless the analyst appreciates the effects of hyperinflation on a banking system. Chinese banks cannot be understood unless the analyst appreciates the bureaucratic culture, which still pervades much of China and the difficulties of economic management in such a vast land.

Or take another example: ten years ago, analysts looking at U.S. banks did not have to spend much time getting to grips with complex financial instruments such as derivatives—because the derivative industry was in its infancy. But now, anyone analyzing a U.S. bank must be able to appreciate not only how those instruments work, but also why a bank uses them and the impact that they have on its creditworthiness. In our opinion, the process of understanding the mechanics and the uses of new financial instruments such as derivatives is similar to the process which an analyst new to Islamic banking would go through to understand a *murābaha̱* transaction or any other Islamic financial instrument.[4]

For an outsider, understanding Islamic banking is a question both of getting to grips with the mechanics of how Islamic financial instruments work, and, equally importantly, understanding the religious sentiment which lies behind them. The acquisition of this knowledge and understanding is not beyond the capacity of an intelligent and open-minded analyst. At the risk of sounding flippant, we believe that you do not need to be a socialist in order to analyze a cooperative bank. You have to respect its individuality and how it differs from other banks, but you don't need to be part of the cooperative movement yourself.

VI. How Does Our Analysis of IFIs Differ from That of *Ribā*-based Banks?

The process and methodology of bank analysis is the same for banks world-wide, but the specific issues driving their creditworthiness may differ from place to place and time to time. This is not a question of Islamic banks versus *ribā*-banks, or developed market banks versus emerging market banks. Even within so-called developed banking markets, issues driving creditworthiness may differ widely. We recognize and respect the individuality and diversity of all banks and banking systems in the world, including Islamic banks.

We would suggest that the key features of an IFI that a western analyst must recognize are the following:

Islamic banks see themselves as having a social responsibility and therefore are not as profit-orientated as *ribā*-based banks. For example, many *ribā*-based banks deliberately eschew customers who keep low deposit balances or do not conduct a high volume of transactions, since these customers are not particularly profitable to the bank. Islamic banks do not behave like that, because part of their business ethic is to offer banking services to whoever needs them.

Some financial instruments used by IFIs are different from those used in *ribā*-based banks—for example, *murābaha̱*. The analyst needs to understand the structure of these instruments and their accounting treatment.

Islamic finance takes a different approach to capital. Islamic financial theory does not draw such a strong distinction between deposits and capital, as do *ribā*-based banks. Islamic banks sometimes argue that their capital is protected by the fact that depositors share losses alongside shareholders. In contrast, the capital of a *ribā*-bank must absorb the full force of losses, with deposits being compromised only after capital funds have been exhausted. Indeed, this would lead some Islamic bankers to reject the western concept of capital as the cushion against loss. This is a complex and difficult issue, and one where there is a huge difference between theory and practice. Nevertheless, for a credit analyst, the notion that the claims of depositors might be treated on a par with the claims of shareholders is a very important issue.[5]

IFIs manage their liquidity differently from *ribā*-based banks, because they cannot use the international interbank market—the market through which *ribā*-banks borrow or place money short-term. It is important to note that "different" liquidity management does not mean "worse." IFIs are conscious of the need for adequate liquidity and that they must therefore develop alternative sources of short-term funding. The job of the analyst is to understand these alternative sources and then make a judgment.

Islamic finance is still an industry in formation. There is considerable discussion within the industry about what is or is not an acceptable Islamic instrument or an acceptable accounting methodology. (Though we should recognize the important work being done by AAOIFI to define and have accepted standard accounting procedures.) This introduces an element of uncertainty into the operations of Islamic banks. Questions such as the validity of subordination of claims, or the liability of fund managers to make good initial investment values, are vital in assessing the creditworthiness of financial institutions. Yet issues such as these are often subject to divergent opinions and lack of precedent.

IFIs are sometimes subject to different regulatory regimes from *ribā*-based banks operating in the same market. This is not always so, but sometimes the prudential ratios imposed by banking supervisors differ between Islamic and *ribā*-based institutions. (Kuwait is an example).

It is worth highlighting one important way in which Islamic banks are *not* different from *ribā*-based banks, even though they may appear to be. In theory, the returns which Islamic banks give to their depositors reflect the overall level of profitability of the bank. So if the bank has a particularly good year, one would expect to see deposit rates being particularly high, and if the bank has a difficult year, they would be low. This does not happen in practice. That is a fact, and one can look at the annual reports of Islamic banks to see how much they pay to depositors and it is about the same as the *ribā*-banks in the same systems are paying. Even in wholly Islamic systems, such as Pakistan, returns to depositors are in line with what macro-economic fundamentals and the economic priorities of the Pakistani government would suggest, rather than what the performance of the banking system would suggest. The point is that if Islamic banks were to pay their depositors below-market rates of return in a difficult year some of those depositors would leave the bank and go elsewhere. So Islamic banks have to keep up with market rates of return—which are driven by events in the *ribā*-based economy.

VII. Conclusion

There are some elements of Islamic finance which make IFIs more creditworthy than *ribā*-based banks and other elements that make them less creditworthy. But we do not believe that IFIs are *inherently* more or less creditworthy than *ribā*-based institutions. Put another way, we do not believe that it is possible to say that IFIs *in their capacity as IFIs* are more or less creditworthy than *ribā*-based banks.

On one side, it is often the case that Islamic banks have a lower cost of funds than *ribā*-based banks because many of their deposits are *qard-hassan* and so free to the bank. This often translates into higher profitability—and strong profitability is an important element in being creditworthy.

IFIs can often count on strong customer loyalty. In countries where Islamic and *ribā*-based institutions operate side by side, those who use IFIs often do so because they feel a religious obligation. If they have a problem with their bank—for example, a mix-up with a financial transfer, or a bank statement that does not arrive on time—they are not going to close their account and go to the *ribā*-based bank down the road. That sort of customer loyalty is a big advantage to a bank, and improves its creditworthiness.

The asset structures of Islamic banks tend to be shorter-term than those of *ribā*-based banks and this would generally imply that they are less subject to risk. On the other hand, we think that some of their assets are less liquid than those of *ribā*-based banks—because they have less access to a deep secondary market—and that would imply greater risk. This is quite a difficult issue, and one that really has to be considered on a bank-by-bank basis.

One area where we do have concern with IFIs is that of internal controls. There have been some cases in recent years of IFIs suffering losses due to poor controls and in our observation of IFIs we see this as an area where they are sometimes less strong than *ribā*-based banks. There is no reason why IFIs *in their capacity as IFIs* should not have equally sound controls. But it turns out that, in our opinion, they often do not, and clearly that is an important point to consider when assessing their creditworthiness.

In conclusion, one returns to the issue of Islamic finance being an industry in development. Moody's ratings are forward looking—we are asking whether an IFI will be creditworthy some years from today. It is easier to be sure of creditworthiness some years down the road when you know that an institution is operating within clearly established precedents—within accepted "rules of the game" which are unlikely to change very much. The lack of that certainty is an important consideration to us. We would not want to over-dramatize this issue, but it is appropriate to highlight it in this paper, since accounting, regulation, and the structure of new instruments are subjects that are of direct relevance to this conference. We believe that in time these uncertainties will be removed, in part through the deliberations at conferences such as this one, and that as a consequence the creditworthiness—and ratings—of IFIs will become stronger.

[1] In this paper, the terms IFI and Islamic bank are both used. IFI refers not only to banks, but also to the full range of Islamic financial institutions. However, in many instances the text is in practice referring to those IFIs that call themselves banks, and so they are called as such.

[2] Moody's assigns two types of ratings to banks: bond/deposit ratings and financial strength ratings (FSRs). Bond/deposit ratings measure repayment ability, which is the issue under discussion here. FSRs are a subset of bond/deposit ratings and look only at a bank's intrinsic financial strength.

[3] Moody's also assigns ratings to mutual funds, which assess their likely volatility.

[4] Note that the point is to draw equivalence between the learning processes involved, not to argue that Islamic financial instruments *are* derivatives.

[5] An interesting related question is whether the claims of depositors and shareholders would be treated *pari passu*. Shareholders would normally expect the return generated on their dividends to exceed the return paid on deposits, and, in western financial markets, that would imply that they would be expected to bear greater losses. There is the further question of whether the *sharīʿa* would recognize differing priority of claim among different types of deposits.

Islamic Finance

Sustaining Success

Koshy Zacharia Karuvelil*

ABSTRACT

Two important principles of Islamic banking are the prohibition of *ribā* and cultural and financial integration between Muslim societies. Advantages of Islamic banking include off-balance-sheet financing, private sources of funding, and equity solutions. The Islamic capital market has grown over the last few years and is estimated to be around US$100 billion. The present market growth of this industry is around 10 to 15% and is expected to grow rapidly. Current developments in Islamic banking include turnkey solutions, Islamic private banking, widening the range of Islamic investment funds, Islamic indexes, mobilization of funds, securitization of assets, Islamic accounting standards, central bank supervision, liquidity management, and capital adequacy. The industry faces considerable challenges; its response to them will determine whether it becomes a significant alternative to the conventional system in global financial markets.

I. INTRODUCTION

The *sharīᶜa* prohibits charging an explicit interest-based return on funds lent. Consequently, Islamic financial and banking transactions operate on the principle of sharing risks and rewards with the borrower. While prohibiting the charging of interest on lent funds, the *sharīᶜa* invokes a financial system that operates on the mutual sharing of risks and rewards by borrowers and lenders. However, the dominant financial system of the day bases itself precisely on what the *sharīᶜa* prohibits. In an era that sees globalization as the dominant paradigm, with the increasing integration of societies, communities, and markets, one is led to wonder: how are Muslims, who cannot, (due to their beliefs and conscience) partake in the dominant interest-based financial system, to meet and take advantage of the opportunities created by globalization? Are Muslim communities to remain isolated in this era? Such a large segment of the world's population cannot be bypassed by a truly global economy. Surely, the contribution of Muslims as active participants in the global economy will only make it stronger. The absence of the enormous Muslim bloc in the global economy would raise difficult questions on the credibility and sustainability of such a system.

There exists a culturally acceptable tool and medium through which Muslim societies may draw efficiently on their national resources and integrate financially into the global economy. Islamic banking and finance, based on the principles of the *sharīᶜa*, allows Muslims to mobilize resources and provides them a bridge to global markets. The common techniques of Islamic finance, presently used by the institutions that practice it most commonly in trade, the raising of working capital, real estate, and equipment-related transactions, are well known. In *murābaḫa*, a cost plus fixed profit approach, the financier enters a simultaneous purchase and deferred-sale operation with two different parties. *Mushāraka* is partnership funding with the distribution of profits under a pre-agreed formula, with losses shared according to the contribution of capital. In *muḏāraba*, an investing party provides capital while another provides management, with profits shared by a pre-determined formula. In *ijāra*, the financier acquires an asset and leases it out on a fixed or variable rental charge to a lessee. In *istiṣnāᶜ*, or pre-production financing, an investor finances the completion of a project or the manufacture or processing of goods.

II. GROWTH IN THE ISLAMIC BANKING INDUSTRY

The Islamic capital market, the global pool of money that demands to be catered to in a manner consistent with Islamic law, is large and growing. The chief contributions to this pool come today from the Persian Gulf region, though South Asia and the Far East are growing in importance. It is anticipated that the 16 million Muslims in Europe and North America will make increasing contributions to this market. The market itself has not only grown in size but has also matured over the last 5-7 years. It has undergone a natural progression from retail to commercial to investment and private banking. This change, at least in the Persian Gulf, can be attributed to two

* Financial Controller, The International Investor, Safat, Kuwait.

reasons. First, a larger middle-income group has recognized the importance of savings. Second, the Islamic banking industry itself has become increasingly sophisticated in meeting the needs of financiers and investors who wish to have part or all of their assets managed in an Islamically compatible manner.

The growth of the Islamic banking sector in the last 20 years is well documented. Most observers agree that this niche market has grown from scratch to $80-100 billion, giving the industry a yearly growth rate of 10 to 15%. It is believed that the Islamic capital market will account for at least 50% of the total savings of Muslims worldwide over the next decade. In a sense, the Islamic capital market is still an arbitrage opportunity, as it is bound to continue to receive attention and resources until it is brought to the mainstream global capital market in terms of price, quality, and variety of product offerings. Institutions such as Al Rajhi Banking and Investment Corporation, Kuwait Finance House, The International Investor (TII), First Islamic Investment Bank, and Abu Dhabi Islamic Bank have realized annual growth rates of 20% in the past five years. Dresdner Kleinwort Benson has an annual turnover of over US$6 billion in Islamic trade finance. According to TII's Annual Review 1999, TII currently manages around US$3 billion in funds, after having been established only in 1992.

The success of Islamic finance has been due to its ability to free up existing credit lines and capital resources. With the prohibition on paying and receiving interest as per the *sharīʿa*, conventional banks working in Muslim communities face problems mobilizing the funds in these communities to their full potential. Islamic financial institutions have developed the market for Islamic customers that operates under the terms of the *sharīʿa*, freeing up capital and credit lines by offering services that are acceptable in Islam.

Using a wide range of financing tools, Islamic financial institutions are able to undertake financing, directly or as fund managers for clients. In the latter case, the institutions act as agents for borrowers or arrangers for lenders, in which case the financing is strictly off-balance-sheet, with the institution acting merely as a fiduciary agent. Islamic financial institutions are now able to undertake private investment activities, either in direct competition, or by way of cooperation, with conventional banks. These activities have increased the earnings of Islamic banks in areas that had traditionally been dominated by conventional banks. With the introduction of asset-based financing, the potential for Islamic financial institutions to grow has increased. Fixed-rate term money can now be accessed freely.

Much of the growth has come in the areas of equity, commodity funds, and leasing. Islamic principles encourage allocation of resources on a productive basis with the mutual sharing of risk and return. Equity finance seems to be a natural fit for Islamic financial institutions.

The past success of Islamic finance naturally leads to a few questions. Is this growth sustainable? Or has it all been a flash in the pan, a temporary success that will be followed by failure? What must Islamic financial institutions do to sustain growth? Perhaps a review of some recent developments in the industry and the issues they raise will suggest answers.

III. Recent Developments and Issues in the Islamic Financial Industry

A. Turnkey Solutions

Turnkey solutions offer a long-term yet flexible arrangement by which a strategic ally is armed with a comprehensive range of solutions that enable it to serve the Islamic marketplace. Turnkey solutions involve more than delivering products and services. They also entail channeling expertise and technologies, along with a brand name that has a proven track record to the client. If successfully implemented, they result in effective, low-cost, low-risk entry into the Islamic capital market. Islamic financial institutions have been acting as advisors for asset managers who wish to address the needs of investors to identify Islamically acceptable securities. They have also been offering wholesale Islamic products and services through franchising. The distribution of the products and services is effected through retail banking networks. TII, for example has provided turnkey solutions to the Gulf Bank of Kuwait (GBK) by making available TII's product under the brand name "Al Deema," to be marketed through GBK's Kuwaiti branches. In addition, TII provides a wide variety of services, including, training, to GBK. At present, no other group has introduced similar turnkey solutions. Al Deema products range from lower risk *murābaha*-based solutions, which returned nearly 6% in the 12 months to May 2000, to riskier portfolio profiles that have returned nearly 50% in the 12 months to May 2000.

B. Islamic Private Banking

High-net-worth individuals, at least in the GCC region, have shown great interest in private Islamic banking services. Like their conventional counterparts, an emphasis is placed on performance as well as on the traditional requirements of safety, confidentiality, and forming personal relationships. Private bankers and asset managers often need to buy or bring in expertise not available to them internally, and this is done typically through takeovers, alliances, and distributive agreements. TII has, for example, started a joint venture called "Al-Bait" with Pictet & Cie, the largest private bank in Switzerland. Al-Bait is a specialized Swiss Islamic financial company that provides full private banking services, including highly personalized asset management, along with custodial, trade, and estate planning services. Investments in the Al-Dar Islamic Fund have seen growth rates ranging from 24.26% to 47.32% in 1999. As IslamiQ Financial Daily reported (May 24 and 30, 2000), Kanz Bank, a Geneva-based Islamic investment bank, is also expanding in the GCC by offering Swiss banking services and a growing range of Islamic investment products.

C. Islamic Indices

Dow Jones has constructed an Islamic Market Index with over 2700 well-traded and fully accessible stocks. The index includes the most liquid securities meeting *sharīʿa* investment criteria in the stock market. Other institutions have followed in the footsteps of Dow Jones. TII, along with FTSE International, has launched a Global Islamic Index Series that can be tracked by referring to major international providers of financial information. These indices will help Islamic investors benchmark the performance of their investments in the growing range of equity funds being offered to them. The constituent list also provides a pre-screened list of Islamically compliant equities. Recent returns for the Islamic versus conventional FTSE Global Indices are as follows:

	1998	1999
FTSE World Index	22.78%	25.57%
TII Global Islamic Index	23.56%	20.19%

The FTSE brand name is widely respected and followed. Plans to launch a tracker fund based on the FTSE Global Islamic Index are well advanced under the banner of a UK-based fund manager. The screening criteria involve the exclusion of non-Islamically acceptable sectors, gearing ratio screens, and the exclusion of companies whose income is influenced by interest or other non-Islamic industries by greater than 5%.

D. Islamic Funding through Securitization

Islamic banks and financial institutions have pioneered the concept of funding through securitization. The goal is to raise or obtain low-cost capital financing by the issue of debt instruments in the capital market. The debt is secured against the financed asset and covered by the receivable cash flow cycle of the borrower. The risk profile of the security is thereby isolated and assessed separately from that of the borrower.

Given the large demand for infrastructure funding projected over the next few years in different parts of the world, Islamic investors will logically want to become involved alongside the conventional market. Increasingly, retail investors will have to be accessed for such purposes when the conventional banking market reaches the limits of its capacity. The integration of *muḏāraba* and Islamic leasing into a structure through which infrastructure assets are acquired should present the most acceptable Islamic solution for securitization of these assets.

E. Islamic Accounting Standards

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1990 with the main objective of developing accounting and auditing procedures relevant to Islamic financial institutions. The AAOIFI has made significant headway in establishing standards. To this end, the AAOIFI has established a Standards Board, composed of renowned *sharīʿa* scholars, university professors, certified accountants, and users of the financial statements of Islamic institutions. The Board has introduced Twelve Accounting Standards to date, which very precisely cover disclosures and the presentation of Islamic financial activities. The Board is working to further enhance the transparency of financial statements.

The standards deal extensively with a range of issues such as the objectives of Islamic banking, definition of financial transactions, and the formulation of accounting policies. After adopting the AAOIFI's Financial Accounting Standards, the nature of Islamic banks' business activities will certainly become more transparent. This will enable depositors, investors, and analysts alike to enhance their knowledge and comprehend the institutions' underlying financial strengths. Standardization of accounting policies is important to Islamic financial institutions for the same reason it is to conventional ones: to facilitate meaningful comparisons and analyses of results. Outsiders, even those familiar with the concepts of Islamic financial accounting, may gain confidence in the standards of accounting and disclosure within Islamic banks' financial statements. It is likely and desirable that the standards become widely adopted as the industry norm. Perhaps this will gain impetus and acceptability with the backing of the central banks under whose jurisdictions Islamic financial institutions fall.

F. Supervision

Each Islamic financial institution is, at least theoretically, under the constant review of its *sharīʿa* board, which reviews the investment transactions of the institution and confirms that they comply with the *sharīʿa*. Furthermore, as mentioned, the AAOFI has introduced Islamic accounting standards on the basis of which qualified accountants may audit the accounts of each institution to prepare a report for shareholders. While there definitely is a trend toward enhanced and constant supervision of activities and thus toward greater transparency, more is needed.

Central bankers, lacking comprehensive knowledge of Islamic law and practices, fail to understand the operation of Islamic banks. As a result, Islamic financial institutions are left to operate without effective control from central banks. This may seem like freedom from government-imposed constraints, but it has been a bane—Islamic banks must operate without the protective cover that central banks provide. Increased involvement of central banks in Islamic finance is thus necessary; it will push the industry toward much-needed standardization, and will increase the transparency that customers and investors crave. It will also raise protections for Islamic finance. Increased central bank involvement is a win-win situation for all: customers, investors, and Islamic financial institutions alike. Government supervision, however, cannot come without efforts aimed at increasing central bankers' awareness of Islamic finance.

Though a trend is clear in which central banks are taking steps to bring Islamic financial institutions under their supervision, it is still to be determined how well these institutions can be regulated and supervised, since no comprehensive regulatory framework has been created. Although efforts must be made to devise comprehensive legislation on the matter, very few examples of regulatory frameworks that have been or are being introduced come to mind. Bahrain has an Islamic banking law under which all Islamic financial institutions are regulated. The Central Bank of Kuwait is currently attempting to pass a new Islamic banking law through the Kuwaiti parliament.

G. Liquidity Management

One problem faced by Islamic financial institutions is in liquidity management. This has arisen due to the unwillingness of central banks to extend borrowing privileges to Islamic banks. Retail banking operations in most cases thus run on self-imposed 100% reserve requirements. There has been much study and work in this direction to introduce an Islamic money market that could solve the problems of liquidity management in the long run.

Investors with savings and deposits accounts in Islamic banks would be sharing risk with the bank. It would therefore be inappropriate if a proportion of these deposits were placed with the central bank, which pay interest to conventional banks on deposits, while deposits from Islamic banks must be interest-free. Moreover, Islamic banks are not allowed to hold treasury bills or other interest-bearing government securities on their balance sheets. Until central banks develop instruments without the element of interest, the issues surrounding liquidity will continue to remain of major concern. Islamic banks are increasingly taking on more long-term exposure, while the maturity profile of their deposits is essentially short-term. A mismatch between assets and liabilities is thus imminent. A suitable treasury-type instrument that central banks can employ for the liquidity management of Islamic banks is needed.

IV. Conclusion

It is true that Islamic financial institutions have witnessed substantial growth in the past twenty years. However, it is clear from the developments and the issues raised above that the industry cannot rest on its laurels. It has not yet grown out of infancy, even though it has grown much. This has two implications. First, the potential for growth is still great; the future holds grand promises. As noted, the sector constitutes an arbitrage opportunity for investors who may realize enormous profits from their involvement. Second, the industry faces enormous challenges as well. Accounting standards are being set; they now need to be enforced. Regulatory frameworks have to be created. The possible mismatch of the term-structure of assets and liabilities was discussed. New opportunities will challenge the industry to take on new roles. For instance, private banking may be growing, but it dares the industry to strive for new levels of performance.

To face the challenges presented by the future and to achieve their promise, Islamic financial institutions must evolve. But in this task they cannot be alone. Increased government awareness of the working of the sector is much needed. Investors must continue to demand higher levels of sophistication in their investments. The scenario, it has been claimed here, is a win-win one. The active participation of Muslims in the global economy in a culturally satisfactory way rests on favorable outcomes in response to these challenges.

Developing the Country Framework for Islamic Finance

Iqbal Ahmad Khan[*]

ABSTRACT

A supporting framework and regulations are important in taking Islamic finance to the next stage of its evolution. The essential ingredients required for the success of an Islamic financial institution in both the OECD and OIC worlds are discussed at length. The framework required for the success of the various Islamic financial instruments, such as *murābaha̲*, *mushāraka*, *ijāra*, and *istis̱nāc*, are examined in detail. Gradualism and implementation of a *sharīca*-based system of corporate governance are advised in the discussion of the monetary, fiscal, and regulatory measures required to make Islamic finance successful.

I. INTRODUCTION

This paper explores the challenges of developing the country framework for Islamic finance. It reviews the cornerstones of the Islamic financial industry from both a historical perspective and a look at its current basic requirements. The process for the creation of a blueprint for the Islamic financial sector is reviewed and followed by an examination of the legal structures required for the success of the Islamic financial instruments. Specifically, the role of the central bank, a central *sharīca* advisory board, and the ethical values that bind this industry will be addressed, as will the erection of a framework for Islamic financial instruments that would broaden the base of products and instruments used in this growth industry.

When we look at the foundations of the Islamic financial industry, we find four major building blocks. The first and foremost are investors, both foreign and domestic. As is well known, investors have responded to this ethical, indigenous, and equitable form of finance with zeal and enthusiasm, and such verve has created and built this industry. The second foundation lies in investment and financing opportunities offered by issuers. This is slowly but surely coming into place. Initially we had desperate issuers, who turned to Islamic finance only if they could not get money anywhere else. Gradually, as Islamic institutions became more proactive in their transaction origination strategies, a good stream of quality issuers is coming to the market. In this regard, the partnership between conventional and Islamic financial institutions needs to be highlighted and commended for bringing together investors with good quality issuers.

Another integral element is competent and committed management. This is easier said than done. Gradually, enlightened owners of Islamic financial institutions are attracting competent management with strong performance incentives. The quality of the people drawn to this industry will eventually determine the sector's future. The final pillar of the Islamic financial industry is an enabling legal and regulatory environment. It is to this strategically important piece of groundwork to which this paper is chiefly devoted, with a view toward the possibilities of creating a country framework in the member countries of the IDB (Islamic Development Bank).

A bit of history first. The Islamic financial industry has come a long way since its humble beginnings in the early 1970s. We have seen Islamic financial markets gradually being opened up in most, if not all, of the major IDB member countries. The process has been evolutionary rather than revolutionary in most nations. This growth industry is gaining increased credibility and mainstream relevance as new financial institutions enter the Islamic financial marketplace. The achievements of Islamic finance are even more laudable due to the fact that they have been made in the absence of legislation or regulation friendly to Islamic finance. To take the field to the next stage of its evolution, an infrastructure of legality and an enabling macroeconomic framework are needed.

II. BASIC REQUIREMENTS

So what are the basic requirements to build these two elemental frameworks? First, an evolutionary rather than a sudden revolutionary approach should be taken in implementing Islamic banking systems in Muslim countries. A gradual, planned path toward the development of Islamic banking markets would go a long way in creating the credible foundations on which this industry can be based. This should begin with a clear-cut

[*] Managing Director and Head of Global Islamic Finance, HSBC Group, London, England.

recognition of the qualitative differences between Islamic financial institutions and their conventional counterparts. These differences should be recognized and acknowledged through legislation that creates the framework for the phased implementation of Islamic finance in IDB member countries. This clearly requires the political will and support of governments in Muslim countries.

On a collective basis, IDB members will have to come together to create an Islamic economic community, an Islamic common market. In this regard, the Islamic Development Bank, the lead bank to Islamic financial institutions, will play an important role in developing the necessary infrastructure for this growth industry. The "Islamic Dinar" would have to make a transition from being a translation currency to a currency with broad appeal and acceptability. Back at the country level, after the legislation has been put into place, there will be a need for a strong and independent judiciary to ensure the implementation of the macroeconomic framework for the Islamic financial industry.

III. At the Country Level

The need for legislation for the Islamic financial sector is acknowledged. Laws are needed that respect and enable Islamic finance to play the role it is destined to in Muslim countries. Furthermore, central banks in IDB member countries require Islamic banking divisions that are empowered to play an enabling role in the implementation of these laws. The heart of implementation of the envisioned blueprint is clear-cut guidelines on *sharīʿa*-related matters. This can be done through the creation of a central *sharīʿa* advisory board at the central bank level, as has been done commendably in Malaysia. Governments must create steering committees to show their commitment to the implementation of the blueprint for Islamic finance.

At the self-regulatory level, Islamic financial institutions will have to unite in each country and adopt the Islamic accounting and *sharīʿa* standards developed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). At the broader social and economic levels, there is a need for implementation of a *sharīʿa*-based system of corporate governance. This is more difficult in practice than in theory: it takes time to create a culture of *sharīʿa*-based corporate governance and independent rating agencies that are knowledgeable about Islamic financial instruments and the intricacies of managing Islamic financial institutions. The regulators, the *sharīʿa* advisory boards, and the accounting standards boards would all have to come together in order to create a framework for individual Islamic instruments. Each of these instruments needs to be studied so an enabling framework can be created for them. Strengthening the self-regulatory organizations in IDB member countries would let them play a pivotal role in the promotion of Islamic finance.

Once the enabling framework is in place, there will be a need for research and development, which includes an Islamic information databank for each country as well as at a global level (as has been done by HIFIP). This could create a database describing the products and instruments available in the industry. Islamic financial institutions worldwide could benchmark each others' best practices and compare themselves to counterparts within and outside their nations. Eventually, we may see a migration of the best practices of Islamic financial institutions across IDB member countries.

IV. Creation of the Framework

Several specific areas are implicated in the creation of this prototype country framework for Islamic finance in IDB members. First, as mentioned, is the legal setup for the sector. Legislation must be enacted that recognizes Islamic finance and supports Islamic financial institutions and instruments. This legislation should define the parameters for the sector. We need to adapt the legal, taxation, and accounting systems of Muslim countries in order to make them friendlier to Islamic finance. This should lead the way for the launch of a complete range of Islamic financial institutions, Islamic investment banks, Islamic insurance companies, Islamic leasing companies, pension funds, brokerage houses, etc.

At the micro level, each institution will have to ensure that its articles of incorporation, memoranda, and articles of association reflect Islamic financial principles and are duly recognized by the company law of the country. There should be a phased introduction of *sharīʿa* law and a focused implementation of ESOPs (employee savings and ownership plans). The heart of the implementation of this strategy is an independent, vibrant, and dynamic central bank in each IDB member country. These central banks will be responsible for regulation of all aspects of Islamic financial institutions, with the strategic objective of a staggered implementation of Islamic financial systems. The central bank requires a high-powered task force focusing on broadening the number of players and instruments in the market. This in turn would encourage the development of interbank markets and contribute to the formulation of regulatory standards for the Islamic financial sector. The central bank through its special Islamic regulatory arm should also work with the AAOIFI to devise accounting standards appropriate to Islamic financial instruments and institutions.

Within these guidelines, Islamic financial institutions would work on prudent liquidity management techniques that are *sharīʿa* compatible. They would cooperate with the finance ministries of their respective nations to create Islamic instruments based on asset-backed lease participation certificates, which could replace interest-bearing treasury bills and government bonds. The task force would also review the capital adequacy and risk weighting regulations for Islamic financial instruments. Collectively, the central banking institutions in IDB member countries would have to educate the Basle Committee of the Bank for International Settlements (BIS) and other OECD central banking regulators to enable the creation of an international framework for Islamic finance.

At the heart of the growth of Islamic finance is a commitment to authentic *sharīʿa* principles. There is a need in each member country of the IDB to create a Central *Sharīʿa* Advisory Board (CSAB). The CSAB would serve as the focal point for *sharīʿa* matters concerning Islamic products, instruments, and services. The CSAB would approve and authorize all Islamic products and services currently practiced, as well as any new products developed by the industry. The CSAB would also oversee the function of the Islamic banking division of the central bank. A *Sharīʿa* Audit Division would be established and would report to the CSAB. The Audit Division would monitor the sector to ensure continued compliance with the *sharīʿa*. It is critical that the CSAB inculcate a culture of self-regulation within the Islamic financial industry and within each Islamic financial institution to foster a strong sense of commitment to *sharīʿa* values. This could be achieved through a code of ethics adopted by each Islamic financial institution, self-certification by all practitioners of *sharīʿa* principles, and *sharīʿa* allegiance statements to be signed by practitioners within the Islamic financial industry.

The special steering committee, to be created in each of the IDB member countries, should comprise bankers, accountants, lawyers, and central bankers as well as Islamic financial professionals and scholars. The Committee's strategic objective would be to map the particular country's strategy and oversee the development of the Islamic financial sector. The implementation of a *sharīʿa*-based system of corporate governance is of strategic significance for the creation of the country framework, as it would create the value framework to serve as the foundation for the Islamic financial sector. A *sharīʿa*-based system of corporate governance would promote a culture based on *taqwa* (moral transparency). Promoting good governance in all respects includes a commitment to ensure the rule of law, checks and balances among the branches of government, improving efficiency and accountability of the public sector, and above all combating corruption. This corporate governance system would ensure values such as fairness and social responsibility and play an important role in shaping the future of Islamic finance.

At the firm level, we need a framework for each Islamic financial instrument. Historically, each Muslim country has developed a framework over a period of time that bears no relevance to individual Islamic financial instruments. Therefore, in the markets of many IDB members, Islamic financial instruments suffer from a competitive disadvantage when competing alongside conventional financial instruments. The disadvantages range from a double stamp duty on *ijāra* transactions to a value-added tax on *murābaḫa* transactions. Some of these disadvantages are making Islamic finance more expensive and thereby forcing issuers to prefer conventional financial options. Thus each central bank, working with the Islamic banking sector, should create the accounting, legal, capital adequacy, and taxation framework for Islamic financial instruments. This would eventually provide the sector with a level playing field and allow it to show its competitive advantage. In this regard, the guidelines for the AAOIFI should be reviewed and implemented at the level of each nation. Once the IDB member countries, individually and collectively, create a blueprint for the Islamic financial sector and have an enabling legal structure, a committed central bank, a dynamic CSAB, and a framework for Islamic financial instruments, the range of products and instruments available in Islamic financial markets will broaden.

The governments in individual member countries can and should play a greater role in issuing Islamic financial instruments. After all, as sovereign states they represent the highest quality issuers in their respective nations. Central banks should ensure that their money-market investments and foreign exchange reserves are in line with *sharīʿa*-compatible asset-backed products, in both domestic and international markets. This would bring a pool of liquidity to the market. With an enabling framework in place, the introduction of new instruments would clearly highlight the benefits of the Islamic financial system and consequently let conventional banks use Islamic financial instruments more comprehensively. Individual governments could issue asset-backed *sharīʿa*-based instruments, both in local and in foreign currencies. Similarly, public-sector entities and municipalities could issue *sharīʿa*-compatible paper. This would encourage multinational firms and leading corporations in IDB member countries to come to the market with good quality commercial paper for investments and the many instruments of Islamic finance. Collectively, this could lead the way toward the establishment of an international and liquid capital market for Islamic financial institutions.

V. CONCLUSION

Different Muslim countries are at different stages of implementing the legislation enabling Islamic finance. Once a comprehensive legal structure for the Islamic financial sector and Islamic financial instruments is in place, the support of both a dynamic and committed central bank and a consensus-driven Central *Sharīʿa* Advisory Board at the international level would provide the foundation to take Islamic finance to the next stage of its evolution. It would lead to the creation of the ethical values and standards of a *sharīʿa*-based governance framework, and in turn allow the launch of a range of new products and instruments for the growing market for Islamic finance. While the challenges of globalization and increased competition would remain, the sector would be better prepared to face them.

Designing Islamic Contracts for Financing Infrastructure Development

Mohammed Obaidullah*

ABSTRACT

The present paper undertakes an Islamic evaluation of the system of infrastructure contracting. The maxim "*al-kharāj bi al-ḏamān*" underlies all forms of financial contracting in Islamic jurisprudence. It requires that benefits (returns) and liabilities (risk) go together, and while it appears simple and straightforward, the required link may not be explicit in composite financial structures used in infrastructure development. In the context of such structures, with a multitude of risk factors and parties involved, identification of *gharar* and its reduction assumes greater importance. Islamic law also requires parity between the risk borne by a party and the reward it deserves: this is a crucial issue for overall system efficiency. History has shown that the success of infrastructure development programs largely depends on the extent to which risks and rewards are shared equitably between the parties. This paper therefore discusses these issues and suggests specific *sharīʿa*-compliant mechanisms that ensure an efficient and ethical allocation, mitigation, and management of risk and that may be used in designing infrastructure contracts.

I. INTRODUCTION

Infrastructure financing is a desirable investment product for Islamic financial institutions. It is in line with the mission of Islamic banking and finance. Investments in highways, airports, power generation and distribution, telecommunication networks, oil and gas pipelines etc. in developing Muslim economies is believed to accelerate the process of economic development, as well as create value and wealth in these societies. Such desirable outcomes are directly in contrast to those of the Islamic equity funds, which generally involve an outflow of capital from these resource-starved economies into the developed ones.

The last decade has witnessed a surge in private financing of infrastructure development creating major opportunities for Islamic banks and financial institutions. Private participation has received approval and encouragement from policy makers all over the globe, largely because of a reduced capital and investment demands on the governments for provision of goods and services. This has been a major reason why many developed and developing nations unable to mobilize the required resources through taxation, borrowing and other means have sought private participation in the development process. Some other benefits flowing from private participation in infrastructure as compared to government provision may be: (i) quicker planning and implementation of privately designed and developed projects, since there is an incentive to generate revenues as early as possible, (ii) lower project costs because of a quicker schedule in an inflationary environment, (iii) greater efficiency in responding to the demands of the market because of availability of price signals leading to introduction of innovative products and services and (iv) economies of scale, scope, experience and benefits of diversification with involvement of multinational companies in the process.

Private financing of infrastructure also raises some concerns. Public-private partnerships substitute government investments in infrastructure with private capital; these also replace taxation with privately collected user fees or other forms of remuneration to pay for use in infrastructure. It is also possible that privatized projects may ultimately involve higher project cost because of tendering costs, higher private financing costs, and of course, the profits for various private parties. There is also the possibility of imperfect project selection because, the private parties would be more interested in financial profitability rather than economic profitability and tend to ignore various externalities and intangible effects of the investment alternatives. The projects may involve costs in the form of environmental degradation, which is not properly accounted for in financial profitability estimates. The projects may also involve a disproportionate incidence on the poor or the disadvantaged. For instance, an individual living near and hence, being forced to use, a private-financed highway may feel genuinely discriminated against when roads in other parts of the locality not frequented by him may continue to be free for public use. Another major cause for concern is related to monopoly behavior of the private parties. The large initial outlays involved in

* Associate Professor of Finance, Xavier Institute of Management, Bhubaneswar, India.

infrastructure projects combined with low marginal costs associated with operation of the facility create ideal conditions for monopolistic tendencies to emerge with all their undesirable consequences. Obviously, some cost factors have potential ethical consequences, and hence are of legitimate concern to Muslims. Though there is generally a consensus among scholars regarding the permissibility of the basic idea of "private" participation in the process of infrastructure development, a comparison of the macro-level benefits and costs needs to be undertaken in the *fiqhī* framework of *Maslahah Mursalah* before a particular project is found acceptable. Of course, the contractual mechanism used to achieve the same must conform to the established principles of Islamic law and be free from *ribā*, *gharar*, *maysir*, *darar*, and the like

An increasing number of infrastructure projects all over the globe are being established on a Build-Operate-Transfer (BOT) structure. Under this model a government or government entity enters an agreement with a private sector company under which the company agrees to finance, design and build a facility at its own cost, and is given a concession, usually for a fixed period to operate that facility and collect revenues from its operation before transferring the facility back to the government at the end of the concession period. There are a number of variants of the BOT, such as Build-Own-Operate (BOO) with no eventual transfer to the government, Build-Transfer-Operate (BTO), Build-Own-Lease-Transfer (BOLT), and a range of such other structures. The difference between these structures primarily relates to the allocation of risk and rewards among various parties involved in the process. History has shown that the success of such programs largely depends on the extent to which risk and rewards are shared equitably between the parties.[1] The association between risk and reward is also central to Islamic finance. The maxim "*al-kharāj bi al-ḏamān*" underlies all forms of financial contracting in Islamic jurisprudence. The maxim, in simple terms, requires that benefits (returns) and liabilities (risk) go together. A party in a financial contract is entitled to returns only if it bears risk.[2] Islamic law also requires a parity between risk borne by a party and the reward it is entitled to,[3] though this issue seems to have attracted lesser attention of scholars of Islamic jurisprudence and is much less explicit in the existing literature on Islamic financial contracting. The same is, however, extremely crucial from the standpoint of overall system efficiency. Arguably, the required link between risk and return may not be easily intelligible and explicit in the above composite structures used in infrastructure finance. Such structures often incorporate a large number of elements that need to be combined and integrated and require an extensive network of interrelated and often inter-conditional contracts.

In the present paper, we seek to examine each component of the popular BOT structure for the possible presence of *ribā*, *gharar*, and other unethical elements and explore ways to avoid the same. For instance, in the presence of *gharar*, Islamic scholars have suggested various ways to reduce such excessive uncertainty (such as, through embedded options) and bring it down to acceptable levels. In the context of composite financial structures, with multitude of risk factors and parties involved in the process, identification of elements of *gharar* and its reduction to permissible levels assumes great importance. There is a pressing need, therefore for a proper appreciation of risk factors and their allocation among various parties, and the use of various risk-mitigating strategies. This should enable the Islamic banks to model the composite financial structures as Islamic modes of financing.

The scope of the paper is limited to privatized initiative in infrastructure and does not cover projects that are developed either entirely in public sector or fall within the ambit of *awqāf*. The rest of the paper is organized as follows. Section 2 subjects the popular conventional structures and their various components to tests of the *sharīᶜa*, and identifies some *sharīᶜa*-based parallel forms of contracting. It reveals various contractual choices available in the Islamic framework for the purpose of infrastructure financing. Section 3 seeks to highlight some agency problems that would arise under the identified Islamic structures and suggests some ways to overcome them. Section 4 examines how various risk factors may be shared between the parties under these contractual mechanisms. It also discusses certain risk-mitigating strategies and tools of risk management with are in line with Islamic rationality and which might reduce *gharar* to permissible levels. Section 5 provides a summary and conclusion.

II. The Contractual Choices

Islam provides a basic freedom to enter into contracts. However, this freedom is not unrestrained and all systems of contracting must not violate the various norms of Islamic ethics. Below, we subject each element or agreement forming part of the popular BOT structure to the test of the *sharīᶜa*. Wherever these do not clearly fit into the category of classical *sharīᶜa*-nominate contracts, we attempt to identify the *sharīᶜa*-based alternatives that serve the purpose.

In general terms, under the BOT structure, a government or government entity enters an agreement with a private sector company under which the company agrees to finance, design and build a facility at its own cost, and is given a concession, usually for a fixed period, to operate that facility and collect tolls or other revenues from its operation before transferring the facility back to the government at the end of the concession period. The intention is that the company is to receive sufficient revenues during the operational phase to service its debt incurred in designing and building the facility, to cover its working capital and maintenance costs, to repay its equity investors, and, hopefully, also provide a reasonable profit for its investors.

BOT structures involve multiple parties, and a multitude of risk factors.

Government: The government grants the concession for the construction and operation of the facility. This is achieved through enabling legislation specific to the project in question. The government is expected to monitor the progress and operation of the project. Since the government would resume possession and operation of the facility after the expiry of the fixed concession period, it seeks to ensure that the quality of the facility is such that the facility has a long usable life with low maintenance costs.

Project Company: The project company is usually a single purpose company and is the grantee of the concession. It is responsible for securing finance, procuring the design and construction of the project, the operation of the project during the concession period and the eventual transfer back to government. The project company is also responsible for servicing debt incurred in the implementation of the project.

Investors: There are generally two types of investors in the project company. One type is project sponsors whose participation in the project is not restricted to their role as investor, such as, a construction company that intends to undertake or participate in the construction of the project, an operating company that intends to operate the completed project, a bank providing debt for the project, and the host government. The second type are long-term investors whose only interest in the project is as an investment and who will often take little role in the management of the project company. Such investors are normally institutional investors or other long-term investors.

Lenders: The lenders usually comprise banks and certain other financial institutions that are empowered to lend money or extend credit under relevant legislation. Project loans are usually on a non-recourse or limited recourse basis. There are certain special considerations for the lenders financing BOT, as opposed to other, more conventional, projects. BOT projects have a complex risk profile due to several factors including the length of the term of the loan, the susceptibility to political and economic risk, the low market value of the security package and the limitations on enforcing security.

Contractor: The main contractor for the project is often also the principal sponsor of the project. One of the greatest elements of risk in a BOT project is completion risk and lenders will often wish to place this risk on the project sponsors, e.g. by completion guarantees. Where the contractor is the principal sponsor, the project company normally passes on these risks to the contractor through time, cost and quality warranties to be given by the contractor to the project company and with the project lenders taking assignments of the benefit of these warranties.

Consultants: A wide variety of consultants will be involved in BOT projects including financial consultants, engineers and technical consultants, insurance advisers and legal advisers. Merchant banks acting as financial advisers play a large part in structuring BOT projects. In a BOT project, independent technical consultants are often employed to monitor the works. Often the independent consultants will be employed by the project company but will owe their primary duties to the government.

Operator: Where the operation of the privatized facility is complex, it is preferable to sub-contract the work to an operator with previous experience in the particular area of operations. The government, lenders, and investors may prefer the operator to be one of the project sponsors and to be committed as a shareholder to the project for a certain minimum time period. Alternatively, the project company may itself undertake the operation of the facility.

Users: Users supply the revenue for the project and in the case of bridges, tunnels and highways are often the toll-paying public. Where the facility has a product, e.g. a power station, the users may be the host government, utility companies, or other product purchasers. In these cases, off-take agreements are often negotiated as an essential element of the contractual structure of the overall project. These off-take agreements will often be on a "take-and-pay" or "take-or-pay" basis.

Given this background, we now turn to various *sharīᶜa*-based contractual choices that may be designed for the various parties in various phases of the project. Prior to that, it is pertinent to note here that the various agreements and contracts or components of the financial structure need to be independent (though these may be executed in parallel fashion) in spite of their interrelated nature in order to avoid the possibility of *gharar*. A well-known principle of *fiqh* asserts that there cannot be two contracts within one. With multiple interdependent contracts forming part of one contract, the possibility that the rights and obligations of the parties to the contract would not be honored in future greatly increases, since default in one component of the structure may lead to defaults in others.

A. Designing the Concession Agreement

This is an agreement between the government authority and a project company. This is the cornerstone of the structure as it effectively gives the project company the right to carry out the project. Various parties that come together to form the project company may include the project sponsors, such as, the contractor or construction company, the operation or utility company, banks as lenders, the host government and also other long-term investors.

The initial transfer of land rights in favor of the project company followed by the eventual transfer of the facility back to the government on a future date without any consideration or fee does not seem to have a parallel in *sharīʿa*-nominate contracts. One possibility is to model the initial transfer as a gift (*heba*) contract in favor of the project company by the government. The reverse transfer on a future date however is problematic, as a gift (*heba*) contract on a future date may not admissible in Islamic law. A possibility of revoking the initial contract is also ruled out subsequent to the development of the land and creation of the facility. Thus a build-operate-transfer (BOT) structure does not seem to be *sharīʿa*-compatible if modeled as a gift (*heba*) contract. It may be noted here that a concession for a build-own-operate (BOO) structure or full-scale privatization perfectly fits into this framework. A gift (*heba*) contract may be conditional and in this sense, the initial transfer of land in favor of the project company, subject to the condition that it would develop the facility in a desired manner seems to be *sharīʿa*-compatible.[4]

The partnership between the government and the private parties with the provision that the government (or the state company having a degree of autonomy from government) ultimately becomes the sole owner of the project, may indeed be modeled as a diminishing *mushāraka* (*mushāraka yantahi bi al tamlik*) contract between the parties. The project company formed as a diminishing *mushāraka* would imply that the stake of the private parties in the project declines over time to zero, ultimately leading to full ownership by the government. The government as the partner would also legitimately enjoy its discretion to exercise varying degrees of control as specified in the partnership contract. The outcome under this arrangement would be similar to that under the build-operate-transfer (BOT) structures though the process of achieving the same is different. Under diminishing *mushāraka*, profits and losses are shared according to the *mushāraka* principle, that is, profit are shared according to a mutually agreed ratio while losses are shared using the participation ratio of both parties in the capital. Further, a proportion of profits accruing to the government is kept in an escrow account. As soon as the value of this account becomes equal to the value of the private partners' capital contribution in the project, payment from this account is made to the private parties and the government becomes the sole owner of the project.

The two crucial variables in this structure which would be determined after taking into consideration the project risk factors, revenue growth, expected return, investment time horizon of the financier etc., are the profit-sharing ratio and the ratio of profits accruing to the government that would be transferred to the escrow account. The others dimensions of this structure are given without any element of uncertainty

It may be noted he that the concept of diminishing *mushāraka* is not a classical *sharīʿa*-based contract. It is an excellent example of Islamic financial engineering. Like many other products of financial engineering or innovation, this too is not free from divergence of views. The major objections from some scholars relate to the *sharīʿa* basis of forward commitments involved in the contract and when the *mushāraka* contract is seen to containing several contracts of forward sale.[5] However, the diminishing *mushāraka* contract may also be viewed as containing a promise by a party (as a condition) to sell a part of its ownership on a future deal. This is generally considered to be binding on the promisor(s).[6] At the same time the counterparty is not making any promise to purchase as a condition to the contract. Thus, there is in fact an option to purchase for the counterparty, which may or may not be exercised.

Another alternative model for the project company could be a special purpose *muḏāraba* with limited liability of the partners and the private parties agreeing to gradually reduce their stake in favor of the government. The advantage in case of a *muḏāraba* as compared to a *mushāraka* structure is in the limited liability of the parties involved in it. The various private parties that may come together to from the *muḏāraba* include the project sponsors as *muḏārib*, such as, the construction company, the government, the operating or utility company, and the parties that are entrusted with managerial or monitoring responsibilities. Long-term investors who are non-sponsors may be part of the *muḏāraba* as *rabb al-māl*.

B. Designing the Construction and Related Agreements

The second element of a build-operate-transfer (BOT) structure is the construction contract between the project company and the construction company. This is generally in the form of a comprehensive turnkey contract, which provides for the project to be handed over and to be ready for immediate operation. Some variations are also possible when the project company is directly and partially involved in the creation of the facility. The project company may enter into an equipment supply agreement(s) with suppliers(s). In order to finance these activities, the project accompany would also enter into credit agreement with the bank(s). The construction company may also enter into direct credit agreement with the banks(s). Since the credit agreements in the conventional structure would involve *ribā*-based loans, alternative financing arrangements may be sought in the Islamic framework. The financing mechanisms that are already being used or have good potential are *bay^c-istis̲nā^c*, *bay^c bithaman ajil*, *ijāra*, and *bay^c-salam*.

An Islamic bank may act as an intermediary between the project company and the construction company or the supplier(s) as the case may be. The bank may undertake financing of the entire or a component of the project by selling the facility or equipment to the project company in need of financing through *istis̲nā^c* or *bay^c bithaman ajil.* The project company may now make payments to the bank on a deferred basis. Prior to this, the Islamic bank would purchase the facility or the equipment from the construction company or the supplier as the case may be. Since the facility or equipment would be of a specialized nature, the Islamic bank may have to make progressive or advance payments to the construction company or the supplier under *istis̲nā^c* or *salam* as the case may be. The Islamic bank may also act as a lessor to the project company and supply the facility or equipment under *ijāra*, acquired from the construction company or the supplier. The bank may also opt for variations of *ijāra* such as, *ijāra wa iktina* or *ijāra thummal bay^c*, which allows the lessee to purchase the facility at the end of the lease period. It is also possible that the construction company may be in need of financing in which case an Islamic bank may provide finance in the same manner as described above. Indeed, various alternative financing structures are possible with combinations of the above contracts because of the fact that various parties involved in the process: the project company, the construction company, the supplier, the operating or utility company, and the Islamic financiers may not be different entities and may also act as agents of each other.

In the recent example of PUTRA LRT II project in Malaysia, Islamic banks are providing financing during the construction phase in the following manner. The Islamic financiers would purchase the original contract(s) to supply goods and services to the project company from the supplier(s), and agree to the subsequent sale of the goods arising from this contract to the project company at a fixed profit markup.[7]

Another structure involving *ijāra* was used in the famous Hub River Power Project in Pakistan. In an *ijāra* between the project company as the lessee and the Islamic financier as the lessor, the former acted as an agent of the latter and entered into a purchase contract with the supplier of an equipment. On satisfactory delivery of the equipment to the lessee, the lessor would make payment of the purchase price and other expenses directly to the supplier. Thereafter the lease contract would be activated and have a definite maturity period at the end of which the lessor would make a gift of the leased equipment to the lessee.[8] It may be noted here that if the *heba* (gift) contract is an independent contract, then forward commitment involved may be problematic as cited earlier. It the *heba* (gift) is part of the *ijāra* (lease) contract then the situation is similar to the case of *ijāra thummal bay^c* (hire-purchase) with two contracts being executed within one contract. The combination of two contracts is believed to be a source of *gharar*. However, the above structure has been found acceptable by some scholars apparently on the ground that there is hardly any uncertainty about the parties' ability to deliver and settle the transaction in future, since the asset is already in the possession of the lessee.

C. Designing the Operating and Related Agreements

In cases where the operating and maintenance is to be undertaken by the project company there is no need for this agreement. But where it is to be undertaken by a utility or operating company having specialized competence, a separate agreement for the operating and maintenance of the facility is needed. After the construction phase is over, the status of the project company as discussed above may be that of an owner or of a lessee with a purchase option. The project company may enter into a contract of *joala* with the utility company under which the former purchases from the latter for a predetermined fee or commission a service relating to maintenance and collection of tolls and other user fees. The commission may be in the form of an absolute amount or a ratio of the revenues.[9]

Another alternative could be that the project company enters another *ijāra* agreement with the operating or utility company for a time period, perhaps matching with the time till the full ownership of the facility by the government is effected. With the *ijāra* contract the project company transfers all the rights of collection of revenues in the form of tolls or others user fees in favor of the lessee, that is, the utility company in lieu of the rental payment in future. It may be noted here that a narrow definition of *ijāra* implies using an object without reducing its substance or consuming its usufruct only. In this sense, only *ijāra* of specific equipment would be permissible, but not of entire facility. Nor would it be permissible to sell the unrealized tolls and user fees for a price because of the condition of *gharar* (uncertainty).

A solution to these problems may be found by drawing a parallel between the above situation and the contract of *ḏamān* prevalent in Damascus during the seventh century of Hijrah and discussed extensively in the writings of Ibn Taymiyyah. Being construed as a combination of *musaqat* (partnership in fruit-trees) and *ijāra* (rent) this contract provides the letting of ground including the different fruit-trees growing on it in return for a fixed amount as a rent. Whereas the contract of *musaqat* belongs to the category of *mushāraka* in which the contracting parties, that is to say, both the landowner (*rabb al-ᶜard*) and the *amil*, who irrigated the fruit-trees, get a stipulated percentage of the crop, *ijāra*, is regard as a kind of sale in which the renter has to pay a fixed amount. The case of *ḏamān* was extensively debated amongst the jurists. The *ḏamān* contract took place when A, the owner of an orchard, wanted to sell the fruits altogether to B, although the fruits were not yet ripe. Obviously, this practice is unlawful and one of the solutions is the contract of *ḏamān*. Thus, Ibn Taymiyyah suggested to A to let his ground with fruit trees to B for a fixed amount, so that B himself can irrigate the trees and gather the fruits, when they had ripened. Ibn Taymiyyah attempted to refute the existing narrow interpretation of *ijāra* as using a thing without reducing its substance, by drawing extensive legal inferences from the tests. He asserted that the contract for *ijāra* includes the consumption of at least parts of the object.[10]

Given this background, one may perhaps discern a possibility that the owner of a project or facility or the project company may enter into the contract of *ijāra* with the operating company. The project company would receive predetermined rentals and hand over the facility to the operating company. The latter would be responsible for maintenance and collection of revenues generated by the facility, which may again be shared between both the parties in an agreed manner. The Islamic acceptability of this arrangement of course, needs further debate, discussion, and *ijtihad* by Islamic scholars.

In projects such as gas and electricity generation, the structure may be very different from what has been outlined above. In gas and electricity generation projects, the generation process is continuous and the producer is also entrusted with the operation and the maintenance of the facility. Further, since spot or retail market sales of the output in these projects are ruled out, there is a need for long-term off-take or purchase agreements between the power producer and the project company. The distribution of electricity and gas is entrusted to the utility company, which may enter into the off-take agreement with the producer as an agent of the project company. If this agreement were modeled as *bayᶜ-istiṣnāᶜ* or *bayᶜ-salam*, this would require prior determination of the price, quantity and the specification of output to be purchased by the utility company. However, if the agreement is modeled as *bayᶜ-istijrar*, there is scope for greater flexibility. The flexibility relates to timing of payments. Unlike *salam*, payments can now be made in the beginning of the contracting period or any time thereafter. It allows for contracting with a definite or a normal price in the market. It also admits the possibility of stipulating options for either or both parties to the contract. This flexibility is understandable in view of the fact that under *istijrar*, by definition, purchases are to be made from a single producer.[11]

III. Issues in Design: Agency Problems and Their Resolution

As stated earlier, various contracts forming part of a financial structure must be independent (though these may be executed in parallel fashion) in spite of their interrelated nature in order to avoid the possibility of *gharar*. It is a well-known principle of *fiqh* that there cannot be two contracts within one. The underlying rationale seems to be that, with multiple interdependent contracts forming part of one contract, the possibility that the rights and obligations of the parties to the contract would not be honored in future greatly increases, since default in one component of the structure may lead to defaults in others. However, it must be recognized that even if the contracts are made independent of each other, the contractual structure referred to above can result in considerable conflicts between the various interests of a particular party within the structure. Often this is referred to as a party wearing "two or more hats." It is important in formulating the structure and in negotiating the parties' overall aims to constantly bear in mind these conflicting interests. Below, we highlight some such possibilities and explore ways of resolving the same. Such conflicts of interest arise primarily with the project sponsors whose participation in the project is not restricted to their role as investors and who may play a major role in the management of the project company that may follow a *mushāraka* or *muḏāraba* structure.

A. The Construction Company as a Project Sponsor

The classic conflict of interest under this BOT model is the majority shareholder in the project company who is also to be the main contractor for the project appointed under the construction documentation. Accordingly, this party's ultimate interest in participating in the project is not necessarily the same as the interest of certain other project sponsors or shareholders, especially the long-term investors.

For example, this party would wish to receive monies from the project as early as possible and the easiest method of achieving this is to obtain a lucrative *istiṣnāc* contract. Payments under this *istiṣnāc* contract would usually be on a periodic or staged basis and will be made during the course of the construction phase. In contrast, a long-term equity investor in the project company will only obtain payments from the project through declarations of dividends, which will not be made until such time as the project has been built and is generating a reasonable return.

Whilst the long-term investors would appreciate that the contractor must obtain reasonable payments under the construction contract to ensure that the project is actually built on time, their obvious concern is that these payments should not be overly generous, as the sums paid are part of the overall development cost of the project which the shareholders are financing through their injection of funds into the project company.

The directors on the board of the project company representing these minority shareholders would therefore want to ensure that the directors representing this majority shareholder do not take advantage of their position to ensure a more favorable deal is made for the contractor with the project company.

There are several agency problems that arise here. For example, whether the project company is modeled as a *muḏāraba* or *mushāraka*, a *muḏārib* or a member of the board of directors owes a fiduciary duty to act in the best interests of the project company. The directors appointed by this majority (contractor) shareholder should therefore act in the project company's best interests when they make decisions in their capacity as directors on the board of the project company. However, having said that, it is often extremely difficult to prove a breach of this type of fiduciary duty by these directors in making decisions to favor the actual company which has appointed them to the board and with whom they are usually in full-time employment. Examples of conflicts that could arise would be the directors of the project company contemplating legal action against the main contractor on the construction documentation, or considering how best to defend or negotiate claims made by the contractor against the project company.

The preferred mechanism for dealing with these particular conflicts lies in the shareholders' agreement regulating the internal affairs of the project sponsors in the project company. It would not be incompatible with a *muḏāraba* or *mushāraka* structure, for example, to stipulate that certain decisions would require the consent of not only the majority shareholders, but also all, or at least a higher percentage of the board of directors. The same situation applies to decisions to be taken by the project sponsors in their capacity as shareholders in the company. Such items may include the following non-exhaustive list: any proposed amendments or variations to the construction documentation, the bringing of any claim or the commencement or settlement of any litigation, arbitration or claim (whether or not above a certain monetary amount). Indeed, if such a claim is contemplated by or against the project company against or by any shareholder, such a shareholder or any director appointed by it may well be disenfranchised by the terms of the shareholders' agreement from voting in determining whether such a claim should be brought, or the terms of settlement thereof, the approval of entry by the project company into a contract with a subsidiary or associate company of any shareholder.

B. The Operating Company as a Project Sponsor

A utility company will obviously want to have as favorable an operating agreement as possible between it as operator and the project company and may again try to use its shareholding in or representation on the board of directors of the project company to obtain such a favorable agreement. Again, the *muḏāraba* or *mushāraka* underlying the project company may stipulate that approval by the board of directors of the project company of the terms of the operating agreement will require directors, other than those appointed by the operating company, to vote in its favor. Alternatively, the directors appointed by the operating company may be disenfranchised from voting on this issue.

C. An Islamic Financier as a Project Sponsor

An Islamic bank that provides debt facility to the project company through *bayc-bithman-ajil*, or *murābaẖa*, or *ijāra*, or *istiṣnāc*, may also be a project sponsor or investor in the project company. It is usually a condition in the loan documentation that no dividends to shareholders be paid out by the project company without the prior approval of the banks providing debt capital to the project company. In such case, there is firstly a conflict of interest in a bank's own internal position should it be both a shareholder in the project company, as well as a member of the syndicate of banks providing debt finance to the project company.

The bank, in its capacity as an investor in the project company, would, like the other investors, want as much dividend as possible to be paid out at as early a stage as possible. However, the bank in its capacity as a debt-provider to the project company would, as a general rule, require the repayments of the installments, or at least would have to be satisfied that forthcoming payments of installments can be made, before it would approve the payment out of any dividend by the project company.

D. Financial Adviser to the Project Company as Arranger of the Syndicated Finance

The project company may appoint an Islamic investment bank as its financial adviser on how to structure and finance the overall project. This investment bank would negotiate on behalf of the project company, with other Islamic banks, leasing companies etc. to provide third party finance to the project company for the project. It may not itself, however, participate in the provision of third party syndicated finance. This may be the preferred situation as it mitigates a possible conflict of interest in that the investment bank would only have the interests of its client (the project company) in mind in negotiating the financial terms. Another view is that this bank as financial adviser, in negotiating and putting together the finance package, and in having perhaps the best overview of the project in total, should itself take up a portion of the third party finance.

The above is by no means an exhaustive list of the potential agency problems and conflicts of interest. The presence of a large number of parties in the financial structures with many parties performing multiple roles is certain to raise many moral and ethical problems. These potential areas of conflict of interest need more exhaustive investigation and must be minimized through appropriate stipulations in the *mud̲āraba* and *mushāraka* structures used for the purpose.

IV. Issues in Design: Risk Allocation and Management

Major infrastructure projects are characterized by big risks. Below, we outline the risk factors related to construction and operation of the project. We also highlight some risk factors that arise because of a specific contractual mechanism being used. We discuss how these risk factors are managed and shared between various parties under alternative financial structures—both conventional and Islamic.

A conventional BOT project may be regarded as a high-risk construction project followed by a low-risk utility project. The various parties among which these risk factors are allocated include the government, the project company, the banks and financial institutions, multilateral credit agencies, the construction company, the operating company, insurance companies, and equipment and other suppliers. The project company is generally seen as a mere pass-through mechanism of both risk and return to the sponsors and non-sponsoring equity providers. In general, in a conventional structure, the market risk factors are borne by the sponsors, which includes the project and operating companies, the government, and the project lenders. The construction and the operating companies bear most construction and operation related risk respectively. Risk of *force majeure* is transferred to insurance companies. The non-sponsoring equity providers bear the residual risk. The major difference between a conventional and Islamic structure is that while conventional lenders are exposed to risk of default only, the Islamic financiers are supposed to share risk in a more significant way.

A. Construction-related Risks

Risk factors during the design, construction and commissioning of the project include, *inter alia*, the unexpected and adverse topographic and geotechnical conditions, weather conditions and labor relations that may adversely affect the project budget and schedule adherence, risk in application and absorption of a new technology resulting in construction and operational defects, cost overruns due to increase in financing costs and/or increase in prices of inputs during inflation (these are in practice the major risks), environmental damage, and *force majeure* events. These risk factors may lead to either delays and defaults in construction of the facility, or non-conformity of the facility to the desired specifications. These risks are often allocated to the construction company, as the project company would like to enter into fixed price, fixed time, and turnkey construction contracts. This is not always achieved, as some costs and timing risks are not borne by the construction company. The risks of environmental damage and *force majeure* events are borne by the party causing the damage or the insurance company. As highlighted earlier, in the Islamic contractual structures, the construction phase of project may be financed through *bay^c-istis̲nā^c*, *bay^c bithaman ajil*, and *ijāra*. There is a need therefore to examine the allocation of the risk factors among various parties under these alternative mechanisms.

Considering the case of *istis̲nā^c* first, as discussed earlier, a contract between the Islamic bank as the seller and the project company as the buyer will provide for the manufacturing or construction of the facility or equipment(s) conforming to the specifications required by the latter and the delivery thereof within the stipulated time for an agreed price to be paid by the latter, normally on deferred basis.

The Islamic bank will then enter into another *istis̲nā^c* contract as a buyer with the manufacturer or the construction company to purchase the same facility or equipment(s) which is the subject of the first contract and then deliver them to the Islamic bank within a stipulated time that will coincide with the time for the delivery under the first contract, for a price which is less than the price under the first contract by a margin that represents the return to the Islamic bank under the first contract.

The price under the second contract will normally be paid in a manner that is commensurate with the progress of works under the contract. The manufacturer or construction company under the second contract will deliver the facility or equipment(s) to the Islamic bank which would in turn deliver them to the project company, or directly to the project company on the orders of the Islamic bank. If the manufacturer or construction company fails to deliver the facility or equipment(s) as per specifications, the Islamic bank would equally be in default of its obligations under the first contract.

A pertinent issue here is whether the *istis̲nāᶜ* contract is binding on both parties from its inception or not. In other words, does the contract oblige the seller to manufacture and deliver the goods and oblige the buyer to take delivery of the goods and pay the price if the goods are manufactured in conformity with the specifications? The predominant view among the classical jurists is that the contract is revocable by either party at any time. In conventional parlance, both the parties, the Islamic bank as the seller and the project company as the buyer (or the construction company as the seller and the Islamic bank as the buyer) have an option withdraw from their commitments. While the option does provide flexibility to either party and may be of value, it also implies great risk for the counterparty.

Fortunately, the contemporary view in this regard, is that the *istis̲nāᶜ* contract is binding on both parties from the moment the contract is concluded by offer and acceptance. Either party will be in breach of his obligations if it fails to perform its part of the bargain. The only situation in which the buyer can revoke the contract is where the seller delivers goods that do not conform to the specifications.[12] Thus, in the first contract between the project company as the buyer and the Islamic bank as the seller, the latter bears the construction completion and commissioning risks. These are passed on to the construction company in the second contract between the Islamic bank as the buyer and the construction company as the seller.

A possible variation in the *istis̲nāᶜ* contract between the Islamic bank and the project company, in addition to providing for the manufacturing of the facility or equipment(s) conforming to the specifications within a certain time for an agreed price, may also provide that the project company agrees to take delivery from the construction company. It may also to provide that the project company agrees to supervise (through a consultant or other expert) the execution of the contract with the construction company in a manner that will ensure that no progress payment under the contract will be effected unless the project company's consultant certified that the work for which payment is sought has been carried out in conformity with the contract and that the issuing by the project company's consultant of the final payment certificate under the contract with the construction company will *ipso facto* operate as acceptance of the goods under the first contract. This arrangement has the advantage of ensuring that no progress payment will be made unless the project company is satisfied that the execution of the work is progressing satisfactorily in conformity with its specifications. Consequently, if all progress payments are released only on the certification of the project company's consultant, it will be extremely unlikely that the project company would reject the facility on the ground of its non-conformity to the specifications. This also implies that all risks arising out of non-conformity of the facility to specifications remain with the manufacturer or the construction company alone and the risk to the Islamic bank is reduced to minimum.[13]

In addition to the above, there is also a risk that the manufacturer or construction company may delay or default in adhering to schedules. Except due to *force majeure* events, this may be caused by a variety of factors, as stated earlier, including the insolvency or bankruptcy of the construction company. Under the conventional structures their risks are managed through security on assets refundment bonds, performance guarantees, and liquidated damages. The scope for use of such tools also exists in the context of an *istis̲nāᶜ* contract.

The most effective means of reducing risk due to insolvency of the manufacturer or the construction company is to undertake a rigorous examination of the financial standing, technical and administrative capability of a company before its selection as the contractor or the construction company. Even then bankruptcy risk cannot obviously be reduced to zero, and hence there is need of some risk management tools. One alternative for the Islamic bank would be to take a mortgage of or a charge on the parts of assets that have been created or over all the assets of the manufactures though this may not be very effective since the process is likely to be cumbersome and time consuming. And if the charge is on the incomplete assets, then sale of these assets in the secondary market is not likely to cover the progress payments made by the bank. Another alternative could be to take a refundment bond or performance bond or a bank guarantee. Unlike a security that could be enforced only in the event of the liquidation of the construction company, a refundment bond guarantee could be made cashable in all cases where there is a failure to deliver the facility as per specifications. Where the construction of the assets is being done on the land of the buyer as in the case of a building a power station or a toll road it may be sufficient for the Islamic bank to require a performance bond and retention money.

The time-related risks or the possibility of losses due to delays on the part of the construction company may be minimized by obliging it to pay liquidated damages for this delay. As per the OIC Fiqh Academy's resolutions, the imposition of a penalty clause for the payment of liquidated damages is acceptable in the Islamic framework. The possibility of damages to the assets during the construction phase due to factors, such as vandalism, acts of war, employee theft, accidents may be insured against and the risks may be shared through *takāful* or mutual Islamic insurance. Under the agreement the construction company may be required to seek insurance against specific risk factors from a *takāful* company and assign the proceeds to these policies in favor of the Islamic Bank.

Another alternative contractual mechanism used for financing the construction phase is *bay^c bithaman ajil* under which an Islamic bank purchases a facility or equipment(s) as required and specified by the project company from the construction company or the manufacturer and sells the same to the project company at a higher price on a deferred basis. Similarly it may also extend direct financing to the construction company through *bay^c bithaman ajil* under which it purchases supplies and sells the same to the construction company at a higher price on a deferred basis. The process involves a risk that subsequent to purchase by the Islamic bank from the original supplier, it may not be in the interest of the client any longer to buy the same from the bank. While according to some scholars the promise by the bank's client to purchase is binding and the bank may demand compensation based on the actual loss suffered, this is not free from controversy. The compensation is paid from *hamish gedyyah*, an amount that is paid with the purchase order to the Islamic bank by the client to ensure that the latter is serious about purchase. If the actual loss exceeds *hamish gedyyah* then the bank would have recourse to the client for the excess.[14] The management of the above risk is also possible in the *khiyar al-shart* framework under which the Islamic bank may retain an option for itself at the time of purchase from the original supplier. Subsequently, if the client buys the same as promised the option would automatically expire and the earlier contract would become binding. However, if the client fails to honor its commitment, then the Islamic bank would be in a position to exercise its option and rescind the purchase contract. This option enables the Islamic bank to shift the above risk to its original supplier. It is also quite realistic that the Islamic bank may have to forgo a part of its profits since the original supplier may charge a higher price in case of the sale with option as compared to a sale without option. This is ethically justifiable since, the original supplier is now exposed to greater risk, and also Islamically valid as long as price is inclusive of the compensation for risk.

A third alternative for financing the construction phase is *ijāra*. It seems to be a popular mode of financing with Islamic banks for financing acquisition of long-term assets, such as land, building, plant and machinery by the construction company and/or the project company. The Islamic bank may either purchase or get an asset as specified by the client on *ijāra* from the original supplier and enter into a second contract of *ijāra* with its client. As in case of *bay^c bithaman ajil*, this involves a risk that the client may not honor its commitment to enter into the second contract after the asset has been acquired by the bank for onward *ijāra*. *Ijāra* transaction also admits of stipulation of options and hence the risk may be managed in a similar manner in the *khiyar al-shart* framework. Another issue of considerable significance in *ijāra* relates to sharing of risk relating to wear and tear, or to partial or total destruction of the object of lease. Since the lessor is the owner of the asset it is supposed to bear the above risk even in a long-term *ijāra* (often with a purchase option resulting in ultimate transfer of ownership in favor of the client) except when the loss is due to misuse or negligence on the part of the lessee. The above risk may be mitigated by the bank seeking a *takāful* cover and including the cost of the cover in the *ijāra* rentals. According to some scholars, this risk may also be mitigated by making the lessee specifically liable for damages, theft, loss, or destruction of assets except in the case of *force majeure*.[15] The risk of delays and defaults by the lessee may be mitigated by the Islamic bank seeking advance rentals as a security deposit against these risks.[16]

B. Operations-related Risks

As discussed earlier, after the construction phase is over the project company may either enter into a contract of *joala* or an *ijāra* with the operator or the utility company. When the contract is *joala* for an absolute fee, the risk of revenue fluctuation is borne by the project company and the operators or the utility company receives a reward which is known and unaffected by the risk factors. When the contract is *joala* for a proportionate share in revenues the project company and the utility company jointly share the risk of revenue fluctuation. Under *ijāra* the risk is further magnified due to use of leverage and borne by the operator of utility company.

Ijāra implies higher leverage for the lessee-operator and increases its financial risk. If the leverage is already too high (as in case of the aviation industry for example), the lessee-operator may be reluctant to increase its financial risk further. An alternative may be to link the *ijāra* rentals to the actual utilization of the object of leasing, (say, flying hours in case of an aircraft *ijāra*). However, this arrangement also exposes the lessor-project company to greater risk, as its revenues in the form of *ijāra* rentals would now be susceptible to the business risk of the operator. Stipulations of *khiyar al-shart* can offer various possibilities of risk sharing between the lessor and the lessee. The lessor-project company may for instance, stipulate that rentals would be linked to actual utilization (flying hours) of the object of *ijāra* (aircraft) subject to a minimum utilization. In other words, if the actual utilization falls below a lower bound, it would have an option to rescind the contract. A similar option may also be provided for the operator-lessee.

Other risk factors relevant during the operation phase may be the risk of insolvency of the operator, risk of incurring liabilities in a litigious society, fluctuations in revenues caused by service interruptions due to accidents, weather conditions, equipment failure, natural disasters etc. Here too, as discussed in the context of construction-related risks, the risk for the parties may be mitigated, transferred or shared through the mechanism of liquidated damages, specific stipulations in *ijāra* agreements or passed on to the *takāful* company.

Risk due to fluctuations in revenues is at times passed on to sponsoring governments. The governments may provide a guarantee for growth in traffic and consequently in revenues and any shortfall may be met by the government. This is very much in line with the framework of *kafāla*. Such guarantees provided by the sponsoring governments usually involve a trade-off between quantity guaranteed and price.

C. Financial and Other Risks

Financial risk factors relevant in infrastructure finance may be in the nature of risks due to inflation, interest rate changes and currency rate changes. Inflation poses a risk when it results in an increase in the cost of the project: an increase in recurring costs without a corresponding increase in revenues. Interest rate increases are also caused by inflation to the extent the same is anticipated by the market and adversely affect the bottom line by increasing the financing costs. To the extent that markups and *ijāra* rates are influenced by interest rates, Islamic financing is vulnerable to interest rate risk. Below we discuss how inflation and interest rate risk may be managed in *ijāra* transactions both in the construction and operation phases of the project.

A major source of risk for Islamic banks as lessors and their clients as lessees is due to the fixed nature of the rentals. In a dynamic economy, rates of returns undergo continuous shifts. If in future the rates of returns were expected to increase driving the cost of funds for the lessor, then the Islamic banks would be clearly at a disadvantage. Similarly if rates were expected to fall, the lessee would be reluctant to go for a fixed commitment of lease rentals. A fixed rent *ijāra* can of course be converted into a floating rate *ijāra* by entering into several short-term parallel fixed rent *ijāra* contracts. To consider a simple two-period case, let us assume that the Islamic bank expects the rentals to increase from ‘x’ percent during current period to ‘x+y’ percent during the next period. Instead of committing itself for an *ijāra* with two-period maturity at the current ‘x’ percent and be exposed to risk of loss, it may opt for two one-period *ijāra* contracts: the first for *ijāra* at ‘x’ percent beginning from now but with a maturity of one period only; and the second beginning from one period hence through the second period at ‘x+y’ percent, The forward commitment to lease involved in such contracting is permissible.[17]

However, in such an arrangement the issue is only partially resolved since the bank would still have to specify the rental (as per its expectations at ‘x+y’ percent). What if the rates turn out to be different from ‘x+y’ percent? Another problem could be due to the fact that the expectations of the lessee may be diametrically opposite to that of the lessor (i.e. if the lessee expects rates to go down in the second period) in which case, no contracting is perhaps feasible. A possible solution can however be found in the framework of *khiyar al-shart*. Both the Islamic bank as lessor and its client as lessee may enter into the contract for the second period and stipulate option for either or both of them. The bank may stipulate that if the rate increases beyond ‘x’ percent or any other definite upper bound, it would have an option to confirm or rescind the contract. Similarly the lessee may stipulate that if the rate decreases beyond ‘x’ percent or any other definite lower bound it would have the option. They can stipulate according to the risk they are willing to bear and the way they decide to share risk.

It may be noted that conventional floating rate leases take care of this problem by linking the rentals to a benchmark index such as the LIBOR. The rentals for future are made dependent on the future level of the interest rates as captured in LIBOR. For Islamic scholars not comfortable with use of a benchmark interest rate, such as LIBOR, this may be substituted with another Islamic benchmark rate, such as, the Consumer Price Index. There is however considerable divergence of opinion on this possibility, as many Islamic scholars do not seem to be in favor of leaving the rental unknown on grounds of *gharar*.

From the above it follows that under *ijāra* there are possibilities of mitigating and managing inflation risk by making the lease rentals variable and perhaps linking the same to some macro economic index. When the contract involves *bay^c*, is there any possibility of making the price and returns vary with dynamic changes in the economy? This is obviously not possible in *bay^c-salam* or pure *bay^c* unless forward contracting is made acceptable or some flexibility is accorded regarding fixation of the contractual price in future. Fortunately, such flexibility exists when purchases are made from a single producer, such as, when the utility company purchases gas or electricity from the producer, or when the final consumers buy goods and services from the single utility company.

The agreement would now be governed by the rules of *bay^c-istijārar*. *Bay^c-istijrar* permits fixation of price at a normal level over a time period and also allows for payment of price at the end of the time period. *Istijrar* also admits the possibility of options in the *khiyar al-shart* framework. With such flexibility, a host of risk management possibilities with alternative contractual mechanisms emerge. To cite an example, one specific contract may contain options for both the buyer and seller that are activated if the market price pierces an upper or lower bound respectively, during a definite rime period. The option provides a right to a party to fix the sale price at the average of the market prices prevailing during the financing period. Note that average of market price reflects the "normal price." If the options do not get activated or are not exercised, then the price is settled at the predetermined contractual price. Both the client-firm and the bank agree on a public undisputed source of price information and also a sampling interval for observing prices. The average price is calculated from there observations.[18]

In a contract between the power producer and the utility in a Power Purchase Agreement, the producer which is likely to be adversely affected with inflation may retain an option for itself (it is also possible to make it conditional upon extreme movements, that is, the option would get activated only when inflation rate exceeds a certain rate) to fix the price at a "normal" level as against the level initially set by the contract. *Bay^c-istijrar*, unlike *bay^c-salam*, by admitting the possibility that the settlement price may differ from the contractual price (*thaman*), thus opens up a number of possibilities through which risks can be shared and managed by the parties.

Another important risk arises out of exchange rate fluctuations. In infrastructure projects in particular, requiring massive investments, the large blocks of capital are often not available within the borders of the country where construction is taking place. International capital flows are frequent because of involvement of parties from multiple countries. In the Islamic framework with its emphasis on spot settlement of transactions, the problems of currency risk largely remains to be addressed. Some Islamic scholars have favored the idea of deferred settlement from one end, which can address the issue in a limited way. The conventional mechanisms of options, futures, and swaps are generally not found to be acceptable on various grounds. Some banks use Islamic swaps to reduce currency risk though complete transfer of risk is not possible under this arrangement.[19] In project finance one acceptable alternative seems to be a guaranteed exchange rate from the host government regarding conversion of inflows and outflows relating to the project. This voluntary bearing of currency risk on the part of the government which has been practiced in the Hub river Project in Pakistan, is quite sound in the framework of *kafāla*.

Liquidity risk is another significant risk factor that may affect the development of infrastructure projects. In view of the fact that such projects require massive investments committed for the long term and that investors in Islamic banks typically have a short time horizon, imparting liquidity to investments assumes great significance. In the absence of liquidity Islamic banks would be constrained to remain out of infrastructure financing to avoid an asset-liability mismatch. Securitization has been suggested as mechanism to impart liquidity to investments in infrastructure and to ensure participation of the average investors in the process. For example, this process may involve a sale of the facility owned by the project company to a special purpose vehicle (SPV) created for this specific purpose and taking it back on lease, The predetermined stream of lease rentals expected to flow to the SPV may now be securitized. The SPV would issue securities entitling the holders a pro rata share in the rental income. The process involving sale and lease back is known as *bay^c-istighlal*, a variant of *bay^c-bil-wafa* and is free from any controversy.[20] The PUTRA LRT II project follows a similar mechanism of securitization. The securities created may also involve a pro rata share in revenues. Such possibilities of sharing revenues exist, as discussed earlier, with contracts of *ḏamān* and *joala*. Other forms of securitization, such as involving *bay^c-bithman-ajil* and *istiṉā^c* receivables are also being practiced and found acceptable in the Islamic framework. There are however few other dimensions of such securitization process, such as sale of receivables or debt (*bay^c al-dayn*) in the secondary market at price lower that the nominal value of the debt, and repurchase (*bay^c al einah*) of assets, which have generated a lot of controversy and divergence of opinion regarding their acceptability. These are rejected primarily on the ground of opening up the doors of *ribā*.

V. CONCLUSION

Islamic finance has a lot to offer for developing the infrastructure sector, specifically in the developing Muslim societies. It provides an ethical alternative while retaining all the advantages of conventional finance. It is demonstrated in this paper how the conventional and popular BOT structure may be modeled and used Islamic contracts. The paper also highlights some agency problems that must be kept in mind while designing an Islamic structure. As it is shown, some of the problems can be easily tackled within the Islamic contractual framework.

Privatized initiative in the infrastructure sector may bring in certain advantages. The benefits expected from privatization are also associated with risk factors. These risks may however be mitigated by suitable government initiative. There is nothing inherently un-Islamic about privatized initiative in infrastructure development and a realistic cost-benefit comparison must be undertaken in the framework of *masalahah mursalaha* for each such project before a decision is taken regarding their permissibility.

Infrastructure projects are characterized by substantial risks. These risk factors must be properly allocated, shared, and managed if privatized initiative in infrastructure development is to succeed. The contractual structure of infrastructure financing is often quite complex incorporating a large number of elements which need to be combined and integrated and require an extensive network of interrelated and often inter-conditional contracts. Various contracts that form part of the structures and lead to risk allocation among the parties include: the concession agreement, the construction agreement, the operations agreement, the credit agreement, the shareholders' agreement, the offtake agreement, the tariff agreement, the agreements relating to insurance, guarantees, and derivatives for managing currency risk. The paper identifies some *sharīᶜa*-based contractual structures that would result in allocation of risk among the parties concerned but in an Islamically acceptable manner that is free from *ribā* and *gharar*. The concession agreement that underlies the formation of the project company may be modeled as diminishing *mushāraka* or *muḏāraba. Bayᶜ-istisnāᶜ*, *bayᶜ-bithman-ajil*, *ijāra* are found to be useful mechanisms during the construction phase. The operations phase may involve use of *ijāra*, *joala*, *ḏamān*, and *bayᶜ-istijrar* contracts. Various risk management tools involving the framework of *kafāla*, *takāful*, *khiyar al-shart* may be used to facilitate risk sharing and management among various parties. Islamic securitization offers solutions to problems of liquidity and asset-liability mismatch for Islamic banks participating in the financing process.

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[1] Kopp, John Christopher. Private Capital for Public Works: Designing the Next Generation Franchise for Public-Private Partnerships in Transportation Infrastructure. Unpublished Thesis, Department of Civil Engineering. Evanston: Northwestern University, 1997. p. 4.

[2] Two articles in Majalla underscore this: Article 85 (The benefit of a thing is a return for the liability for loss from that thing); and Article 86 (Payment of hire and indemnity for loss do not go together). See Majallahel-Ahkam-I-Adliya. Trans. C.R. Tyser. Lahore: Law Publishing Company, n.d.

[3] Article 88 of Majalla asserts that the burden is in proportion to the benefit and the benefit in proportion to the burden. However, existing literature on Islamic financial contracting deals with the risk-return relationship in a broad sense and does not necessarily require risk-return parity. This is because it supposedly deals with permissible contracts, which are not necessarily optimal, though the importance of the latter is hardly ruled out. For example, *murābaḫa* transactions, though permissible, may contain an element of exploitation. The markup rate in some cases appears high compared to the minimal risk borne by the financiers. The issue of parity is left to be handled under externally imposed constraints, such as the abolition of monopolistic tendencies in a market. Islamic markets are competitive markets; competition would ensure parity between risk and return.

[4] See Articles 854, 856, 869, and 855 respectively of the Majallahel-Ahkam-I-Adilyya.

[5] Bendjilali and Khan (1995) describe the unresolved *sharīᶜa* issues as follows in the case of a diminishing *mushāraka* between the bank as a financier (with a declining stake) and the entrepreneur: "The *sharīᶜa* problem, as discussed by the expert, revolves around the fact that the diminishing *mushāraka* contract contains a sale provision. The financier agrees to sell certain part of its ownership share every year to the entrepreneur. To some scholars this agreement, even if it may merely be a promise, implies that a sale contract has effected, i.e. the bank has sold its ownership; what then entitles the financier for his claim on the profits of the enterprise? Second, if a sale contract has effected, what is the exact amount of the price and what is the exact description of the object of sale? In the absence of the two, a sale provision of the diminishing *mushāraka* contract becomes null and void. Third, it is unjust to make the entrepreneur binding to purchase something in future. Similarly, it is unjust to fix tomorrow's price today." See Bendjilali, Boualem and Tariqullah Khan. "Economics of Diminishing *Mushāraka*." Islamic Research and Training Institute, Research Paper No. 31. Jeddah: Islamic Development Bank, 1995. p. 18.

[6] Article 84 of Majalla asserts, "Promises when they take a conditional form are binding." See Majhallahel-Ahkam-I-Adliya

[7] The PUTRA Light Rail Transport System II Project in Malaysia involves the design, construction, operation, and maintenance of the Light Rail Transport System II for the city of Kuala Lumpur and the undertaking of ancillary services as defined by the concession agreement between the government of Malaysia and Projek Usahasama Taransit Ringan Automatik Sdn, Bhd, (PUTRA). The project is being financed through several sources, conventional and Islamic. The Islamic tranche is being co-financed by Bank Islam Malaysia Bhd, Commerce International Merchant Bankers Bhd, and Commerce MGI Sdn Bhd. For details, see Hamdan, Mohd. Bintang. "The PUTRA LTR II Project: A Case Study on *Al-Ijāra* Financing." Paper presented at the International Capital Market Conference. Kuala Lumpur, Malaysia, July 15-16, 1997.

[8] Khan, Mansoor H. "Designing an Islamic Model for Project Finance." International Financial Law Review (June 1997). p. 14.

[9] Cizakca, Murat. "Islamic Project Financing Conference: A Personal Observation." New Horizon (May 1997). p. 6.

[10] Baker, Mohamed Daud. "Al-Suyulah: The Islamic Concept of Liquidity." Paper presented at the International Capital Market Conference. Kuala Lumpur, Malaysia, July 15-16, 1997. pp. 7-9.

[11] Umar, Mohammad Abdul Halim. "*Sharīᶜa*, Economic, and Accounting Framework of *Bayᶜ al-Salam* in the Light of Contemporary Application." Islamic Research and Training Institute, Research Paper No. 33. Jeddah: Islamic Development Bank, 1995. p. 62.

[12] The OIC *Fiqh* Academy examined the contract of *istiṣnāᶜ* in its Seventh Session and resolved (Resolution No. 67/3/7), "*Istiṣnāᶜ*, which is a contract the subject matter of which are the goods identified by description and the provision of services, is binding on both parties if the constituent conditions and terms are satisfied." Further, "It is necessary for the validity of *istiṣnāᶜ* that the nature, quality, quantity, and description of the thing to be manufactured are known and that a time is fixed for manufacturing the goods. It is permissible in a contract of *istiṣnāᶜ* to defer the price or pay it in installments within a fixed time period. It is permissible to include in a contract of *istiṣnāᶜ* a penalty clause, if the parties so agree, save for cases of force majeure."

[13] Hamid, Mohammed El-Fatih. "*Istiṣnāᶜ*: Classical Concept in a Modern Framework." New Horizon (February 1997). pp. 3-7.

[14] Accounting and Auditing Standards for Islamic Financial Institutions. Manama: Accounting and Auditing Organization for Islamic Financial Institutions, 1996. p. 142.

[15] Hussain, Syed Mohammed. "Leasing" and "Lease-based Investments." Papers presented at the World Islamic Banking Finance and Investments Summit. Kuala Lumpur, Malaysia, September 23-24, 1996.

[16] Kamil, Wan Abdul Rahim. "Financing through *Al-Ijāra*." Paper presented at the International Capital Market Conference. Kuala Lumpur, Malaysia, July 15-16, 1997.

[17] See Article 440 of the Majallahel-Ahkam-I-Adliya.

[18] For a detailed discussion on *istijrar* with options, see Obaidullah, Mohammed. "Financial Engineering with Islamic Options." Islamic Economic Studies 6(1).

[19] For a more in-depth discussion of currency-risk management, see Obaidullah, Mohammed. "Contracting in Currency Markets: An Islamic Evaluation." Journal of King Abdulaziz University. (forthcoming).

[20] See Articles 118 and 119 of the Majallahel-Ahkam-I-Adliya.

Islamic Banks

Technology and Global Challenges and Opportunities

Abdullah Sulaiman Al Rajhi*

ABSTRACT

Islamic banks that are growing quickly have achieved a prominent status in the banking industry today, but still have to accelerate their efforts to meet the technology and global challenges that they are likely to face. It is fitting for Islamic banks to focus their developments not only on retail banking but also on diversifying their banking and financial products. They must search out longer-term investment products such as Islamic equity instruments, bonds, and leases to meet Islamic investors' needs and the long-term financing needs of customers. Conventional banks have recently introduced an increasing number of Islamic products. This reflects growing customer demand for these products and reveals a spirit of cooperation between conventional and Islamic banks. While such cooperation needs to be further cultivated and strengthened, it would at the same time impose competitive pressure on Islamic banks, which would be one of its major challenges.

I. INTRODUCTION

In 15 years, the Islamic banking market has grown to approximately $100 billion. This market is growing today at between 10% to 15% a year. Our projections suggest that the demand for Islamic financial services will continue to grow in the next 10 years.

During this period major improvement occurred in the business practices of Islamic banks both in the quality of provided service and investment activities. It is evident to economists and bankers that these banks were able to achieve a prominent status among international banks. This achievement should prompt Islamic banks to accelerate their efforts for the development and improvement and the observation standards of quality in response to the dynamic, rapidly evolving investment and finance environment. Islamic banks should thus consider certain approaches to meet the global and technological challenges of the future in order to benefit from the substantial opportunities that exist there for them.

II. ISLAMIC BANKS AND INTERNATIONAL FINANCIAL MARKET TRENDS

In the past, Islamic banking appeared to concentrate on retail banking, to meet the immediate needs of retail customers seeking an alternative to conventional banking. Over time, however, Islamic investors and customers grew more sophisticated and looked for Islamic financial instruments.

It is fitting that Islamic banks develop not only on retail banking but also diversify their banking and financial products into the areas of wholesale and investment. The challenge here is the lack of Islamic instruments in the market. Cooperation and coordination among *sharīʿa* authorities and Islamic bankers should thus be strengthened and a common scientific base for collective cooperation (*ijtihad*) established in order to develop Islamic banking products and investment instruments and the Islamization of instruments used in the international financial markets. For instance, Islamic banks will need to acquire and develop the necessary investment banking and fund management skills. They will also need to search out longer term investment projects such as Islamic equity, bonds and leases to achieve the Islamic investors' liquidity needs and the longer-term financing needs of borrowers.

Recently, conventional banks have introduced an increasing number of Islamic products. This is, of course, due to the increasing demand for these products. Some conventional banks find it profitable to deal with Islamic investment funds such as asset-leasing funds and share-dealing funds. This trend supports our view that we will see continuing expansion and growth in the relationship between Islamic and conventional banks.

In addition, some conventional banks are trying to improve the management of these funds so as to compete with the Islamic banks here. Islamic banks should benefit from this by using the experience of these

* Director and General Manager, Al Rajhi Banking and Investment Corporation, Riyadh, Saudi Arabia.

conventional banks. This can be achieved through the exchange of expertise between conventional and Islamic banks.

Finally it must be stressed that Islamic and conventional banks should move from competition to cooperation. This will lead to a healthy environment that is in the interest of their customers and shareholders. The Islamic and the conventional banks will expand their Islamic activities and have much to offer to each other in the exchange of skills and knowledge and in identifying joint ventures and shared opportunities for syndication.

III. Islamic Banks and Globalization

Though globalization ranks high on the list of overused words in the banking business, it is an important trend that requires preparation. Globalization is associated with growing interconnections among financial institutions, facilitated largely by advances in communications and computer technology. Capital moves across national borders primarily as investment flows and secondarily as international trade financing.

The increasing volume of financial transactions and their decreasing costs have put strong competitive pressures on institutions to change the ways in which they operate. Automation of trading includes a number of innovations that have improved the efficiency of financial transactions.

Islamic banks, in order to survive and develop, must cope with these developments. There are many challenges that are imposed by globalization on the banking industry, some of which relate to institutional capacity for self-development in methods and organizations and in providing banking and financial services that can compete and survive. Technology is another challenge. Islamic banks are competing in a highly developed technological market that utilizes a wide range of sophisticated banking products. The problem is not only in the adoption of technology but in the preparation of a suitable environment that will enable them to utilize the technology in order to compete effectively.

Finally, globalization also imposes a challenge on the *sharīᶜa* authorities in Islamic banks in the issuing of *fatāwā* required in the rapidly evolving international financial markets.

IV. Cooperation between Islamic Banks and International Banking and Development Organizations

There are great opportunities for Islamic banks to play an important role in financing development projects in the private and public sectors in the developing countries in cooperation with development organizations such as the World Bank, Islamic Development Bank, IMF, and IFC, especially in situations where these organizations need to develop specific Islamic financial instruments for selected development projects. A good example is the IFC's experience with Islamic funds and leasing instruments in project financing through *muḏāraba* for private sector projects in Pakistan and the Middle East. The IFC's successful experience illustrates the fact that there is great potential for the accessibility and employment of Islamic instruments by international organizations to finance private or public projects. The participation of IFC and other international organizations (WB, IDB, and IMF) will also serve to boost confidence in Islamic products.

Islamic Convertible Bonds

An Alternative to Bay[c] al-'Inah *and Discounted* Bay[c] al-Dayn *Islamic Bonds for the Global Islamic Capital Market*

Saiful Azhar Rosly[*] and Mohd. Azmi Omar[†]

Abstract

This paper provides a critical overview of Islamic debt securities in Malaysia and ways to make them more attractive to global Islamic funds. Doing so involves an attempt to design an Islamic convertible bond (ICOB), which is a hybrid of *al-qard*, *al-wadiah*, *kafāla*, and *muḏāraba* contracts. *Sharīᶜa* issues on equity kickers or warrants and call option of the convertible/exchangeable bond will be explained. Advantages of an ICOB include its smaller denominations and therefore salability to the Islamic unit trust sector and individual investors. It is also attractive to small- and medium-scale industry. Muslim venture capitalists will find ICOBs a suitable alternative to loan stocks and convertible loan stocks. Being equity substitutes, ICOBs will be more affected by company fundamentals than by macroeconomic factors such as interest-rate movements and inflation, and they will suffer from speculative tendencies less than straight bonds and common stocks. ICOBs should widen the application of Islamic bonds by the backbone of Malaysia's manufacturing sector.

I. Introduction

This paper begins with the assumption that Malaysia has difficulty in attracting Islamic capital inflows due to the nature of Islamic bonds issued by Malaysian companies. Since 1992, the Rating Agency of Malaysia (RAM) and Malaysian Rating Agency Corporation (MRAC) have both rated 20 Islamic private debt securities (IPDS) issued in Malaysia. RAM undertook most of the rating exercises amounting to 8 issues while the newly formed MRAC rated the remaining two. In principle, most of these bonds are issued and traded on the basis of *bay[c] al-'inah* and discounted *bay[c] al-dayn*.[1] Others, such as Khazanah zero-coupon and promissory notes have also incorporated *bay[c] al-'inah* and *bay[c] al-dayn* as the basis of trading both for liquidity and closing position upon maturity.[2] But both *bay[c] al 'inah* and *bay[c] al-dayn* are not acceptable to the majority of Middle Eastern jurists. Only the Shafie school of thought leaves a loophole into allowing *bay[c] al-inah* since the *niyya* or intention does not matter in determining the validity of a contract. But the same does not hold among the Hanafi, Hanbali, and Maliki jurists who still hold *niyya* as an essential element to a valid contract.

This paper will see attempt to design of a new Islamic financial instrument known as the Islamic convertible bond (ICOB) in which the elements of *bay[c] al-inah* and discounted *bay[c] al-dayn* are absent. It will apply the contracts of *Al-Wadiah*, *kafāla*, and *Al-Qirad* in three distinct and separate places to ensure that the attachment of sweeteners such as call option is observed within *sharīᶜa* guidelines

II. Three Main Steps for Islamic Bond Issuance

To further understand the role of *bay[c] al-inah* and *bay[c] al-dayn* in an Islamic bond market, it is worthy to look at the three main steps involved in the bond issues, namely:[3]

1. Securitization – The creation of the *bay[c] al-'inah* assets
2. Bond issues – Issuance of debt certificate – *Shahdah al-dayn*
3. Trading of debt certificates – sale and purchase of debt certificates in the secondary market via the contract of *bay[c] al-dayn*.

[*] Associate Professor, Department of Economics, International Islamic University Malaysia (IIUM), Kuala Lumpur, Malaysia.

[†] Dean, Kulliyyah of Economics and Management Science and Assistant Professor of Business Administration, IIUM.

A. Step 1: The Creation of a *Bay[c] al-'Inah* Underlying Asset

Asset securitization is the essence of Islam bond issues as a bond must assume the role of *al-māl* or property to qualify as an object of sale (*mahallul 'aqdi*). An object of sale in the Islamic law of contract must be a property of value. When a bond certificate is supported by an asset (as evidenced in the securitization process), it is transformed into an object of value and therefore as claimed, qualifies to become an object of trade whereby it can be purchased and sold in both the primary and secondary market. Investors then will have to the right to sell (*haqq māli*) these bonds. In the *bay[c] al-'inah* asset securitization, the financier purchases an asset from the issuer and sells it back to the same party at a credit price. This purchase-back agreement will ensure that the issuer will receive the money in cash while financier will be paid a prefixed or contracted amount in a future date. Debt payments will be made by installment through bond issues. The principle capital will be paid in bullet or lump sum at maturity date while the profits are paid once or twice a year. The difference between cash and credit price will represent the profit due to the financier.

The underlying asset is therefore crucial in determining the Islamic acceptability of these bonds as claimed. In the Malaysian experience these assets include factories, equipment, stock and inventory and even intangible asset such as a list including building and properties.[4] Some are given in Table 1.

TABLE 1. SELECTED ISLAMIC DEBT SECURITIES (IPDS) IN MALAYSIA: UNDERLYING ASSETS

Issuer	Instrument	Underlying Asset
Hicom Holdings Bhd	Guaranteed *Murābaha* Notes Issuance Facility	Mixture of *halāl* shares (including unquoted shares)
Amanah International Finance Sdn Bhd	Guaranteed *Murābaha* Notes Issuance Facility	A list including buildings and properties
KFC Holdings	*Al-bay[c]-bithaman ajil* Islamic debt securities	Restaurants, breeder, farm, and hatchery
Petronas Dagangan Bhd	Redeemable Islamic debt securities	Gas processing line and pipeline

Source: Rating Agency Malaysia, 1998

The first stage is critical because it is where the yield or simple the rate of return is determined. The purchase-back arrangement using a deferred sale approach will show that the yield is a fixed one since there the contract specifies only one selling price.

B. Step 2: Issuance of Islamic Debt Certificates (*shahdah al-dayn*)

This usually takes place in the primary market where in settling its debt, the issuing company will sell debt certificates or bonds to investors. As mention above, debt certificates issues is valid only when an asset supports it. In other words, the bonds must be securitized. Here the underlying security is the BBA or *murābaha* asset. The underlying asset need not be BBA or *murābaha* alone. If the first stage involves a contract of *ijāra*, then the debt certificate is called *Sukuk al-ijāra.* If an *istisnā[c]* contract is used, we can called it *Sukuk al-istisnā[c]*.

Islamic bonds new issues can be categorized into two, namely bonds issued with coupons and those with none. The former is known as the Islamic coupon bond while the latter Islamic zero-coupon bond.

1. Islamic Coupon Bond

The term "coupon" here denotes the profit component of the Islamic bond issues in both forms of *murābaha̱* notes issuance facility (MuNif) and *al-bay^c-bithaman ajil* Islamic debt securities (ABBA).[5] The difference between MuNif and ABBA is mainly on their respective maturities. Long-term issues normally apply *the al-bay^c-bithaman ajil* purchase-back contract while short-term and medium-term issues will use *murābaha̱*. Some selected bond issues are given below:

TABLE 2. SELECTED ISLAMIC DEBT SECURITIES IN MALAYSIA: TENURE AND MATURITIES

Issuer	Instrument	Tenure	Date of Issue	Maturity Date
Houlon Corporation	*Al-Bay^c-Bithaman Ajil* Islamic debt securities	7 years	Sep. 3, 1997	Sep. 2, 2004
Teledata Sdn Bhd	Guaranteed *Murābaha̱* Notes Issuance Facility	5 years	Apr. 4, 1996	Apr. 4, 2001
Moccis Trading Sdn Bhd	Guaranteed *Murābaha̱* Notes Issuance Facility	5 years	Mar. 29, 1996	Mar. 28, 2001

Source: Rating Agency Malaysia, 1998

In both MuNif and ABBA, two types of debt certificates were issued. Certificates that represent the capital component are called primary notes while the profit portion is known as secondary notes or coupon notes. Coupon need not mean interest alone. In the IDS, it also refers to the profit or markup portion of the deferred sale. So it is safe to say that the Islamic version of the conventional coupon bonds are the MuNif and ABBA.

2. *Murābaha* Notes Issuance Facility (MuNif)[6]

The selling of *dayn* or debt by the issuer to the financier therefore involves two types of bond issues. In other words, *Shahdah al-dayn* (debt certificates) consists of the primary and secondary notes. The process is shown the following illustration:

Cost of financing: RM100 million
Annual profit rate: 8%
Underlying asset: Land and building
Issue Date: February 5, 1999
Maturity: February 5, 2002
Tenure: 3 years
Total profit: RM100,000,000 x 8% x 3 = RM24 million
Selling price = cost of financing + profit margin = RM124 million

Number of Primary notes: 100,000 units
Price per unit = RM100,000,000/100,000 = RM1000
Number of Secondary notes = 50,000 units
Price per unit = RM24,000,000/50,000 = RM480

FIGURE 1. MODE OF PAYMENTS IN MUNIF

1st month	6	12	18	24	30	36
•	•	•	•	•	•	•
RM4m	RM4m	RM4m	RM4m	RM4m	RM4m	+RM100m

Based on the above calculations and illustration in Figure 1, all primary notes will mature on February 5, 2002, which implies that the capital component will be paid in a lump sum of RM100 million at maturity. Since investors desire to take out the profit out periodically, secondary notes maturing every six months were normally issued. In the above case, a 3-year maturity shall imply 6 semiannual profit redemptions at RM4 million each. The above example shows that MuNif or BaIDS are not zero coupon bonds. The absence of coupon interest payments does not mean that Islamic bonds are zero-coupon. MuNif and BaIDS are coupon bonds because profit payments are contractual or fixed. Although similar to conventional coupon payments, issuance of secondary notes issues are said to be valid in Islamic law since it is based on sale (*al-bay^c* while the former is based on debt (*al-duyun*)

3. Islamic Zero-coupon Bonds

Zero coupon bonds are bonds sold at a discount. Although no coupon or interest payments are made, the implicit interest is the difference between par value and discount value. The Islamic zero-coupon bond operates on the same principle but works on a sale contract (*al-bay^c*) which makes it a valid transaction in Islamic law. The Khazanah benchmark bond will be used to illustrate some pertinent issues.

4. Khazanah Islamic Benchmark Bonds

Unlike MuNif and BaIDS, the Khazanah bonds are government guaranteed. But for trading purposes, Khazanah bond issues must fulfill the securitization requirement, which involves assets of Khazanah Nasional Berhad (KNB). The securitization of Khazanah bonds is similar to other Islamic bonds in which the contract of *bay^c al-inah* is applied. Securitization creates *hak māliy*, the right to sell or purchase a commodity one owns.[7] To exercise this right shall also imply an ability to derive usufruct or *manfaat* from it, which in essence qualify Khazanah bonds to take the role of *al-māl*.[8]

Although the Khazanah Islamic benchmark bonds are sold at a discount, the discount price is market determined through a bidding process (*bay^c al-muzayadah*). The bidding process allows the bond to be priced according to the forces of demand and supply so as to produce a yield that can be used as a benchmark for the local bond market.[9] While the issuer sets the purchase-back price at par value, secondary trading will mean selling rights of debt to the third party. At this point, the contract of *bay^c al-dayn* at a discount is intensively applied to create liquidity (*al-suyulah*) through secondary trading.

The basic feature of the Khazanah Islamic bond is quite straightforward. Say that through the bidding process, a RM1000 bond at par value is sold at RM800 per unit. For one million unit issues, the market value of securitized asset is therefore RM800 million, while the purchase back price is RM1 billion. The return to investors is RM200 million. The *bay^c al-'inah* element emerges in the securitization process, involving of some underlying assets, namely *Khazanah* assets consisting of physical and financial assets that the Malaysian government owns such as land, buildings, shares, bonds and reserves in hard currencies.

C. Step 3: Trading of Debt Certificates (Discounted *bay^c al-dayn*)

For liquidity purposes, bond trading in the secondary market is crucial. However, almost all Islamic bonds today were bought for long-term investments. The lack of secondary market however should not imply that trading issues is no longer significant. One of the objectives in the Khazanah bond issues is to create a dynamic secondary market. This calls the need to explain the Islamic view of bond trading in the secondary market.

As mentioned earlier when a debt certificate is securitized, it now becomes property (*al-māl*) which is also an article of trade. As an article of trade, investors can sell the bonds to the issuer or the third party if a secondary market for Islamic bonds exists. The trading i.e. sale and purchase of the debt certificates is called *bay^c al-dayn.* In Malaysia, the contract is *bay^c al-dayn* at a discount is acceptable while Middle East Ulama' considered it invalid even though the debt is supported by underlying assets. Any profit created from the sale and purchase of a debt is *ribā*. For example, consider a person holding a bond worth RM1000. His urgent need for cash makes him sell the bond for RM900. For whatever reasons, the buyer purchases the RM900 bond because he felt the price of bonds might go up. He will dispose the bond when price exceeds RM950 to make a RM50 that according to Islamic law is *ribā*.

In the case of a zero coupon Islamic bond, the company issues the bond at a discount, say RM900. The bond is redeemable at par value of RM1000 upon maturity. In other words, when the bond matures, the bondholder sells the bond to the issuer or another dealer for RM1000. Here trading of debt took place where the bondholder received RM100 as profit over a period of 1 year. In the Malaysian Islamic capital market, the $100 profit is considered permissible (*ẖalāl*) while it is not permissible (*ẖalāl*) in the Middle East countries although the bond is asset backed. It is therefore not surprising to observe that none of the deals made in the Arab countries so far has embraced *bay*^{c} *al–dayn* bonds. The mode of financing applied in these countries were mostly the syndicated *murābaẖa* and *ijāra* as shown in Table 3 below.

III. Islamic Securities in the Middle East

Financial instruments for project finance in the Middle East have largely been dominated by *murābaẖa* and *Ijāra* financing, as shown in Table 3 below. The *murābaẖa* project financing however, did not utilize bond instruments, as doing so will mean applying *bay*^{c} *al-'inah* for securitization purposes as well. The process simply involves the usual *murābaẖa* technique where financiers will purchase the raw material and equipment from the supplier. The goods will be sold to the customer at a markup price. This type of purchase and sell technique proves suitable in projects involving lumpy items since it retains most of the characteristics found in traditional debt such as the need for collateral, debentures and guarantees. Among others, the documentation normally include the asset sale and purchase agreement among the contracting parties while the installment payments made adopts the usual traditional amortization principle.[10]

Table 3. Selected Project Finance Deals and Transactions in the Muslim World

Country	Amount	Project	Mode Of Financing
Bahrain	US$30m	Purchasing construction material for Pakistan's Lahore-Islamabad Highway	Syndicated *Murābaẖa*
Kuwait	US$30m	Purchase of capital equipment for the production of medium-density fiberboard	*ijāra* (lease finance)
Malaysia	RM1 billion	Finance of Tenaga Nasional's current capital expenditure	*Bay*^{c}*-bithaman ajil- bay*^{c} *al-dayn* (debt trading)
Bahrain	US$70m	Water and Power Development Authority	Syndicated *Murābaẖa*
Egypt	US$11.2m	Alexandria National Iron and Steel Company	*ijāra* (lease finance)
Pakistan	US$2.05m	Equity capital investment in Al-Meezan Investment Bank	*mushāraka*

Source: Islamic Banker, various issues

Ijāra financing on the other hand involves the issuance of profit certificates called *Sukuk- al-ijāra* bearing the name *ijāra* on which leasing transaction is based. The securitization process is valid since the underlying asset is not fictitious but real *ijāra* assets from which cash flows are created from the lease payments. Here a special purpose vehicle (SPV) is first created to purchase the asset from the supplier. The asset is then leased to a company that will use it in real production. The lessee makes periodic rental payments to the SPV who in turn will use these proceeds to pay the financiers. Prior to the purchase of assets, the SPV issues the *ijāra* certificates to the investors with a predetermined profit. This is valid because in *ijāra* finance the lessor can always stipulate the rentals in advance so making it possible to guarantee profits to the investors. Apart the examples given in Table 3, some other examples of project financing using *Sukuk al-ijāra* include the Kentucky Fried Chicken and Citibank *ijāra* facility with Guthrie worth US$30 million and the ANZ Investment bank with the Beximco group in Bangladesh worth at US$4 million.[11]

As mentioned in the above, the absence bonds instruments in most *murābaha* project finance in the Middle East countries may be explained by the controversy on the validity of using *bay^c al-'inah* in the securitization process and the application of *bay^c al-dayn* at a discount in bonds in secondary trading. The question now is what is the underlying issues behind this controversy about the legitimacy of *bay^c al-'inah* and *bay^c al-dayn* in Islamic law?

In a nutshell, the Shafi'e school of thought allows *bay^c al-'inah* in view since the *niyya* or intention factor is not relevant in determining the validity of contracts. However, jurists from the Hanafi, Maliki and Hanbali schools have rejected this contract since the *niyya* element does play an important role in contractual agreement. In addition, *bay^c al-inah* is a special and isolated case during the lifetime of Imam Shafi'e. Only if Imam Shafi'e himself witnessed the rampant use of this contract in Malaysia, he must have condoned it as well

IV. Islamic Convertible Bonds (ICOB)

The need to provide new instruments that can avoid the application of *bay^c al-'inah* and *bay^c al-dayn* is therefore crucial into making Malaysia an attractive place for Islamic global investments. Although Islamic funds have make their way into various Islamic units trust and mutual funds in the Muslim countries and capitalist financial center such as New York and London, these took the form of equity instruments. Being risky and subjected to price volatility, these investments are relatively unsafe and may turn off potential Islamic investors who like to see more safety valves in their portfolio. A hybrid of debt and equity elements can thus provide a supplement to the existing *sharī^{c}a*-approved instruments. This will help diversify Islamic investment portfolios so that potential losses arising from unsystematic risks can be reduced.

A. Main Features of the Islamic Convertible Bond (ICOB)

Traditional or conventional convertible securities or convertible loan stocks as it is called in Malaysia is used to raise capital. They are sometimes called deferred equity since they can be converted into shares later on a pre-specified date and on pre-specified terms. An owner of convertibles therefore owns a bond and a call option. He is not only entitled to interest payments and the principal but also the right to convert loan stocks into equity.

The Islamic convertible bond model in essence incorporates conventional convertible bonds or loan stocks features. Here the interest or *ribā* element as contained in the debt component will be eliminated and replaced by *Al-Wadiah* contract while the equity component will see the application of *al-muqarada* or *al-qirad*. Thus ICOB will retain the following tradition features of convertible securities:

1. Conversion Ratio = Number of shares per bond
2. Conversion Price = Par Value/Conversion ratio
3. Conversion Value = Conversion ratio x Current stock price

Conversion ratio is the number of shares the Islamic bondholder receives per $1,000 par value when converting the bond into equity. The conversion price is found when the price of bond at par value is divided by the conversion ratio. Lastly, one can obtain the conversion value by multiplying the conversion ratio with the current stock price of the company.

The above features however assume that crucial *sharī^{c}a* properties of the ICOB are already in place, which is not an easy thing to do here. There are several *sharī^{c}a* issues one must attend to. These are given below:

1. **Contractual returns**: The debt component must be free from any contractual and predetermined compensating element due to positive time preference. This is the *ribā* issue. At this stage, one can use any contracts in *fiqh muamalat* as long as it does not violate *sharī^{c}a* principles.
2. **Call options**: The conversion of bonds into common stocks normally involves a call option, which is the right to sell. Normally this call option has a price. The question now is what does the *sharī^{c}a* says about

the attachment of warrants or call options to the Islamic bonds. Are these equity kickers or sweeteners similar to *ribā* since they are part of the incentives that issuers gave away in order to attract investors.

3. **Single Product-Multiple Contracts:** The ICOB shall contain at least three distinct Islamic contracts, namely *Al-Wadiah*, *kafāla*, and *Al-Qirad*. Could such product with multiple contracts violate the pillars of Islamic contracts? Would it create *al-gharar* and other *bathil* elements in the investment? These are questions one must not overlook in any attempt to design an Islamic financial instrument.

We now look in greater detail how the above issues can be tackled from an Islamic perspective. Apart from these issues, one main problem now lies in the decision to convert or not to convert bonds into common stocks. Normally in traditional convertible securities, conversion will take place when the conversion value exceeded the bond market price. However in ICOB, bond market trading even for liquidity purposes (*al-suyulah*) will involve some form of discounting or selling bonds at a premium which may go against the ruling on *bay^c al-dayn*. The majority of Islamic jurists today have no grudge against *bay^c al-dayn* at par value and also *dhawa ta'ajjal* (bond discounting between the debtor and creditor). In the former, the bond is sold or redeemed upon maturity at face value. In the latter however, the bond is sold by the creditor (second party-financier) to the debtor (first partner-issuer) at a discount. However, trading of Islamic bonds on the basis of capital gains or loss is not allowed between the financier and a third party as this may amount to *ribā* on either side. For the same reason, selling the bond at a premium to the issuer (i.e. first party) is also not permissible in Islam. Would this mean the ICOB is solely meant for investment and therefore cannot serve as a speculative tool?

B. The Contract of *Al-Wadiah*

The application of *Al-Qard* (loan) to replace debt component of convertible securities is plagued with problems since Islamic issuers are not in the position to make any contractual commitment in the form of interest payment since this amounts to *ribā*. In the contract of *al-Qard*, legal claims by lenders can only be made on the principal sum. Any surplus given away must only be voluntary and will not be mentioned in the contract of lending. Certainly Islam enjoins debtors to pay more. Narrated Jabir bin Abdullah: I went to the Prophet (peace be upon him) while he was in the mosque. After the Prophet told me to pray two *Raka'at* he repaid me the debt he owned me and gave me an extra amount. In another occasion, the Prophet (peace be upon him) says, "The best amongst you is he who repays his debts in the most handsome manner (al-Bukhari)." Certainly this is not a policy but observed to acknowledge the fact that money today is worth more than money tomorrow by virtue of opportunity cost, which in Islam is non-contractual in nature. The extra payment was not be made contractually but released according to the paying capacity of the debtors.

On this basis, *Al-Qard* is not a viable financial instrument for commercial application. In the contract of *Al-Qard*, the lender has also no right to know the purpose of borrowing and this will make it even difficult to asses the risk of default although borrowers are required to place collaterals or seek guarantors. Most crucial is its inability to provide certainty in future cash flows as it cannot make promises on the payment of interests.

The contract of *Al-Wadiah* can help overcome this problem since it is not a contract of loan. (*Al-Qard*) even though at some point it does. *Al-Wadiah* is a contract of deposits or safe-custody with guarantee where the caretaker (*al-mustawda'*) is not liable to damages inflicted by market risks except his own for example due to negligence or transgression (*ta'addi*).[12] In classical form, *Al-Wadiah* is not applied commercially as it only serves as a voluntary mechanism of mutual aid (*ta'awun*). However, it can serve as a commercial tool when the owner or depositor (*al-mudi'*) allows the custodian to use his assets as long as the latter is returned safely and in good original condition. This is one way to reward the custodian for the service rendered.

In other words, if the assets are given away on the basis of *Al-Wadiah*, the owner possesses the legal right to be informed the manner in which the assets is utilized. For example, when it is used for business purposes, where a possibility of capital appreciation and depreciation is imminent, distributive issues will now take center stage. For example, when the assets are invested from which profits are created the question now is the following: who hold a legal claim on these profits? Three juristic views are in order, namely that:[13]

1. The profits belong to the custodian. This approach is presently observed by Islamic banks in Malaysia. However, not guarantees are given on any form of surplus gained from the investment of *wadiah* deposits.
2. The profits belong to the owner of assets (*al-mudi'*). This is an opinion of 'Abd Allah ibn 'Umar. He said that if the depository-custodian used the deposited money, without any agreement of *al-Qirad* or *muḏāraba*, any profit created from the transaction must be returned to the depositor.[14]
3. The profits belong to charity (*sadaqah*)

To accommodate a guarantee on a contractual surplus but without involving *al-Qard*, the following must prevail:

1. Asset owners can only make legal claim on the principal asset, namely capital. This contract is known as *Al-Wadiah Dhamanah* (safe keeping with guarantee).
2. If profits are realized according to projections, it must be distributed accordingly to the agreed upon profit-sharing ratio. For example, if profit is 15%, the profit-sharing ratio is 40% (Custodian): 60% (Owner). Higher rate of returns say, 20% may increase custodian's share to say 45%. This graduated distributive scheme can be worked out as an alternative to the coupon rate. This is not *ribā* since no contractual nominal sum is defined in the *Al-Wadiah* contract. Only when the targeted rate of return is reached that profits must be distributed based on the distributive scheme that both party have mutually agreed on.
3. If the investment resulted in capital depreciation, the custodian must only return the full amount of capital. This is a better alternative to debt capital since the custodian is not burden with the interest payments or any contractual surplus if losses were incurred.

Since *Al-Wadiah* is not a loan (*al-Qard*), it is likely that some contractual return can be guaranteed based on mutual consent (t*a'awun*) if and only if the investment is profitable. This arrangement does not seem to violate the *sharīᶜa* since it readily observe the principle of *fath al-dzari'ah* (commanded to do). It serves to make way toward doing something good. *Dzari'ah* means "a way or means toward something." The opposite of *fath al-dzari'ah* is *sadd dzari'ah*, which means "to block the means toward destruction." Hence the principle of *fath al-dzari'ah* allows man to pursue an action if it helps achieve goodness. Likewise, the distributive scheme of *Al-Wadiah* can help provide an incentive to asset-owners cum investors to take minimal risk but assured of some returns when some profits are indeed realized. Leaving the prerogative of profit distribution to the fancies of custodians may lead to agency problem.

Once the rights of asset owners and custodians are defined in clear terms such as the above, the expected coupon rate can be computed based on simulations. This rate however is ex-post and turned contractual if the targeted profit rate is attained. This Islamic coupon rate should be higher than coupon rate of traditional bonds but lower than returns on equity. The premium over traditional coupon rate is explained by the variable rate of return that *Al-Wadiah* convertible bonds can offer. Next is the issue of call options that is, the rights given to *Al-Wadiah* bondholders to purchase common stocks when they opted for conversion.

C. Call Options/Warrants

It is interesting to note that the issue of options need not imply one to make hasty juristic or *sharīᶜa* decisions on derivatives in the market for futures and options contracts. Even without one, issues on convertible securities or loan stocks requires one to study the Islamic view of awarding the right the purchase stocks at a certain strike price. Convertible securities are not only used today by corporations but also by venture capitalists. It is thus, crucial to understand the Islamic view of call options or the right to purchase shares.

Call warrant is a contract that gives the warrant holder a legal right to purchase the underlying shares. The right to purchase or not to purchase the shares comes with a price. For example, a person purchases a call warrant from TA Securities for $4.00 each for one Telekom Malaysia share at an exercise price of $25.00. Thus if the individual bought 10000 call warrants he pays a sum of $4000. To the hedger, if the market price of Telekom Malaysia increases to $30.00 per share at the expire date he will exercise his right to purchase the shares and therefore makes a capital gain of $5.00 per share or $50,000. Thus his net gain will be $45,000. But if the share price falls to $20.00, he can avoid losses by opting not to purchase the shares.

But to the speculator, his main intention is not to exercise the right of conversion. Instead he will trade the call warrant, when there is capital gain in sight. Normally, price of call warrant increases as the market price of underlying shares rises. For example, when the market price of Telekom shares increases from $25.00 to $28.00, the price of the call warrant increases from $4 to $4.50. A speculative trader in this case will not think of conversion but to sell the call warrant at a capital gain of 50 sen each. However, if the share price falls which reduces the price of the warrant, the individual is expected to sell the warrant for fear of losing more if the price falls further down. For example, if Telekom shares fall to $20 each and cause the price of the warrant to fall from $4 to 3.50, selling the warrant will cause him to lose 50 sen per share. Thus, if he purchases 100,000 warrants, his total loss is $50,000.

The question now is what is the Islamic position on the trading of warrant? Since warrant is the right to purchase the underlying shares, trading of warrants implies trading of rights or *Al-Haq*. Usually, a contract (*al-'aqd*) in Islam is built on four basic fundamental rules, namely:

1. Rights or (*hak*) and commitment (*iltizam*) to pursue the objective of the business transaction (*maudlu'ul 'aqdi*)
2. Agents of contract (*Tharafayil 'aqdi*)
3. The object of trade in the contract (*mahallul 'aqdi*) and
4. The pronouncement of willingness to enter into a contract (*shighatul 'aqdi*).

Of the four above rules, only the rule pertaining to the object of trade or *mahallul 'aqdi* is most intriguing as it requires an answer whether the "right to purchase common stocks" i.e. the warrants is *al-māl* or property? But this is not our main concern since ICOB does not involve the trading of warrants. ICOB investors cannot sell the right to purchase stocks to any foreign party. This is also true for traditional convertibles.

Recall that a call warrant is the right to purchase an underlying share of a corporation. The focus of ICOB however is not about the trading of warrants but the conversion of *Al-Wadiah* bonds to common stocks. The right to convert is not free in common trading but now it is given away free as sweeteners. Which then imply that *Al-Wadiah* bond issuers have given investors a contractual gift, which unlike the variable rate coupon is measurable in nominal terms.

For example, a $1000 *Al-Wadiah* convertible bond is sold by XYZ to investors and is convertible to say, 25 shares per bond on a certain date. The conversion price is = Par Value/Conversion ratio = $1000/25 = $40 per share. This means that bondholder has the right to buy 25 shares of XYZ at $40 apiece for each $1000 par value held, regardless of the current stock price.

If the current stock price of XYZ is $50, the conversion value of ICOB is = conversion ratio x current stock price = 25 x $50 = $2500. Given that ICOB remains at par value till maturity, it is always profitable to exercise the option to convert. Thus the lower the conversion price, the higher gain one can enjoy when XYZ stock prices go up. This readily imply that giving the warrant or call option free as gifts or equity kickers is extremely costly to XYX if stock prices is always rising.

The question now lingers around the issue of call options as a contractual gift to investors. This contractual surplus is the legal right to convert bonds into stocks without paying a price. It is given out as a sweetener so that people are attracted to invest in convertible bonds. Since it will be problematic to infer Islamic legality of conversion without paying any price, it is important to consider separating this feature from the *Al-Wadiah* contract.

D. One Product with Multiple Contracts

The above problem can be overcome by allowing contracts to operate separately, so the sweeteners can be detached from the *Al-Wadiah* bonds. Our experience in designing Islamic auto-financing based on the *Al-ijāra Thumma Al-Bay^c* contract (Leasing ending with sale) explains well how two different contracts are applied to produce one banking product.[15] Here, the first stage saw the application of leasing (*ijāra*) contract. If the lessee wish to exit or finishes his rental payments, the bank will offer him to purchase the car (*al-bay^c*) at a nominal price. The same technique can be applied to ICOB.

1. First Stage: *Al-Wadiah* Contract

1. XYX offers ICOB at $1000 per bond.
2. XYZ guarantees the *Wadiah* asset.
3. A guarantee on profit is made if targeted rate of return(s) is attained.
4. Bond is redeemable only at par value upon maturity date.

2. Second Stage: *Kafāla* Contract

1. A third party guarantee on the conversion of *Al-Wadiah* bonds into common stocks.
2. Conversion price will be based on a discount sale of stocks (*bay^c al-Wadhiah*).[16] That is, the *kafāla* company will guarantee to sell the stocks below market price (i.e. at the conversion price).
3. Based on this conversion price, which is below current market price a conversion ratio can be determined.
4. The *kafāla* is applied here so that investors can obtain guarantees of conversion without involving the issuer. The issuer (first party) pays some fees to the guarantor (third party) for the service rendered.

3. Third Stage: *Al-Qirad* Contract

1. Upon redemption at par value the investor will use the cash proceeds to purchase common stocks at the conversion price.
2. If current stock price is higher than the conversion price, the investor enjoys a paper gain.
3. Profit distribution in the *Al-Qirad* contract will be based on performance and therefore not guaranteed.

The above three stages in which ICOB operates can be further understood in the following illustrations.

Iecons Corporation issues $1 million ICOB (no fixed rated coupons) in denomination of $1000 each with maturity date 2005. At the same time, the *kafāla* contract guarantees investors of conversion from *Al-Wadiah* into *Al-Qirad* in two pre-specific dates.

The term of conversion is handled by the *kafāla* contract while the *Al-Wadiah* contract takes care the investment of deposits. The terms of conversion pre-specified in the *kafāla* agreement are:

1. Each ICOB share with face value $1000 can be converted into 20 shares with a term of trade of 20:1. The conversion value is therefore equal to $1000 divided by 20 = $50.
2. If the stock is currently selling for $30, then the conversion premium is $20. The conversion premium is the spread between the conversion price and current market price.

V. Conversion Decisions

A. Conversion when Current Stock Price Is Higher than Conversion Price

1. *Al-Wadiah* Contract

When the stock is selling above $50 (say $55), an investor may want to convert his *Wadiah* bonds into *al-Qirad*. This takes place within the *Al-Wadiah* contract in which he will ask for full redemption at par value.

2. *Kafāla* Contract

As he now holds $1 million in cash, he will turn to the *kafāla* contract for conversion, which is to purchase 20 million shares at $50 each. The *kafāla* company will sell Iecons shares at $50 each.

3. *Al-Qirad*

The investor as the *rabb al-māl* can either hold the stocks if he expects the price to further increase or sell them to realize the profit equivalent to $100,000 (i.e. $1.1 million to $1 million).

B. Conversion when Current Stock Price Is Lower than Conversion Price

The investor will not convert when current stock price is lower than conversion price. Failure to convert can also mean losses when Iecons declares large dividends and bonus issues. Thus it is important for investors to study and monitor the business performance of ICOB issuers, which means that ICOB investments tend to be less speculative.

VI. Conclusion

In summary, the Islamic convertible bond shall consist of three separate contracts. This is done to prevent *gharar* arising from inability to fulfill bond redemption or conversion by the issuer. Since the ICOB can only be redeemed at par value, it is less volatile compared to traditional convertible securities. Here, speculation can only take place on the basis of equity price movements rather than bond price or interest rate movement, which can still affect the performance of ICOB in dualistic banking setup such as the one in Malaysia. However, investors can redeem the bond at discounted value. This is allowed in Islam under the contract of *Dha'wa Ta'ajjal* but only to take place between the issuer (first party) and investors (second party). This will help serve to provide liquidity (*al-suyulah*) arising non-speculative investments. We have shown that ICOB is able to do away with *bay^c al-inah* and discounted *bay^c al-dayn* such that it is relatively easier and more attractive for Middle Eastern investors to take up this bond in Malaysia. On the supply side, it should also be cheaper than the *bay^c al-inah* bonds such as MuNif and ABBA since the ICOB provides investors an option to convert bonds into stocks through the *kafāla* company at no cost. It is also expected to be less volatile than traditional convertibles since *Wadiah* bonds can only be redeemed at par value. In this sense, ICOB holders observe the development and performance of Iecons corporation (i.e. the issuer) so that they can the right of conversion without inflicting harm on themselves and others as well.

[1] For a more detailed exposition on *bay^c al-inah and al-dayn*, see Rosly, Saiful Azhar and Mahmood Sanusi. "Islamic Bond Issues: Malaysian and Middle Eastern Islamic Bonds in Comparative Perspective." Paper presented at Asia Business Forum Seminar on Restructuring Islamic Project Financing. Kuala Lumpur, Malaysia, April 16-17, 1999.

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[2] The absence of an active secondary market for Malaysian Islamic bonds, however, limits the application of *bay^c al-dayn* for liquidity purposes.

[3] Rosly, Saiful Azhar. "Sukuk-Islamic Securities." The Sun. April 25, 1997.

[4] Note that these underlying assets do not act as collaterals or securities to the facility. In the event of default, the bond indenture makes no mention about securities involving these underlying assets, which usually are taken up by debentures and performance bonds.

[5] In the *bay^c al-'inah* mechanism, the sale of underlying assets using the name of *murābaha* and *al-bay^c-bithman ajil* does not mean putting *bay^c al-'inah* in a legitimate setting. These underlying assets are not part of the plant and equipment needed in the project operation. If these assets are collaterals to the issuers' existing interest-based debt, it is again difficult to gauge the legitimacy of this so-called Islamic securitization. As a precautionary note, Islamic securitization has nothing to do with asset-backed securitization (ABS) when the latter deals with financial claims on the cash flows of securitized assets such as mortgages, credit card account receivables, and vehicle loans.

[6] See Kamil, Wan Abdul Rahim. "Jati's Pioneering Commercial Paper Chase." Islamic Banker (May/June 1996). pp. 8-10.

[7] Ahmad, Hassan. "*Fiqh* Methodology for Islamic Benchmark Bonds." Paper presented at Seminar on Islamic Bonds. Malacca, 1998.

[8] Further discussions on Khazanah bonds can be found in Hussain, Abdul Rashid. "Malaysia's Khazanah Benchmark Bonds." Islamic Banker (April 1998). pp. 9-11.; and Ahmad, Hassan. "*Fiqh* Methodology for the Creation of the Benchmark Bond in Islam." Paper presented at Seminar on *Sharī^{c}a* Experts. Melaka, Malaysia, October 30, 1998.

[9] At present, the yield on the Malaysian government bond (MGS) cannot be used as a benchmark yield since its demand is captive, while its supply is irregular. Banks will subscribe to the MGS only to fulfill liquidity requirements, while the supply of MGS to finance economic development is irregular due to the privatization of public works.

[10] A good source of deals and transactions made in the Arab countries using Islamic modes of financing can be found in Islamic Banker magazine, published in London, England.

[11] At present, only one *ijāra* bond is issued in Malaysia. Known as *Sukuk al-ijāra*, it was issued by Segary Energy Venture Sdn. Bhd worth RM337.5 million with a four-year maturity. For more detail, see "Segari Uses Islamic Facilities to Refinance Loan." Islamic Banker (March 1997). pp. 8-9.

[12] On this point, 'Ali ibn Abi Talib and 'Abd Allah ibn Mas'ud regarded the custodian or depository *(al-mustawda')* as a trustee (*amin*). Therefore, the custodian is not liable to make compensation except when breaching the contract by deception (*khiyanah*). Ibrahim al-Naka' asserted that there is no liability to the depository/custodian, except when infringement or misdemeanor has occurred. See Hasan, Abdullah Alwi Haji. Sales and Contract in Early Islamic Commercial Law. Islamabad: 1997. pp. 127-131.

[13] The authors would like to thank Mahmood Sanusi of the Kulliyyah of Laws, International Islamic University Malaysia, for this input. Further textual exposition will be given as this research proceeds into *fiqh* matters.

[14] Hasan, Abdullah Alwi. Sales and Contract in Early Islamic Commercial Law. p. 129.

[15] *Ijāra Thumma Al-Bay^c* auto financing was designed for EON Finance Pte. Malaysia.

[16] *Bay^c al-Wadhiah* is a discount sale, while *Al-Wadiah* is a deposit. These are two distinct contracts.

Cross-Border *Ijāra*

A Case Study in the U.S. Taxation of Islamic Finance

Robert W. Toan[*]

ABSTRACT

An Islamic financial instrument is subject to U.S. taxation whenever the transaction involves one or more U.S. parties. As the number of such transactions grows, U.S. tax treatment of Islamic financial transactions is becoming increasingly important. Two critical tax questions arise. Will Islamic financial instruments be taxed less favorably than their conventional counterparts? And if so, can transactions be structured that satisfy the *sharīʿa* while enjoying favorable U.S. tax treatment? This problem is illustrated by cross-border *ijāra*, in which a foreign Islamic financial institution leases equipment to an American company. U.S. tax law grants favorable treatment to "finance" leases—those treated as loans for tax purposes. While it may seem paradoxical for an *ijāra* transaction to qualify as a loan, Islamic law and American tax law emphasize different factors in determining whether the lessor or the lessee is the "owner" of the property, and, therefore, whether the transaction is treated as a loan or a lease. With careful attention to both systems, *ijāra* transactions should be able to secure favorable U.S. tax treatment.

I. INTRODUCTION

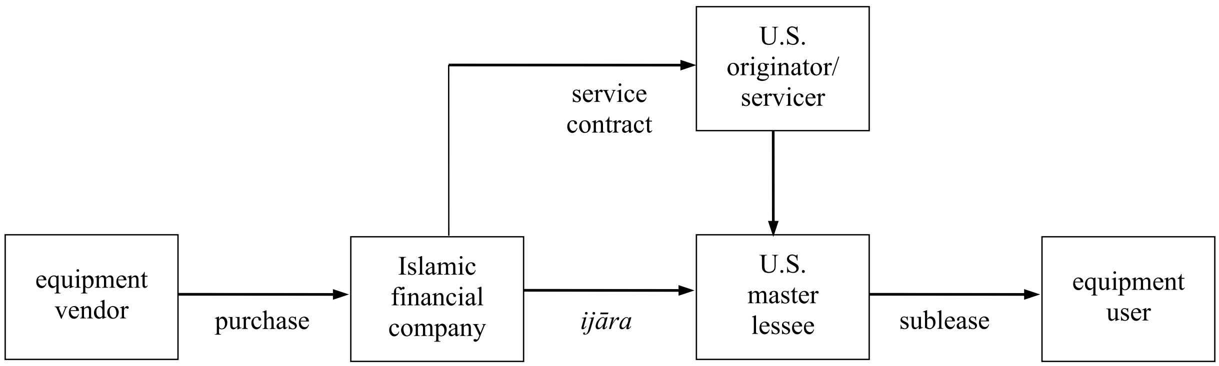
The dramatic growth of Islamic finance over the last two decades is one of the more striking phenomena in international banking. Twenty years ago there were a handful of Islamic financial institutions; today there are over 187 Islamic banks worldwide, and major international banks such as Citibank have established their own Islamic financial arms.[1] Total assets of Islamic financial institutions are estimated at over $100 billion[2] compared with $5 billion in 1985, and the market is growing at an annual rate of 15% per year.[3] Moreover, this growth is not limited to Islamic countries such as Indonesia, Pakistan, or the Gulf States. The Islamic banking sector has gained a toehold in the United States and Western Europe, with a number of non-bank Islamic financial service entities presently in operation. At least three Islamic leasing companies are operating in the U.S. The United Bank of Kuwait has recently begun offering retail Islamic mortgages in the United States, and U.S. and foreign-based multinationals such as GE, Exxon, and Royal Dutch Shell have utilized Islamic financing.[4]

Little attention has thus far been paid to the U.S. tax treatment of Islamic financial transactions. This lack of attention is scarcely surprising considering that Islamic finance is in its infancy in the United States and other Western jurisdictions. And yet, as Islamic finance continues to expand, it will inevitably come into more contact (and perhaps conflict) with the U.S. tax system. U.S. taxation becomes relevant to a financing transaction when one or more parties is a U.S. tax resident.[5] The author has seen a number of Islamic financial transactions in which the financing party is a non-U.S. Islamic financial entity and the financed party is a U.S. tax resident. The number of such transactions appears to be on the increase.

This article focuses on the taxation of one type of Islamic financial transaction—*ijāra* or Islamic leasing—in the cross-border context. In the past few years, a number of transactions have been consummated in which an Islamic financial company located outside the United States, or alternatively a fund for Islamic investors located outside the United States, has entered into an *ijāra* transaction with a U.S. lessee. The foreign finance company acquires equipment or other assets and grants their use to the U.S. company pursuant to the *ijāra*. The *ijāra* may be an isolated transaction, or part of an ongoing leasing program. Typically, the entire transaction would be originated by a U.S. leasing company, which may play an intermediary role as purchaser and reseller of the equipment or as an intervening user of the equipment, and which would also service the leases. This basic transaction structure is shown on Figure 1.

[*] General Counsel and Director of Structured Finance, Wafra Investment Advisory Group, New York, N.Y.

FIGURE 1. THE STRUCTURE OF AN *IJĀRA* TRANSACTION



How will this type of transaction be taxed in the U.S.? In particular, how will the Islamic financial company be taxed? Will this taxation differ from the taxes that would have been payable if the finance company had entered into a conventional leasing transaction? Put another way, will the Islamic financial party suffer disadvantageous U.S. taxation because it has chosen the *ijāra* form rather than a conventional lease?

As we will see, under some circumstances *ijāra* transactions may be subject to decidedly more unfavorable taxation than certain other forms of leasing. However, the tax treatment will depend upon the terms of the *ijāra* transaction and need not necessarily be more unfavorable than a conventional U.S. lease. With attention to both the Islamic principles of *ijāra* and the U.S. tax principles governing cross-border leasing, an *ijāra* transaction can be structured to provide essentially the same tax benefits as other forms of leasing transactions.

The starting point is to understand the distinction between "operating" leases, which are treated as "normal" or "true" leases for tax purposes, and "finance" leases which are generally treated as loans for U.S. tax purposes. As we will see, this distinction has a number of important U.S. tax consequences. In the cross-border leasing context, it will often, although not invariably, be more favorable to have the lease qualify as a finance lease. The critical question will become this: Can *ijāra* transactions be structured to qualify as finance leases (that is, loans) for U.S. tax purposes?

II. "OPERATING" LEASES VERSUS "FINANCE" LEASES FOR U.S. TAX PURPOSES

U.S. tax law divides leases into two types: "operating" leases, also known as true leases, and "finance" leases, which are treated as similar to loans.[6] Generally speaking, an operating lease for U.S. tax purposes is a lease where the lessor, the nominal owner, has retained sufficient ownership attributes—the so-called burdens and benefits of ownership—to be treated as the true owner for tax purposes. If the lessor is found not to have retained these attributes, the lease will be a "finance" lease and the lessee will generally be treated as the tax owner, although in some cases, depending upon the structure of the transaction, the vendor of the property or the secured lender might be considered the owner.

The most important test of tax ownership is whether the lessor has an opportunity for significant economic gain or loss with respect to the property.[7] If substantially all the property's economic value is contained in the lease, and the lessor has no reasonable prospect for gain or loss in respect of the property (separate and apart from the value of the lease), the lease will likely be viewed as a finance lease.

Critical in determining the lessor's opportunity for gain or loss is the residual value available to the lessor at the end of the scheduled lease term. The lessor will be classified as the owner of leased property only if there is a meaningful residual value available to it. Under the advance ruling guidelines of the Internal Revenue Service, the residual value at the end of the term must be at least 20% of the lessor's equipment cost.[8] The courts, however, have not followed any particular percentage rule and may find a true lease even where the expected residual value is substantially less than 20%.[9]

The remaining useful life of the property at the end of the lease term is closely linked to residual value. A lease for the entire expected useful life of property will leave little if any value at the end of the term. The advance ruling guidelines specifically require that the remaining useful life at the conclusion of the lease term, including fixed rate renewals, be at least 20% of the estimated useful life.[10] If the lease term, including subsequent renewals at a fixed rate or nominal value, exceeds this limit,[11] the lease may be treated as a sale.[12] A lease that does not run for the entire useful life may nevertheless be treated as a sale if there is a fixed-price purchase option substantially below the expected fair market value at the conclusion of the lease term.[13]

The issue of residual value is not, however, the sole criterion of the treatment of finance leases. It is well established that all the facts and circumstances surrounding the lease must be considered.[14] In addition to insuring that the lessee will at all events have the risk and reward of the property's residual value, a lease intended to qualify as a finance lease should seek to provide the lessee as nearly as possible with the same rights and obligations as it would have in a secured borrowing. The burdens and benefits of ownership should both belong to the lessee. The documentation should limit the lessee's obligations in default and other early termination circumstances, such as casualty, to what they would have been if the documentation had followed the form of a loan. Thus the lessee should bear the risk of loss or diminution in value (a significant burden of ownership) and the lessor should be deprived of any upside potential in the property's value over what the lessor would have received had it been a mere lender. The lessor should attempt to place all of the obligations to maintain the equipment and to insure the equipment against loss on the lessee. Most finance leases will be structured as "triple net" leases in which the obligation of maintenance, the obligation to pay taxes, and the risk of loss, all of which are burdens of ownership, are placed on lessee, and the lessee must pay its full rent to the end of the lease term regardless of circumstance. In short, the structure attempts to mirror the rights and remedies associated with a secured loan transaction.

III. The Tax Advantage of Finance Leases

In the cross-border leasing context, there will generally, though not always, be a U.S. tax advantage in structuring a lease as a finance lease.[15] If the cross-border lease is structured as an operating lease, the foreign lessor will definitely be subject to some form of U.S. taxation. This taxation can take one of two forms. First, the foreign lessor could be considered to be engaged in a U.S. trade or business and the cross-border lease income could be considered "effectively connected" with that business. In this event, the lessor will be subject to U.S. taxation on its net income at regular corporate tax rates (assuming that the lessor is a corporation) of up to 35%.[16] The foreign lessor will receive the benefit of depreciation to help offset its taxable income from rent, but this depreciation will generally be "recaptured" upon a sale of the property, the gain from which will also be subject to net income taxation. In addition, subject to possible treaty relief, the earnings and profits of the lessor may be subject to a 30% "branch profits" tax and certain of its interest expense payments may be subject to U.S. withholding taxes.[17]

A cross-border lessor that does not carry on regular and continuous business activities in the U.S. will probably not be treated as engaged in a U.S. trade or business as a result of a single lease or a very small number of leases.[18] However, the terms and scope of the lease will have an impact on trade or business status. Operating leases may require the lessor to perform equipment maintenance, payment of taxes, and other oversight functions either directly or through an agent. Even a single lease may require significant business activity in the U.S. if the lease relates to a number of assets, such as a fleet of cars, or if the tasks needed to maintain the assets are extensive. The activities of a U.S. agent acting on behalf of the lessor are likely to be attributed to the lessor where the U.S. agent has broad power to act for the lessor, including the power to execute contracts in the name of the lessor.[19] The mere ownership and operation of property in the U.S. may constitute a U.S. trade or business. It is unlikely that a foreign lessor can enter into any significant number of operating leases in the U.S. without being engaged in a U.S. trade or business.[20]

If the lessor under an operating lease structure is not treated as engaged in a U.S. trade or business, it will not be subject to net income taxes or branch profits taxes, nor need it file U.S. tax returns. However, the foreign lessor's gross rental income will be subject to a 30% withholding tax (unless reduced by applicable tax treaty).[21] Because the lessor will not receive the benefits of any deduction to offset the gross income subject to tax, these withholding taxes could exceed the taxes that would have been paid on a net basis.

In contrast to the foregoing, in the case of a finance lease the lessor will be viewed as making a loan to the lessee and the rental payments will generally be considered to be interest and principal payments on the loan.[22] The lending activity might be considered to constitute a U.S. trade or business, in which case the tax consequences would be quite similar to an operating lease which is treated as a U.S. trade or business activity. However, finance lease characterization should generally be helpful in avoiding U.S. trade or business status. Since the lessee is treated as the tax owner, the operation of this property would not generally be attributed to the foreign lessor. Finance leases are generally net leases, with the lessee performing all maintenance obligations, insuring the property, and incurring the risk of loss. All of this should be helpful in avoiding the imputation of a U.S. business activity to the foreign lessor. Of course, if the volume of leasing activity is significant, these activities could rise to the level of U.S. financing, but the volume of the required activity is probably higher than the case of operating leases.

Assuming that the foreign lessor is not engaged in a U.S. trade or business, its interest income from financing leases will very likely escape U.S. taxation altogether. Pursuant to the "portfolio interest" exemption, interest will be exempt from withholding taxes provided that certain conditions are met. In general, those conditions require that the foreign lessor not be a bank or a "10% shareholder" lessee, that the debt satisfy certain registration requirements, and that the lender provide certification of foreign status.[23] It should usually be feasible to structure cross-border finance leases to satisfy the portfolio interest rules, assuming that the lessor is not a disqualified person pursuant to the foregoing rules.

The conclusion is this: When the foreign lessor is not engaging in a large number of leasing transactions, and is not otherwise engaging in U.S. trade or business, the potential for complete exemption from U.S. tax will make the financing lease structure attractive.[24]

IV. *IJĀRA* AS A FINANCE LEASE

Islamic leases are similar in many respects to conventional U.S. leases. An *ijāra* transaction is considered to be the sale of the future use of an asset (usufruct, under civil law) and is an exception to the usual rule of Islamic contract law that at least one side of the contract must be performed immediately. It is required, however, that the use term and the lease consideration be fixed at the time of leasing and the lease must involve the use of a real tangible asset.[25] Floating rate leases are not permissible, although rent may be reset from time to time by using short-term renewable leases or mutually consensual repricing. Islamic thought views leases as containing an element of risk (*gharar*) since the value of the future use of the property may be unknown. Some schools of Islamic thought require that the lease permit either party to rescind if the value of the property is reduced through casualty or unforeseen business changes. Other schools permit more generally binding agreements although it is necessary that the lessor retain the ultimate risk of loss.[26]

Ijāra transactions that are intended to be treated as operating leases for U.S. tax purposes present no particular classification problems. In this situation, the ownership of the property for tax purposes, the ownership under *ijāra* principles, and nominal ownership all coincide. In the cross-border context, however, as previously noted, operating lease treatment may be undesirable for U.S. tax reasons, and the parties may seek finance lease tax treatment. A number of Islamic law issues may make it difficult to create *ijāra* transactions that are treated as finance leases for U.S. tax and accounting purposes.[27]

The law of *ijāra* does not give the parties complete flexibility in setting the lease terms. Certain rights and obligations are viewed as inherently belonging to the lessor, as the owner of the property, and other rights and obligations inherent to the lessee. One important point is that in an *ijāra* arrangement the duty to repair and maintain the property is always the obligation of the lessor. This obligation may not be shifted to the lessee. It is not clear the extent to which a lessee may even have the obligation of ordinary day-to-day maintenance.[28]

Since the use of property is something which by its nature arises in the future, and therefore involves risk as to changes that may occur in the future as to the value of the asset or its use, Islamic law suggests that the lessee should have rights to cancel the lease if events cause the use to become diminished in value, consistent with the general Islamic rule that risk of loss falls on capital. The most dramatic example is a destruction of the leased property. It is fundamental that the lessor bears the risk of the loss or destruction, and that the lessee has the right to terminate the lease in the event of a significant diminution in value of the property.[29] If insurance is permitted (under certain interpretations insurance may be a form of forbidden *gharar*—see below), the lessor must pay the premium, although, of course, such cost could be incorporated in determining rent.[30]

Another problem relates to the sale or option rights at the end of the lease term. Islamic finance in general is highly adverse to the notion of gambling, or taking a risk on value, illustrated by the famous quote: "Do not buy fish in the sea, for it is *gharar* [overly speculative]."[31] An agreement to buy an asset at a fixed price in the future, or an option to do so, may in strict Islamic practice be invalid since value can only be known at the end of the lease term. The OIC Fiqh Academy recommends that leases allow the lessee three termination options: (a) to extend the lease term, (b) to return the rented property, or (c) to purchase it at then current market value.[32]

In summary, the following requirements of *ijāra* can make finance lease characterization difficult:

1. The obligation to maintain the equipment cannot be shifted to the lessee, as typically done in finance leases.
2. The risk of loss, diminution in value or destruction cannot be shifted to the lessee.
3. Fixed price purchase options may not be permissible.

All of these issues relate to the fact that the risks of ownership, for Islamic law purposes, must remain with the lessor. This is a matter of substance, not mere form. The possession of naked title will not suffice.[33]

Nonetheless, the apparent contradictions between ownership of the lessee (for tax purposes) and ownership by the lessor (for Islamic purposes) can probably be resolved. U.S. tax law and Islamic law each has substantive requirements for determining ownership, and these requirements are not identical.

U.S. tax law, in determining ownership, looks primarily at the issue of residual value. If the lease covers substantially all the useful life of the property, or if there is a below-market value purchase option, the lessee will ordinarily be treated as the owner. The law of *ijāra* looks more to certain burdens of ownership: namely, the requirement of maintenance and the risk of loss or diminution in value.

Under Islamic law, the parties have complete freedom with regard to one element in the transaction that is key to finance lease treatment: the term of the lease. Nothing prohibits a lease for the entire useful life of the property. A lease that is truly for the entire useful life of the property may automatically satisfy another important requirement of finance lease: that the residual value at the end of the lease term, and therefore the upside/downside potential for the lessor, be minimal.

Under Islamic leasing concepts the availability of fixed price purchase options may be problematic. In the case of a lease for the entire useful life of the property, this problem may possibly be sidestepped by a zero dollar "gift" of the property to the lessee at the end of the lease term. There is at least some authority that such zero dollar purchase options are acceptable. If the parties desire that the primary term of the lease be less than the full useful life, however, and yet desire that the lease be treated as a finance lease for U.S. tax purposes, it is difficult to see how the problem of the fixed price option can be overcome. A fair market value purchase option at a time when, for example, 40% of the property's useful life remains, would leave substantial upside/downside potential in the hands of the lessor and would not be consistent with finance lease treatment.

Placing the duty of repair and maintenance on the lessor, as *ijāra* requires, is inconsistent with the usual finance lease that places such obligations on the lessee. Moreover, performing these maintenance obligations can easily entangle a foreign lessor in a U.S. business. Foreign lessors that desire finance lease treatment should circumscribe their maintenance activities as much as possible. One approach may be to hire an agent to maintain the property pursuant to a separate maintenance contract. The activities of such an agent may be attributed to the lessor and could rise to the level of a U.S. trade or business, as discussed above. Nonetheless, it may be possible to structure a maintenance contract which is sufficiently separated from the lease to constitute an Islamically valid arrangement and yet avoid agency principles under U.S. tax laws. For example, the maintenance contract might simply call for the return of the property in good order while leaving it entirely in the hands of the U.S. party to determine how to carry this out.

The retention of risk of loss or destruction by the lessor is also inconsistent with the usual finance lease. However, the lessor can obtain insurance and add the cost of insurance to the rental payments. Of itself, such an arrangement should not be fatal to finance lease treatment.

Taken overall, it should be possible to structure an *ijāra* contract to qualify as a finance lease without violating Islamic principles, provided that the lease covers most of the useful life of the property. It will be more problematic to achieve finance lease treatment in the case of a short-term lease where there is substantial residual value.

V. Burden of Proof

In order to treat an *ijāra* transaction as a finance lease (or loan) for U.S. purposes, a further issue must be confronted: Can the taxpayer avail itself of the substance over form argument to obtain tax treatment that differs from the form it has adopted? We have already concluded that the substance of *ijāra* contracts can be consistent with the U.S. tax criteria of a finance lease. Even in the case of conventional finance leases, however, it is not always clear that the taxpayer will be successful in obtaining treatment as a loan. To do so, the taxpayer must successfully argue that the lease transaction is, in substance, a secured loan, contrary to the form of the transaction.[34] The Internal Revenue Service is always free to assert substance over form; the taxpayer, however, may be bound to respect the form of the transaction. The Tax Court has held that the taxpayer, in order to treat a lease transaction as a loan for tax purposes, must produce "strong proof" that the burdens and benefits of ownership have been shifted to the lessee.[35]

The "strong proof" burden is not unique to *ijāra*; it applies to any form of lease that seeks to be treated as a lending transaction. The "strong proof" burden is of special concern in the *ijāra* context, however, since there may be more ambiguity as to the substance of an *ijāra* transaction than in the case of a normal finance lease. Certain risks of ownership must be retained by the lessor and cannot be shifted to lessee.

Nonetheless, the parties to an *ijāra* contract should be free to specifically provide in the contract that both parties agree to treat the *ijāra* as a finance lease, or loan, for U.S. tax purposes. Islamic scholars have generally considered the U.S. tax or accounting treatment of an *ijāra* contract as irrelevant for Islamic law purposes. Thus, even though the contract takes the form of a lease, the parties can demonstrate their intent that the transaction should be treated as a loan for U.S. tax purposes. This will insure that the U.S. tax authorities cannot be "whip-sawed," with the two parties each claiming different tax treatment. The absence of this whipsaw possibility eliminates one policy reason for preventing the taxpayer from arguing substance over form.

VI. Conclusion

U.S. tax law has been called "interest biased." Debt is a favored form under the tax law in a variety of circumstances, treated more favorably than other forms of payment. As an example, cross-border interest payments generally escape U.S. taxation (assuming that the recipient has no U.S. trade or business) while other forms of cross-border payments, including rents, dividends and royalties, are subjected to substantial withholding taxes.

Given this preferential tax treatment accorded to interest, Islamic financial structures are at a disadvantage since the use of interest is forbidden. The problem is real. The differences between Islamic financial instruments and their Western counterparts are substantive, not mere questions of form. Islamic finance requires, fundamentally, that the risk of ownership be associated with earning a return on capital. This creates distinctive difficulties in according Islamic financial transactions the benefits associated with loans for U.S. tax purposes. In loan transactions it is the borrower, not the lender, that is the owner of the property.

Nonetheless there is good reason to believe that these contradictions can be resolved. The concepts of U.S. tax ownership are not identical with Islamic concepts of ownership. In the context of *ijāra*, Islamic law has tended to focus on certain types of risks associated with the ownership of property, while U.S. tax law has focused on different issues, predominantly related to residual value. With careful structuring, *ijāra* transactions should be able to satisfy *sharīʿa* requirements and still qualify for the favorable U.S. tax treatment accorded to lending transactions.

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[1] See DeLorenzo, Yusuf. A Compendium of Legal Opinions on the Operations of Islamic Banks. London: Institute of Islamic Banking and Insurance, 1997. p. x. The author wishes to thank DeLorenzo for numerous discussions and invaluable guidance concerning the Islamic law of *ijāra*.

[2] Khalili, Sarah. "Unlocking Islamic Finance." Infrastructure Finance (April, 1997). p. 19.

[3] Iqbal, Zamir. "Islamic Banking Gains Momentum." Middle East Executive Reports (January 1998).

[4] Martin, Josh. "Islamic Banking Raises Interest." p. 25.

[5] U.S. taxation may also be relevant if the borrowing entity is an offshore corporation controlled by U.S. shareholders, or where the lending entity is a foreign entity with U.S. shareholders and is classified as a "passive foreign investment company" for U.S. tax purposes. Pursuant to the subpart F rules governing the taxation of controlled foreign corporations, income and earnings of the foreign corporation must be determined under U.S. tax principles in determining the taxation of the U.S. shareholders. See Sections 951-959 of the Internal Revenue Code of 1986, as amended (the "IRC"). Under the passive foreign investment company rules, a U.S. shareholder of a foreign company that dominantly earns passive income such as interest is subject to special tax rules concerning his tax liability in connection with his share in the offshore company's earnings. See Sections 1291-1297 of the IRC.

[6] Depending on the circumstances, a finance lease could instead be characterized as a conditional sale for tax purposes. See Revenue Ruling 55-540, 1955-2 C.B. 39.

[7] See, for example, Union Planters National Bank v. U.S., 426 F.2d 115, 118 (6th Cir. 1970).

[8] The Internal Revenue Service, in Revenue Procedures 75-21, 75-28, and 76-30, 75-1 C.B. 715, 75-1 C.B. 752, and 762 C.B. 647, sets forth guidelines for ruling purposes as to the existence of a true lease as opposed to a sale or financing arrangement. The ruling guidelines may be summarized as follows: (1) The lessor must have a minimum unconditional at-risk investment throughout the lease term of at least 20% of the property's cost; (2) The residual value of the property at the end of the lease term must be at least 20% of the original cost, net of lease amounts received that are considered capital recovery; (3) The remaining useful life at the end of the lease term must be at least 20% of the original useful life; (4) The lessor cannot have the right to put the property; (5) The lessee cannot have a purchase right at less than fair market value; (6) The lessee cannot supply or guarantee the purchase cost of the property; and (7) The lessor must have a profit motive. It should be noted that these are only advance ruling guidelines, and not a statement of the law concerning tax ownership. Nonetheless, most of the factors taken into account by the ruling guidelines are found in one form or another in the case law.

[9] See, e.g., LTV Corp. v. Commissioner, 63 T.C. 39, 50 (1974) (residual value of 10% of original cost).

[10] Rev. Proc. 75-21, Section 4(1)(C), 1975-1 C.B. 715.

[11] See Rev. Rul. 55-540, Section 4.06, 1955-2 C.B. 39 (Internal Revenue Service would treat contracts as a sale if lessee may continue to lease property for its remaining life for a nominal payment).

[12] See Oesterreich v. Commissioner, 226 F.2d 798, 803 (9th Cir. 1955) (rent after year 28 in a 67-year lease declined well below fair rental value although property increased in value); Estate of Starr v. Commissioner, 274 F.2d 294, 295 (9th Cir. 1959) (special use of property had no remaining useful life or residual value since not useful to anyone other than lessee).

[13] Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982), reversing 76 T.C. 547 (1981).

[14] See Frank Lyon v. U.S., 435 U.S. 561 (1978).

[15] In the purely domestic context, the financing lease structure is not necessarily preferable to the operating lease structure. Numerous tax consequences result from having tax ownership either in the hands of the lessors or in the hands of the lessee, and which is more advantageous will depend upon the tax goals and tax positions of the parties. In the cross-border context, however, there are very particular advantages to the financing lease structure. Often, the financing lease structure is employed in order to create so-called "double-dip" leases in which tax ownership is considered to be in the hands of the lessor for foreign tax purposes but in the hands of the lessee for U.S. tax purposes, thus affording depreciation benefits in both jurisdictions. In the present discussion, we are ignoring any potential foreign tax benefits. However, as will be seen, in certain common circumstances there are sizable U.S. tax benefits to financing lease treatment.

[16] See IRC Sections 11, 882.

[17] See IRC Sections 884(a) and 884(f).

[18] See, e.g., Lewenhaupt v. Commissioner, 20 T.C. 151 (1953); Neill v. Commissioner, 46 B.T.A. 197 (1942). See also Rev. Rul. 73-522, 1973-2 C.B. 226. A foreign lessor that is regularly engaged in U.S. business through other activities needs to consider whether its leasing activities will be "effectively connected" to its other business.

[19] See, e.g., InverWorld v. Commissioner, 73 T.C.M. 2777 (1997).

[20] Another pitfall should be noted. If a foreign lessor takes the position that it is not engaged in trade or business in the United States, and therefore does not file U.S. tax returns, but is later found to be engaged in a U.S. trade or business, the Internal Revenue Service is authorized to disallow the benefit of all deductions. See Inverworld v. Commissioner, supra, footnote 17. This situation could easily arise where a lessor believes that it is acting as an investor in a few lease transactions, with all U.S. activities in connection with the leases carried out by the U.S. originator/servicer as an agent of the foreign lessor.

[21] IRC Section 881(a).

[22] If the lessor were treated as making an installment sale of the property, the tax consequences would in most respects be similar. The rental payments would in this case be treated as the purchase price of the property plus interest. See Rev. Rul. 55-540, 1955-2 C.B. 39.

[23] See Sections 871(h)(2)(B) and 881(c). An interesting question could arise in connection with an Islamic financial institution as to whether such an institution is a "bank" for purposes of the portfolio debt rules. If the institution is organized pursuant to a banking statute it will probably be difficult to avoid classification as a bank. However, the special structures of Islamic financial organizations, which do not pay interest or accept deposits in the Western sense, could raise interesting speculations.

[24] Different considerations will apply if the foreign lessor is otherwise engaged in U.S. trade or business or when a large number of leases are contemplated. A detailed discussion of how much leasing activity will constitute a U.S. trade or business, and other considerations that may affect this determination, is beyond the scope of this article.

[25] See Vogel, Frank E. and Samuel L. Hayes, III. Islamic Law and Finance. The Hague: Kluwer Law International, 1998. p. 104. (hereafter Vogel Hayes)

[26] Ibid.

[27] Finance leases have been stated to be un-Islamic since they are like pure financing transactions. See Accounting Issues in Islamic Banking. London: Institute of Islamic Banking and Insurance, 1994. pp. 29-30.

[28] Vogel Hayes at p. 144.

[29] Vogel Hayes at pp. 104, 144.

[30] Vogel Hayes at p. 104.

[31] Vogel Hayes at p. 88; citing authority.

[32] Vogel Hayes at p. 263.

[33] It is sometimes mistakenly thought that Islamic legal requirements are entirely formal, so that transactions that are in essence loans bearing interest will be acceptable provided that they are given other labels. This is not the case. Each form of Islamic finance has substantive as well as formal requirements. These substantive requirements often relate to the fundamental principle that the risks of ownership (of property or a business) must be inextricably associated with earning a yield on capital. That being said, there may be transactions that for one purpose (such as taxation) will be treated as a loan under U.S. law while still satisfying the requirements of Islamic finance.

[34] See Rogers v. Commissioner, 29 T.C.M. 869, affirmed, 845 F.2d 1020 (2nd Cir. 1921). See also Smith. "Substance and Form: The Taxpayers Right to Assert the Priority of Substance." Tax Lawyer 44(137) (1990).

[35] Coleman v. Commissioner, 87 T.C. 179 (1986).

The Revitalization of Islamic Profit-and-loss Sharing

Ibrahim Warde*

ABSTRACT

Initially the raison d'être of modern Islamic finance, profit-and-loss sharing (PLS) now accounts for only about 5% of the operations of Islamic financial institutions. This paper argues that PLS (*muḏāraba* and *mushāraka*) can and should be revitalized. It addresses the obstacles that have hindered its development, and proposes solutions based in part on the lessons of the American venture capital experience (particularly in Silicon Valley). The paper introduces some concepts and principles of venture capital, and considers the experience and strategies of American banks active in partnership finance. The basic argument is that successful entrepreneurial subcultures can be created in unlikely places through the judicious use of appropriate methods and incentives. While the logic and principles of venture capital differ sharply from those of classical banking, Islamic financial institutions can build their PLS units and skills while minimizing mistakes, fraud, and conflicts of interest. Finally, the paper discusses the need to adapt Western venture capital practices to the Islamic religious, social, and economic environment.

I. INTRODUCTION

The great disappointment of Islamic finance is that despite a growth rate exceeding 15% a year, the relative share of profit-and-loss sharing (PLS)[1] operations such as *muḏāraba* or *mushāraka* has been steadily dwindling. Initially the raison d'être of the industry, PLS now accounts for less than 10% of the operations of Islamic financial institutions.[2] The vast majority of Islamic deals are in the areas of trade finance, markup operations (*murābaẖa*), and leasing (*ijāra*). Such modes of financing, while generally accepted by Islamic scholars—sometimes without great enthusiasm, either because they do not bring significant social and economic benefits to the community, or because they mirror conventional finance—were once perceived as temporary, and designed to allow banks to generate income while building resources and experience in partnership finance. But when early PLS experiences failed, most Islamic banks responded with policies ranging from benign neglect to outright abandonment of partnership finance.

Today there is a vast gap between the theory and the reality of Islamic PLS. On the one hand, Islamic banks keep reaffirming their commitment to partnership finance, the literature on the subject is abundant, and indeed Islamic finance is often equated with profit-and-loss sharing. On the other hand, the share of PLS in Islamic finance keeps falling, and few institutions seem serious about reversing the trend. Indeed, there is an implicit consensus that attempts at partnership finance are doomed to failure because the required skills and institutions, let alone the appropriate culture and mentalities, are lacking in the Islamic world.

The theoretical foundations of contemporary Islamic PLS were established in the mid-to-late 1970s—the formative years of modern Islamic finance.[3] Although for centuries the dominant financial practice within the Islamic world, PLS had by then been largely displaced by conventional, interest-based lending. Thus, *muḏāraba* and *mushāraka* had to be reformulated by scholars to fit the contemporary environment. In those years, venture capital (outside the Islamic world) was still in its infancy and was therefore of little use in the updating effort. Yet in recent years, the boom in venture capital, in particular in California's Silicon Valley, has been accompanied by vast advances in our understanding of partnership finance.[4] This boom has allowed the development, if not of a "science" of venture capital, at least of a corpus of principles, rules of thumb, and best practices.[5]

Unfortunately, these advances have not been incorporated in the scholarship on Islamic partnership finance. While abundant, this scholarship is highly abstract, and still based on the worldview and economic assumptions of the 1970s. It barely touches on the causes of the early failures, and offers scant examination of actual case studies and few practical recommendations.

This paper argues that recent advances in our understanding of venture capital—based in particular on the author's work on the Silicon Valley phenomenon—could be usefully adapted to an Islamic environment, and serve to revitalize Islamic PLS. This paper addresses the role of partnership finance in Islam and in the global economy, and draws lessons from the failure of recent Islamic PLS experiments. It also discusses the institutional and cultural

* Lecturer, University of California, Berkeley, Calif.

conditions that have allowed partnership finance to thrive, and suggests ways of adapting the best practices of modern venture capitalism to the religious, institutional, and cultural context of Islam.

II. Partnership Finance in Islam and in the Global Economy

Muḏāraba and *mushāraka* are at once the most Islamically authentic and the most socially and economically useful forms of Islamic finance. They are also ideally suited to the global economy. The difference between the two is one of mechanics, not of principle. The traditional *muḏāraba* is a contract between two parties whereby one party, the *rabb al-māl* or *s̱āḫib al-māl* (beneficial owner or the sleeping partner), entrusts money to the other party, the *muḏārib* (managing trustee). The *muḏārib* is to use the money according to clearly defined conditions, and after the business transaction is concluded return the principal and a pre-agreed share of the profit to the *rabb al-māl*. The *muḏāraba* mechanism was common in early Islam, and later inspired the French system of "commandite."

The traditional *mushāraka* is a partnership, normally of limited duration, formed to carry out a specific project. Participation in a *mushāraka* can either be in a new project, or in an existing one, where additional funds are provided as needed, in exchange for an equity stake. Profits and losses are shared in proportion to the capital contribution, adjusted for contribution to the management effort and other factors. The primary difference with the *muḏāraba* is that the *mushāraka* entails an equity position in the venture.

Why is profit-and-loss sharing considered the cornerstone of Islamic finance? First, *muḏāraba* and *mushāraka* have their roots in the Islamic tradition.[6] In the days of the Prophet Muhammad, it was common for wealthy merchants to finance the caravan trade. They would share in the profits of a successful operation, but could also lose all or part of their investment if, for example, the merchandise was damaged, stolen, lost, or sold for less than its cost. In recent centuries, PLS had fallen into obsolescence. By the nineteenth century, it was all but superseded by Western-style interest-based banking.

Second, it goes to the root of traditional misgivings (common to a number of religions and societies) about interest.[7] Since risk is shared by the lender and the borrower, profit-and-loss sharing is just and equitable—a rich lender cannot take advantage of a penniless borrower. Third, it is conducive to a dynamic economy in which the benefits of growth are shared by the community at large. Indeed, the essence of Islamic finance is that money be used for productive purposes: "Islamic banks have a moral and social responsibility toward their economies by investing in long-term projects."[8]

Partnership finance also happens to be fully compatible with the changing financial environment as well as the norms and principles of the global economy. The catch-all term "globalization" encompasses a wide range of phenomena that have appeared since the end of the Cold War and the emergence of a unipolar world: deregulation and increased openness of markets; the growing role of international finance; and the acceleration of technological change; among others.[9] More importantly for our purpose, banking worldwide has since the 1970s undergone profound changes.[10] Competitive pressures have intensified and lines within the financial sector are increasingly blurred. The cozy world of national oligopolies started fading with the erosion of the near-monopoly of banks on the intermediation process (i.e., the conversion of savings into loans).[11] With commercial banks in competition with securities firms, insurance companies, mutual funds, pension funds, and other financial services companies, investors face a growing range of choices.[12] Financial institutions rely increasingly on fee (as opposed to interest) income, and entrepreneurial banking is on the rise.[13]

In much of the Islamic world, the regional economy that characterized the 1970s has broken down.[14] Less autonomy and fewer options are now available to national governments. Unless they prefer autarky, countries are forced to conform to the dictates of the global economy. Given that most countries are heavily indebted,[15] raising funds in the international markets, or obtaining aid from the International Monetary Fund or the World Bank, requires adopting policies conforming to the new international orthodoxy—the "Washington consensus"—which consists of a number of inter-related components: economic austerity, liberalization of trade and capital flows, privatization, dismantling of the public sector, etc.[16]

On the issue of economic growth, the new orthodoxy holds that development and job creation should come primarily from the private sector: the state should be downsized, the economy should be deregulated, and government-owned companies should be privatized.[17] The role of the government should be limited to facilitating the growth of the private sector, the modernization of financial markets, and more generally the encouragement of entrepreneurship. In the wake of the Asian financial crisis, which started in July 1997, the new consensus has expanded to include the elimination of "crony capitalism," the oligarchic system by which capitalists are not really risk-taking entrepreneurs but rather "rent-seekers" who take advantage of their close ties to political leaders.[18]

In this new world economy, partnership finance, with its reliance on free markets and entrepreneurship, holds a place of choice. Equity-based solutions are preferred to resolve the problems of poverty and economic growth. Partnership finance is also perceived as more democratic than conventional lending because it empowers people with potential but no collateral. The U.S. economy has been held up as an exemplar of what all other countries should do. Indeed, much of the credit for the success of the American economy in the 1990s has gone to entrepreneurship and those institutions—chief among them venture capitalism—that have allowed it to thrive. Not surprisingly, the promotion of venture capital has figured prominently in attempts by countries such as Germany and Japan to unshackle their economies and promote growth.[19] And every emerging market, including in the Islamic world, is keen on creating its own "Silicon Valley" that would emphasize entrepreneurship and high technology.[20]

A renewed emphasis on PLS may provide an adequate response to the numerous challenges faced by Islamic financial institutions themselves. They typically operate within overbanked environments; lack the size, resources, and product base to compete internationally; suffer from an overhang of bad loans; and lag behind their Western counterparts in technology and expertise—all at a time when Islamic countries are urged to liberalize their financial systems and open them up to foreign competition before these problems are fully addressed.[21] The original Islamic banking philosophy is fully consistent at once with the principles of the global economy—equity orientation, market-led growth, etc.—and the innovative logic of international finance. Insofar as partnership finance was the initial raison d'être of Islamic banks, its revitalization could provide Islamic banks with a significant competitive advantage. In the absence of effective capital markets, venture capital can provide long-term funding for those entrepreneurs who would otherwise not have access to conventional banking loans.[22] Partnership finance also holds the potential, through such instruments as *muḏāraba* and *mushāraka* certificates, of a secondary market and, over time, of a truly Islamic capital market.

III. Parallels between Western Venture Capital and Islamic Profit-and-loss Sharing

Contemporary Islamic writers have emphasized the "modernity" of the Islamic profit-and-loss philosophy since it is similar to financing techniques that have emerged only recently in the West. In Islam, partnership finance is seen as more than mere financing—it is central to creating economic added value and giving money back to the community.[23] Similarly, modern venture capital in the West plays a central role in the very process of economic transformation. In the words of one author: "Venture capitalists play many roles (...). They are intermediaries between the vast pool of private and institutional wealth that is the fuel for all economic activity and the most hazardous use for investment capital: the formation of new companies. Their ability to assess and manage enormous risks, and to wring from them exceptional returns, is a critical element in America's ability to mobilize its entrepreneurial talent. They are brokers of risk, agents of a new style of financial service that is crucial to our ability to transfer resources from fading industries and technologies to the goods and services that will dominate a restructured world economy in the next century."[24]

The philosophy of partnership finance—whether in its modern venture capital or in its Islamic PLS variant—is that the "lender" should share the risk and rewards of the "borrower." This section discusses the parallels between Islamic profit-and-loss sharing and American-style venture capital, dispelling in the process common myths and misperceptions.

A. Differences with Conventional Lending

Like bankers and other financiers, practitioners of partnership finance are engaged in a process of financial intermediation: they turn savings into investments, collecting money from people who have excess savings and handing it to businesses in need of financing. But the fundamental difference is that in partnership finance the financial institution is not a lender but a partner: instead of lending money at a fixed rate of return, it forms a partnership with the borrower, sharing in a venture's profits and losses. More specifically, partnership finance differs from conventional banking in the following respects:

1. Involvement in Management

Conventional lenders are solely preoccupied with the repayment of the loan. They are seldom involved (except in rare cases of repayment difficulties) in management and business guidance. In contrast, partnership financiers are not passive investors, but have an active and vested interest in making the venture as profitable as possible. They seek to add value through their knowledge and experience.

2. Expectations, Concerns, and Motivations

Conventional lenders are mostly concerned with creditworthiness—the ability of borrowers to repay loans along with a specified interest. Such lending, usually collateral-based, is inherently conservative since it favors established businesses, and is only indirectly concerned with the success of the ventures it finances. This is why conventional lenders usually provide "expansion capital" for going, successful concerns. In contrast, the focus of partnership finance is on "creative capital," usually for funding new ventures from scratch or for major transformations in the size or scope of an existing firm. Unlike conventional lenders, partnership financiers link their own fate to the success of the projects they finance. A capital-poor, but promising, entrepreneur can obtain financing that conventional lenders would not normally provide.

3. Time Horizon

Most traditional lending is short-term. In contrast, partnership finance is long-term and involves "patient capital." Indeed, partnership finance offers the potential to unleash the entrepreneurial impulse by freeing the entrepreneur from the pressures and preoccupations of servicing a conventional short-term loan.

B. The Participants in Partnership Finance

There are three sets of participants in partnership finance: the investors who put up the money, the professionals who select and supervise the investments (the venture capitalists), and the entrepreneurs. The investors can be individuals, institutional investors (private and public pension funds, endowment funds, foundations, etc.). Their funds in turn are managed by venture capitalists who scout and monitor start-ups or young, rapidly growing companies.

Yet the lines are often blurred. Indeed, one of the founding principles of modern Islamic banking is the "double *muḏāraba*." In the words of Frank Vogel, "A first-tier *muḏāraba* is created when investors (we shall call them 'depositors') place their capital with an Islamic bank, fund, or other financial institution, which here acts as the *muḏārib* or working partner. The financial institution or *muḏārib* in turn invests these funds with entrepreneurs (the equivalent of a conventional bank's borrowers) by means of second-tier *muḏārabas*, in which the Islamic financial institution now has the role of capital investor."[25] In addition, the bank or the venture capitalist usually invests its own funds in addition to those collected from investors or depositors.

C. Structuring Transactions

American venture capital firms usually operate through specific venture capital funds. Each fund is comprised of limited and general partners. Limited partners are passive investors—thus akin to depositors in an Islamic bank—whereas general partners play an active role in managing the fund and are compensated accordingly. Under the most common arrangement, the venture firm distributes 80% of the profits from a fund back to investors, while the partners split the other 20%. The firms generally collect annual management fees in the neighborhood of 2% of the committed capital. A successful venture capital firm usually raises funds in rapid succession in order to provide more opportunities for existing and new investors. Each fund—which typically has a specific focus, based on specific industries, regions, stages of development, etc.—is managed separately and has its own limited and general partners. Usually, a fund is organized as a fixed-life partnership (ten years, for example). It is capitalized by commitments of capital from the limited partners. Once the partnership has reached its target size, the partnership is closed to further investment from new investors (or even existing investors), so the fund has a fixed capital pool from which to make its investments.

In Islamic banks, the liability-side of the balance sheet is not managed in uniform fashion. Most banks offer three types of accounts: non-remunerated demand deposits (for transaction purposes), savings accounts (for precautionary purposes), and investment accounts (for profit-making purposes). In theory, only the investment accounts correspond to PLS operations. Depositors can reap profits from such operations, but risk losing money if investments perform poorly. But in some Islamic banks, the return paid on investment accounts is determined by the yield obtained from all activities of the bank. After deducting administrative costs such as wages, provision, and capital depreciation, the bank pools the yields obtained from all ventures, and the depositors, as a group, share the net profits with the bank according to a predetermined ratio, which cannot be modified for the duration of the contract. In addition, different banks have different policies concerning the calculation and disbursement of profits. Some do it monthly, others quarterly, and others still semi-annually or even annually.[26]

Many institutions also offer special investment accounts, which are linked to specific ventures. These are usually reserved to institutional investors or high-net-worth individuals. In that respect, they are very similar to the limited partnerships offered by American venture capital firms.

D. The Pragmatism of Partnership Finance

The American venture capital industry epitomizes pragmatism. It began in the most informal fashion, when wealthy individuals such as Laurance Rockefeller or John Whitney took chances financing risky start-ups. The industry then went through a lengthy process of trial-and-error before certain structures and practices took shape. By the 1960s, venture capitalism had become a distinct, if small, component of the financial services industry. In the 1980s and especially the 1990s, it experienced a veritable boom, becoming an increasingly important and sophisticated financing tool for a variety of companies.[27] Firms such as Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft, Genentech, and Netscape received venture capital early in their development. The center of the industry is Silicon Valley in Northern California, but venture capitalists are now active in all parts of the world.

The most common type of venture capital firm is the "private independent firm," with no affiliation with any other financial institution. Increasingly, one can find venture capital firms that are affiliates or subsidiaries of a commercial bank, investment bank, or insurance company and make investments on behalf of outside investors. A third category comprises the subsidiaries of non-financial, industrial corporations that make investments on behalf of the parent itself.

The rules and principles of Islamic PLS were initially quite flexible, though an increased degree of formalism was later introduced. In the days of the Prophet, the religious injunctions stressed the sanctity of contracts, the need to put down financial commitments in writing, and the importance of ethical behavior. As the Islamic world expanded and trade flourished, *muḏāraba* contracts were codified by medieval jurists and could take on extreme complexity. Different *fiqh* (jurisprudence) traditions later brought their own biases to partnership finance. Hanafis and Hanbalis argued, for example, that the profit from a *muḏāraba* transaction could be shared only when the activity was completed and the financier had been reimbursed his principal, while Malikis and Shafiis permitted the distribution of profits even before the operation was completed and the principal reimbursed.[28]

Another element of flexibility is provided by the existence of financial instruments and mechanisms that can complement Islamic PLS. Thus the *qard hasan* (interest-free loan or "good loan") can be used to tide over an entrepreneur facing difficulty. And most Islamic banks have a *zakat* fund (based on the Islamic obligation of *zakat* [almsgiving], one of the five pillars of Islam) on which they can draw to relieve distressed debtors.[29]

As for the adaptation of ancient financing techniques to a contemporary environment, two approaches are possible. Traditional scholars tend to adopt a literalist or legalistic approach, insisting on strict adherence to medieval rules and practices, whereas modernists try to uncover the spirit, or the "moral economy," behind formal rules. The "moral economy" of Islamic PLS is founded on the need for fairness in sharing the risk inherent in any business venture. Only a few rigid principles follow: the division of profits between the two parties must necessarily be on a proportional basis and cannot be a lump-sum or guaranteed return; the *rabb al-māl* is not liable for losses beyond the capital he has contributed; the *muḏārib* does not share in any losses except for the loss of his time and efforts (but in case of negligence or mismanagement, the entrepreneur may be responsible for the financial loss and be obliged to compensate the financier); the financier cannot require any guarantee, such as security and collateral, from the entrepreneur in order to secure his capital against an eventual loss. Beyond such principles, whatever is serviceable is allowed, as long of course as other religious or legal injunctions are not transgressed.

E. Some Myths and Misperceptions

A number of common myths and misconceptions should be dispelled. Venture capital is not only designed to finance technological breakthroughs in high technology sectors such as biotechnology, semiconductors, or the Internet. It is also used, even in Silicon Valley, to finance light industry, energy projects, health care, and a wide array of services. In Europe, to this day, the greatest part of venture capital funds is invested outside high technology.[30]

Nor did venture capital emerge spontaneously or "fully formed" in Northern California. After all, transparent and efficient markets are not natural but man-made. It took considerable travails before venture capital came of age. The "libertarian" rhetoric of many venture capitalists notwithstanding, government policies played a major role in propelling, if not in shaping, the industry. The lowering of capital gains taxes in 1978 spurred the creation of new businesses. The 1980 U.S. Supreme Court decision that man-made organisms could be patented marked the birth of the biotechnology industry.[31] As for the Internet—in the late 1990s the sector of predilection for venture capital—it started as a defense-related project.

IV. Recent Islamic Experiences in Profit-and-loss Sharing Revisited

Shortly after Islamic finance came into existence in the 1970s, Islamic institutions plunged with great enthusiasm (and virtually no experience) into *muḏāraba* and *mushāraka*. The result was, to say the least, disappointing, and most institutions have since increasingly steered clear from partnership finance.

Islamic bankers clearly underestimated the difficulties of partnership finance. The literature did enumerate the proper rules and practices: bankers were expected to exert due diligence; all operations had to be transparent; the *muḏārib* had to prove that he was reputable and experienced, and that he enjoyed high moral standing within the business community; the project had to be viable and assessed independently by the bank or by external consultants; and the bank had to ensure that its funds were properly spent and that the venture being financed was properly monitored.[32] But these precepts were vague and abstract. Little attention was paid to the banks' lack of experience and to the institutional vacuum within which they were operating. Perhaps most importantly, there was the implicit assumption that all participants in the process were competent as well as honest. This section considers the mistakes made and suggests ways of correcting them.

A. Lack of Experience and Appropriate Skills

Since the early days, Islamic banks have suffered from a lack of experienced and qualified personnel. Bank officers had to possess at once management skills appropriate to a conventional institution and religious training. It was probably too much to ask also for skills in partnership finance, since such skills were not anywhere in existence. In other words, even otherwise competent bankers proved ill suited to partnership finance:[33] trained for the most part at conventional institutions, they were bound to bring with them the mindsets and the attitudes of conventional banks. Yet as noted earlier, partnership finance is fundamentally different from conventional lending. In the words of John Wilson, "(t)o do well in venture capital, banks must train and retain a cadre of specialists who differ markedly in background, skills, and temperament from most of their employees."[34]

Partnership finance requires a wide range of experience and skills. Its practitioners must know how to ferret out deals, how to value, negotiate, and structure investments, and how to supervise investments without stifling them. They must combine the skills of the banker (in assessing business risk and the likelihood of repayment) and the creativity of the entrepreneur (in sizing up and seizing opportunities). A recent survey of Islamic PLS highlights typical blunders: the inability to critically assess business plans (the tendency not to question assumptions or rosy "hockey stick" projections of sales and revenues); the tendency to approve most projects submitted, without an independent assessment of their market potential, of the competition and of the caliber of the people involved; the propensity to "follow the crowd" and go for "me-too" financings; and the preference for well-connected businesspeople rather than for truly creative entrepreneurs.[35]

Partnership finance is as much science as it is art. Conventional bankers are often not temperamentally suited to the uncertain and complex world of partnership finance. For example, pricing a venture deal—that is, setting a value for a company that has no products, no assets, and decidedly no profits—is an arcane process that does not lend itself to standard formulas. The practitioners of partnership finance must have a keen understanding of business and economic cycles. They must at all times question the conventional wisdom. They are constantly engaged in a balancing act: between caution and recklessness, between ignoring red flags and danger signs and overreacting to difficulties, between giving up too soon and not knowing when to cut their losses, between guiding new businesses and stifling them.

B. Institutions and Cultures

Beyond internal resources, banks suffered from the lack of a proper institutional and cultural environment. Necessary institutions include standard accounting and financial reporting norms and enforceable commercial rules and regulations concerning rights and obligations, contracts, bankruptcy, etc. More elusive are cultural factors, which are themselves influenced by institutions and history. The attitude toward risk is a case in point. The image of businessmen as entrepreneurs as described by Joseph Schumpeter or George Gilder, who thrive on risk and creative destruction, does not quite fit much of the contemporary Islamic context.[36] Even within supposedly entrepreneurial environments, rent seeking is the norm. Consider, for example, this description of the typical Egyptian businessman:

> "A Cairene entrepreneur, even one who faces no serious competition, still has to cope with unpredictable changes in inflation, vacillating exchange rates, and capricious government policies. The country lacks genuine capital markets, so the odds are that the entrepreneur's capital represents the sum of his family resources, either saved over long years or inherited from some glorious ancestor. One of the reasons that rent

> seeking is such a popular technique among businessmen is that it holds risk to a minimum. It is a way of getting the government to guarantee against the risks of certain ventures. As a result, Egyptian businessmen are not unimaginative, but they are justifiably cautious."[37]

Under such circumstances, risk avoidance is a perfectly rational behavior. Long-term investment requires a culture and institutions that are predictable and foster trust.[38] In order to take a calculated risk, the entrepreneur will expect political and economic stability in his environment, and consistency in the enforcement of the law. In much of the Islamic world, people still have memories of expropriation and arbitrary decisions by governments that have adversely affected their business ventures.[39] Rampant inflation also discourages long-term investment, and so do currency fluctuations, which can wipe out savings overnight.[40]

Another factor is that the worlds of business and finance are likely to be politicized and embedded within social institutions (family, tribe, ethnic, or religious group). "Connected lending" (lending to entities otherwise related to the financial institutions) tends to be very high, and when loans go bad, custom and social mores prevent the use of modern enforcement techniques (foreclosures, forced bankruptcies, etc.). The protection of the law is not always assured, and the Islamic moral hazard (defined in the following section) is likely to make things worse. In many countries, delaying payment is a common practice, and defaulting borrowers—provided that they are well connected—can be beyond the reach of the law.[41]

C. The Islamic Moral Hazard

The notion of moral hazard is commonly used in connection with financial regulation. It refers to policies that may encourage reckless behavior.[42] By the same token, one could identify an "Islamic moral hazard" in that certain features of Islamic finance can encourage unscrupulous behavior. In the words of Hamid Algabid: "At the beginning, confidence was the rule. The good faith of the participants could not be questioned since it was identified with religious faith. Since spiritual and temporal matters could not be dissociated, a pious man could only act in good faith. Experience has since shown that banking operations could not be based on that assumption, and particularly that guarantees could not be limited to the affirmation of one's Islamic faith."[43] Indeed, in the early years, it was axiomatic that all people involved in Islamic finance—bank employees, clients, etc.—were people of virtue, who acted at all times in a righteous manner. Bank executives acknowledged that they had trusted people who did not deserve their trust.[44] The chief executive of the (now-defunct) London branch of the Dallah Albaraka group explained why his bank was not involved in profit-and-loss sharing (PLS) operations: "The depositors wanted an Islamic deal without risk. They liked, at least, to guarantee their capital. The problem with PLS is that [the Islamic economists] assume the scenario of the entrepreneur being a good Muslim."[45]

A subtler but equally pervasive form of Islamic moral hazard is the advantage that can be taken from ambiguity. Unlike secular systems, the legal system of Islam incorporates both an economic and a religious logic. As Noel Coulson noted: "Commercial law (...) in the West is orientated toward the intrinsic needs of sound economics, such as stability of obligation and certitude of promised performance. In the religious law of Islam, on the other hand, equitable considerations of the individual conscience in matters of profit and loss override the technicalities of commercial dealings. It is the harmonization of these two very different approaches which poses the real challenge for developing Islamic law today."[46] In the absence of a clear regulatory and legal framework, such ambiguity has allowed borrowers to escape their obligations with impunity.

D. Exit Strategies

The main "exit strategy" anticipated by Islamic PLS was based on progressive disengagement from a successful concern: the share of the financial institution would progressively diminish in favor of the entrepreneur. Funds would thus be freed up and invested into new ventures, while the entrepreneur would increase his control over his business. Hence the variations on *muḏāraba* and *mushāraka* respectively called the "diminishing" *muḏāraba* (*muḏāraba mutanāqiṯa*) and the "diminishing" *mushāraka* (*mushāraka mutanāqiṯa*). In both cases, the bank's share is progressively reimbursed, allowing the entrepreneur progressively to increase his share in the project.

In the literature on Islamic finance, few provisions were made for a venture's failure. The assumption was that all projects would be successful—with the corollary that the financier had a moral obligation to keep on subsidizing a money-losing operation. In contrast, venture capitalists assume that most companies will fail to fulfill their potential and fold. When they conclude that a project is not viable, they cut their losses by refusing further injections of money. It is a logic based on the view that the business world is one where the "gales of creative destruction" make sure that the success of the few is counterbalanced by the failure of the many. Although the ideal exit strategy for a venture capitalist is through an initial public offering (IPO), or a merger or acquisition, most exits occur when the venture capitalist "pulls the plug" on an investment. The lack of a properly functioning liquidation system combined with the proliferation of "connected lending" makes it difficult for banks to "just say no" to entrepreneurs seeking more financing.

E. Business Cycles and the Boomtown Mindset

Modern Islamic banking coincided with the oil boom of the mid-1970s.[47] It was a time of euphoria in much of the Islamic world (especially among oil-producing countries) with high hopes of more equitable North-South relations—the so-called New International Economic Order (NIEO)—and a prosperous regional economy. There was a widespread belief that new trends were here to stay: business plans extrapolated from the most optimistic assumptions. As a result, most projects presented for funding were approved. But the price of oil peaked in 1981 and much of the Islamic world experienced recession for much of the 1980s.[48] The oil-related euphoria had masked the vagaries of the business cycle. Too much money was chasing too few good opportunities. Get-rich-quick mindsets clouded the judgments of financiers as well as entrepreneurs. By the time banks had rediscovered time-honored truths—economies go through cycles of boom and bust, growth and recession; more businesses fail than succeed—they had already soured on profit-and-loss sharing.

V. The Organizational, Cultural, and Strategic Challenges of Partnership Finance

This section considers lessons based on the experience of American venture capital firms that could be usefully applied to the revitalization of Islamic finance. It discusses the role of a partnership finance unit within a bank, the mechanics of venture capital financing, culture and mindsets, and the strategic dilemmas of partnership finance.

A. Banks and Venture Capital

Increasingly, for reasons already explored, banks and other financial institutions are involved in venture capital. This raises organizational and strategic questions: How to integrate partnership finance within a broadly based financial institution? And how to reconcile the logic of risk-taking with the fiduciary responsibility of a deposit-taking institution? In answering such questions, the experience and strategic choices of American banks active in partnership finance is useful.

The involvement of commercial banks in venture capital has taken different forms. Certain institutions, such as the Silicon Valley Bank or Comerica Bank, cater principally to the entrepreneurial and venture capital communities. Most large American banks—particularly San Francisco-based Bank of America—have been active in venture capital, directly or through dedicated subsidiaries, since the 1960s.[49] Understandably, most initial forays were marked by failure. Despite ups and downs, some of these banks have become quite skilled in partnership finance. In the late 1970s and 1980s, the larger banks experienced returns exceeding 30% from their Silicon Valley venture funds.[50] In 1997 and 1998, some of the most successful funds achieved returns of 80%.[51] Because of existing laws and regulations—in particular the Glass-Steagall Act, which as of this writing seems likely to be abolished—limiting direct involvement by commercial banks in other areas of finance, banks could act as venture capitalists only through dedicated subsidiaries.[52]

The forced autonomy of venture capitalist subsidiaries proved a blessing, since it insulated venture capitalists from the meddling of conventional bankers. Insofar as the logic and principles of venture capital differ sharply from those of classical banking, successful banks have learned to understand those differences and address the strategic challenges of entrepreneurial banking. From a bank's standpoint, the attractions of venture capital are many. In addition to the intrinsic profitability of venture capital funds, banks can, in an environment of deregulated finance, conduct a wide range of transactions—ranging from loans to initial public offerings (IPOs)—with the new and promising companies they fund.

From the above, we can infer the preliminaries to the involvement of financial institutions—Islamic or otherwise—in partnership finance. They must:

1. create semi-autonomous PLS units staffed by people with special skills, whose career paths and compensation are not necessarily comparable to other bank employees;
2. give substantial decisional autonomy to those units, in particular avoiding interference by top executives;
3. decide on a share of the bank's assets that should be dedicated to PLS, and devise funding strategies accordingly.

B. Venture Capital Mechanisms

There are different stages in the venture capital process. Each has its own financial and economic characteristics. "Seed money" refers to the funding of the nucleus of a company. Often it is designed to simply move on beyond the idea stage. At the other extreme is the "exit," which marks the end of the venture capital process. Exit occurs when the company goes public (for instance through an IPO), merges with or is acquired by another company, or folds.

There are a number of stages in financing, from "early stages" that allow the company to start functioning, to "expansion stage" financing that provides the company with resources to grow beyond critical mass. "First-round financing" truly establishes the company, giving it the resources to fulfill its potential. Mezzanine financing refers to "in-between" financing for a company with IPO prospects. There can be many more rounds of financing before that stage. Understanding the characteristics of those stages is crucial.[53]

At all times, there must be clear awareness of the odds. In a typical venture capitalist's portfolio, there are a few huge successes, a number of modest winners—and a majority of money-losers. From the standpoint of the entrepreneur, seeking money is nonetheless brutal: in Silicon Valley, the typical venture capitalist looks at about 400 prospects a year, studies closely about two or three dozen, and ends up investing in possibly three or four.[54] As the next section shows, the mindsets of venture capitalists reflect this reality.

C. Mindsets

Silicon Valley venture capitalists have an idiosyncratic culture.[55] Perhaps the best illustration is the prevalent attitude toward failure. Paradoxically, given the pervasive glorification of success, failure does not, as it does in other cultures, carry a stigma.[56] It is viewed as a learning experience—an indication that past mistakes are less likely to be repeated. Thus, having failed at a previous venture is not necessarily disqualifying for future financing. Michael Lewis wrote:

> "(t)he Valley has responded (to frequent failures) by making failure something of a badge of honor. In the past 20 years or so, it has created the closest thing in capitalism to the old aristocratic idea of the nobility of failure. Get any prominent Silicon Valley person talking about what makes his culture special, and sooner or later he will say something like this: 'We have built a new system. Unlike you people back East, we do not stigmatize people as failures. Here we understand that failure is what happens when you try. We reward it.' By this he does not mean that people get rich by failing—though they do sometimes make a lot of money by selling to the overheated public stock in companies that will never turn a profit. He means that an entrepreneur who has gone broke three times in a row can, if he has a fourth good idea, find people who will back him."[57]

D. Involvement in Management

One of the basic rules of traditional Islamic PLS is a clear separation of roles: the *rabb al-māl* provides the funds; the *muḏārib* manages the venture; and at the end of the process, the accounts are settled. Such an arrangement made sense in the old days, when financing typically involved trade ventures involving distant travel. In today's environment, there is no reason why the roles should be so clear-cut. Indeed, success comes from a creative partnership in which the investor's lengthy and often painful experience in the company formation process is combined with the entrepreneur's management skills and detailed knowledge of a market or technology.[58]

Unlike conventional lenders, venture capitalists foster growth in companies they fund through their occasional involvement in strategic decisions (although a good venture capitalist also knows the stifling effect of too much involvement in a company's operations). Typically, the partner who arranges an investment in a company will take a seat on that company's board of directors and, for the next several years, play an active role in guiding the company. Some venture firms are also successful by creating synergies between the various companies in which they have invested. For example, a company with a good software product but no adequate distribution may be paired with another company or its management in the venture portfolio that has better distribution technology.

E. Between Diversification and Specialization

Venture capital funds come in all shapes and forms. Some are specialized by industry, region, or type of financing, whereas others are diversified. Indeed, there are two seemingly contradictory imperatives to partnership finance: there must be diversification (for hedging purposes) as well as specialization (as a way of building expertise in specific areas, industries, financing rounds, etc.). There is an actuarial logic to such investing—mitigating the risk of venture investing by developing a portfolio of reasonably diverse investments, and tailoring specific funds to the risk appetites of investors. The most diversified approach occurs when a financier invests in a "fund of funds," a partnership organized to invest in other partnerships, thus providing the limited partner investor with added diversification and the ability to invest smaller amounts in a variety of funds.

But at the same time, venture capitalists must be specialists, building expertise and taking advantage of synergies within a specific region, sector, or type of financing (seed financing, first-round financing, expansion stage financing, turnaround situations, etc.).

VI. Building Networks of Partnership Finance

Partnership finance cannot be consistently successful unless broad networks are created, linking PLS practitioners with one another, with other professionals, and with the community at large.[59] Such networks are especially important if a secondary market in *muḏāraba* certificates is to be developed. Despite the mythology of the individualistic entrepreneur unable to thrive within a structured environment, venture capital works best within "networks" or a "community." The storied Sand Hill Road in Menlo Park, California, on the northern edge of Silicon Valley, provides an example of a cluster of firms benefiting from being situated in the same geographic area. It is also revealing that Kleiner Perkins Caufield & Byers, the most famous venture capital firm of all, speaks of its *keiretsu*, by analogy with Japanese "families" of companies.

This section focuses on related activities that can facilitate the partnership finance process. Islamic financial institutions should strive to create and position themselves at the center of such networks. Here again the Silicon Valley experience is invaluable. Networks include "angels," "incubators," "venture catalysts," and other elements designed to foster appropriate institutions and subcultures, instill new attitudes, devise common standards (in financial reporting for example), and impose the necessary controls and discipline on borrowers. In addition, Islamic institutions should use their clout to lobby governments to promote an environment favorable to PLS.

A. Angels

The recent stock market boom has led to the emergence of a new sub-category of venture capitalists, the "angels," so-called because of their almost providential role. Indeed, what sets angels apart from typical venture capitalists is that they invest in companies that the typical venture capitalist would not touch. Angel investors may either be wealthy people with management expertise, or retired businesspeople who seek the opportunity for first-hand business development. The angels' occasional and often informal investments are usually in fields related to their background. They mentor a company and provide needed capital and expertise to help develop it—which in due course may result in attracting other financiers.

B. Incubators

Business incubators provide start-up business owners with low cost office space, advice, and other types of managerial and technical assistance. Their purpose is to shelter inventors and entrepreneurs whose ideas hold promise but are too fragile to survive in the free market. Big companies like Xerox as well as a number of venture-capital firms have their own incubators. And increasingly, government agencies, at both the national and local levels, are promoting them as tools of business development and economic growth. One of the best known Silicon Valley incubators is that of the National Aeronautics and Space Administration (NASA), which attempts to help promote technologies spun out of the space agency. As in the case of angel-supported projects, being part of an incubator confers credibility. Often, lawyers, accountants, and other professionals line up to offer their services in exchange for a tiny piece of a new company.

C. Venture Catalysts

Venture catalysts help entrepreneurs navigate the venture capitalism maze. In the early stages, they help write, rewrite, and "package" the business plan, and provide assistance in honing the "pitch" entrepreneurs make to professional investors. In later stages, they can perform various forms of "hand-holding," ranging from strategic advice to the recruitment of a board of directors. They are often compensated with shares of the company.[60]

D. The Role of Islamic Financial Institutions

Given their positions in their respective societies, Islamic financial institutions have a crucial leadership role to play in building such networks and influencing public policy. Indeed, entrepreneurial networks cannot thrive unless the political system sets rules of play and enforces them. In much of the Islamic world, "individuals and enterprises are at the mercy of administrative interpretations and applications, and can only succeed through the informal facilitation and evasions of bureaucratic functionaries."[61] Islamic banks must use their political clout to achieve a number of public policy goals, chief among them consistency and coherence in a number of areas, ranging from uniform accounting and financial reporting rules to a comprehensive legal system that addresses issues such as bankruptcy and directors' liability.

VII. Adapting Venture Capital Practices to the Islamic World

The American venture capital environment could not, and should not, be transposed as is to the Islamic world. For one thing, there are major institutional and cultural obstacles to such a transposition. More importantly, features that have proven successful—and that may be legal—may be ethically dubious. Many features of venture capital should be tempered with the moral values of Islam, especially as they pertain to *gharar* and *ribā*.

The injunctions against *gharar* (usually translated by the trilogy "uncertainty, risk, speculation") are not injunctions against risk per se, but against taking advantage of uncertainty and risk. *Gharar* has also been interpreted as speculation that brings no economic benefit, or transactions driven solely by financial engineering. And it is prohibited by analogy with the prohibition of gambling or of any scheme where the allocation of rewards is random, and where people get something for nothing.[62] The general argument is congruent with the moral economy of Islam as well as with the PLS logic: wealth should come from industriousness as well as risk-sharing, which is why Islam is firmly against selling and otherwise transferring risk to third parties, without assuming a share of the risk.

Ribā is commonly translated as usury or interest. While partnership finance bypasses the interest-rate problem, *ribā* (literally meaning increase) in its broader sense—the equivalency of counterparts—may still pose a problem as venture capital is fraught with conflicts of interest, and it is relatively easy to take advantage of one party's lack of knowledge (*jahl*) or weak bargaining position.[63] The *muḏārib* can ask for more money than he needs, or he can engage in high-risk endeavors, knowing that he is not be committing his own money. A bank can also take advantage of a *muḏārib* who is pressed for cash to snare a bigger share of a venture. It can also structure the transaction so as to "privatize profits and socialize losses," i.e., reserving for itself the lucrative parts of a deal, while transferring the least profitable ones to the passive investors (the bank depositors).[64]

VIII. Conclusion: From Vicious to Virtuous Circle

This paper argued that the revitalization of Islamic partnership finance is long overdue, and that rather than "reinventing the wheel" through a lengthy trial-and-error process, Islamic financial institutions should draw on the experience of American-style venture capitalism. It would be easy to adopt a fatalistic attitude, arguing that cultures and institutions in the Islamic world are ill adapted to partnership finance, or to find it incongruous to associate Silicon Valley and Islamic business practices. To be sure, culture cannot be changed overnight, but subcultures and appropriate institutions can be created. The example of micro-lending is in that respect revealing: small-scale entrepreneurial networks were established in the most unlikely areas by devising appropriate institutions and incentives.[65] Most importantly, as we saw, the logic of Islamic PLS and that of Western-style venture capitalism are identical. Properly understood, most principles and strategies are transposable, albeit with appropriate modifications, to an Islamic environment. The global economy will no doubt impose pressures on Islamic financial institutions to reconsider their neglect of Islamic finance. The lessons from Western venture capital will at the very least shorten the learning curve.

In justifying the weakness of Islamic PLS, there is a lot of blame to go around banks, governments, depositors, and entrepreneurs who did not play their assigned roles. It became a vicious circle: if failure was likely, there was ample reason for all involved to shun partnership finance. This vicious circle should be transformed into a virtuous one. By adopting the proper strategies, banks can become successful at partnership finance. This in turn will encourage depositors and improve the attitudes of entrepreneurs. Only a consistent track record can inspire the necessary public confidence. Banks must work on many fronts: they must understand why early experiments failed and why venture capitalism has succeeded elsewhere; they must devise proper strategies, procedures and mechanisms; they must work at creating networks and lobbying public officials. Perhaps the greatest challenge is to instill a culture fostering the development of profit-and-loss sharing.

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[1] Partnership finance, profit-and-loss sharing (PLS) venture capitalism, and commenda partnerships are all synonymous. For clarity purposes, in this paper, partnership finance will be used as a generic term, profit-and-loss sharing (PLS) will refer to the Islamic practices of *muḏāraba* and *mushāraka,* venture capitalism will refer to partnership finance outside the Islamic world (principally in the United States), and commenda partnership will refer to a corporate structure (allowed in certain countries such as France) based on profit-and-loss sharing between a financier and an entrepreneur.

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- dollars raised by venture capitalists from institutional investors: $25.3 billion (1998), $15.2 billion (1997), $10.5 billion (1996).
- dollars venture capitalists disbursed to companies: $16.7 billion (1998), $13.6 billion (1997), $9.9 billion (1996).

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[48] On the expectations bred by bullish markets, see Galbraith, John Kenneth. A Short History of Financial Euphoria. New York: Viking, 1990.

[49] The initial vehicle was the Small Business Investment Corporations (SBICs). See Wilson. The New Venturers. p. 157.

[50] Wilson. The New Venturers. p. 158.

[51] Warde, Ibrahim. "Banks and Venture Capital." IBPC Working Papers. San Francisco: IBPC, 1999.

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The Islamic Commodity Trust

With Application to Crude Oil Forward Sales

Rudy Yaksick*

ABSTRACT

This paper addresses the following dilemma confronting a consumer and supplier of a commodity who wish to execute an Islamically acceptable forward sale of a commodity. The consumer wants to receive the commodity over several time periods and wants to make installment payments beginning only after all the desired quantity is received. In contrast, the supplier wants to receive the entire payment before delivering any shipments to the consumer. This dilemma can be solved with a financing mechanism called an Islamic commodity trust. The trust has three key components: 1) a *muḏāraba* partnership; 2) a *salam* contract; and 3) a *murābaẖa* with an order-to-purchase contract. The paper concludes by discussing the practical relevance of the trust mechanism (applied to forward sales of crude oil) for financing upstream oil facilities in the Persian Gulf region.

I. INTRODUCTION

This paper addresses the following dilemma confronting a consumer and supplier of a commodity who wish to execute an Islamically acceptable forward sale of a commodity. The consumer wants to receive the commodity in the future—with the price "locked-in" today—and begin making installment payments, only after the desired quantity is received. In contrast, the supplier wants to receive the entire (single) payment before delivering the commodity to the consumer. In other words, the financing problem is that the consumer and the producer cannot agree on either the timing ("before" versus "after" delivery) or the frequency (single versus installment basis) of the payment(s). Hence, they cannot consummate an otherwise mutually agreeable deal for forward delivery of a commodity at a price agreed upon today.

The solution to this dilemma involves the provision of credit to the buyer and, simultaneously, the provision of debt financing to the seller. Hence, the forward sale dilemma can be solved via a financing mechanism called an Islamic commodity trust. The trust has three key components: 1) a *murābaẖa* with an order-to-purchase contract that provides credit financing to the buyer; 2) a *Salam* contract that provides debt financing to the seller; and 3) a *muḏāraba* partnership that provides both credit and debt financing as well as structures the "deal."

The structure of the mechanism is described in part II. Then, part III addresses the issue of whether the trust-financing mechanism is consistent with Islamic legal principles. This legal analysis is complemented by a financial-risk analysis in part IV. Part V concludes by discussing the contemporary relevance of the trust mechanism, which lies in its ability to harness local (as opposed to foreign) savings to provide financing for "upstream" oil facilities on the Arabian Peninsula.

II. STRUCTURE OF A COMMODITY TRUST

The preceding financing problem—disagreement over timing and frequency of payment—can be efficiently solved by an Islamic commodity trust (ICT). In particular, the ICT provides a single payment to the commodity producer before delivery as well as enables the consumer to pay a fixed price on an installment basis for the commodity after it is delivered.

A. Three Key Components

This solution is achieved by linking two basic Islamic contracts—*Salam* and *murābaẖa* with order-to-purchase—with a *muḏāraba* partnership serving as the linchpin. In particular, the commodity producer's need for immediate payment of future delivery of the commodity is satisfied by a *Salam* contract. The customer's need for

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* Founder and Principal, Financial Engineering and Risk Management, Concord, Mass.

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future delivery and deferred payment is met by the *murābah̲a* with order-to-purchase contract. Financing and commodity brokering services for this pair of transactions are provided by the *mud̲āraba* partnership. In sum, the ICT mechanism has three key components:

1. a *mud̲āraba* partnership whose investors provide the capital to purchase the commodity from the commodity producer;
2. a *Salam* contract between the *mud̲āraba* and the commodity producer that provides for the forward delivery of the commodity with a single payment made to the commodity producer, prior to the delivery of the commodity; and
3. a *murābah̲a* with order-to-purchase contract, in which the consumer orders the *mud̲āraba* to purchase the commodity for future delivery and the *mud̲āraba*, in turn, agrees to accept installment payments from the consumer after the commodity is delivered.

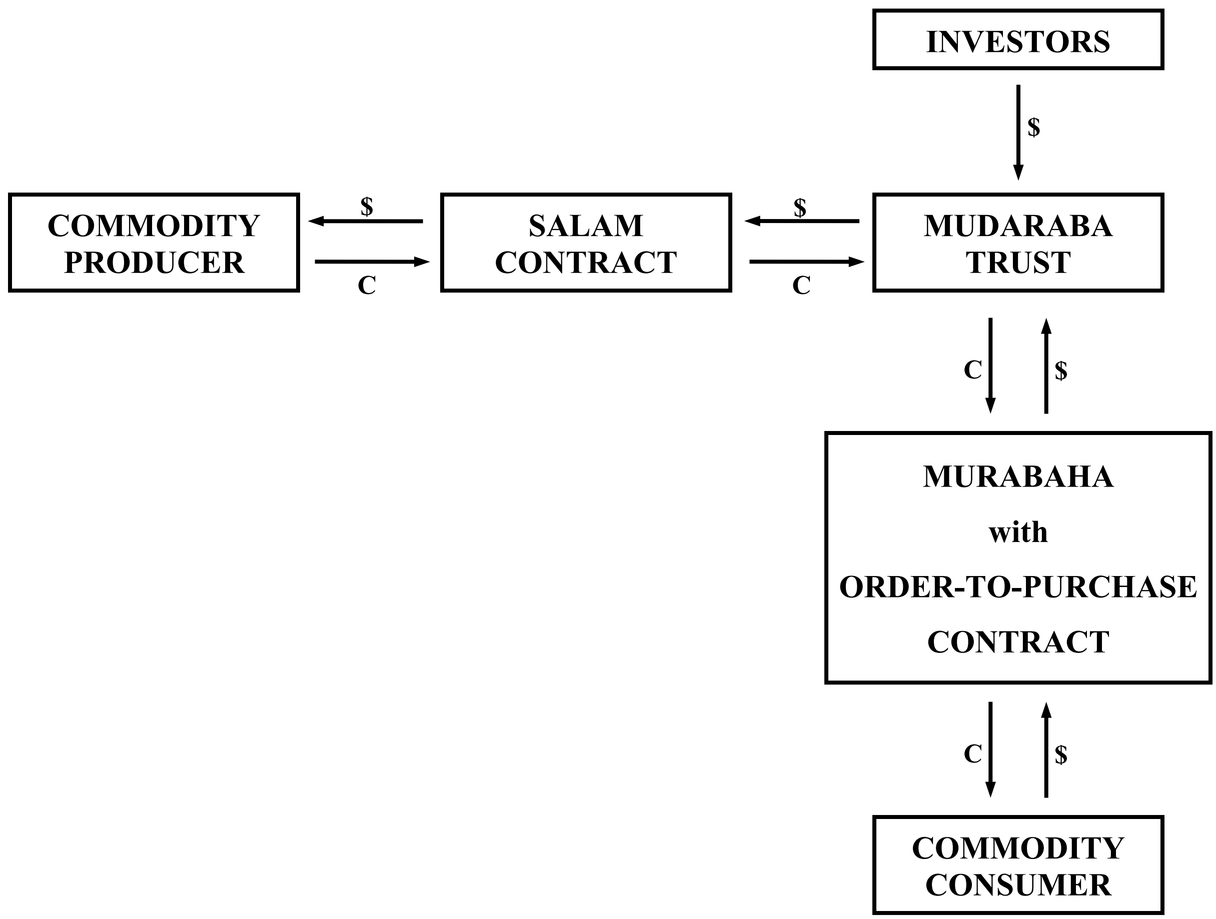
The relationship among the key components of the ICT mechanism is illustrated in Figure 1. Briefly, the *Salam* contract links the commodity producer and the *mud̲āraba* partnership; the *murābah̲a* with order-to-purchase contract links the *mud̲āraba* partnership and the consumer of the commodity.

Note that Figure 1 is drawn under the assumption that only one consumer and producer participate in the transaction. However, one can easily generalize Figure 1 to a situation of several consumers and producers.

B. Transactions

As illustrated in Figure 1, there are two separate transactions in the ICT mechanism. To fix ideas, the transactions are described in the context of the forward sale of crude oil. First, the *mud̲āraba* party instructs its agent/manager (*mud̲ārib*) to enter a *Salam* contract with the oil producer. The *mud̲ārib* uses the *mud̲āraba*'s capital to do so immediately. Evidence of the *mud̲āraba*'s ownership of the crude oil is provided by both the *Salam* contract and future-dated oil storage tank receipts.

FIGURE 1. STRUCTURE OF AN ISLAMIC COMMODITY TRUST



LEGEND:

C – denotes flow of commodity (future delivery)

$ – denotes flow of money

The second transaction is a conventional, frequently used Islamic trade (credit) financing deal. That is, the *muḏāraba* party enters a *murābaḫa* and an order-to-purchase contract with the oil consumer. The sequence of events in this transaction is as follows:

1. The *muḏāraba* party takes delivery of its oil—at the oil company's port—at future delivery dates (specified in the order-to-purchase agreement);
2. The quantity and quality of the oil (as specified in the order-to-purchase contract) are verified by an independent, licensed surveyor;
3. After the consumer agrees to the surveyor's report, the oil is shipped via a certified, insured vessel to the port designated by the consumer;
4. After taking delivery, the consumer begins making installment payments to the *muḏāraba* financier(s), according to the terms specified in the *murābaḫa* agreement; and,
5. After the final payment is made, the consumer's collateral deposit is returned and the deal is completed.

C. Why Is the Mechanism a "Trust?"

Let us briefly discuss the reasons for labeling the financing mechanism a "trust." In this paper, we assume that the *muḏāraba* partnership is organized in a traditional manner. That is, the *muḏārib* (i.e., the agent/entrepreneur for the investors) does not invest in the partnership. Moreover, the *muḏārib* is compensated by receiving a pre-agreed percentage share of the profits generated by his/her managerial or entrepreneurial activities.

In this classical form, the liability for loss (*ḏamān*) is assigned entirely to the investors. Thus, the *muḏārib* is not held liable at all for economic loss, unless he/she is shown to be in breach of trust.[1] Consequently, the *muḏārib* does not bear the risk of (financial) loss. Instead, the *muḏārib* risks only his/her labor expended in managerial/entrepreneurial activities. Within this context, the *muḏārib* is considered to act as a trustee (*amin*) for the investors (*rabb al-māl*). Hence our reason for labeling this financing mechanism a (commodity) trust.

III. Legal Analysis

Is the financing mechanism consistent with Islamic legal principles? To guide our analysis, the conditions that must be satisfied for each of the contracts (and related transactions) to be deemed Islamically valid are stated. This section provides a series of checklists to assess the legal feasibility of the trust mechanism. It also constitutes within this paper a self-contained section that is aimed at readers unfamiliar with Islamic contract law and financial principles.

Of course, only a *sharīᶜa* board has the authority to determine the Islamic validity of the trust mechanism. However, one may be optimistic that a *sharīᶜa* board would approve of this mechanism because, as the following analysis indicates, all components of the trust mechanism comply with Islamic law. In particular, the contracts and organizational arrangements embedded in the trust have the following properties, explained in detail in the following sub-sections:

1. The *bayᶜ salam* contract satisfies the conditions of ordinary sale as well as the conditions unique to the *Salam* contract;
2. The *murābaḫa* with order-to-purchase contract satisfies the conditions of: a credit sale, a general sale, and the buyer's order-to-purchase promise; and,
3. The *muḏāraba* Partnership satisfies the conditions of an Islamic partnership.

A. *Bayᶜ Salam* Contract

The *Bayᶜ Salam* contract is a sale agreement in which advance payment is made to the seller for deferred delivery of goods (Hasanuz Zaman, p. 225). A unique feature of the *Salam* contract is that the price paid (advance payment), on the date the buyer enters the contract (denoted P^S), is lower than the price that would have been paid if the sale were a cash (spot) sale at the time of delivery (denoted P_T). According to Vogel and Hayes (p. 213), "The magnitude of the discount ($P_T - P^S$) is a function of the credit uncertainty of the debtor (buyer) and the time preference of the investor (seller)." Hence, the *Salam* contract can be viewed as providing a form of debt financing.[2]

The *Salam* contract must satisfy the conditions of an ordinary sale as well as conditions unique to the *Salam* sale. These conditions are listed below.

1. Conditions of an "Ordinary" Sale

The conditions of an "ordinary" sale that the *Salam* contract must satisfy are, as noted by (Ray, pp. 38-39), the following.

1. Both parties to the sale must be voluntary participants.
2. Both parties must be fully competent (in a legal sense) to transact.
3. The object of sale must be property (*māl*). The definition of this varies, but it generally means an object having a legal use (a dead dog, for instance could not ordinarily be the object of a sale, since a dog is considered unclean when alive, useless when dead).
4. The seller must own the object of sale, or he must be authorized to sell it. Such authorization without ownership could come about in several ways, including partnership, agency (*wakala*), or guardianship of a minor.
5. The seller must be able to deliver the object of sale. For instance, the sale of a lost object or an escaped animal is forbidden because the seller cannot deliver the goods.
6. The buyer (and seller) must take cognizance of the object of sale, either by examination or by an adequate description. Thus the sale of a "grab bag" of unknown contents is forbidden.
7. The price must be determined precisely and known by both parties.

Finally, Ray (p. 39) also points out, "In the event of an intrinsic defect existing in the object, the buyer has the unconditional right to rescind the sale. This right (*khiyar al'ayb*) cannot be ceded by a contractual stipulation; any such stipulation would be null and void."

2. Differences between "Ordinary" and *Salam* Sales

In addition to the conditions of an ordinary sale, the *Salam* contract must also satisfy five additional criteria. These are (Hasanuz-Zaman, p. 226):

1. In a *salam* sale, it is necessary to precisely fix a period for the delivery of goods; in an ordinary sale this is not necessary.
2. In a *salam* sale, a commodity not in the possession of the seller can be sold; in an ordinary sale, it cannot be.
3. In a *salam* sale, only commodities that can be precisely determined in terms of quality and quantity can be sold; in an ordinary sale, everything that can be owned is saleable, unless the Qur'ān or the Sunna prohibits it.
4. A *salam* sale cannot take place between identical goods (e.g., wheat for wheat, or potato for potato); in an ordinary sale, the exchange of identical goods is permissible.
5. Payment in a *salam* sale must be made much in advance of the delivery of goods and at the time of contract; in an ordinary sale, payment may be deferred or made at the time of delivery.

3. Specific Conditions of a *Salam* Contract

The final set of conditions that the *salam* contract must satisfy (in addition to satisfying the conditions of an ordinary sale) is: (refer to Hasanuz-Zaman, p. 227)

1. A person who is a potential grower or manufacturer of a commodity is qualified to contract a *bay*ᶜ *salam* against advance payment. Thus, it is not necessary for this seller to have possessed the merchandise at the time of the contract. It is also not necessary that he should himself be growing or manufacturing it.
2. The buyer should advance the price of the commodity at the time of contract.
3. The commodity should be generally available in the market at the time of delivery; it should not be an extinct or rare commodity, out of supply, or out of season when the seller must deliver it.
4. The commodity in exchange should in itself not be in the nature of money.
5. The specifications of the commodity should particularly cover all those characteristics that are responsible for variations in price.

B. *Murābaẖa* with Order-to-purchase

The *murābaẖa* contract permits the immediate delivery of a commodity with deferred payment, as well as a profit markup included in the selling price (Vogel and Hayes, p. 182). Note that the *murābaẖa* contract is a credit sale since it provides for deferred payment. Hence, we must first consider the basic legal requirements of credit sales.

1. Credit Sale Conditions

As Ray (pp. 39-40) points out, there tends to be differences of opinion, among the four major Islamic schools of thought, regarding five key parameters of credit sale contracts:

1. Goods that can be sold via credit;
2. Contract price: immediate sale versus credit sale;
3. Forfeitable down payment;
4. Rescission of the deal; and,
5. Penalty for late payment.

a. Goods Eligible for Sale

Hanafis consider all goods, except species of *māl ribawī*, permissible for credit sale. For the Hanafis, *māl ribawī* means weighable goods—other than currency—subject to *ribā*. For Malikis, all *ard̲* goods can be sold for credit. They differ on the meaning of *ard̲* goods, however, with three (differing) opinions: 1) everything except currency; 2) everything except currency and weighable or measurable goods; and 3) everything but currency, weighable, or measurable goods, and animals. Under Shafi'I law, all goods except currencies and foodstuffs can be objects of credit sale. An exception is made for foodstuffs when they are exchanged against future payments in currency (but not in other goods). Hanbalis permit the sale on credit of all goods except those weighable and measurable and foodstuffs. However, like the Shafi'is, they permit the sale of foodstuffs for future payment of currency only.

b. Contract Price: Immediate (Spot) Sale versus Credit Sale

Can an article be sold at one price, if the buyer pays immediately, yet at another price if payment is deferred to a future date? According to Ray (p. 40), Hanafis permit the setting of two different prices. Likewise, he concludes that the Shafi'is and Hanbalis appear to permit the charging of a higher price in credit sales than in sales with immediate payment. Finally, Malikis appear to hold conflicting views, since Imam Malik forbade the charging of different prices.

c. Forfeitable Down Payment

Only the Hanbali school views the down payment to be forfeitable.

d. Rescission of the Deal

All schools allow both the buyer and seller to rescind the deal, but the rescinding party must compensate the other party.

e. Late Payment Penalty

All schools agree that the seller (creditor) cannot assign a penalty to the buyer (debtor) if the latter makes a late payment to the former.

2. General Sale Contract Issues

In addition to credit sale requirements, the *murābaha̲* contract must also satisfy the following conditions: (Ray, pp. 45-59)

1. All expenses incurred in relation to the object being sold may be included as part of the base cost.
2. All documents relevant to the sale object must be given to the buyer. This includes informing the buyer if the purchase price was denominated in foreign currency and, if so, whether the exchange rate has changed.
3. If the seller receives a rebate for the object sold, even after the *murābaha̲* sale has been consummated, the buyer is entitled to benefit from the rebate as well.
4. There is a difference of opinion regarding the time at which the seller can legally sell the object to the buyer.

According to Ray (p. 48), by the orthodox and legally correct doctrine, "Selling is postponed until the bank (seller) gets actual ownership and possession of the goods and becomes responsible for any defects therein." This view has been adopted, for example, by the Faisal Islamic Bank of Egypt (FIBE) and the Islamic Bank for Investment and Development. However, Ray notes that not all Islamic banks follow these rules: Kuwait Finance House does not.

3. Order-to-Purchase

There is some debate surrounding the "order-to-purchase" component of the contract. According to Ray (pp. 51ff), the question, "Is the order-to-purchase binding?" leads to two differing views. He cites several *fatāwā* that treat the order-to-purchase as binding (*lazim*). For instance, FIBE—drawing upon quotations from the Sunna—issued a *fatwā* stating, "Promises were valid as long as they neither permit that which is forbidden nor forbid that which is permitted." (Ray, p. 52)

By contrast, the non-binding view (*ja'iz*, *ghayr lazim*) has been supported by the International Association of Islamic Banks (IAIB) and Abdul Aziz Ibn Baz (until recently, the highest legal authority in Saudi Arabia). The IAIB believes, "The person who ordered the goods is allowed the right to withdraw against payment of reasonable compensation." (Ray, p. 53) Similarly, Ibn Baz's *fatwā* interprets the promise (written or spoken) as non-binding.

In spite of this difference of opinion, Ray (p. 54) observes that most Islamic banks consider the promise to purchase binding. Further, they require collateral against the possibility that the promise will not be honored. In sum, this difference of opinion among Islamic scholars has spawned a general objection to the *murābaha̱* contract.[3]

C. *Muḏāraba* Partnership

This form of business organization provides for equity investment via a profit-sharing arrangement. The investing party (*rabb al-māl*) provides the capital, while another party, the *muḏārib*, supplies the managerial and/or entrepreneurial effort. Note that the *muḏārib* has the right to sell goods on credit (Khan, p. 218).

Profit is shared between the passive investor and the entrepreneur according to a pre-determined percentage rather than a fixed amount. According to Khan (p. 213), "Profit is any increment in the original capital." However, he also points out (p. 214), "So far no law has been able to define this concept (profit) clearly and precisely. Most of what is being believed depends on court rulings." Finally, if past losses have occurred, Khan (p. 216) indicates, "It has been clearly provided that profit will be determined after all past losses have been written off and the original capital brought intact."

If losses occur (i.e., the original capital is depleted), the investors incur the loss. The *muḏārib* only loses his/her time and effort allocated to the partnership. In particular, the investors share any loss (except credit-related loss) in proportion to their capital contribution. However, if the business has obtained credit (with the unanimous consent of all partners) and cannot repay the credit with the assets of the business, then the loan will be repaid equally by all investors and the *muḏārib*.[4]

IV. Financial Risk Analysis

The objective of this section is to analyze the price risk faced by the *muḏāraba* partnership from both the *Salam* and *murābaha̱* contracts.[5] By price risk it is meant the lack of equality between the *muḏāraba*'s markup and the total economic value of the *Salam* and *murābaha̱* contracts, where this potential lack of equality is due to unexpected (random) changes in the spot commodity price at the delivery date. For example, the *muḏāraba* is said to face no price risk, if, on the delivery date, the *muḏāraba*'s markup equals the total economic value of the two contracts. In other words, the *muḏāraba* partnership, after entering the *Salam* and *murābaha̱* contracts, will not experience an "opportunity" gain (or loss) that differs from the markup—i.e., experience no risk—regardless of the level of the spot commodity price on the delivery date. When this equality occurs, the two contracts create a perfect hedge: the contracts' combined economic value will, with probability one, equal the *muḏāraba*'s markup. Finally, note that we focus on the *muḏāraba*'s risk because this paper is written from the perspective of an Islamic financial institution that might wish to serve as the *muḏāraba* partnership.

A. *Salam* Price Risk

Two steps are required to estimate the price risk of the *Salam* contract: 1) specify the economic value of the contract; and 2) estimate the relationship between changes in the economic value of the contract and changes in the spot commodity price that prevails on the delivery date.

1. Contract Value

When the *muḏāraba* partnership enters the *Salam* contract, it agrees to buy the commodity at the delivery date (T) and pay the agreed price (P^S), even though the spot commodity price on the delivery date (P_T) may differ from the agreed price. Thus, at the delivery date the economic value of the contract equals the economic payoff (gain or loss) that the contract generates for the *muḏāraba* partnership. More precisely, the value of a *Salam* contract at the delivery date (V_T^S) is the spot price at the delivery date minus the price initially agreed to:

$$V_T^S = P_T - P^S \qquad \text{...... (1)}$$

The reasoning underlying this value equation is as follows. Economic ("opportunity") gains accrue to the partnership when the spot market price on the delivery date (P_T) exceeds the buying price specified in the *Salam* contract (P^S), for the partnership can purchase the commodity for the lower (contractually stipulated) unit price P^S and avoid the higher spot price P_T. This avoidance of the higher unit price is an economic or "opportunity" gain. In this case, V_T^S has a positive value, since $P_T > P^S$.

The partnership incurs economic losses when the spot price (P_T) is less than the agreed buying price (P^S). In this situation, the partnership is forced to pay more for a unit of the commodity than the commodity is currently selling for on the spot market (at the delivery date). In this situation, the partnership incurs an economic loss; the terms of the *Salam* contract prevent the partnership from taking advantage of the lower unit (spot) price (P_T). Hence, V_T^S has a negative value, since $P_T < P^S$.[6]

Consider the following numerical example. Suppose that the partnership agreed to buy the commodity at a unit price of \$15 (P^S = \$15); and that the spot commodity price on the delivery date is \$17 (P_T = \$17). From the partnership's perspective, the value of the *Salam* contract (V_T^S) is \$2 (V_T^S = \$17 – \$15 = \$2). That is, the partnership experiences a \$2 economic gain per unit of the commodity purchased. In contrast, if P_T = \$10, then V_T^S = \$10 – \$15 = -\$5. The partnership incurs an economic loss of \$5 per unit.

2. Contract Value/Spot Price Relationship

The magnitude of the price risk is illustrated by graphing the relationship between the *Salam* contract value (payoff) and spot commodity price changes. Since the *Salam* contract obligates the *muḏāraba* partnership to take future delivery of the commodity, the *Salam* contract's payoff (gain/loss) profile is identical to the standard payoff profile for a "long" position in a conventional (non-Islamic) forward contract.

As illustrated in Figure 2, the profile line is the positively sloped 45-degree line, intersecting the horizontal axis at the agreed purchase price (P^S). The horizontal axis measures the unit spot commodity price at the future delivery date. The vertical axis measures the *Salam* contract's economic value (payoff per unit of commodity purchased) at the future delivery date.

Economic gains are represented by the portion of the profile that lies above the horizontal axis; economic gains, below. The slope of the profile is 45° degrees, since the buyer experiences an additional \$1 of gain (loss) for every \$1 increase (decrease) in the spot price relative to the agreed buying price (P^S).

B. *Murābaḫa* Price Risk

The price risk of the *murābaḫa* contract is also estimated via the two-step methodology used above.

1. Contract Value

The *murābaḫa* contract requires the *muḏāraba* partnership to deliver the commodity to the consumer at the delivery date. Moreover, the *murābaḫa* contract permits the *muḏāraba* partnership to charge a fixed markup over the price that the partnership paid for the commodity. The relationship between the *muḏāraba*'s buying and selling prices is expressed algebraically as:

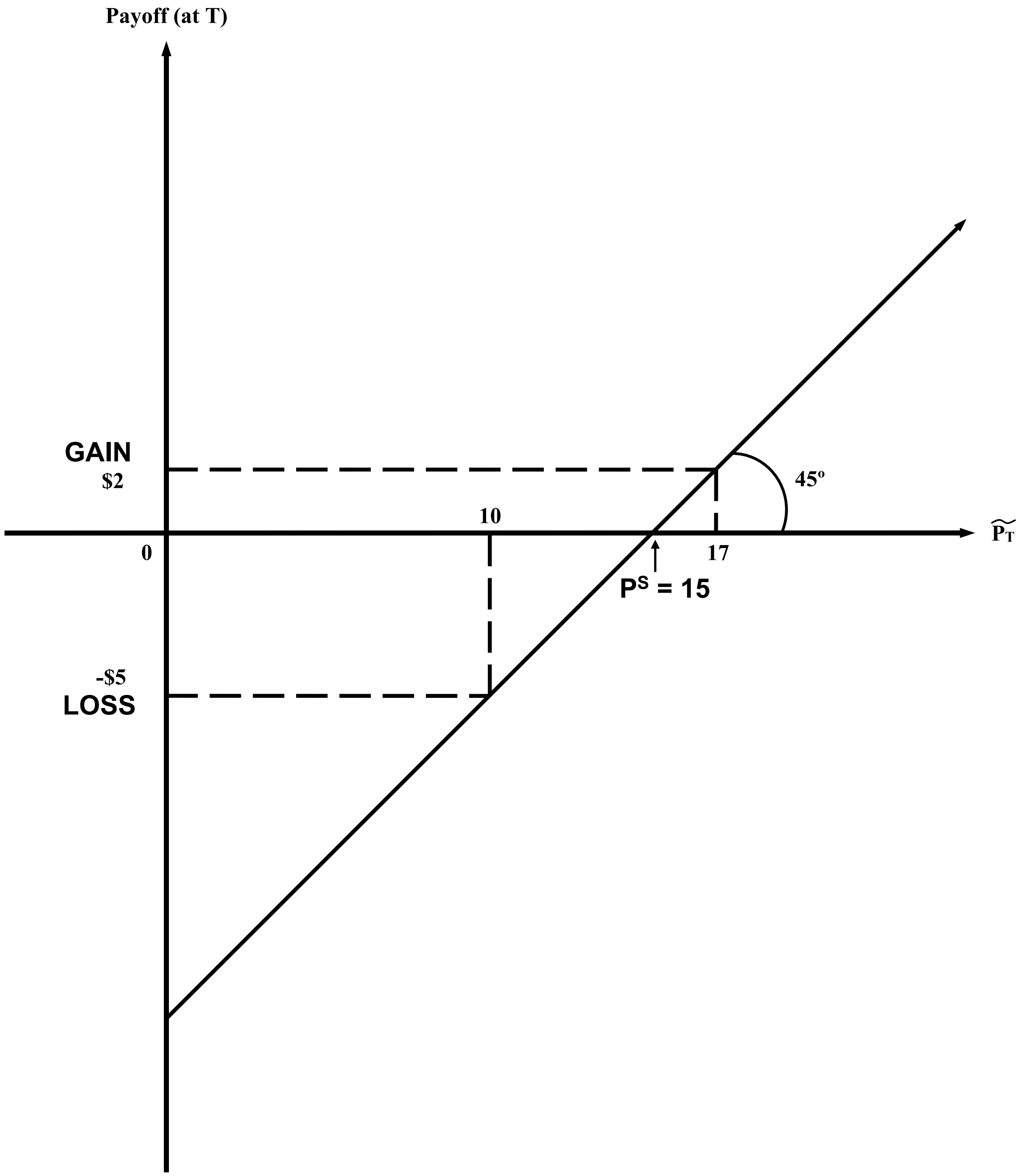
$$P^M = P^S + Markup \qquad \text{...... (2)}$$

P^M denotes the *muḏāraba*'s selling price;

P^S denotes the *muḏāraba*'s buying price (here, equal to the price paid the *Salam* seller); and

Markup denotes the additional money that the *muḏāraba* receives for providing broker and customer services and covering storage costs, damage costs, payment default risk, and delivery risk (i.e., the buyer's refusal to accept delivery).

FIGURE 2. *MUḎĀRABA* PAYOFF PROFILE—*SALAM* CONTRACT



<u>LEGEND:</u>

P^S – *muḏāraba* purchase price (*salam* contract)

$\widetilde{P_T}$ – spot commodity price at delivery date (T)

Note that the *muḏāraba* partnership agrees to receive the contractually stipulated selling price (P^M), even though the spot commodity price on the delivery date (P_T) may be different than P^M. Thus, at the delivery date the economic value of the *murābaẖa* contract equals the economic payoff (gain or loss) that the contract generates for the partnership. More precisely, the value of a *murābaẖa* contract at the delivery date (V_T^M) is the markup price minus the spot price, i.e.,

$$V_T^M = P^M - P_T \qquad \text{...... (3)}$$

The reasoning underlying this value equation is as follows. Economic ("opportunity") gains accrue to the partnership when the selling price specified in the *murābaẖa* contract (P^M) exceeds the delivery-date spot market price (P_T). The reason is that the partnership can sell the commodity for the higher (contractually stipulated) unit price P^M than the current (delivery date) spot price P_T. This contractual right to charge a higher unit price is an economic or "opportunity" gain. In this case, V_T^M has a positive value, since $P^M > P_T$.

Conversely, the partnership incurs economic losses when the spot price (P_T) is greater than the agreed selling price (P^M). In this situation, the partnership is contractually obligated to charge less for a unit of the commodity than the price the commodity currently commands on the spot market (at delivery date). In this situation, the partnership incurs an economic loss because it is selling the good below the market price. The terms of the *murābaẖa* contract prevent the partnership from taking advantage of the higher unit (spot) price (P_T). Hence, V_T^M has a negative value, since $P^M < P_T$.

Consider the following numerical example. Suppose that the partnership agreed to sell the commodity at a unit price of \$17 (P^M = \$17) and that the spot commodity price on the delivery date is \$10 (P_T = \$10). Then, from the partnership's perspective, the value of the *murābaẖa* contract (V_T^M) is \$7 (V_T^M = \$17 – \$10 = \$7). That is, the partnership experiences a \$7 economic gain per unit of the commodity purchased. In contrast, if P_T = \$22, then V_T^M = \$17 – \$22 = -\$5; an economic loss of \$5.

In conclusion, note that the partnership can incur economic losses even though it will (with probability one) receive its markup (accounting "profit").[7] The point of the analysis is that economic value (gains/losses) does not necessarily equal accounting value (profits/losses). In other words, the *murābaẖa* contract forces the partnership to forgo opportunities (alternative deals) that generate larger profits than those implied by the markup specified in the contract.

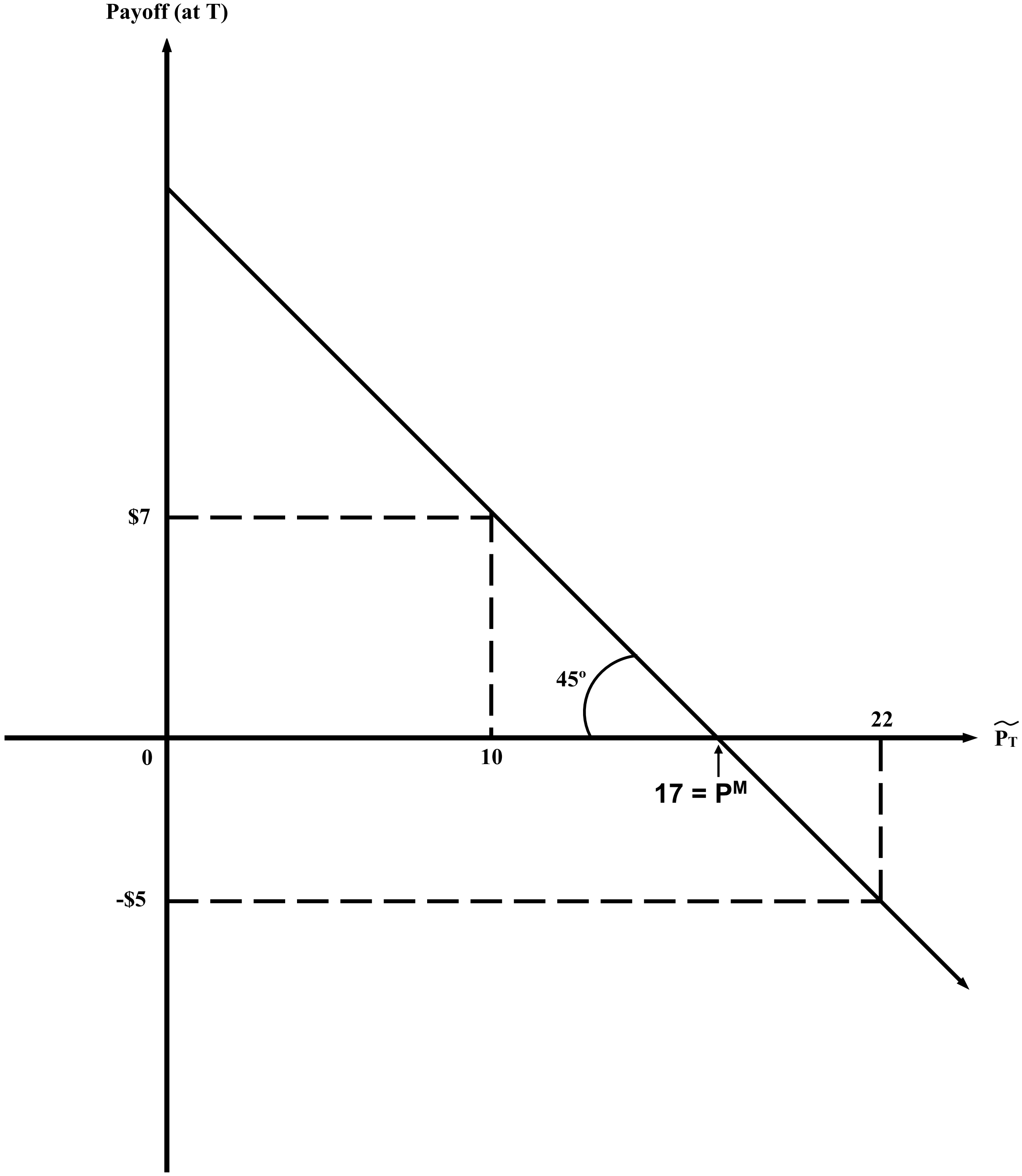
2. Contract Value-Spot Price Relationship

The magnitude of the price risk is illustrated by graphing the relationship between the *murābaẖa* contract value (payoff) and changes in the spot commodity price. Since the *murābaẖa* contract obligates the *muḏāraba* partnership to make future delivery of the commodity, the *murābaẖa* contract payoff (gain/loss) profile is identical to the standard payoff profile for a "short" position in a conventional (non-Islamic) forward contract.

As illustrated in Figure 3, the payoff profile line is the negatively sloped 45-degree line, intersecting the horizontal axis at the agreed selling price (P^M). The horizontal axis measures the unit spot commodity price at the future delivery date. The vertical axis measures the *murābaẖa* contract's economic value (payoff per unit of commodity sold) at the future delivery date.

Economic gains are represented by the portion of the profile that lies above the horizontal axis; losses by the portion of the profile that lies beneath the horizontal axis. Note that the profile has a slope of negative 45°: the buyer reaps an additional \$1 of gain (loss) for every \$1 decrease (increase) in the spot price, relative to the agreed selling price (P^M).

FIGURE 3. *MUḎĀRABA* PAYOFF PROFILE—*MURĀBAḪA* CONTRACT



LEGEND:

P^M – *muḏāraba* selling price (*murābaḫa* contract)

$\widetilde{P}_T$ – spot commodity price at delivery date (T)

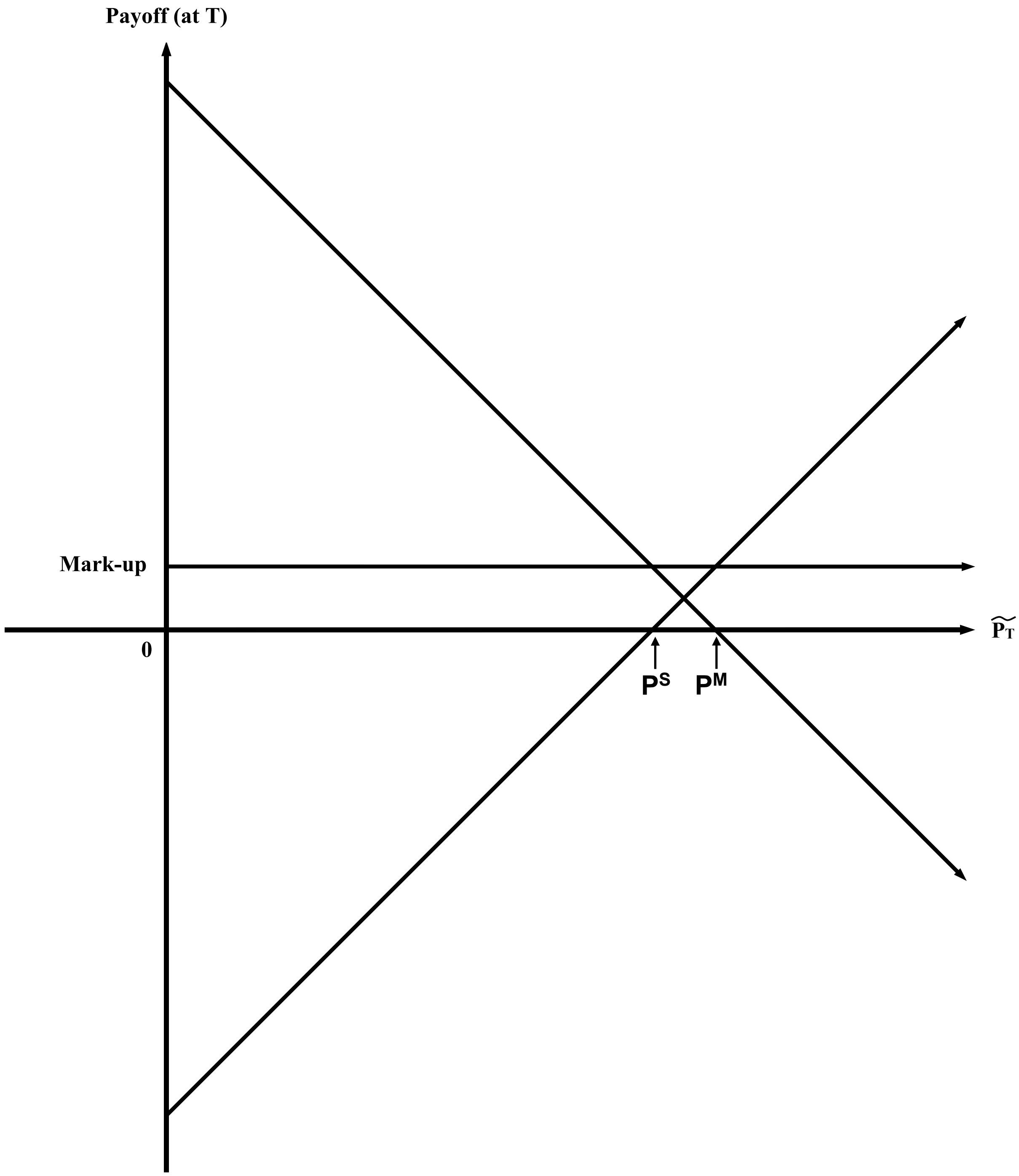
C. Price Risk of Both Contracts

The combined payoff from both contracts is illustrated in Figure 4. This horizontal payoff profile (labeled Markup) is created by overlapping Figures 2 and 3 and then vertically (and algebraically) summing (at each commodity price) the payoff from each contract.

1. Main Analytic Result

As the reader can see, the combined payoff is a constant amount equal to the *muḏāraba* markup, regardless of the level of the spot commodity price (P_T) on the delivery date. In other words, the *muḏāraba* partnership obtains a perfect hedge against uncertainty in the spot commodity price by combining the *Salam* and *murābaẖa* contracts: the economic value of the contracts equals the markup (accounting "profit") received by the partnership. This is the main analytical result of the paper. Moreover, to the best of the author's knowledge, this is a novel result.

FIGURE 4. *MUḎĀRABA* COMBINED PAYOFF

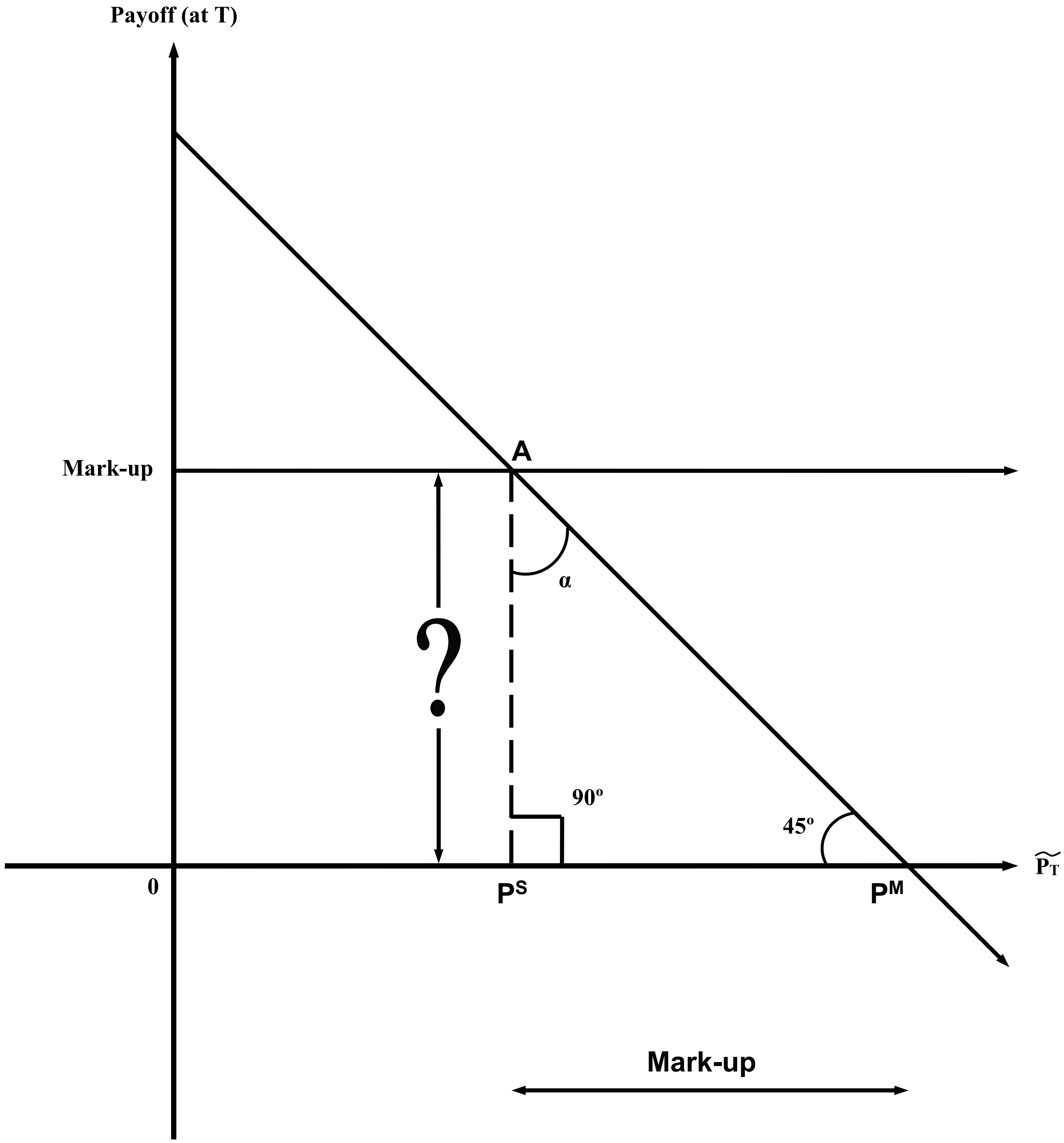


LEGEND:

P^M – *muḏāraba* selling price (*murābaẖa* contract)

$\widetilde{P}_T$ – spot commodity price at delivery date (T)

FIGURE 5. GEOMETRIC PROOF OF PERFECT HEDGE



2. Proof of Main Result

We now prove the main result using algebra.[8]

a. Proposition

The value of the contracts equals the *murābaha* markup. Suppose that: 1) an entrepreneur simultaneously enters a pair of *Salam* and *murābaha* contracts for forward receipt and delivery of the same commodity on the same delivery date; and 2) the entrepreneur's markup for the *murābaha* contract is defined as the difference between the selling price (P^M) and the buying price (P^S). This pair of contracts enables the entrepreneur to construct a perfect price hedge. That is, on the delivery date, the entrepreneur's total payoff (economic value) from the *Salam* and *murābaha* contracts will equal the markup (accounting "profit") agreed to in the *murābaha* contract, regardless of the level of the spot commodity price on the delivery date.

b. Proof

The combined payoff (economic value) that accrues to the *mudāraba* partnership equals the sum of the payoffs from both contracts entered into by the *mudāraba*, i.e.,

$$\begin{aligned}
\text{Combined Contract Payoff} &= \textit{Salam}\text{ Payoff} + \textit{murābaha}\text{ Payoff} \\
&= V_T^S + V_T^M \\
&= (P_T - P^S) + (P^M - P_T) \\
&= P^M - P^S \\
&= \text{Markup (by definition). QED}
\end{aligned}$$

3. Intuition of Result

The intuition underlying this result is straightforward. Recall that the *mudāraba*'s markup is fixed (non-random) since it is specified in the *murābaha* contract. In particular, the markup ($P^M - P^S$) is the pre-agreed (hence, non-random) spread between the *mudāraba*'s selling price (P^M) and the *mudāraba*'s buying price specified in the *Salam* contract (P^S). In contrast, the *mudāraba*'s payoff from either the *Salam* or the *murābaha* (forward) contract is random because the payoff for each contract varies as the spot commodity price (at the delivery date) varies around the contractually agreed forward price for each contract, i.e., P^S and P^M.

However, when the two contracts are combined, their total payoff is constant—equal to selling price minus buying price—for each spot price scenario. Suppose that on the delivery date the spot commodity price (P_T) is equal to the buying price (P^S). Then, the partnership reaps no economic gain and suffers no loss from the *Salam* contract; $V_T^S = P_T - P_T = 0$. However, when $P_T = P^S$ the partnership incurs an economic gain on the *murābaha* contract; $V_T^M = P^M - P^S =$ Markup.

Note that for any P_T less than P^S, the *Salam* contract will incur a loss. However, the *murābaha* contract will incur a gain. Fortunately, however, a dollar's worth of loss from the *Salam* contract is exactly offset by a dollar's worth of gain from the *murābaha* contract. Moreover, the *murābaha*'s initial economic gain (Markup) at $P_T = P^S$ is maintained throughout the spot price region $0 \leq P_T \leq P^S$.

The reverse argument can be made when the (delivery date) spot commodity price is in the region $P^M \leq P_T \leq$ infinity. That is, in this region a dollar's worth of gain from the *Salam* contract is exactly offset by a dollar's worth of loss from the *murābaha* contract. Moreover, the *Salam*'s initial economic gain (equal to the Markup) at $P_T = P^M$ is maintained throughout this region.

In the intermediate spot price region, $P^S < P_T < P^M$, both contracts have an economic gain. However, as P_T increases by \$1 (from P^S), the *murābaha*'s economic gain decreases by \$1 while the *Salam*'s economic gain increases by \$1. Hence, throughout this price region, the total economic gain from both contracts remains constant and equal to the combined payoff at $P_T = P^S$, the markup. In conclusion, the total economic value (payoff) of the *Salam* and *murābaha* contracts equals the *mudāraba*'s markup, regardless of which spot price scenario is observed on the delivery date.

4. Numerical Example

To verify the main result, below the payoffs of each contract are computed for five price scenarios. The scenarios differ by the relationship between the spot commodity price on delivery date (P_T) and the *mudāraba*'s buying price (assume P^S =\$15) and selling price (assume P^M=\$17). Table 1 illustrates the individual and combined contract payoffs for each scenario. In every scenario, the combined payoff equals \$2, which, in turn, equals the markup on the *murābaha* contract (\$2 = \$17 – \$15).

TABLE 1. CONTRACT PAYOFFS OF *MUḎĀRABA* (PARTNERSHIP)

Scenario	*Salam* ($P_t - P^s$)	*murābaḫa* ($P^m - P_t$)	Combined ($P^m - P^s$)
$22 = P_T > P^M$	7 = 22 – 15	-5 = 17 – 22	2 = 7 + (-5)
$17 = P_T = P^M$	2 = 17 – 15	0 = 17 – 17	2 = 2 + 0
$P^S < 16 = P_T < P^M$	1 = 16 – 15	1 = 17 – 16	2 = 1 + 1
$15 = P_T = P^S$	0 = 15 – 15	2 = 17 – 15	2 = 0 + 2
$10 = P_T < P^S$	-5 = 10 – 15	7 = 17 – 10	2 = (-5) + 7

V. CONCLUSION: CONTEMPORARY RELEVANCE

An Islamic commodity trust has a great potential to stem capital outflows from commodity-exporting developing countries that have Islamic-oriented investors possessing significant amounts of investment capital. By doing so, the trust simultaneously encourages local ownership and control of national assets. Thus, the trust-financing mechanism can help developing economies achieve both economic and political objectives.

For example, an Islamic oil trust (IOT) can resolve a very contentious political issue currently being debated in Kuwait and Saudi Arabia: should foreign oil companies be allowed to take equity (partial ownership) positions in upstream production?[9] An IOT can eliminate the need to engage in heated, divisive debate over this issue by harnessing local capital to provide the financing for maintenance, facility upgrades, and exploration that otherwise would be provided by foreign oil companies. Also, IOT financing does not require that national oil companies surrender control over key field management and exploration decisions.

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[1] By a breach of trust is meant an act that is Islamically illegal, meaning ordinarily a breach of contract or a negligent or intentional tort. (Vogel and Hayes, 112).

[2] From the seller's perspective, the cost of obtaining this debt financing is the internal rate of return on the discount. In other words, "the implied cost of capital to the *salam* seller is simply the difference between the present value of the future market price (P_T) and the price that one would receive today (P^S)." (Vogel and Hayes, 213)

[3] Consult Ray (pp. 54-57) for a succinct analysis of the objections—and the reformer's counterarguments—against the *murābaha* contract.

[4] For more details about the *muḏāraba* partnership, e.g., liability of parties, dissolution, and rights of the *muḏārib*, consult M.A. Khan, Ch. 11 in Shk. G. A. Abod, et al., pp. 212-223.

[5] The *muḏāraba* partners also face several non-price risks when entering a *salam* contract, such as delivery risk (late delivery, damage/destruction of goods in transit, or even no delivery) and credit risk (late payment or even default). A complete risk analysis would also measure these exposures as well as evaluate alternative risk-mitigation measures. Interested readers should consult Ray (pp. 49-50) for a brief discussion of delivery and payment risk. Finally, for purposes of contrast, a detailed analysis of the benefits and risks of a conventional oil trust is contained in Al-Mazeedi and Yaksick (1995).

[6] For additional details regarding the value of a (non-Islamic) forward contract, consult Ch. 9 in Chance (1995).

[7] Strictly speaking, accounting profit—revenue minus costs—is not equal to the *muḏāraba*'s markup. That is, the markup includes reimbursement for deal-related storage costs, risk bearing, and professional services rendered. Hence, the decision to place the word profits in quotation marks.

[8] More formally, one can easily demonstrate, using high school plane geometry, that the vertical distance of the combined payoff profile equals the markup. A sketch of the proof follows. Begin by noting that in Figure 4 the markup equals (by definition) the length of the line segment $P^S - P^M$, via equation (2). Then, using the properties of an isosceles right triangle, one can easily show that the height of the combined payoff profile equals the size of the markup. Hence, the *muḏāraba*'s combined payoff equals the markup.

[9] Details of this debate are provided in the Financial Times (April 15, 1999), World Energy Supplement, pp. vi-vii.

PART IV

COMMERCIAL PRODUCTS, BUSINESS MODELS, AND OTHER

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Introduction

Iqbal Ahmad Khan *

Harvard University, through the Harvard Islamic Finance Information Program (HIFIP), is playing a leading role in the research and collation of data on the Islamic financial industry by providing important information on the market players, an archive of transactions, and a databank of *sharīʿa* rulings pertaining to various products and structures used in the industry. HIFIP should be commended in helping to narrow the information gap that exists across the industry, which has come a long way since the establishment of pioneering institutions such as the Islamic Development Bank, the Dar Al-Maal Al-Islami (DMI) Group, Albaraka Investment & Development Company, Kuwait Finance House, Faisal Islamic Bank of Egypt, and Dubai Islamic Bank. The sector is now gaining momentum, sophistication, and capturing market share in a number of key markets. This has resulted in advancements at the retail, corporate, and investment banking levels. Over the last few years, we have witnessed the growth of Islamic asset management, insurance, and leasing companies. The entry of new financial institutions, from both Western markets and the Muslim world, will continue to provide the competitive spur for innovation and development in the sector. The six papers published in this section in part reflect key themes and trends emerging in the sector and signify a broadening and deepening of the Islamic financial market as a whole.

In the early years, Islamic finance was built around a committed retail investor base in key markets, notably the Persian Gulf and Malaysia. However, as the industry has gained mainstream relevance and increased credibility, institutional investors have been drawn into the marketplace. Among the more important of these institutional investors have been *waqf* institutions. In their paper, "Applying *Waqf* Formula on a Global Basis," Khaled R. Al-Hajeri and Abdulkader Thomas examine the pioneering transaction jointly carried out by the Kuwait *Awqāf* Public Foundation (KAPF), the United Bank of Kuwait, and the Islamic Cultural Center of New York in the development of a real estate project. By unlocking value from land belonging to ICCNY, the project was able to support the ongoing financial requirements of an educational establishment and realize value for KAPF, both financially and through its strategic mission of supporting Islamic institutions throughout the world. More importantly, the paper suggests that *waqf* institutions such as KAPF can play an important role in extending finance to those projects that may not feature in the immediate remit of contemporary Islamic banking institutions.

Few, if any, empirical studies have been carried out to examine the size of this *waqf* market and how the investment needs of these institutions are being addressed. Considering the fact that *waqf* institutions represent one of the oldest wealth preservation schemes in the world, much more research needs to be carried out in this area. Furthermore, the current example of cross-border ownership by a *waqf* institution is by no means the first. I am reminded here of the Nizam Waqf in Hyderabad, which owned property in Arabia. The need now is for the creation of a dedicated institution aimed at unlocking the wealth potential of these institutions, locally and globally. The transaction Al-Hajeri and Thomas discuss serves as a model example of cooperation between Islamic financial institutions and *waqf* bodies, and of the social benefits inherent in Islamic finance.

Building on the theme of *waqf*, M.A. Mannan proposes a cash-*waqf* certificate as a tool to further social welfare and lower income inequality. Mannan argues for a broadening of the concept of *waqf* from a property-based charitable function (as it currently exists in many Muslim countries) to that of an institution with the broader goals of income distribution and social welfare. Mannan provides valuable insights into *awqāf*, from the literal Arabic meaning of the word to its history as a functioning institution, which spans the very first *waqf*, established by the Prophet Muhammad (peace be upon him), to the reforms of *awqāf* in Egypt and the Indian subcontinent.

Citing corruption of income tax departments in his home country, Bangladesh, as the principal factor behind the inefficient allocation of fiscal resources, Mannan has devised the concept of cash-*waqf* certificates, which he proposes as a partial substitute for income tax in financing projects in education, health, and social welfare. The concept, as the authors rightly acknowledge, requires political will if it is to gain any chance of acceptability and implementation. The concept, however, also assumes that taxpayers in Bangladesh would be willing to pay taxes in the form of cash-*waqf* certificates if these funds were allocated efficiently and in an appropriate manner. Given the strength of the culture of tax evasion in many Muslim countries, it would be wrong to assume that a system based on cash-*waqf* certificates would be free from the ills of the incumbent system.

* Managing Director and Head of Global Islamic Finance, HSBC Group, London, England.

The next paper takes us to the Islamic equities market, which has witnessed tremendous growth in recent years. This followed the approval in the early 1990s of equities as an Islamic asset class by the OIC Fiqh Academy. The Islamic equities market has developed both in terms of the number of participating institutions and the increasingly sophisticated nature of these funds. From the launch of plain-vanilla global equity funds, Islamic investors have developed an appetite for regional, sector-, and market-capitalization specific funds. David Moran, in "The Role of the Dow Jones Islamic Market Index in Islamic Finance," discusses the foray of his company into the market through the launch of this and other indices, which in a relatively short space of time have become the industry benchmark—thus bringing much needed uniformity to the industry.

Moran rightly highlights benchmarking as an important phenomenon impacting all areas of money management. For an industry still in evolution, this benchmarking will allow increasing numbers of money managers to enter the market and bring their know-how and considerable experience in investment management to the Islamic market.

From an index of global equity stocks, Dow Jones has developed country, a global technology, and a blue-chip extra liquid indices. The last is being used by institutions in the development of capital-protected equity funds, which are targeted toward investors wishing to hedge their exposure to the volatility of global equity markets. However, the Dow Jones Islamic indices suffer from a lack of exposure to Muslim capital markets. This, as Moran points out, is not due to any aversion to the Muslim world but rather because "the markets themselves are not terribly well-developed or are not as transparent as they could be, and in many cases suffer from substantial restrictions on foreign ownership." The pace of capital markets development has been painfully slow in a number of key Muslim markets. As these economies now begin to liberalize and open up, the rulebooks for the capital markets of these countries are slowly being written. This will lead eventually to the creation of local benchmarks.

In the field of project finance, the Equate Petrochemicals project stands out as one of the major achievements of the Islamic financial industry in recent years. Kuwait Finance House (KFH), one of the largest Islamic banks, underwrote, arranged, and syndicated a US$200 million sale and lease back facility. Mohammad Al Omar provides a close look into the structure of this groundbreaking facility in his paper, "Islamic Project Finance: A Case Study of the Equate Petrochemical Company." He also examines some of the key challenges in structuring an Islamic project finance facility that forms part of an overall conventional project finance facility. Issues such as intercreditor arrangements and security trust agreements remain a challenge to all those who are involved in the documentation of these transactions. The ruling on *sharīʿa* issues should prove important for anyone interested in pursing further research in this area. For example, *sharīʿa* scholars have recognized that lease assets may include work in progress and can be based upon actual invoices rather than the cost of the assets to the lessee.

Similarly, Al Omar highlights the issue of insurance, whereby KFH's *Sharīʿa* Committee approved "the assets of Equate to be comprehensively insured, with the insurance policies to be assigned in favor of the Security Trustee on behalf of the participating financiers." In the absence of a *takāful* (Islamic insurance) market, this *sharīʿa* ruling assumes significant importance.

Project finance is by its very nature non-recourse finance, and this fits well with the spirit of Islamic banking. However, for reasons such as the lack of liquidity in its underlying instruments, project finance has yet to take off in this market. The author fails to touch upon this issue. Equally important would be to address the challenges of securitizing such an asset. Nevertheless, the Equate project serves as a model for other project finance deals in the region and should take on increased significance given the imminent launch of the Islamic Development Bank's private sector arm—the Islamic Corporation for the Development of the Private Sector.

The theme of community banking, ethical investments, and affinity marketing in the United States context is discussed by Yahia Abdul-Rahman, Mike Abdelaaty, and Gary Findley in "The Challenges of Offering a LARIBA Products and Services Window in an American Bank." The American Muslim community, with an estimated nine million adherents, is an important market for Islamic finance. The banking needs of this community, as Abdul-Rahman suggests, have in the past been neglected. In the United States, the community has been reliant upon small, regionally-based Islamic financial institutions, which in turn have been dependent on localized conventional institutions and national Islamic organizations for support. Larger conventional banks have to date stayed away from this market. The constraints on conventional commercial banks in offering Islamic financial services are the main subject of Abdul-Rahman and his colleagues' paper.

One of the many topics covered in the paper is that of a conventional bank offering Islamic products and services. This issue came under scrutiny in earlier years, when the very concept was frowned upon. However, many prominent scholars believe that conventional banks can play an important role in this market. After opening Islamic units within commercial bank branches, a large number of conventional banks, notably in Saudi Arabia and Malaysia, have now opted to open full-fledged Islamic branches. The authors also examine the structural differences between a conventional car loan and an Islamic lease-purchase facility. Yet this is done without a thorough examination of the *sharīʿa* issues and how they lead to a more equitable distribution of both the risks and returns in financing such assets. Another key area the authors highlight is the regulatory treatment of the lease-to-purchase (*ijāra*) mortgage model. The authors point to the ruling of the Office of the Comptroller of the Currency (OCC) that a bank cannot hold title to a property financed. While this requires a re-examination of the *ijāra* contract vis-à-vis U.S. regulations, the OCC has opined that an Islamic lease structure will be subject to a risk weighting similar to that of a conventional mortgage. This ruling impacts favorably on the pricing of Islamic mortgages for U.S. residents.

"Islamic Banking in Bangladesh: Growth, Structure and Performance" by Md. Abdul Awwal Sarker is a comprehensive analysis and review of Islamic banks in the South Asian state. Five Islamic banks now operate in Bangladesh, all private-sector initiatives. These, according to Sarker, are regulated on terms similar to those of conventional banks, with no recognition of the structural differences between these banking institutions. Sarker rightly highlights the challenges faced by Islamic banks in Bangladesh when confronted by an unfriendly legal and regulatory environment. Islamic financial institutions operate in the absence of an interbank money market and a lender of a last resort, and must deal with inefficient and weak capital markets and commercial law drafted around British law.

Sarker suggests a number of policy reforms to strengthen the operations of the nascent Islamic banking sector in Bangladesh. Among the reforms suggested include the conversion of the Islamic banking sector into a pure profit-and-loss sharing (PLS) system. Without the necessary legal and regulatory reforms in place and minimal levels of accountability and transparency, the shift toward PLS banking will seem forever distant. The problems and challenges he discusses are not particular to Bangladesh and scale across a large number of Muslim countries. Unless greater collective effort is undertaken on the part of Islamic financial institutions, these obstacles will continue to stifle the development of the sector, holding back the development of new products and structures.

In its own way, I hope that the publication of these papers will play a part in addressing some of these deficiencies in the Islamic banking sector.

Applying *Waqf* Formula on a Global Basis

Khaled R. Al-Hajeri* **and Abdulkader Thomas†**

ABSTRACT

Muslim minorities once enjoyed substantial donations from private and public agencies in the Persian Gulf region, but such gifts have recently tapered off. One reason is a desire by some donors to assure that good causes outlive the ability of any given donor to support them. This study covers the goals of a major agency that succeeds a formerly large donor in this transition. In New York, the Kuwait *Awqāf* Public Foundation (KAPF) is testing a project meant to support key American Islamic charities. The Islamic rules of *waqf* are very similar to American endowment practices. The project, for which KAPF engaged Al Manzil as advisor, entails relationships with a New York developer, the City of New York, the endowed entity, its constituents, and others. These points are covered, together with how this project is a durable, duplicable model.

I. INTRODUCTION

For many years, Muslim minorities enjoyed substantial donations from an array of private and public agencies in the Persian Gulf. Since the early 1990s the size and consistency of such gifts has tapered off. A variety of reasons have contributed to this decline, including more efficient giving programs in which donors seek out only the most needy, lower or less consistent oil revenues, and a desire to assure that good causes will outlive the ability of any given donor to support them. In this study, we will cover the goals of a major agency that succeeds a formerly large donor and marks its shift to endow Islamic centers and schools.

A properly structured endowment in the United States, for instance, might take initial shape as investment real estate. Depending upon market conditions or location, the investment may prove monetizable in a form that will increase long-term investment alternatives in support of the endowed institution. In New York, Kuwait *Awqāf* Public Foundation (KAPF) is testing what may prove to be the first of a series of projects meant to support key Islamic charities of substance throughout the United States.

The project, for which KAPF has engaged Al Manzil as advisor is the development of an $85 million apartment project on land belonging to the Islamic Cultural Center of New York (ICCNY). This complex relationship involves ICCNY as a ground lessor, KAPF as primary financial sponsor, a major New York developer as a partner in the to be developed property. The project's goal is to unlock value from the underlying land and deliver funds to complete ICCNY's school as well as to deliver a substantial operating subsidy to both ICCNY and the school.

This project, novel among U.S. Muslims for its scale, is a durable model that should prove replicable for the benefit of other communities in the coming years. Part of the message built into the presentation is that the model neither requires foreign donors or investors. Rather it requires a focused mission of the key parties blended with qualified experts.

II. GOALS OF KAPF

Among the many important goals of KAPF is the support of Islamic institutions on a global basis. KAPF does so through the collection of zakat, *sadaqat*, and other donations, as well as through the generation of investment revenues in *sharīᶜa*-compliant investments. The array of KAPF activities runs from local needs to the support of projects like ICCNY in New York.

KAPF was invited to support the ICCNY project by the Permanent Mission of Kuwait to the United Nations which for years had arranged donor support for ICCNY including construction of the main mosque and school and support for operations. Initially, the Mission anticipated that KAPF would donate funds to complete ICCNY's long planned school. Instead, KAPF reviewed the situation and proposed an investment that would be simultaneous with the completion of the school, allowing its ongoing endowment.

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* Deputy Secretary General for Investment, Kuwait *Awqāf* Public Foundation, Safat, Kuwait.

† General Manager, United Bank of Kuwait Plc, New York, N.Y.

Further analysis revealed that ICCNY controlled an additional plot of land adjacent to the school and mosque complex. Given both the shortages of land and apartments in New York, as well as the attractive location of the undeveloped parcel, ICCNY held a critical asset of value that would prove capable of unlocking value.

III. CAPABILITIES OF AMIFS/UBK

The team at Al-Manzil Islamic Financial Services (AMIFS), a division of the United Bank of Kuwait (UBK), is uniquely qualified to assist in this form of project. Historically, UBK has a real estate focused bank on the cutting edge of building Islamic financial services. The AMIFS New York team has extensive construction and development experience. In addition, AMIFS has secured a slew of U.S. regulatory approvals for Islamic financial structures. These have allowed AMIFS to launch an aggressive U.S. program of retail and commercial real estate finance structured according to the *sharīʿa*, as well as to advise the IIBU (AMIFS London head office) on real estate investments including a REIT (real-estate investment trust) fund that complies with the *sharīʿa*. This range of experience assures that AMIFS has the local contacts to assist KAPF in the execution of endowment programs that are based upon real estate investments.

IV. THE AMBASSADOR'S QUANDARY

In the case of ICCNY, the center was a cooperative effort of the local Islamic community and the OIC members at the United Nations. ICCNY's start came with long range foresight by various OIC ambassadors in the 1960s. Over time, the primary supporter of ICCNY came to be the State of Kuwait through its Mission to the United Nations. But, Kuwait came to understand that ICCNY represented a noble long-term goal that was simultaneously unfulfilled and deserving of a broader base of support.

Ambassador Muhammad Abul Hassan knew he could secure funding to start the expansion of the ICCNY mission to include a school. So, with a major donation from Jabber, the Ambassador was able to erect the shell. Unfortunately, other members of the support group were unable to fund the completion of the school, let alone its future operations. At this stage, the Ambassador contacted KAPF to fund the project.

Following KAPF's analysis, AMIFS was engaged as their advisor.

V. THE GROWING COMMUNITY NEED

The process of creating endowments or *awqāf* is not top down. Rather it is flows with the current trend of Islamic community life in America. Not only are many new mosques opening throughout the country, but also those centers formed during the last thirty years are establishing Islamic schools. Two observations that any participant at ICCNY Friday prayers and other activities will make are that the mosque is used to capacity, and it has its own local community. With the latter comes a natural constituency for an Islamic school. Ensuring the long-term viability of this school requires an endowment or a *waqf*.

VI. THE PROCESS AND PARTNERSHIPS

A project of this magnitude has three levels. The first is between ICCNY and the developers. The second is between KAPF and the developers. The third is between the developers and the City.

The first is governed by a pre-development agreement between ICCNY and KAPF, and ultimately by the ground lease. The pre-development agreement assures ICCNY of a professionally executed plan to turn a parking lot into an apartment tower. The single most critical element of this agreement is the element of design control that it gives to ICCNY. Secondarily, it empowers KAPF to move on with minimal project interference.

Thirdly, the ICCNY/KAPF agreement allows for a ground lease between ICCNY and the developer. The ground lease means that rent income paid to ICCNY is not taxable. It is a key element of the deal that ICCNY is protected from tax exposure which would come from active participation, a tax term, in the development. The ground lease incorporates three major points that frame the relational points between ICCNY and the developer:

1. The lease term is 99 to 125 years and is subordinated to investors. This means that the developer can arrange a third party master lease investor for the project. Such an investor will demand the capacity to restructure the commercial project if anything should go wrong, hence subordination, and to be assured that the asset will not revert to the community before such time as the investor has been able to earn its return.

2. An initial ground lease payment will be made that will approximate the cost of building the school. The dollar value of this payment, in fact, approximates the cost of similar land acquisitions in today's market.
3. An annual ground lease payment will be made that will equal the operating costs and reserve requirements of the ICCNY as a whole. Again, the agreed rental rate equates to market conditions.

The second agreement entails the implementation of the pre-development guide. This is a classic U.S. law development agreement. It is modified on two levels. Not only are the pre-development guidelines (the KAPF ICCNY agreement) brought into the picture, but also the developer makes specific commitments to assure that the project is not despoiled by any non-Islamic features. This document, likely to be two inches thick will allow for every detail of executing the project in compliance with local law, budget and on time.

Once empowered by the development agreement, the developer will form the required structures to assure project execution. Among these will be the securing of various approvals from the City of New York and will be obliged to review key elements of the development agreement and ground lease with city authorities. In this project, the work benefits from existing rights that run from the property. In other transactions, a developer may be obliged to define rights and secure their approval where none existed. In our case, it means we can fast track the process compared to the two years that might otherwise be spent if no high rise residential rights attached to the property. Community boards and citizens groups may have the capacity to review the project and make suggestions.

VII. Exit Strategies for the Core Investment

Two years after the construction starts, leasing should take place. Given the demand for market rate rental and 80-20 apartments in the upper East side, it is believed that the project will lease up rapidly. Once it is stabilized, an entire new set of questions will arise. First, should KAPF retain the investment for the medium or long term? Assume for the moment that the answer to both terms is "no." This means that the development venture must have planned an exit strategy.

Foremost, the development venture includes a buy-sell agreement. This gives either KAPF or the American partner the capacity to buy the other out of the deal according to a specific formula. The formula is devised in a manner to prevent one party from cheating or gouging the other, and includes a third party appraisal as well as a minimum strike price below which the buy-sell cannot be invoked. The buyer is always bound by the original ground lease.

Alternatively, both parties could seek a market sale. In this case, the improved property is subject to the ground lease. Such a sale would seek to maximize revenues relative to the improved property. If proceeds are re-invested in a qualified property investment within 18 months, then the taxation of capital gains are deferred. This, of course, points to the alternative of reinvesting to support the same or other good causes discussed below.

The beauty of either sales scenario is that they are subject to the ground lease. On the one hand, KAPF and the investors may enjoy a gain. On the other hand, ICCNY continues, in perpetuity to benefit from ground rents supporting its operations.

Not infrequently a question arises in the U.S. context that refinancing is the best strategy to cash out of a project without triggering major tax events. The net effect can be very similar to a sale, but the actual fact is that KAPF remains an investor in the original project. For this project, taking advantage of 80-20 rules may unlock a prospectively *sharīʿa*-compliant refinancing strategy.

In our program, we are designing the project to conform to the 80-20 rules. These mean that 80% of the units will be market rent units and 20% will be reserved for low to moderate income persons, whose incomes must be within certain percentage bands of the local population. The units are identical to the other units and such tenants are dispersed throughout the building. The low to moderate tenants are subsidized through a favorable tax treatment and eligibility for tax favored municipal bond programs.

Before all and sundry complain that this could not be Islamic, let us examine a simple development within many municipal bond programs including New York where our project is located. It turns out that long-term net leases and synthetic leases are frequently approved for inclusion in such programs. In these cases, they are municipal lease pass-through obligations. These are equivalent to *sukuk* as applied to leases in the GCC and Malaysia.

In this scenario, we have built a project for $95 million. The state confirms compliance within its 80-20 rules and accepts the master or net lease as a suitable investment. The state next appraises the property, and let us say the value is $116 million. The state will now be prepared to buy the leasehold estate and lease from the existing lessor, paying a premium of $21 million. The existing financier will recover its invested capital, and the development partnership will receive $21 million (more than their initial investment) on a tax-deferred basis. The partnership will also enjoy continued sharing in the income.

VIII. Alternative Investments for the Proceeds

If all has gone well the exit strategies will have deposited up to $21 million in the hands of the KAPF and its partners. Now, the obvious alternative is to start over with a new real estate project. The choices are varied and must be matched to KAPF's long-term goals in the U.S. For instance, KAPF may not seek the level of involvement of development projects, either in U.S. commercial real estate or domestic Islamic programs. In such cases, investments in income oriented lease funds, Manzil pools, or other acceptable Islamic income oriented investments may be best. These would allow a definable annual income to be allocated to established projects.

Alternatively either balanced pools including equities, equities or real estate development would allow for capital growth with or without income.

KAPF likes the capacity to be flexible according to its own long-term goals as well as the specific needs of communities where KAPF wishes to be of assistance. KAPF has no preconceived notions but benefits from the fact that the array of Islamically acceptable investments continues to grow.

IX. A Model for Other Areas

KAPF and AMIFS share the goal to pool several leading *waqf* and donor groups to make a fund for North America and Europe. This would be complementary to the current IDB fund, which is geared toward poorer IDB member states with under-performing *awqāf*. The new fund would seek to develop properties in support of key Islamic centers and schools, assuring their cash flow and long-term viability. Here are three of the concepts that we are working on together or with other parties.

1. *Complicated U.S. Urban Areas*: The pattern of Muslim immigration and conversion in the U.S. should not surprise anyone. Muslims have gravitated toward the major immigration gateways, the key centers of learning and technology. As a result of AMIFS mosque and school programs, we have been approached by a number of sophisticated communities that have plans relating to public-private redevelopment programs, expansion of Islamic community services. This is precisely the mix of needs and opportunities that one might find in Boston, Chicago, or Los Angeles.
2. *Less Complicated U.S. Jurisdictions*: Secondary urban centers, Sunbelt, and Western U.S. locations typically enjoy less complicated real property investment issues. Whereas major urban areas may require tax incentives, condemnation, or other special assistance to make a project economically, these areas frequently have few barriers to entry. The trade off is that planning and marketing a project is more important.
3. *Globally*: In Europe, particularly the UK, AMIFS operates a similar program to support mosques and schools. KAPF is also interested in replicating these ideas in Europe. KAPF, the IDB, and Saudi *awqāf* have also embarked upon an exciting program to revitalize existing *awqāf* in the poorer member states of the IDB.

The modernization and re-generation of *waqf* application does not rely upon the success of a single deal in New York. But, that deal has each of the core elements that serve as a useful model elsewhere:

1. *Professional Investment Partners*: Although the ICCNY project is conceived to build an Islamic school and endow ICCNY's activities, the project is conceived with professional local market developers. The partners are found through a bidding process and assessed solely on their professional competence and their ability to put together the project.
2. *Local and International Financial Partners*: In the ICCNY project, KAPF seeds with its "international equity" a U.S. project. On the one hand, other international players which either share KAPF civic-commercial values or simply have commercial motivations, are ready to join in. On the other hand, the project is a well-conceived market transaction. That means that the U.S. development professional is desirous of investing in the deal, and is able convince domestic U.S. investors to join the deal, even if the structuring is completely Islamic.
3. *Public-Private Partnerships/Tax Incentives*: The ICCNY project does not take advantage of any specific public investments, but it benefits from two forms of tax incentive. Foremost, the project is located on the

border of a redevelopment zone, making it eligible for a staged tax abatement (no real estate taxes for five years, then easing up to full taxation by the 20^{th} year). It also is structured to benefit from tax and financing incentives by blending into the tenancy 20% low or moderate-income households.

4. *Economically Viable Businesses*: The project is designed to fulfil a tiny part of a substantial shortage in apartment units. The location is well suited for the type of unit proposed and the costs are partially defined by ICCNY's low cost basis in the land. If KAPF and ICCNY did not pursue the use of this land, then the development partner would. It is simply good business.
5. *Marketable Investments*: Although property is not necessarily monetizable, one need only think back to the 1990s recession in the U.S., it is often marketable. In the case of the ICCNY project, an apartment building is typically the most marketable form of property. It could be sold, refinanced, traded for REIT shares, traded into a REIT, and so forth. Beyond this, the long-term strategy of our partnership does not preclude selling out the property and investing in liquid instruments.
6. *Renewable Resources*: One key aspect of this approach is that the financial resources of the various *waqf* and donor agencies may not be as deep as in the past. But, the desire and ability to do substantial good works remains. Therefore, these investment programs take a finite resource and make it a renewable, prospectively an infinite resource.

X. Conclusion

KAPF and AMIFS came together because of a simultaneous development of convergent programs. Each of our teams has the long-term strategic goal to support Islamic cultural institutions, mosques, schools, community centers, etc. Each proposed to do so with commercial solutions structured in conformance with the *sharīʿa*.

On the one hand, KAPF has the concern to use finite resources wisely and in a manner that makes them renewable. The KAPF team is geared to support Islamic institutions through its investment department by the establishment of *waqf* in places where KAPF might have previously donated money.

On the other hand, AMIFS has identified the fact that the domestic U.S. and European Islamic communities are grossly under-served in terms of physical plant and capital. Often communities can support medium to long-term capital plans, but lack the funding for short-term programs. The shortage of Islamic financial alternatives has meant that many plans for acquisition or expansion of Islamic facilities has been deferred. Or, when communities have turned to the conventional market, they have been gouged, often paying 200 to 300 basis point premiums to comparable funding for churches (in one case the premium was 1000 basis points.).

The facts that each of us was working on a case, each of us employed a high caliber professional team, made us a natural fit for the ICCNY project. As we systematize the lessons learned in this project, we will see a number of high quality programs and funds develop to assure that the Islamic communities of the West enjoy the facilities that their growth has mandated, and that these facilities are not financially at risk.

Ultimately, we believe that we are embarking on an exciting new area in both Islamic finance and Islamic community life and on a period in which we will see a greater flourishing of cultural and social services based upon improved planning and the coordination of a wider array of professional skills.

Cash-*waqf* Certificate

Global Opportunities for Developing the Social Capital Market in 21st-Century Voluntary-sector Banking

M.A. Mannan*

ABSTRACT

This paper explores the Cash-*waqf* Certificate of Social Investment Bank as an innovation in Islamic social finance. The history of *waqf* and its new use as a financial instrument are covered. As a case study, the operational thrust of the Social Investment Bank is reviewed to provide real-life evidence of the process of floating a Cash-*waqf* Certificate. Instead of being strengthened by the wave of the market economy, formal sector Islamic banking may be submerged; the social and ethical ingredients of Islamic finance may be marginalized in the process. In this context, voluntary-sector Islamic banking can help mobilize savings and investment. The Cash-*waqf* Certificate can monetize the Islamic voluntary sector and help accumulate social capital and national wealth. While the indirect tax system of Bangladesh and other Muslim countries is favorable to its growth, political will is needed for the success of this form of *waqf*.

I. INTRODUCTION

This paper seeks to develop an understanding of the Cash-*waqf* Certificate as an innovation in Islamic social finance as well as to unfold some of the key issues involved both at the theoretical and operational level with special reference to Islamic voluntary sector banking. Generally, *waqf* is defined as the endowment of any property of permanent nature by a Muslim for any purpose recognized by Islamic law as religious, pious or charitable. This paper will demonstrate that "Cash-*waqf*" as recognized in Islam was used during the Ottoman era and also in Egypt. However, the Cash-*waqf* as a financial instrument is indeed a new product in the history of Islamic banking. I will argue in this paper that Cash-*waqf* supported activities can be divided into social and private good, thereby providing a basis for interesting economic analysis of resource allocation in public finance. Therefore, my analysis of the implications of spending a Cash-*waqf* fund will be in terms of the "good-deed effect," the "free-rider effect," and the "income redistribution effect."

This paper is based on primary data generated from experience and assumptions drawn from the realities of Muslim countries: it intends to provide a forum for constructive dialogue on the challenges and opportunities for developing Islamic social capital market on a global scale. As a case study, the operational thrust of the Social Investment Bank is reviewed with a view to providing real-life experience and exposure to the process of floating Cash-*waqf* Certificates as a financial instrument in voluntary sector banking for the first time in history. The Social Investment Bank is a modern, participatory, three-sector banking model, in operation since November 22, 1995 in Dhaka, Bangladesh.

However, it is felt that instead of gaining strength, Islamic corporate formal sector banking is getting submerged in the wave of market economy and global corporate power and its networks of mutual obligations. In the process, there is indeed a risk of marginalizing the social and ethical ingredients of Islamic finance. In this context, it is argued that Islamic voluntary sector banking can help mobilization and capitalization of social savings and investments. Thus the paper indicates that the floating of Cash-*waqf* Certificates can help in monetizing Islamic voluntary sector; they can also serve as the most effective and perpetual mode of accumulation of social capital and national wealth and the profit from them can be used for strategic social investments. The Cash-*waqf* Certificate is intended to empower the family heritage of the rich for the benefit of society and future generations.

It is, however, argued that the introduction of the Cash-*waqf* Certificate is highly suggestive in the context of the present fiscal system of Bangladesh and other Muslim countries, where tax systems are heavily dependent on indirect tax which is generally regressive in nature (i.e. in Bangladesh 85% of the total tax revenue in 1995-1996 is indirect tax). A great part of direct tax can be converted to social assignments thorough Cash-*waqf* Certificates. Cash-*waqf* Certificates can partially or wholly substitute an income tax for financing the development of human and social infrastructure. What is needed is a political will. A new beginning can be made for a participatory economy

* Founder and Chairman, Social Investment Bank Ltd., Dhaka, Bangladesh.

and a caring society. In this context, the Cash-*waqf* endowment can also be viewed as a movement for new social development that can expand as well as open new frontiers of human freedom, including freedom from educational, social and economic deprivations.

While operational guidelines governing the operation of the Cash-*waqf* Certificate will be explained, an outline will be given on the achievement of operational results on the ground, thereby providing opportunities for people to share their experiences. The diverse areas of investment by the Social Investment Bank include various social investment activities having enduring value which will create a base for perpetual social capital, and help develop a credit program that reinforces family values and stimulates the social and moral foundation of a civil and caring society. At the end, the paper offers an Agenda for Action by Muslim countries and communities, Islamic banks, and Islamic voluntary Organizations around the world in the 21st century.

II. Revival of Islamic Socioeconomic Institutions

There is a rich legacy, culture, and history of Islamic voluntary sector institutions including *waqf*. The rising expectations and signs of revival of Islamic Institutions should be studied objectively with reference to at least five basic historical facts: (a) the ideal Islamic system as developed in the early Islamic period, (b) the legacy of Islamic Civilization, (c) the historic decline and successive stages of several centuries of colonization of the vital areas of Muslim World, resulting in progressive neglect of the role of *Ijtihad* (i.e., fresh thinking) (d) preservation of basic Islamic values and institutions at the grass-roots level of Muslim societies and (e) re-emergence of most of the Muslim states and institutions in recent times.

Without going into the detailed analysis of each of the five factors, it can be said that the momentum of Islamic social and economic ethics, and their creative values of new ideas, technology and institutions which can alter the status quo, received a serious setback due to the successive stages of several centuries of colonization and cultural domination of vital areas of the Muslim world. Even though Muslims themselves must share part of the responsibility for the loss of this Islamic momentum, the process of colonization indeed contributed greatly in bringing about the de-Islamization of contemporary Muslim societies and the consequent decline of Islamic socioeconomic institutions.

Nevertheless, the basic Islamic values and injunctions dealing with economic behavior—such as payment of Zakat, establishment of *awqāf*, granting benevolent loans without interest, implementation of the Islamic law of inheritance to ensure equitable distribution of wealth, internalization of socioeconomic values arising out of the Qur'ānic verses emphasizing God's sovereignty over all resources, and many other popular phrases relating to socioeconomic issues—continue to guide succeeding Muslim generations particularly at the grass-roots level of Muslim societies. The issue of internalization of Islamic values among the masses of Muslim societies today needs to be understood in greater depth for insight into sustainable development of Islamic socioeconomic institutions in the 21st century.

The recent revival of Islamic socioeconomic values has manifested itself in many ways, including the establishment of the Organization of Islamic Conference (OIC) of Muslim States, the consequent establishment of the Islamic Development Bank (IDB) in which 53 Muslim countries are now members, and the growing links of Muslim majority Central Asian Republic with the OIC, IDB and neighboring Islamic countries coupled with the resurgence of Islam in the former Soviet republics. In addition, there have been a number of local Islamic banks set up from the 1970s to the 1990s having declared objectives to conduct each of the bank's economic and financial activities in conformity with the principles of Islamic values, as well as the setting up of Islamic Chambers of Commerce, the creation of an Islamic Solidarity Fund of OIC and the call for establishment of an Islamic common market, Islamic monetary system, Islamic insurance, and Islamic dinar, etc., confirm the hypothesis that the serious process of revival and rediscovering of Islam has began. It does not, however follow that all contemporary Muslim countries or societies of today are necessarily "Islamic" in the actual operation of their economies.

In this context, it is to be recognized that the motivational properties of economic premises of Islamic economics and finance tend to be significantly different either from the market or the command economy. As such, the common tools of economic analysis such as scarcity, choice, opportunity cost, marginal efficiency of capital, discount rate, profit, rent, wages, and a host of other concepts will have uncommon meanings in Islamic economics, banking and finance. Therefore, it is extremely important to develop understanding of the depth of the ethical and moral foundation of economic premises of Islam today at the grass-roots level together with the structure of vested interest of a group of local people who are foreigners in their own countries, linked to a global elite and its network of mutual obligations.

III. The New Frontiers of Islamic Voluntary Sector: an Overview

The real glory of the Islamic voluntary sector lies in the fact that it has a rich legacy, culture, and history. It is indeed an area where a thousand flowers can bloom; given the revolution in information technology, it is the right time for the globalization of Islamic voluntary sector activities. In this process the Islamic bank in the 21st century can play a very vital role in re-activating and institutionalizing the role of Islamic socioeconomic institutions, as well as various voluntary and obligatory tools of redistribution of income through innovative financial instruments and management of funds such as *waqf* properties development bond, Cash-*waqf* Certificate, Zakat Certificate, Hajj Saving Certificate, Trust Fund and so on.

Despite the fact that many of the activities of the Islamic voluntary sector-which may include institutions such as Zakat, *awqāf*, Mosque, Hajj, Islamic non-profit charitable trusts and foundations-do not come under the conventional calculation of GNP, these institutional activities need to be reviewed and analyzed in light of the challenge and change Muslim societies are facing today. In the wake of great transformation in the East-West relationship resulting from (a) the emergence of a formidable economic bloc in Europe, (b) the collapse of communism, (c) the rise of Muslim republics in Central Asia, (d) the widening of the economic gap between North and South, (e) severe economic backwardness, under-development and poverty in the Islamic countries of the Organization of Islamic Conference (OIC), despite their potentialities and vast resources, and (f) the rise of ethnic militancy and growing threat to Muslim minorities in non-Muslim countries, there is an urgent need to restore these institutions to their true spirit and utilize them fully for promoting the moral, spiritual, social and economic welfare of Muslim societies and mankind as a whole. The crucial question before us is how to operationalize and institutionalize these activities of the voluntary sector so that they can be integrated into the mainstream of economic activity, resource mobilization, savings and investments and capital markets.

Viewed from this perspective, there is an immense scope of utilization of *Zakah* Fund in lawful *mudāraba* Projects as a financial partner. *Zakah* revenue redistributes wealth into consumption flows for the poor, raises their productivity, reallocates ex-ante saving by checking the tendency to hoard idle cash, and stimulates production through inter-sectoral allocation of resources. Similarly, Hajj affairs can be viewed as one of the significant socioeconomic institutions of Islam. The mosque can serve as an agent of social development.

Furthermore, from a historical perspective the institution of *waqf*, which is one of the most powerful elements of the Islamic voluntary sector has, among others, played a significant role in furthering the cause of Islamic education, health and research through establishment of schools, hospitals, *madrasas*, mosques and public libraries.

In the context of the 21st century, Islamic banks must work for the securitization of the Islamic voluntary sector. In this connection, it is to be noted that in the voluntary sector, Social Investment Bank Ltd. is in the process of organizing voluntary capital market operation for the mobilization of necessary funds, and is in the process of developing the following financial instruments with different sets of rules in conformity with the *sharīʿa*:

1. *Waqf* Properties Development Bond (specific and general)
2. Cash-*waqf* Deposit Certificate (specific and general)
3. Family *Waqf* Certificate
4. Mosque Properties Development Bond (specific and general)
5. Mosque Community Share
6. *Quard-e-Hasana* Certificate (specific and general)
7. Zakat/*Ushar* Payment Certificate
8. Hajj Saving Certificate
9. Non-Muslim Trust Properties Development Bond (specific and general)
10. Municipal Properties Development Bond (specific and general)

The value of all the Bonds and *Quard-e-Hasana* Certificate can be guaranteed by the Bank against surrender of the instrument on maturity. In this paper we shall, however, try to unfold the Cash-*waqf* Certificate and identify issues it implicates.

IV. Institution of *Waqf*: Its Meaning and Role from Historical Perspectives

The word *waqf* (pl. *awqāf*) comes from a root meaning “to prevent or restrain.” In Arabic, it literally signifies “confinement or detention.” In the terminology of Islamic jurisprudence, it may be defined as refraining from the use and disposal of any asset from which one can benefit or can use its proceeds for any charitable purpose as long as it exists. In fact, the vast majority of Hanafi scholars regard *waqf* as "taking the corpus of any property out of ownership of God, and dedicating its usufruct to others." In the language of the contemporary law, *waqf* "does signify the usufructuary donation, made in favor of a beneficiary, with a view to fulfillment of some pious aim or some projects of general utility and which entailed the legal sequestration of gift or donation, whether this donation included, did not include, a usufruct." It is also defined as "non-negotiable property dedicated to charitable purposes, once for all," or as "the permanent dedication by a person professing the Musalman faith of any property for any purpose recognized by the Musalman law as religious, pious or charitable."

Following up these definitions, we can say that "by *waqf* is meant a thing which, while retaining its substance, yields a usufruct of which the owner has surrendered his power of disposal with the stipulation that the yield is used for permitted purposes. *Waqf* really means, however, the legal process by which one creates such an endowment (synonymous with *tahbis*, *tasbil* or *tahrin* or *tahrim*)."

A. *Waqf*, *Sadaqa*, and Gifts

From the very nature of its transaction, *waqf* may be seen as a kind of *Sadaqah*. But what distinguishes it from *Sadaqah* is that in the case of *Sadaqah*, the substance is transferred and also the profits. In *waqf*, however, the substance is retained but the profits go to the beneficiaries of the *waqf*. Similarly, the difference between *waqf* and a gift is that, in the case of a gift, the substance is transferred from one person to another person without consideration but a *waqf* is for a consideration, that is, religious merit. Clearly, *waqf* revenue cannot be regarded as Zakat which is obligatory and its eight heads of expenditure are specified in the Holy Qur'ān.

B. *Waqf* and Trust

It should be noted here that a *waqf* must also be distinguished from Trust. In a *waqf*, the property is vested in God, while in a Trust it is vested in the Trustee. Unlike a *waqf*, in a Trust, it is not necessary that a Trust must be perpetual, irrevocable or inalienable or made with a pious or religious motive. *Waqf* can, however, be created in favor of both affluent and indigent alike, or in favor of family or indigent exclusively, although pious and religious motives become the predominant concern of *awqāf* endowments. Thus, according to all schools, a *waqf* may be created for the benefit of any person or class of persons or for the service or well-being of humanity, although a founder may make his own maintenance for life a first charge on the income of the *waqf*. All *sharīᶜa* schools have, however, stressed the importance of the creation of a *waqf* which played an important role in ameliorating poverty and in furthering learning in the past and is expected to play its role in the future provided this institution is re-activated and its management is placed on sound footing.

The very development of *waqf* as an institution in Islam and its legitimacy can be deduced from the Qur'ānic repeated "exhortation at a number of places, and in different ways and contexts to render voluntary economic assistance to the fellow-beings and the poor" as well as from various traditions of the Prophet (peace be upon him). In fact, the positive evidence of the legitimacy of the institution of *waqf* can implicitly be found in the Qur'ānic verse in Sura Al-Imran that says: "You shall not receive godliness unless you have spent out of that which is dear to you." Again the Prophet (peace be upon him) is reported to have said that "a man's work ends upon his death except for three things: (a) contribution to knowledge, (b) ongoing charity, and (c) faithful child praying for him." Here scholars see the Institution of *waqf* as an "ongoing charity."

Throughout the history of Islam, the *waqf* played a very important role in promoting social, economic and cultural activities of Muslim communities. For example, the *waqf* provided scholars with a secured means of livelihood, thereby providing them an opportunity to engage in research and schooling in a manner which made them independent of governments and the ruling class. In fact, it did perform the duties of a number of government institutions, or specialized ministries of our contemporary period, such as Ministries of Health, Education, and Social Welfare. We have evidence to support that *waqf* resources were used not only to construct libraries and reading rooms, but also for residential quarters of the scholars, as well as for other research activities such as copying services by professional copiers and centers for decorative arts, etc.

In an attempt to encourage research, a translation program was supported out of the revenue of the *waqf* properties. A large number of books were either written or translated by Muslim scholars and scientists with the support of the *waqf* fund. Research using empirical and scientific methods were encouraged and supported.

The *waqf* supported and encouraged the development of medical science by providing facilities for better public health and education through the establishment of hospitals, medical schools, and by encouraging the development of local medicine and chemistry. *Waqf* revenues were used not only for the development of human medicine and health care but also for veterinary medicine. Students used to learn medicine and its applications by studying at these hospitals. Medical education was not confined only to medical schools and hospitals but also offered in mosques and universities such as Al-Azhar in Egypt. Even as early as the fourth century of Hijra, a hospital for the treatment of children was built in Istanbul out of the *waqf* fund. In Spain hospital facilities were made available to both Muslims and non-Muslims. The *waqf* fund helped establish the center for decorative arts particularly during the Abbasid period and contributed immensely toward the growth of Islamic architecture particularly in the construction of mosques, schools, and hospitals.

The first *waqf* in Islam was Quba' mosque near Madina which was established by Prophet Muhammad (peace be upon him). The second *waqf* was the Prophet's mosque in Madina, Dar Al-Hijra, which was built by the Prophet (peace be upon him); the Prophet is also reported to have made the first *waqf* for charitable purposes when he endowed the gardens of Mukhairaiq, a Jew who was reported to have been killed while he was fighting on the side of the Muslims in the battle of Uhud. The endowment was made in accordance with Mukhairaiq's wishes. The endowments of Umar and other companions like Abubakar, Osman, Ali, and others followed this.

During the Abbasid period, the *waqf* property and revenues were left outside the treasury department and the Qadi was entrusted with the supervision. A special *bayt al-māl* (treasury) was instituted during the Abbasid period.[1] Again, in the Mamluk period the *awqāf* properties were divided into three groups: (a) "Abbas," comprising extensive estates in Egypt used mainly to keep up mosques; (b) "*awqāf hukmiya*," comprising town lands in Misr and Kahira intended mainly for the two holy cities; and (c) "*awqāf ahliyah*" or family endowments. Each of these categories had its own administrator.

Although the *waqf* played a significant role in social development of the Muslim communities throughout Islamic history, we have evidence to support that the *waqf* did not always produce the desired result. On the contrary, the study of actual *waqf* administration provides many valuable details not only about its uses but also its abuses. Mismanagement and embezzlements of *waqf* funds were not unusual. As a result, various administrative strategies were adopted to achieve the objectives for which the *waqf* was made.[2] Thus, varieties of agreements were created not only for the letting of *waqf* estates but also for granting perpetual leases, adapted to the institution of *waqf*. Since the sixteenth century of the Christian era, in contrast to temporary leases of three years, perpetual leases were granted in some cases to encourage personal incentives in the management and maintenance of the *waqf*. In some cases, the condition of the *waqf* possessions deteriorated so much that the revenues were not even sufficient for the necessary maintenance of the properties, not to speak of benefiting the poor, or achieving the objectives for which the original endowment was made. Under these perpetual leases, particularly in Turkey and Egypt, the tenant used to pay lump sum rent so that right of ownership would not lapse. Sometime rental income was also linked to the value of the properties in Syria and Egypt.

Perhaps Turkey, which has one of the longest histories of *awqāf* administration, reached its peak during the Ottoman era, where *awqāf* properties were estimated to have three quarters of the whole arable land in 1925. A Central Administrator of *Awqāf* was re-established after its abolition in 1924. Recently, a *Waqf* Bank and Finance Corporation has been set up to mobilize the *waqf* resources and to finance various types of joint venture projects.

The need for reform in many Muslim countries arises due to the fact that about one half (1/2) of the cultivable land in Algeria in mid nineteenth century was dedicated to *waqf*. Similarly, in Tunis one third (1/3) (1883), in Turkish Empire (3/4), (1928), in Egypt (1/7) (1935), in Iran about 15% (1930), of the whole arable land was endowed to *waqf*. The accumulation of such extensive possession of land under *waqf* had prompted many countries to introduce many reforms. Thus, Egypt enacted a law in 1946 under which all family *awqāf* were made temporary. Then, in 1952, a new decree was issued to the effect that no private *waqf* could be created except for charitable purposes. Egypt, which also has a long history of *waqf* management, allowed bank credit as a subject of *waqf* endowment. In Syria, the question of family *waqf* was prohibited in 1949, while in Lebanon it was allowed but limited to two generations in duration after which ownership reverts to *wāqif* or heirs. Therefore, the *waqf* was not considered to be an irrevocable legal transaction. Furthermore, several reforms were introduced both in Tunisia and Algeria during the French colonial rule where the legal position of land was brought completely under French law and the sale of *waqf* (habous) was recognized in practice.[3]

In India, statutory control of *awqāf* started with the passing of the Musalman *Waqf* Act of 1923 during the pre-partition days. During the post-partition era, several acts were enacted and ordinances promulgated in Pakistan, which was adopted in Bangladesh also. Though the Chief Administrator has assumed the administrative control and maintenance of *awqāf* properties in Pakistan as well as in Bangladesh, in many cases, the income from many small and scattered *awqāf* properties are insufficient for the upkeep of *waqf* properties. While permanent leases give insufficient income to maintain the property, family *waqf* has become one of the sources of litigation, particularly in Bangladesh. This calls for necessary reforms in the management and administration of *awqāf* properties. Although there is a general tendency to have state control over the management and administration of *awqāf* properties, there are notable exceptions (e.g., Uganda, South Africa, and the Philippines) where *waqf* is still designed as a purely private managed institution. This brief survey shows that there is considerable flexibility and scope for further reform in the development, management, and administration of *waqf* properties in Muslim countries as well as in Muslim communities with special reference to Cash-*waqf*.

V. Social Investment Bank and Cash-*Waqf* Certificate

Social Investment Bank Ltd. (SIBL) is a three-sector banking model beyond conventional banking and cooperatives which aims at alleviating poverty and empowering families through social investment based on participatory economy. Various activities of the bank are conducted through formal, informal, and voluntary sectors. In the process of organizing social capital market operations in the voluntary sector of the bank, it has for the first time in the history introduced a "Cash-*waqf* Certificate" scheme. It also aims at empowering the families of the rich for the sake of social investment and welfare.

A research study entitled "Structural Adjustments and Islamic Voluntary Sector with special Reference to *Awqāf* in Bangladesh," written by the author and published by Islamic Development Bank, Jeddah, in 1995 showed that "Cash-*waqf*" is also recognized in Islam. Its use can be traced to the Ottoman era as well as Egypt. But the use of Cash-*waqf* as a financial instrument is indeed an innovation in Islamic social finance.

Cash-*waqf* provides a unique opportunity for making investment in different religious, educational and social services. Savings made from earnings by the well off of the society can be utilized by purchasing Cash-*waqf* Certificates. Income earned from the Certificates will be spent for different purposes like the purposes of the *waqf* properties itself.

Historically speaking, the immovable asset mainly in the form of landed properties is the predominant feature of *awqāf*. It follows then that one of the main characteristics of *awqāf* is their low degree of liquidity. Liquidity as defined by economists refers to the transferring of funds into cash money within a short period of time and at a reasonable cost. We know that landed property even in the case where it is legally permissible to be sold or replaced by another-such as giving up landed property-takes a considerable amount of time and expenses to be transferred from landed property into liquid cash. Therefore, we can safely consider low liquidity as a distinctive feature of the *awqāf* properties. Even when we want to invest in *awqāf* properties, e.g. constructing a building on a piece of *waqf* land with a view to leasing it, this will entail the availability of liquid cash money that would enable us to transfer *waqf* from one shape to another. In this context, raising funds through the sale of Cash-*waqf* Certificate for development of *awqāf* properties assumed a special significance in the 21st century.

Another significant aspect of the Cash-*waqf* Certificate lies in the fact that it has corrected the misperception that the privilege of making *waqf* belongs only to the rich. Since Cash-*waqf* Certificate as introduced by Social Investment Bank is expressed in terms of a small denomination of Tk. 1000/- (US$21 only), it has become affordable to a large section of the Muslim population; it can also be expressed in even smaller denominations also. Seen in this light, the Cash-*waqf* Certificate Scheme can be seen as a movement of social reconstruction and development in which a vast majority of the population can participate.

Attempts should then be made to popularize the role of *waqf* in the country, including cash-*awqāf* which can be instrumental in transferring the savings of the rich to those entrepreneurs and members of the public who finance various religious, educational and social services in Muslim countries. Cash-*waqf* can work as a supplement to the financing of various social investment projects undertaken by Islamic banks, which can eventually emerge as a *waqf* bank. Even today, for example, Cash-*waqf* in Bangladesh is extremely important in terms of mobilization of funds for the development of *waqf* properties. According to a 1986 census of *waqf* estates, there are 150,593 *waqf* estates in Bangladesh having multipurpose uses. According to a 1983 mosque census, there are 131,641 mosques in Bangladesh out of which 123,006 mosques are *waqf* properties. Out of the total *waqf* estates 97,046 are registered, 45,607 are verbal and the rest 7,940 are *waqf* by tradition. Out of these large *awqāf* estates, only 13,200 *waqf* estates are under the administrative control of the *waqf* Administrator out of which 10,683 *waqf* estates are of mixed nature.

As noted earlier, Cash-*waqf* Certificate can empower multigenerational family heritage as indicated in the following extended family chain.

VI. Cash-*Waqf* Certificate: Empowering Multi-Generational Family Heritage

An individual can easily link himself for at least two hundred years in the family chain in the following way: Consider yourself, your parents, and your grandparents, which is at least one hundred years of your family history. Consider yourself, your children, and your grandchildren, the next hundred years of your family's future history. In this way, an individual can easily link himself for two hundred years within a framework of family heritage and develop a vision for his family contribution to society and people.

FIGURE 1. THE EXTENDED PRESENT: A FAMILY CHAIN

200 years

1900 (past)	2000 (present)	2100 (future)
• Beneficiaries of the continued charity/*waqf*	SIBL offers: • output • employment • income • management of continued charity/*waqf* • *zakah*/*sadaqah* endowment	• family stability and sustainable opportunities • future beneficiaries of continued charity/*waqf*

VII. IMPLICATIONS OF CASH-*WAQF* CERTIFICATE

As a part of extending the three-sector model banking services toward the achievement of the corporate objectives of Social Investment Bank Ltd. (SIBL), SIBL introduced the Cash-*waqf* Certificate, for the first time in the history of voluntary sector banking. Cash-*waqf* can be seen as a social assignment replacing income tax in many Muslim countries; income tax departments are reported to be among the most corrupt in most Muslim countries, including Bangladesh. Its introduction is highly suggestive in the context of the fiscal system of Bangladesh, which is heavily dependent on indirect tax (i.e., 85% of the total tax revenue in 1995-1996). A great part of direct tax can be converted to social assignments, and the Cash-*waqf* Certificate can partially substitute a substantial part of the income tax for financing strategic social projects in education, health, and social welfare activities proposed to be undertaken by the rich. What is needed is a political will. Together, a new beginning can be made for a participatory economy and a caring society.

Besides, Cash-*waqf* can be used as a strategic investment in alleviating poverty and economic deprivation as well as in improving education, health, and research to be discussed later on. By taking part in the scheme one can contribute not only toward development of a social capital market operation, but also sharing in permanent social investment. As deposit of Cash-*waqf* is made once and for all, the bank can safely invest it on a short-term, medium-term, or long-term basis as indicated below:

1. Short-term investment: Microcredit and micro-enterprise investment for poverty alleviation and family empowerment, Tokai rehabilitation, etc.
2. Medium-term investment: Cottage industry, weaving industry, small garments industry and dairy farm, etc.
3. Long-term investment: Various heavy industries/factories, etc.

These investment activities shall result in the creation of new avenues of employment opportunities. A large number of unemployed shall have the opportunity for earning their livelihood and thus making contributions to social progress.

As noted earlier, there are 150,593 *waqf* estates in Bangladesh. All of them are in immovable properties. There is an immense scope for commercial development of such properties through raising funds by selling Cash-*waqf* Certificates.

There are many rich people who would like to create Cash-*waqf* for the public good as well as for the benefit of their descendants. But they cannot proceed for lack of necessary institutional arrangements for the management of Cash-*waqf*. Social Investment Bank provides the necessary institutional support and a unique opportunity for opening Cash-*waqf* Deposit Accounts with a view to achieving the following objectives:

1. To provide banking services as facilitators for the creation of Cash-*waqf* and to assist in the overall management of *waqf*;

2. To assist in mobilization of social savings by creating Cash-*waqf* with a view to commemorate living or deceased parents and children, and to strengthen the integration of the family relationship of the well-off;
3. To increase social investment and to transform the social savings into capital;
4. To benefit the general public, specially the poor out of the resources of the rich;
5. To create awareness among the rich regarding their social responsibilities to society;
6. To assist in developing a social capital market;
7. To assist in overall development efforts of the country and to make a unique integration between social security and social peace.

VIII. CASH-*WAQF* SERVICES AS SOCIAL AND PRIVATE GOOD AND CRITERIA OF ALLOCATIVE EFFICIENCY

The *waqf*-fund-supported activities can be divided into social and private good, thereby introducing an interesting area of economic analysis of resource allocation in public finance. Generally speaking, social good is non-rival in consumption: it is difficult to price social goods because their consumption does not reduce the benefits available to others. This is not true in the case of private good, where a price can be placed on the good, and others can be excluded from consuming it. Its consumption is, therefore, rival. "Putting it differently, the benefits derived by anyone consuming a social good are "externalized" in that they become available to all others. This is the situation with social goods. In the case of private goods, the benefit of consumption is internalized with a particular consumer and consumption by him excludes consumption by others."[4]

When a *waqf* fund supports construction of a bridge it assumes the character of social good, and when it supports construction of a hospital or a school, it provides public provision of a private good on which there can be a price tag. Thus, when the total resources generated by *waqf* properties are divided between private and social good or when a mix of social goods are chosen, the existence of non-rival consumption changes the condition of efficient resource use from those conditions which are applicable when consumption is rival. Thus, the institution of *waqf* is performing an allocation function, however rudimentary it may be. This allocation function involves not only the adjustment of income and wealth, but also adjustment of the price of goods and services with which *waqf* is associated. Thus it should be possible to do in-depth case studies to show how *waqf*-supported goods and services perform allocation, distribution, and stabilization functions in a modern Muslim state.

It should then be possible to discuss further the implications of the spending of *awqāf* revenue under the following three effects:

1. Good-deed effect;
2. Free-rider effect;
3. Income redistribution effect.

A. Good-deed Effect

Historically speaking, once an endowment is made, it is considered to be a good act because the *sharīᶜa* attributes the quality of goodness to it. The satisfaction an individual receives by instituting an endowment is, however, distinctly different from the results of the act. In economics there is no direct and fixed co-relation between the goodness of the act and its results.

This distinction is not generally clearly understood. Are we merely concerned with the act of endowment? Is it enough to say that the goal of such an act is utility, not the utility of the result the endowment brings about? Should the individual be primarily concerned with the satisfaction he desires from the good deed of making the endowment? These are some of the questions that require attention from the viewpoint of the *sharīᶜa*. The fact is that the cost of the endowment is that the alternative uses of the funds are given up.

What is equally important for the individual who makes endowments is to evaluate the results or consequences of such endowments, particularly when they are intended to make provision for public goods designed to help the community. Do different types of public good tend to yield different results? Some kinds of broader public goods bring more goodness from their results than others, therefore making dollar-amount contributions equal. For example, there is more goodness for most persons in the act of providing schooling facilities for orphans than in providing toys for them. There is probably also more good in building a hospital for the poor than in establishing a college of liberal arts, or in constructing a bridge in a community that can already afford it, given collective effort. The point is that at a given level of social expenditure on public good out of *waqf*-supported properties, the attempt should be made to maximize the utility of the results. It is, therefore, imperative that once a person desires to make an endowment he should be provided with necessary "advisory services" which would provide information on the different ways the endowment can be used. In this way, the resources generated from them can be better utilized to attain predetermined socioeconomic objectives.

B. Free-rider Effect

Any theory of expenditure of *waqf* fund must try to minimize the free rider effect, particularly when such a fund is directed to providing a public good that is indivisible. In the context of an Islamic economy, this free rider effect will take place when contribution of a dollar will result in an increase in the total provision of the public good less than a dollar, because other individuals would tend to lower their voluntary contributions. We have evidence to show that *waqf*-financed education was for children of both rich and poor parents. Since the beneficiaries of education cover children of those who could otherwise bear their education expenses, it tends to create the problem of "free-rider effect." Although it was not immediately visible in simple agricultural societies of the Middle Ages, the issue of "free-rider effect" needs to be taken rather seriously in today's much more complex society. In the Middle Ages, the wealthy and rich did compete with one another in contributing to the *waqf*-supported schools. The related educational development was possible due to *waqf* grants by the successive rulers. The socioeconomic realities of the contemporary period are not the same as we found in the early days of Islam.

C. Income Redistribution Effect

It is also important to examine the income redistribution effect of the *waqf*. The net income redistribution effects and income transfer payments cannot be analyzed in isolation. It depends on the impact of all public taxation and spending activities on various income groups. Generally speaking, the disbursements of *waqf* funds should play an important role in any vertical income redistribution. The disbursement of *waqf* funds needs to be coordinated so that its redistribution effects in favor of the poor are not cancelled out. It is to be noted that one of the important ways to achieve vertical redistribution is to make the provision of certain key services public, particularly education for the poor. Historically speaking, a close look at the operation of the *waqf* shows a considerable horizontal income distribution from one earning class to another earning class. It is important to see the total effect of its spending in relation to other public expenditure in a modern Muslim state. It is generally alleged that in the past this institution of *waqf* was responsible for the industrial backwardness of Muslim communities, because a large amount of resources were diverted for purposes other than development activities. It is also argued that it led to the fragmentation and sub-division of agricultural holdings, thereby retarding the process of modernization of agriculture in Muslim countries. It is also criticized on the ground that mismanagement of *awqāf* properties led to the decline of total revenue of concerned countries that could have been utilized more effectively for other purposes. It is to be examined how far these criticisms are valid in the context of the present day situation. Cash-*waqf* offers a better scope for utilization of *awqāf* resources.

IX. Guidelines Governing the Operations of Cash-*Waqf* Certificate

The guidelines governing the operation of the Cash-*waqf* Certificate as introduced by Social Investment Bank are as follows:

1. Cash-*awqāf* shall be accepted as endowment in conformity with the *sharīᶜa*. The bank will manage the *waqf* on behalf of the *wāqif*;
2. *Awqāf* are done in perpetuity and the Account shall be opened in the title given by the *wāqif*;
3. *Wāqif* will have the liberty to choose the purpose (s) to be served, either from the list of 32 purposes identified by SIBL as noted later or any other purpose(s) permitted by the *sharīᶜa*;
4. Cash-*waqf* amount will earn profit at the highest rate offered by the bank from time to time;
5. The *waqf* amount will remain intact and only the profit amount will be spent for the purpose(s) specified by the *wāqif*. The unspent profit amount will automatically be added to *waqf* amount and earn profit to grow over time;
6. *Wāqif* may also instruct the Bank to spend the entire profit amount for the purpose specified by him/her.
7. *Wāqif* will have the opportunity to create Cash-*waqf* at a (later?) time. Otherwise, he/she will declare the amount he/she intends to build up and will start with a minimum deposit of Tk. 1000/= one thousand only (or equivalent foreign currency). The subsequent deposits shall also be made in thousand or in multiples of thousand;
8. *Wāqif* shall also have the right to give standing instruction to the bank for regular realization of Cash-*waqf* at a rate specified by him/her from any other a/c maintained with SIBL;

9. Cash-*waqf* shall be accepted in specified endowment receipt voucher and a certificate for the entire amount shall be issued as and when the declared amount is built;
10. The principles and *sharīʿa*-based rules of Cash-*waqf* Account are subject to amendment and review from time to time.

X. CASH-*WAQF*: ACHIEVING RESULTS ON THE GROUND AT THE OPERATIONAL LEVEL OF SOCIAL INVESTMENT BANK LTD.

The thirty-two purposes for utilization of Cash-*waqf* fund as indicated below show the diverse areas of investment by Social Investment Bank. Although this is not exhaustive, these social investment activities will create a base for perpetual social capital, and help develop a credit program that reinforces family values and stimulates the social and moral foundation of a civil and a caring society.

TABLE 1. THIRTY-TWO PURPOSES OF CASH-*WAQF* FUNDS

Family Empowerment	Uplift of absolutely poor Rehabilitating handicapped Rehabilitating beggars Rehabilitating destitute women Uplift of urban slum dwellers	
Education & Culture	Education of orphans Educational development Providing informal education Providing physical education Supporting local culture and heritage Conducting Dawah activities Student scholarships	Supporting vocational education Education in neglected areas Financing educational institutions Educating deserving descendants Projects for memory of mother/father Establishing educational chairs
Health and Sanitation	Village health care and sanitation Supplying pure drinking water Establishing hospitals, clinics, etc. Research in health sector	
Social Utility Services	Setting disputes Legal aid to deserving women Arranging dowry-less marriages Public transportation and plantation Assistance to non-Muslims	Protecting anti-social activities Public utility services Mosque development projects Graveyard development projects Eidga development projects

It appears that the Cash-*waqf* Certificate scheme, introduced by Social Investment Bank Ltd. (SIBL) offers a unique opportunity at the institutional level to drive social benefits and receive divine blessing for this life and the hereafter.

One can purchase Cash-*waqf* Certificates for:

1. Self
2. Parents
3. Heirs
4. Spouse
5. Neighbors
6. Brothers/Sisters
7. Improvement of the living standard of the poor
8. Rehabilitation of the physically crippled ones
9. Improvement of living standard of the slum dwellers
10. Assisting education of orphans
11. Facilitating education of meritorious students
12. Expansion and development of modern and up-to-date education
13. Expansion of education program of the School/College/Madrasa/University you studied
14. Establishing "Education Chair" in assisting research and education
15. Assisting mother-care education
16. Conducting research on specific diseases and establishing research center
17. Establishing Hospital and Blood Bank
18. Alleviating dowry system and motivating dowry-free marriage
19. Establishing small scale industries for social welfare
20. Assisting research, development and education program to commemorate parents or any other predecessors
21. Mitigating social problems of non-Muslims
22. Assisting alternative employment and income generating projects for poverty alleviation and any other *sharīʿa*-permitted schemes. Above all, one can purchase the Cash-*waqf* Certificate with a view to fulfilling investment target in at least the following four areas:

A. Self Benefit

Man is mortal. At birth we are indeed poor; at our death, we are poor as well. It goes without saying that all of our activities end on death except the three things stated earlier. Cash-*waqf* falls within the purview of ongoing charity (*Sadaqa-E-Jariah*). As an instrument of *Sadaqa-E-Jariah*, Cash-*waqf* may play a vital role in bringing self-benefit for life here and hereafter.

B. Family Benefit

As indicated earlier Cash-*waqf* certificate scheme offers an opportunity to discharge our responsibility toward our parents, wife, children, and other members of the family. Cash-*waqf* Certificate can be purchased also for the betterment of future generations, for education, marriage etc. of children and/or grandchildren, or for establishing memorial for one's parents or grandparents. Since the bank will remain in charge of management of profit derived from the purchase of Cash-*waqf*, this will ultimately lead to empowerment of one's future generation as explained earlier.

C. Social Development

The Cash-*waqf* Certificate also offers a unique opportunity to contribute to society. With the profit from Cash-*waqf*, one can make valuable contributions to establishing/running different educational institutes, including Mosques, *Madrasas*, Hospitals, Schools, Colleges, and Universities. This scheme can assist in implementing any project of education, research, religion, social welfare, or medical services to the poor and alleviation of poverty.

By means of Cash-*waqf*, an Educational Chair can be established in the University. The scheme can also be used for awarding scholarships to meritorious students of School/College/Madrasa/University, etc. The benefits of Cash-*waqf* Certificates are thus perpetual in nature. Unlike temporary charity, Cash-*waqf* is well planned and everlasting. As a result, a vast group of people in society will enjoy its benefit perpetually.

D. Building a Caring Society

The fund established through Cash-*waqf* would be invested, which will ensure social security for the poor and social peace for the rich. Eventually, Cash-*waqf* would create a bridge of mutual care and compassion between the rich and the poor, thereby contributing to the process of social harmony and cooperation. The fact of the matter is that the Cash-*waqf* Certificate Scheme is likely to bring about wide ranging economic and social benefits to the society as a whole.

At this stage it is interesting to report that the Social Investment Bank introduced Cash-*waqf* Certificates on an experimental basis in December 1997, and formally launched the program on January 12, 1998. Since then the growth of the number of accounts and deposits is very encouraging, as indicated in Table-I below:

TABLE 2. THE GROWTH OF CASH-*WAQF* ACCOUNTS AND DEPOSITS

Item	1997	1998	1999 (to Aug. 31)
Number of accounts	21	215	367
% increase	-	924%	71%
Amount deposited (Taka '000)	39	1,249	2,763
% increase	-	3103%	121%

(1 USD = 48.3 Taka)

Source: Fourth Annual Report of Social Investment Bank, 1998

XI. AGENDA FOR ACTION

Islamic banks in the 21st century should make an effort for global mobilization and the creation of Cash-*waqf* for US$1 billion by 2010. This would be done mainly through the sale of Cash-*waqf* Certificates to support the development of human and social capital infrastructure of the Islamic world in particular, and disadvantaged people of the world in general. On a global scale, "three billion people live on less than $2 a day, 1.3 billion do not have clean water, 130 million children do not go to school, and 40,000 children die every day because of hunger-related diseases. Within this deprivation is another dimension: hundreds of millions of girls and women whose lives are diminished and shortened by inadequate economic means, and discrimination in social status and medical attention."[5] In this context, the challenge of bankruptcy of the Muslim world in the fields of education, science and technology, health, and research as well as the level of general economic deprivation of the masses, has reached the level of a global crisis. The lack of human and social capital infrastructure, colonial era bureaucratic set-up, pervasive corruption, lack of political and social will and national commitment in the fields of economics, education, health, and research have placed more than half of one billion Muslims in the darkness of illiteracy and ignorance and poverty.

An average of hardly 4% of the GNP of Muslim world was spent on education, as opposed to 7% on defense. The total number of universities in the Muslim world, irrespective of their quality, is not beyond a mere 400. A recent survey shows that in the industrialized world, only three out of every hundred adults were not able to attend any school, while in the Muslim world as much as 77% of the population aged 25 and above had never been to any school. This figure is even higher than that of the rest of the Third World countries where it was found to be 64%. The survey further reveals that the Muslim world has: the lowest school-going population, that is 47 per every 100 children aged 5-19; the highest student/teacher ratio, which is 88 students per teacher; and the lowest enrolment in higher education, which is just 8 per 100 in the age-group, 20-24. In most of the Muslim African countries, it is below 1% of the adult population. Very few Muslim countries have created basic institutions in the field of Research and Development (R&D). At present, the Muslim World has the lowest amount of manpower in the field of science and technology.

Cash-*waqf* can be seen as a process of expanding and unfolding the frontiers of human freedom that includes economic and social deprivation. Currently, the United States is perhaps the most generous nation in the world. For example, Americans gave nearly US$2 billion to international causes in 1997. Last year according to figures by Giving USA, Americans donated $143 billion to non-profit organizations. Just over three-quarters of this came from living individuals ($109 billion); the rest from foundations ($13 billion), bequests ($13 billion) and companies ($8 billion). The non-profit part of the economy accounts for 8% of GDP, a figure that has more than doubled since 1960; and it employs nearly 10% of the American work force—more than federal and state governments combined.[6] Perhaps, given its rich heritage and legacy, Muslim philanthropy in the 21st century can match American philanthropy in the 20th century. What is needed is to rediscover Islamic socioeconomic values and revive Islamic institutions in the 21st century. Islamic banks and voluntary organizations must explore this opportunity for mobilizing this social capital.

A. Global Mobilization and Creation of Cash-*waqf* Fund

Each of the local Islamic banks, Islamic voluntary organizations or non-profit trust and foundations may volunteer to act as an agent to sell Cash-*waqf* Certificates for global mobilization, and to raise Cash-*waqf* funds of at least US$100 million in a year from member countries of IDB and Muslim communities in non-member countries of IDB.

B. Forming a Confederation of Islamic Voluntary Organizations

Since the purchase and sale of Cash-*waqf* Certificates provides new opportunities to transfer liquid assets and make connections with one another on a global scale, opens up possibilities for a greater variety of pluralism in the expression of Muslim identities and re-construction of the Islamic *Ummah*, and in the services of mankind as a whole or Non-Government Organizations (NGOs), Islamic Development Bank may initiate the formation of a confederation of Muslim voluntary organizations by holding a meeting of the volunteers. Islamic Development Bank's effort to establish the "*Awqāf* properties Development Fund" is a move in the right direction. Private sector initiatives should be considered vital in this area also.

C. Globalization of Islamic Voluntary Sector Activities

The Social Investment Bank is already in the process of introducing other new financial instruments and products for financing development in the Islamic voluntary sector in Bangladesh, such as *Awqāf* Properties Development Bond (specific and general), Mosque Properties Development Bond, Zakat Certificate, etc. This relates to the issues of securitization and coordination of social capital market operation and globalization of Islamic voluntary sector activities. The Cash-*waqf* Certificate is a building block. As a part of the process, a comprehensive action plan needs to be drawn. Social Investment Bank can act as the coordinator of all concerned.

D. Strategic and Futuristic Social Investment by Committee of Volunteers

A coordination committee of volunteers of Islamic banks, voluntary organizations, and NGOs should be set up to prepare an Action Plan that includes establishment of a Cash-*waqf* Fund and identification of the areas for conducting joint strategic and futuristic social investment in the 21st century.

XII. CONCLUSION

Evidence suggests that there is considerable mismanagement and misuse of *waqf* properties, despite their contribution to social development over time. The Cash-*waqf* Certificate Scheme is an epoch making event. As the bank manages this Cash-*waqf*, the Cash-*waqf* has transparency, liquidity, and accountability, is a perpetual deposit, and its profit can be invested in a wide spectrum of social investments. Besides the 32 areas identified by the bank, the *wāqif* or subscriber can select one or more sectors according to his wishes in conformity with the *sharīʿa*. Money for Cash-*waqf* can be deposited as a lump sum or by installment. The bank shall manage the Cash-*waqf* on behalf of the *wāqif*. This ensures appropriate utilization of the fund of the *wāqif* in terms of its goals and objectives. The bank's 32 sectors/areas of investment include diverse social investment activities having enduring value which will create a base for perpetual social capital, help develop a credit program that reinforces family values, and stimulate a caring society. The Holy Qur'ān has emphasized the virtues of charity in life on earth and life hereafter. The Cash-*waqf* Certificate offers an opportunity to get divine blessing and to have a rewarding social and spiritual experience and internal peace. Viewed from this perspective, it becomes a social and moral imperative on the part of the well to do to come forward and invest under the Cash-*waqf* Certificate Scheme for his own benefit. This will certainly pave the way for a new dimension of social development. The Cash-*waqf* fund can be spent for the welfare of non-Muslims also, thereby paving the way for serving humanity at large.

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The Role of the Dow Jones Islamic Market Index in Islamic Finance

David E. Moran[*]

ABSTRACT

Dow Jones Indexes is a leader in creating innovative indexes for established and emerging markets. The Dow Jones Islamic Market Index (DJIM) was launched in Bahrain on February 9, 1999. The DJIM was launched because a global Islamic index did not exist, and Dow Jones Indexes' objective was for the DJIM to become the industry benchmark. Islamic investors have been seeking transparency and accountability to measure the relative performance of their portfolios. Islamic funds and fund sponsors were seeking an established index provider to create a *sharīᶜa*-compliant benchmark and a universe to structure *sharīᶜa*-compliant investment products. Presently, Dow Jones Indexes calculates (real time) and disseminates six Islamic indexes, and Islamic index certificates have been launched by DJIM licensees such as Brown Brothers Harriman, Wafra Investment Advisory Group, Samba Capital Management International, Merrill Lynch, and others.

I. INTRODUCTION

Dow Jones and Company, a Fortune 500 company listed on the New York Stock Exchange, is probably best known as the publisher of the Dow Jones Industrial Average, but is also the publisher of *The Wall Street Journal* and its international and interactive editions. Other publications include Barron's and SmartMoney magazines and other periodicals; Dow Jones Newswires and Dow Jones Indexes; and the Company is also the co-owner of Dow Jones Reuters Business Interactive which is a joint venture with Reuters in the desktop publishing world, and the CNBC television operations in Europe and Asia. The Company also provides news content to CNBC in the United States.

II. HISTORY AND DOW JONES' INDEXES

Dow Jones Indexes published its first index in 1882. It was made up of a number of stocks that were traded in New York—principally railroad stocks—that later became the famous Dow Jones Industrial Average, which is internationally considered the most important indicator of the United States economy, and equity market prices in the United States generally. The index environment is extremely competitive, however, and the Company has been trying to take advantage of certain trends in marketplaces, and provide index solutions and measurement tools for investors globally. The first example of this is a set of indexes for Europe, launched about 18 months ago, called the Dow Jones STOXX family of indexes. The rationale for these indexes is that with monetary union coming to Europe, residents of the countries joining the Euro zone can suddenly consider investing across their borders without currency risk. Since the introduction of the indexes it is probably fair to say that Dow Jones has become the dominant equity benchmark for the emerging Euro zone. It also publishes a whole series of internet indexes; the most recent being an index that seeks to measure certain aspects of Sustainability, an emerging investment concept which considers a combination of factors, including adaptive use of technology, sensitivity to the environment and a clear concern for the social welfare of the company's employees and constituencies.

III. THE DOW JONES ISLAMIC MARKET INDEX

The Company decided to launch the Islamic Market Index because it had been observed that a number of investment managers were seeking to run exclusively *sharīᶜa*-compliant investment management. This market was expected to grow extremely quickly, and Dow Jones decided that it was possible to create a benchmark for *sharīᶜa*-compliant investing. The famous academic and Christian apologist C.S. Lewis once wrote that if he were a banker he would tremble thinking that the three great monotheistic religions of the world all in one way or another criticized the lending of money at interest. When Rushdi Siddiqui presented his plan for an Islamic index, and with Lewis's words in mind, the Company decided to actively pursue the creation of an index for a large population intent on

[*] President, Dow Jones Indexes, New York, N.Y.

following its religious principles. The Company feels that it is now well on its way to becoming the benchmark for Islamic investing. It has been participating in many of the increasing number of Islamic banking conferences. Any Islamic undertaking requires a competent *sharīʿa* board, and the Company's is one of the most respected and recognized internationally. It includes Muhammad Taqi Usmani of Pakistan, Mohamed A. Elgari of Saudi Arabia, Abdul-Sattar Abu Ghuddah from Syria, Nizam Yaquby of Bahrain, and Yusuf Talal DeLorenzo of the United States, who have helped Dow Jones establish screening parameters for the Islamic Market Index, and have been extremely understanding of the need for stability in an equity market index. It is expected that the *sharīʿa* standards will not stay firmly in place for any particular period of time; in fact, the *Sharīʿa* Board will guide the Index in new developments. It is, however, very important for people actually using an equity market index to be able to rely on a certain amount of stability in its composition.

The Dow Jones Islamic Market Index consists of nearly 600 companies globally from 30 countries, covers over 100 industry groups and nine economic sectors and today has a market cap of nearly 8 trillion dollars. It was launched in February 1999 in Bahrain to the banking community, and its initial licensees were Brown Brothers Harriman and WAFRA, which is part of Kuwait's Public Institute for Social Security. It has been well received by the world media, having been widely published around the world, as well as in the Wall Street Journal every day, in the United States, Europe, and Asia. Since that time, the Company has had the ability to launch additional sub-indexes: one for United States companies only; one sector index for global technology; indexes one for Islamically appropriate UK companies; one for Canadian companies; and a blue chip extra liquid index. Indeed, on a year to date basis, the Islamic Market Indexes have generally outperformed their conventional counterparts. Dow Jones expects to launch additional indexes; possibly a REIT (real-estate investment trust) index, an Internet index, or a United States Small Cap Islamic index.

The implications of the introduction of the Dow Jones Islamic Market Index series are notable. It is expected that additional Islamic funds will come into the public domain, and one of the aspects of professional money management, that is really rapidly taking over the world, is this benchmarking phenomenon. Many investment managers would prefer to have their returns compared to something like the consumer price index but modern finance indicates that a reasonable benchmark of equity prices that relates to the investment manager's objective is what is really needed. Moreover, fund sponsors generally do not want to be in the index providing business; they simply want to manage assets, which is what they are very good at; so a third party with some reputation for publishing indexes is a good thing for the marketplace and its modernization.

Dow Jones does not, as yet, have many Muslim countries covered by the Dow Jones Islamic Market Indexes, principally because the markets themselves are not terribly well-developed or are not as transparent as they could be, and in many cases suffer from substantial restrictions on foreign ownership. The goal behind Dow Jones Indexes is to create indexes that everyone, foreigners and locals, can use, so until such markets develop further, the existing country group will remain unchanged.

IV. CONCLUSION

A new trend occurring in the United States, at least, which will probably reach other markets soon (to a certain extent Muslim countries have been thousand-year leaders of this trend), is faith-based investing. The United States has upwards of 20 to 30 billion dollars being publicly managed on a socially responsible basis. Islamic Market Indexes are a good example of this kind of index, and are usable by anyone interested in making his or her beliefs real in investing life. The Company certainly expects competition from other index providers, and in fact, welcomes it, as does its *Sharīʿa* Board. Competition is healthy for anyone; it will keep the Company trying to improve constantly, make it more accountable to the marketplace, and assist in the development of the emerging world of Islamic finance.

Islamic Project Finance

A Case Study of the Equate Petrochemical Company

Mohammad S. Al Omar*

ABSTRACT

Kuwait Finance House underwrote, arranged, and syndicated the US$200 million Islamic lease finance facility, which was structured on a sale/lease basis, for Equate Petrochemical Company (Equate) in Shuaiba, Kuwait, a joint venture between the Petrochemical Industries Company (PIC), Kuwait, and Union Carbide Corporation, U.S.A. The Islamic facility was part of the total US$1200 million long-term financing that Equate raised through major international and regional banks. KFH negotiated with attorneys, finalized documentation (particularly those related to the Islamic tranche to ensure *sharīʿa* compliance), and refinanced the facility to bring the pricing closer to market levels for similar projects regionally and globally. The success of this Islamic lease facility signals the debut of a new era of Islamic long-term financing in conjunction with conventional facilities.

I. Introduction

The Equate project is unique in the sense that, perhaps for the first time, an effort was made to combine Islamic financing with conventional financing. *Prima facie*, it may sound odd, even incongruous, if not blasphemous, that two modes of financing thus far considered irreconcilable both in concept and performance—one based on interest and the other on avoiding interest—are sought to be brought together. But the task is not altogether impossible provided that care is taken to clearly demarcate their respective roles and keep each part of the financing within its own bounds, with and under the benign guidance of learned scholars of the *sharīʿa* on the one hand, and experts of conventional finance and law on the other.

Kuwait Finance House (KFH) underwrote and arranged the US$200 million Islamic lease finance facility for Equate Petrochemical Company, Kuwait (Equate), a joint venture between Petrochemical Industries Company, Kuwait (PIC) and Union Carbide Corporation, USA (UCC), toward Equate's petrochemical plant project. As an underwriter and arranger, KFH was actively involved at all stages of the entire financing process, including all negotiations with *sharīʿa* experts and with lawyers in the successful finalization of documentation, particularly those related to the Islamic tranche, in order to ensure *sharīʿa* compliance.

The Islamic facility was part of the total US$1200 million long-term financing which Equate raised through major international and regional banks. Subsequently, KFH was involved in the renegotiations of the pricing with Equate and other facility arrangers. As a result of this, the pricing was re-fixed in line with the market rates. The refinancing aimed at bringing the pricing closer to the market level for similar projects regionally and globally and as such received active support from all the underwriters. The changes became effective at the technical completion of the plant on 16 November 1997.

The total project financing package also provided for a working capital facility equivalent to US$150 million (approx. KD45 million), in addition to the US$1.2 billion long-term financing.

II. The Islamic Facility in Brief

Islamic financing was designed to adhere to *sharīʿa* requirements and was structured on sale/lease basis. This was the first time that Islamic financing had been arranged for a major project of such a large amount and unusually long tenor, and in complete unison with the conventional facility. It was also unique in being the first Islamic and largest "limited recourse" financing facility ever arranged in Kuwait or elsewhere.

* Assistant General Manager (Investment Sector), Kuwait Finance House, Safat, Kuwait.

III. The Project: Technical Brief

The project involved the construction of a petrochemical plant (Equate plant) at Shuaiba, Kuwait, by major international contractors. It was hailed as Kuwait's most ambitious private sector downstream project. It was completed as per schedule. Right from inception and the start of production, the plant has been delivering superior operating performance and is also making timely rental payments (both the profit element and the amortization of lease amount). Equate has also been enjoying full support and continued cooperation of its sponsors and project lenders/lessor. The refinancing of 1997 enhanced the cost competitiveness of Equate's products. An independent project feasibility report rates Equate as one of the most competitive petrochemical plants in the world, both in product quality and cost structure.

At the very outset the Equate Project was considered a priority project by the State of Kuwait and to this end, the Ministry of Oil and Kuwait Petroleum Corporation (KPC) and its subsidiaries, including the Petrochemical Industries Company (PIC), agreed to provide the project and the Company (Equate) with all appropriate support and assistance to facilitate successful construction and operation in accordance with the original plan. The plan was to construct and operate a 650,000 metric tons per year ethylene plant (by the USA's Brown & Root), a 450,000 metric tons per year polyethylene unit (by Italy's Snamprogetti) and a 340,000 metric tons per year monoethylene glycol facility (by Foster Wheeler Italiana) at Shuaiba Industrial Area, Kuwait. USA's Fluor Daniel served as Project Manager. The local Ahmadia Contracting & Trading Company carried out architectural services on the complex, including the construction of Equate's headquarters.

On the technical side, PIC has been able to utilize Union Carbide's licensed technology, and management and marketing skill. The participation of such a huge U.S. enterprise has also helped ensure the interest of private sector financiers.

IV. The Project: Financial Summary

The total project cost was estimated to be around US$2 billion with the non-debt portion coming from the partners' equity. PIC, Union Carbide, and Bubiyan Petrochemicals Company are providing US$730 million in equity and subordinated debt toward the project. A large quantity of Union Carbide's subordinated debt is in the form of technology licenses for the plant.

The debt portion of the project involved the US$1.2 billion package, comprising US$1 billion of conventional facilities and US$200 million of Islamic facilities. The award, to 11 Gulf institutions (including Kuwait Finance House) and three U.S. banks was especially sweet for the Arab banks since they managed to beat off a US$1 billion financing package led by the Export Import Bank of the USA (U.S. EXIMBANK) that would have covered almost all the cost of the financing. The group of Arab banks, led by the National Bank of Kuwait, was able to provide the long-term funding on a limited-recourse basis. If things went according to plan, the main recourse was the project itself. The Group included five main Kuwaiti banks, some of the major Persian Gulf based banks and international banks (among them Citibank, Chase, and J.P. Morgan) and Kuwait Finance House (KFH). KFH exclusively underwrote the entire US$200 million Islamic facility.

The whole project financing involved a complex web of agreements including an intercreditor agreement with the other participants, including both conventional banks as well as KFH.

The joint venture approach on a project of this scale is a new development in Kuwait.

V. Guarantees and Insurance Aspects

This groundbreaking limited-recourse facility reported strong demand and was oversubscribed by over 50 participating banks and financial institutions, despite the lack of credit agency guarantees. The sponsors—PIC, UCC, and Bubiyan—took out some investment insurance with the World Bank's Multilateral Investment Guarantee Agency and a political risk insurance facility underwritten by National Bank of Kuwait and Gulf Investment Corporation.

Both Union Carbide Corporation (UCC) and PIC, each on several basis with respect to 45% and 55% of the total facility respectively, guarantee the borrower/lessee's (Equate's) payment obligations in relation to all amounts falling due and payable under the term loan, the working capital facility and the Islamic lease facilities until released upon completion. ("Completion" includes mechanical completion, integrated reliability test, unit performance test, commercial completion test and financial completion). The sponsors' guarantee will remain in place for the entire period of the facilities, if completion is not achieved by September 30, 2000 at the latest.

VI. Some Details of the Islamic Facility

The Islamic lease facility provided by Kuwait Finance House is denominated in U.S. dollars and is comprised of two tranches:

1. **Tranche A:** US$100 million to be amortized *pro rata* with tranche A of the conventional term loan facility of US$400 million. Tenor 10.5 years. Repayments for ten years in 20 semi-annual equal installments starting June 1998 – final maturity December 2007.
2. **Tranche B:** US$100 million to be amortized *pro rata* with tranche B of the conventional term loan facility of US$600 million. Tenor 8.5 years. Repayments for 8 years in 16 semi-annual equal installments starting June 1998 – final maturity December 2005.

This Islamic lease facility signaled the debut of a new era; that of Islamic long-term financing in conjunction with conventional facilities. The leading role played by Kuwait Finance House in arranging, underwriting, syndicating, and also in subsequent re-pricing/refinancing, underwriting and limited syndication of the facility opened a window of opportunity to many potential project financing syndicates to gain access to the Islamic market.

Islamic banks have usually taken a cautious approach to non-recourse financing and generally tend to concentrate at first on deals within their domestic market to avoid cross-border risk. For them, the preferred technique for medium and long-term financing has been leasing. The Islamic facility utilized the product structure of a full payout (finance/capital) lease. The Islamic institutions participated by way of an Islamic sub-funding/sub-participating structure.

VII. Related Aspects

It is believed that some competing groups bidding for the financing, including some credit agencies (like the U.S. EXIMBANK, Germany's Hermes and Italy's SACE), had asked for terms that Kuwaiti authorities considered too rigorous, including a financial covenant from PIC parent company, Kuwait Petroleum Corporation and other guarantees from the Government of Kuwait, a sort of sovereign risk structure. The overall conditions attached to the loans in such proposals were thought to have been too stringent. Besides, some such groups wanted the Kuwaiti government to guarantee feedstock supplies to the complex as well as minimum output levels. With the selected loan package, the government has guaranteed feedstock supplies and has offered cheap power to the plant. The Union Carbide Corporation, which has a 45% stake in the project (state owned PIC 45% and Bubiyan Petrochemicals Co., a US$50 million public shareholding company establish in June 1995 own the remaining 10% stake) had offered to pick up output at market prices.

The deal, described as a surprise victory, demonstrated that Arab banks have the capability to arrange and fund big regional projects against stiff opposition and fierce competition. Moreover, the introduction of the Islamic element demonstrated the depth of virtually untapped financing resources in the region. Such blending of Islamic and conventional funding may become an important source for the future. The success of regional and international banks to negotiate such a complex arrangement in conjunction with Islamic banks has raised hopes that other large-scale private sector projects can be financed in a similar way. The success of local and regional banks in funding such a high profile project may well be the start of a new trend. These banks have proved that they can handle such a large and complex transaction by beating bids from other reputed funding sources. The Equate project will not only enable Kuwait to join the elite club of major petrochemical producers but will also have broken new ground for the traditionally state-dominated energy sector in Kuwait.

With this, project financing in the Middle East can be said to have come into a new limelight. Deals of this nature show that where governments are no longer willing or able to pick up the entire bill for development, banks can step in to take the risk, in some cases even without the security of guarantees from states or export credit agencies.

VIII. Certain Terms and Conditions of the Equate Lease

Under the Lease Agreement between KFH (the Lessor) and Equate (the Company, the Lessee), the Company has agreed to lease from the Lessor, and the Lessor has agreed to lease to the Company the Project Assets. (This is subject to the passing of title to such assets from the Company to the Lessor pursuant to a sale arrangement under the Sale Agreement between these two parties, and upon terms and conditions of the Lease Agreement). The

Lease period commenced on the date on which the Lessor acquired title to the Project Assets pursuant to the Sale Agreement and shall end on the final maturity date. The Company is entitled to replace any of the Lease Assets by way of renewal of obsolete or worn out items or by way of replacement of items that are damaged beyond repair for any reason. Title to such replacement item shall vest in the Lessor upon such replacement and such replacement item shall form part of the lease assets. The Lessor shall have no obligation to maintain the Lease Assets which obligation shall fall entirely on the Company pursuant to the covenants contained in the Common Terms Agreement. In consideration of the lease of the Lease Assets to the Company, the Company shall pay to the Lessor lease payments that will constitute periodic rental (profit element) and reimbursement element (periodic amortization of capital/principal) without any deduction of any nature whatsoever. Each of the Lease Assets (including any replacement part) shall remain the property of the Lessor at all times, from the commencement of its leasing until the ownership thereof is transferred to the Company upon full and final payment upon maturity, in case of sale to the Company by delivering a duly executed bill of sale and transferring of all of the Lessor's rights or under certain conditions by way of gift on "as is, where is" basis. No sub-lease is allowed. Under certain terms and conditions, the Lessor may require the Company to purchase all the Lease Assets from the Lessor for an agreed price. The Lessor shall be entitled with the approval of the Company to assign or transfer all or any of its rights, benefits, and obligations to any person who accedes to the Common Terms Agreement and the Security Trust Agreement.

IX. Islamic Lease Financing

Islamic leasing transactions are more or less similar to conventional ones, except few differences arising mainly from the standpoint that:

1. Ownership of asset rests with the lessor (Islamic investor) during the entire period of lease.
2. Major maintenance and major repair responsibility rests with the owner, not lessee. The owner can, however, separately contract out the above to anyone, including the lessee.
3. Total loss risk is to the owner, not the lessee. The owner can, however, separately insure the same, or separately contract out the insurance responsibility.

X. Rulings on *Sharīʿa* Issues

Kuwait Finance House (KFH) underwrote the US$200 million Islamic Tranche out of a total US$1.2 billion Equate financing in unison and *pari-passu* with the other commercial banks. The banks were involved in providing senior debt of US$1 billion under conventional terms, while KFH participated under a lease (*ijāra*) transaction, which involved the signing of two exclusive Agreements with the Lessee: one a Purchase Agreement and the other a Lease Agreement. As KFH was a party to various other agreements with Equate in which other conventional banks were also parties and signatories, a number of *sharīʿa* questions arose. The entire project and *modus operandi* was explained at length to the *Sharīʿa* Board, which discussed each and every perceived problem and issue in depth and their ruling was obtained prior to participation. The following important issues deserve mention.

1. Kuwait Finance House could be a signatory to documentation along with the other conventional banks, where certain non-Islamic provisions are included as long as KFH does not receive benefits from the non-Islamic clauses.
2. The rental income of the Islamic Lease transaction could be computed by reference to LIBOR. The use of LIBOR as a benchmark to compute the rent would only serve as a mechanism to compute KFH's lease rental/profit element on the Lease transaction and would not amount to charging any usury (*ribā*), interest, or equivalent.
3. As one of the many parties providing the project term facilities (and as a consequence of being a signatory to the Intercreditor and Security Trust Agreements), KFH could assign the lease assets to a common security trustee to hold the property on trust and to be jointly shared *pro-rata* with the conventional participants, i.e. the other commercial banks. In case of default, KFH would be entitled to receive its share of Project Assets of the Company on a *pari passu* basis. In other words, KFH was allowed to have its security interest in the leased assets to become part of the general security pool, which both conventional banks and Islamic financiers would share *pari passu*. However, there was an overriding condition that assets initially the subject of Islamic lease, even after being assigned to the common Security Trustee, would only cover the Principal due to conventional banks and not their interest portion.

4. The documentation allowed dealing with the issue of delayed payment without making it a contractual calculation. Logically, if payment is not duly made on time the credit standing deteriorates and hence a higher spread may be charged on subsequent facility period to compensate for the implied higher risk. Any loss of profit to KFH as a result of late/delayed payment could be dealt with by building that loss (lost profit) into the subsequent Lease payment, i.e. any delay in payment of previous lease rentals may be considered in calculation of the next lease payments along with the new LIBOR rate for computation of profit. This allowed us to address *sharīʿa* concerns by not charging compensation in relation to time, while addressing the business concern not to reward default.
5. There should be no purchase/lease transaction without the involvement of an underlying asset.
6. All prepayments should be shared *pro-rata* by conventional and Islamic investors.
7. Participants were allowed to assign their rights and obligations because the facility was backed by assets.
8. The *sharīʿa* links the lessor's entitlement to lease payment to his responsibility to secure the ability of the asset to yield utility at all times for the lessee.
9. In case of destruction or a total loss of the lease property, the lessee should not be obligated to make lease payments or purchase the leased assets at book value. In such circumstances, insurance claim proceeds could be the main source of repayment or compensation. In other words, there should be no lease payment to be made by the Lessee in case of total destruction, which would entail the termination of the Lease Agreement itself.
10. The Lease Agreement is only one part of the finance documents which together clearly mention that all assets of Equate are to be comprehensively insured with the insurance policies to be assigned in favor of the Security Trustee on behalf of the participating financiers. This was considered *sharīʿa*-compliant.
11. Lease payments could be allowed to vary at intervals coinciding with the lease repayment dates to take care of changing LIBOR rates and the prevailing market rates and circumstances. The Lease Agreement allowed these changes so that there was no real separation between principal and profit elements. Instead a more appropriate description of the mechanism to revise the rentals at agreed dates would be that each rental payment consisted of a total amount, comprised a fixed amount plus a variable element. The Lessee was to pay rental on the basis of such mechanism.
12. In case of delay in commencement of the Project operations in the beginning, Equate was to be allowed to delay payments by six months, without increasing the total period of financing. Consequently, the last payment was to consist or comprise of two payments. If on technical/business grounds such a thing is permissible, this would be acceptable to the *sharīʿa* and as such it should not be considered a *sharīʿa* issue at all.
13. The *sharīʿa* does not allow taking of a commitment fee. However, a role was recognized and we were allowed to negotiate management fees with the Sponsors on the basis that compensation of Islamic financing is promised to be not less or more than the conventional financing on *pro-rata* basis. Equate agreed to pay all KFH's fee in the form of management fees, irrespective of how they were calculated. We were allowed to accept the same without going into conventional type of calculations applicable in case of conventional commitment fee. (In fact, any deviation from standard conventional method of calculation was to be considered a blessing in disguise instead of a cause for dispute.). Equate made a very clear arrangement with us through a "Fee Letter" arrangement that any income available to KFH or Islamic financiers would always be paid in Islamically acceptable modes i.e. either as profit or management fee (a lump sum amount) and for that no standard/conventional method of calculation would apply. KFH was fully aware of ways and means of calculating the commitment fee on unutilized balances and never tried to deviate from the *sharīʿa* by giving commitment fee a different name, as we knew that would not have changed its nature and that substance is always required to prevail over form specially in *sharīʿa*-related issues. In the particular circumstances it was found acceptable to agree to take management fees as a lump sum amount.
14. Up-front Fee could be similar to conventional financing using the same methodology.
15. Each disbursement should be either less than or equal to the book value of assets submitted for the purchase/leaseback transaction. Each disbursement under purchase/leaseback is to be *pro-rata* to the proportion of Islamic financing to the total financing i.e. 200/1200 = 1/6th

   The following issues were also ruled upon:

1. Lease Assets could include work in progress. The Lease value could be different from the value of underlying asset i.e. the lease could be based on invoices generated by the lessee instead of the actual cost of the assets to the lessee.
2. KFH could accept insurance on security from a conventional insurance company.
3. Transfer of the leased assets to the lessee at the end of lease term could be carried out by way of a gift.
4. KFH could accept insurance as Lease Assets identifiable pieces of plant and equipment from all over the Project and not necessarily only from one particular/distinct/discreet unit of the Project. In other words, we could accept insurance benefits of a *pro-rata* value, and the insurance could be of any identifiable pieces of plant/equipment from all over the project.

XI. Conclusion

It is shown here that there exist the possibility and advantages to combining the conventional and Islamic systems of finance to the mutual benefit of both, as also to the national economy. This can be done without violating the principles of the *sharīᶜa*—though it might seem—to some of "traditionalists" that, *prima facie*, the two systems cannot operate together in a single transaction. The two systems are not irreconcilable if acted upon within proper bounds. This will be evident from the fact that the arrangement made in the case of Equate has received the blessings and approval of eminent *sharīᶜa* scholars on the one hand, and of the mainstream financiers and distinguished legal experts on the other.

The Challenges of Offering a LARIBA Products and Services Window in an American Bank

Yahia Abdul-Rahman[*], Mike Abdelaaty[†], and Gary S. Findley[‡]

ABSTRACT

Several challenges are met while attempting to own an American community bank in an effort to provide an alternative banking outlet. The bank offers a LARIBA (Islamic) window of banking products and services to meet the growing demands of the 6 million Muslims in the United States. The obstacles encountered included American banking regulators, Islamic legal requirements, and the American Muslim community's reaction to Muslim ownership of a bank offering *ribā* and LARIBA services. Some creative solutions to these challenges are discussed.

I. INTRODUCTION

The American banking system has grown from a community-based banking network to one of the most disciplined and sophisticated banking systems in the world. It offers products and services that meet the traditional needs of the community while at the same time developing new services and products based on technology or focused on expanding the types and quality of financial services and products. The American banking system is going through a revolution such that today's services and products do not resemble those of a few years back. While the American banking system is primarily based upon tradition, to a certain extent it has only recently recognized the financial and banking traditions of a significant segment of the American population—the American Muslim Community. The Community Reinvestment Act ("CRA"), which has played an important part in the American banking system over the last two decades, was originally introduced to allow community banks to gather community savings and reinvest these savings into the community. The CRA has helped communities develop their housing, consumer, and business needs, and has created job opportunities for members of the community.

However, the CRA, as applied by bank regulatory authorities, to a certain extent has missed a major population base in the American society, the American Muslim community. Banking institutions have been unaware of the need to develop products and services geared to this community's needs and beliefs. The American Muslim community has grown over the last 50 years to a current population estimated at 10 million, which is expected to expand to 15 million by 2020, mainly through birth. The community has been endowed with a reservoir of highly qualified professionals, entrepreneurs, business executives, scholars, and students. Due to the unavailability of interest-free banking services, most of American Muslims are compelled to violate one of the most basic requirements of their faith. This paper reviews the experience of the authors in trying to offer an interest-free consumer-banking product through a specialized window in a conventional American community bank.

II. *RIBĀ* VERSUS LARIBA

In today's banking terminology, one can conceptually define *ribā* as unsecured and non-collateralized credit that is not asset- or service-based. In a LARIBA (or NO-*ribā*) setting, the financing activity by a bank is looked upon as an investment by the bank in the individual (or company) in order to help that entity acquire tangible assets and/or services. In this capacity, the LARIBA bank loan officer ensures that the loan has merit and is used for the specified purpose.

Furthermore, an important aspect in LARIBA banking is the absence of a predetermined value measurement for money, which in *ribā* banking is known as interest. In LARIBA banking, the return on investment is obtained as a result of the investment or leasing of the asset in question. That return on investment is the real measure of the value of the investment activity and the location of such an investment activity. The LARIBA banker marks everything to the market instead of utilizing a unified interest rate throughout the country. For

[*] Founder, American Finance House – LARIBA, Pasadena, Calif.
[†] President, American Finance House – LARIBA.
[‡] President, The Findley Company, Pasadena, Calif.

example, a house rent should reflect the value of that house and not a "cap" rate, as is done in most leases. The rent of two similar homes, one in Alabama and another in California, should be different because of the differences in the costs of living and economies between the two states. This difference should be reflected in the financing process by the lease rate determined by market forces of supply and demand. In other words, LARIBA banking can be defined as a socially responsible and ethical conventional banking service for community economic development that utilizes asset- and/or service-based financing. One way of determining the economic utility of the item to be financed is to look at the lease rate it commands on the market.

Given the extant size and composition, and future growth, of the American Muslim community, the time is ripe for offering a LARIBA banking window as a complimentary banking and financing service to this community. This window should be offered on a stand-alone basis, as an alternative to the prevailing conventional system. The performance of the LARIBA system in a free, competitive market will show its real value to the average consumer of banking services in the United States.

III. Benefits of Offering a LARIBA Banking Window by a Conventional *Ribā* Bank

As noted previously, the United States enjoys one of the most well developed financial systems in the world. An advantage of a *ribā* bank's offering LARIBA products and services through a dedicated window lies in the application to the latter of the strict banking, regulatory, and supervisory environment, and competitive practices, enjoyed by U.S. banks. This adds credibility to LARIBA banking and makes its products more reliable and acceptable in the market.

Moreover, such an approach can create a larger pool of bankers of all faiths, training, and experience who are conversant in both conventional *ribā* and LARIBA banking. This can bring a large pool of banking experience, expertise, and creative abilities to manufacture new products and services for the LARIBA banking industry, and can create the foundation for nationwide provision of LARIBA banking services, by a large and sophisticated network of banks, and at the lowest cost. An atmosphere of healthy competition between conventional and Islamic banking products would benefit both the systems and their patrons, who would be offered a choice between conventional *ribā* and Islamically-acceptable LARIBA banking methods. They benefit from the ability to choose from a wider variety of banking, financing, and saving products and services from one organization.

It is also expected that the wider availability of LARIBA banking services would encourage the nation's Muslim community to participate, with its wealth, in the American economic system without violating its religious beliefs. This will have a great social impact on the growing American Muslim community and encourage savings.

IV. Comparison between the Approaches Used in *Ribā* and LARIBA Financing

In order to contrast *ribā* conventional financing with LARIBA financing, let us consider the following hypothetical situation. A family wants to buy a car for $30,000 but has only $6,000 available at the moment. It approaches a bank to help finance the purchase of the car. A *ribā* banker is likely to go through the following process:

1. Evaluate the application form.
2. Conclude that the family has a steady income and a strong balance sheet; and that its cash flow is sufficient for the purchase of a larger car, or even for a bigger loan on the original car by paying less than $6,000 down.
3. Decide to lend the family the necessary amount at a certain interest rate, payable over a period of time.
4. The repayment period defined by the banker can be longer than necessary because the banker wants to help improve the family's surplus cash flow. In fact, this also helps the bank derive more interest income, as the loan repayment period is extended.
5. In fact, the banker may convince the family to buy a bigger or better-equipped car. The higher amount of the loan will translate into small additions to monthly payments and will be compensated by prolonging the financing period (the term of the loan).

By contrast, a LARIBA banker engages in a distinctly different process:

1. Evaluate the application form.
2. Conclude that the family has a steady income, a strong balance sheet, and good tax returns; and that its cash flow is sufficient to cover the monthly payments for the purchase of the car.

3. Inquire with rental car agencies as well as manufacturers' leasing agencies about the utility value of the car measured by the lease rate.
4. Sign a contract with the family that complies with LARIBA legal requirements. In this agreement:
   a. The family owns 6,000/30,000, or 20%, of the car, while the bank would (temporarily) own 80%. In the same agreement, the family agrees to buy the bank's share of the car for the same value, or $24,000. This way, the bank does not own the asset in order to complies with American banking regulations. The family, based on its cash flow, agrees to pay back the bank's share, interest free, over a period of 3 years, or $8,000 per year. This is the return of capital.
   b. The family and the banker, independently, survey the market to find a fair leasing rate for the car. They negotiate a fair lease and agree on it. Here, the lease is divided between the family (20% in the beginning and rising to 100% over 3 years) and the bank (80% in the beginning and declining to 0% over 3 years). This is the return on capital for the bank. The workings of LARIBA banking mechanically are not much different from a regular amortization schedule. The difference is that the variable in the LARIBA program is the lease rate defined by the market, while the amortization schedule uses the interest rate as the parameter.
   c. The family and the LARIBA banker, in order to satisfy banking laws, sign a promissory note, which documents the repayment of the debt (no time value of money) and the declining lease rate in a total monthly payment. The LARIBA banker uses the monthly payments, representing the lease rate and the return of capital, as variables in a conventional amortization schedule to determine the "implied" interest rate. This rate is disclosed to the client in order to comply with "truth-in-lending" laws.

Note carefully, however, that the resulting "implied" interest rate is not uniformly the same: it differs from one car to another, and differs based on the leasing rate in the relevant market. In a LARIBA environment, the banker encourages the family to pay off its loan as quickly as possible in order to reduce the burden of debt on the family's cash flow.

V. Issues Faced in Offering a LARIBA Financing Window in an American Community Bank

A. Opinion of Jurists about Operating a Bank Using Both *Ribā* and LARIBA Models

The problem of dealing with *ribā* (conventional) and LARIBA financing models in the same institution has troubled many of Muslim jurists and ordinary Muslims. The issue of concern is how one can justify, from a jurisprudential point of view, ownership of a financial institution that deals with forbidden interest and offering a LARIBA banking window through it. In fact, many puritan and strict Muslims believe that this is a clear case of hypocrisy and should never be allowed.

A number of jurists and scholars have investigated this problem at length, first in Malaysia, then in the Middle East. The Central Bank of Malaysia (Bank Negara Malaysia) sought the views of three jurists on the permissibility of establishing a LARIBA banking window as an additional but unique service offered by a conventional *ribā* bank. The jurists involved were Almarhoum Tan Sri Professor Ahmad Ibrahim and Professor Mahmoud Saedon Awang Uthman from the International Islamic University, Malaysia, and Tuan Haji Mohammad Shahir Ahmad from the Department of Islamic Affairs in the Malaysian Prime Minister's office. These scholars stated, "A conventional *ribā* bank, whose operations are conducted on the basis of interest, is not prohibited from operating a LARIBA window." The conclusion was based on the foundation of jurisprudence rule.

Many jurists and scholars around the world have concluded that owning and operating a conventional bank that offers LARIBA products and services, such as lease-to-purchase financing, is not only acceptable but encouraged.[1] Scholars such as Al-Qari and Abdul-Rahman Serri have concurred with this opinion. This, however, does not make *ribā* permissible; the ownership and operation of a conventional bank by Muslims is desirable and encouraged if the intention is to offer LARIBA products as a unique service that can compete with conventional banking products. Such a gradual, clearly planned approach will allow LARIBA banking products and services to be tested by consumers, who make the final decisions about which system they prefer.

B. Concerns Raised by U.S. Banking Regulators Regarding LARIBA Financing Methods

The various bank regulatory agencies responsible for overseeing the American banking system, including the Federal Reserve Board of Governors (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) have only recently begun to address the issues implicated in the provision of LARIBA products and services by conventional financial institutions in the United States. To our knowledge, the FRB and FDIC do not have any interpretive letters concerning LARIBA banking. However, the OCC has been evaluating LARIBA products by evaluating requests for certain activities by the United Bank of Kuwait in New York City.

OCC rulings forbid a bank from holding title to the property financed. The LARIBA system in fact abides by that rule, for a LARIBA bank holds a lien on the property, like any bank does, in the form of collateral. The question then is whether a national bank can offer residential net lease home finance pursuant to relevant laws.[2] This question was addressed by the OCC in a study conducted in response to an application made by the United Bank of Kuwait.[3] The following is an excerpt from the OCC's document.

1. Applicable Laws

The National Bank Act provides that national banks shall have the power to:

> Exercise … all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes…

The Supreme Court of the United States has held that this clause is a broad grant of power to engage in the business of banking, including, but not limited to, five specifically recited powers and the business of banking as a whole.[4] Judicial precedent reflects three general principles used to determine whether an activity is within the scope of the "business of banking." These principles are:

a. Is the activity functionally equivalent to or a logical outgrowth of a "recognized banking activity?";
b. Would the activity respond to customer needs or otherwise benefit the bank and/or its customers?; and
c. Does the activity involve risks similar in nature to those already assumed by banks?[5]

2. Leasing by Banks

Today, banks structure leases so that they are functionally equivalent to lending secured by personal property. In the M & M case involving a leasing decision, the court noted that in appropriate circumstances, "a lease transaction may constitute a loan of money secured by the property leased."[6]

The court reasoned, "Because secured lending and personal property leasing are functionally interchangeable, personal property leasing is within the business of banking and is therefore permissible."[7]

According to the court:

1. The business of banking is in constant state of evolution and must be given a broad and flexible interpretation to allow national banks to use modern methods to meet modern needs.
2. The comptroller may "look beyond the label given to a certain activity and determine whether or not it is permissible."
3. A lease that has the economic attributes of a loan is simply a new way of conducting an activity that is within the business of banking.

The Ninth Circuit Court rejected the "narrow" interpretation of national banks' leasing authority. It stressed that the "functional interchangeability" of leasing and lending was the touchstone of its decision.[8]

The Court has, nevertheless, laid down several limitations. Only leases interchangeable with loans are allowed. However, a lease, which from its inception inevitably must be repeated or extended to enable the bank to recover its advance plus profit, is not a "loan of money on personal security."[9] A lease of this type is similar to a rental business. It can expose national banks to risks that they are not permitted to bear.

C. The Human Factor

The human dimension is the most important one facing a LARIBA banker. Individuals in a multicultural and multiethnic society such as that of the United States have different experiences with, varying images of, and possibly unspoken stereotypes toward other ethnic, cultural, and religious groups. This represents a very difficult factor because it cannot be expressed openly and cannot be quantified. That is why we believe that the LARIBA banker should exercise extreme patience, determination, and persistence in order to teach the public and the regulators about the benefits a LARIBA system would bring in its capacity as an alternative to the conventional *ribā* system. It is also important for the LARIBA banker to realize that the United States possesses a deep-rooted policy of separating church and state. Therefore, it would be unwise to present LARIBA banking as an Islamic banking system. While the Islamic faith and principles of just and fair economics inspire the LARIBA system, its benefits should be made available to persons of all faiths and beliefs. It is the religious duty of every LARIBA banker not to concentrate on labels; the goal, rather, is to bring to participants in retail financial markets the spirit and essence of LARIBA banking.

V. Conclusion

The LARIBA (Islamic) banker in the United States must satisfy requirements and rules stipulated by two sources. The first is the body of Islamic jurisprudence, which distinguishes allowable from forbidden financial dealings and transactions. The other source is U.S. banking laws and regulations. The LARIBA banker has to meet and incorporate these requirements in the design of the financing agreement with a client. The LARIBA banker should pay close attention and be extremely sensitive to the important American political principle of the separation of church and state.

The offering of a LARIBA window in a *ribā* bank is not only sanctioned by LARIBA banking scholars, but also encouraged as a duty on responsible community members. The ownership and operation of a conventional bank by Muslims is desirable and encouraged if the intention is to offer LARIBA products and services for those who need them, and to complement what conventional banks provide. This sort of gradual approach will allow LARIBA banking products and services to be tested by the consumers who, in a free market, decide which banking system to patronize.

Finally, a concentrated educational effort is needed to educate several groups. Conventional bankers must be relieved of any fears of the "unknown," their concern about discrimination, and their personal prejudices. Muslim and non-Muslim consumers should understand the spirit of LARIBA banking and the differences in approaches used by conventional *ribā* banking and Islamic LARIBA banking. U.S. bank regulators must be assured that LARIBA banking does not expose the bank providing such services to unnecessary additional risks. As noted, the U.S. Office of the Comptroller of the Currency has sanctioned the lease-to-purchase approach to financing as a legitimate banking activity. The risk of exposing bank capital and bank deposits to market fluctuations in property value is absent because the bank, in a LARIBA contract, does not hold title to the property, but rather holds a first lien on it. This is exactly what happens in a conventional banking situation.

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[1] Saleh Malaikah, in a private communication to the authors dated May 17, 1999, noted this. The opinion is based on research conducted by Malaikah.

[2] 12 U.S.C. §24 (7th) and 12 U.S.C. §371.

[3] OCC Interpretive Letter #806, December 1997, 12 U.S.C. 24 (7) and 12 U.S.C. 371.

[4] See National Bank of North Carolina N. A. v. Variable Life Annuity Co., 513 U.S. 251 (1995), 115 S. Ct. 810 (1995) ("VALIC").

[5] See also Merchant's Bank v. State Bank, 77 U.S. 604 (1871); M & M Leasing Corp. v. Seattle First National Bank, 563 F.2d 1377 (9th Cir. 1977), cert. denied 436 U.S. 956 (1978); American Ins Ass'n v. Clarke, 865 F.2d 278 (2nd Cir. 1988).

[6] Id. at 1380.

[7] Id. at 1382.

[8] Id. at 1383.

[9] Id. at 1384.

Islamic Banking in Bangladesh

Growth, Structure, and Performance

Md. Abdul Awwal Sarker*

ABSTRACT

Bangladesh has participated in the worldwide spread of Islamic banking: it currently has five full-fledged Islamic banks, and two conventional banks with Islamic branches or counters. Since the first Islamic bank in Bangladesh in 1983 was established a decade and a half ago, it is now time to analyze their function and performance. This paper examines the banking system of Bangladesh and its size, structure and environment. It explores the role of the Central Bank in formulating monetary policy in line with Islamic banking, and deals with the origin and features of Islamic banking in Bangladesh. The resource mobilization and deployment of funds by the Islamic banking sector and the role of *sharīʿa* committees is discussed, and a performance analysis of Islamic banks is conducted. The problems and challenges that Islamic banking faces in Bangladesh can be confronted by a better legal framework, judicious banking management, and the development of tradable instruments and suitable markets.

I. SUMMARY

Islamic banking commenced operations in Bangladesh in 1983, with the establishment of the first Islamic bank "Islami Bank Bangladesh Limited." Four more full-fledged Islamic banks and two Islamic banking branches of a conventional bank have since begun operations. One and half decade has passed since the introduction of Islamic banking, and it is now a suitable time to analyze the operational methodology and performance of this emerging sector. This paper discusses this methodology and performance, and finds that Islamic banks cannot operate well under a conventional banking framework, which, in fact, reduces their efficiency. The deterioration is not because of deficiencies inherent in Islamic banking, but is due to the inefficient operation of the obstructive conventional banking system. This does not mean, however, that the survival of Islamic banks operating within the conventional banking framework is threatened. Evidence from Bangladesh indicates that Islamic banks can survive within a conventional banking framework by switching over from PLS to trade-related modes of financing. Therefore, as a result of the excessive use of trade-related modes of financing, the advantage of Islamic banking over traditional banking in allocative efficiency is narrowed. Where distributional efficiency is concerned, it is evident that Islamic banks are not exceptional to the current trend of transferring investable resources from low-income depositors to high-income borrowers. Stabilization efficiency has also not been achieved, due to the dependence on markup-based financing techniques.

II. INTRODUCTION

Islamic banking is now spread over almost all the world, in both Muslim and non-Muslim countries, as a viable entity and financial intermediary. The second half of the twentieth century witnessed a major shifting of thinking in devising banking policy and framework on the basis of the *sharīʿa*. This new thought was institutionalized at the end of the third quarter of the century, and emerged as a new Islamic banking system. Ahmed El Naggar is considered to be the first man to implement this concept. After the establishment of Mit Ghamr Local Savings Bank in a provincial rural center in the Nile Delta, Egypt in 1963, through the initiative of Naggar, the initial shape of Islamic banking modality was injected into the Egyptian economy. The establishment of the Islamic Development Bank (IDB) in 1975 gave formal momentum to the Islamic banking movement.

Since the establishment of IDB, a number of Islamic banking and financial institutions have been established all over the world. At present, more than two hundred Islamic banking and financial institutions are working in different parts of the world, and Iran and Pakistan have taken steps to reorganize their entire banking systems along Islamic lines (Ahmed, A).[1]

* Joint Director, Internal and Islamic Economics Division, Research Department, Bangladesh Bank, Dhaka, Bangladesh.

Bangladesh was not inactive in this movement toward Islamic banking. One and a half decades have passed since the establishment of the first Islamic bank in Bangladesh in 1983, and the number of banks has risen to five, in addition to two Islamic branches of conventional banks. It is now time to analyze their function and performance. Keeping this in view, an attempt has been made here to focus on the growth, structure, and performance of Islamic banking in Bangladesh. This essay has been structured into seven sections. Section III highlights on the banking system of Bangladesh and its size, structure and environment; Section IV explores the role of the Central Bank in formulating monetary policy in line with the Islamic banking, while Section V deals with the origin and features of Islamic banking in Bangladesh. Resource mobilization and deployment of funds by the Islamic Banks in Bangladesh is discussed in Section VI. A performance analysis of the Islamic Banks is made in Section VII, while the role of *Sharīᶜa* Councils and Islamic interbank money market in Bangladesh is highlighted in Section VIII. Section IX describes the problems and challenges of Islamic banking in Bangladesh, while Section X attempts to give some indications on the future of Islamic banking in Bangladesh. Section XI discusses the conclusions reached by this paper, and their implications.

III. BANKING SYSTEM OF BANGLADESH: SIZE; STRUCTURE; ENVIRONMENT

The banking system of Bangladesh is composed of a variety of banks working as Nationalized Commercial Banks (NCBs), private sector banks, foreign sector banks, specialized banks, and development banks. Seventeen of the thirty-nine banks are private, out of which only five; Islami Bank Bangladesh Limited, Al-Baraka Bank Bangladesh Limited, Al-Arafah Islami Bank Limited and Social Investment Bank Limited, and one of thirteen foreign banks; Faysal Islamic Bank of Bahrain E.C., operate as Islamic banks. Besides these full-fledged Islamic banks, two conventional banks in the private sector, namely Prime Bank Limited and Dhaka Bank Limited, have opened two full-fledged Islamic banking branches, and an Islamic banking counter, respectively. The operations and accounts of the branches and the counter are maintained separately from the main business of the respective banks.

Despite the rapid expansion of Islamic banking throughout the world, its coverage is still insignificant compared to traditional banks. In countries, where Islamic banks and financial institutions operate alongside traditional ones, they operate a relatively small number of branches. Conventional banks, on the other hand, are growing very fast. The five Islamic banks in Bangladesh cover only 5% of total deposits and 4% of total investments (loans and advances in the conventional sense), and operate only 2.84% of the bank branches.

Historically, conventional banks are guided by the broad-based capitalistic monetary framework and business environment, which is predominantly based on interest. Only Iran, Pakistan, and Sudan, and Malaysia to an extent, are on the way toward establishing an interest-free monetary and banking system on an economy-wide basis. It is gratifying that the transition from an interest-based banking system to an interest-free one has proceeded smoothly both in Pakistan and Iran.[2] Both countries have provided some legal coverage to protect the interests of the Islamic banking sector. The central banks of both countries have been designed to guide, supervise, and control the activities of the Islamic banks and financial institutions under their respective national monetary and credit policies. In many countries, on the other hand, Islamic banks operate without any proper legal backing or provision, and face difficulties from the hostility of the entire environment. In Bangladesh Islamic banks have been operating since 1983 without any legal backing, relying instead on the guidelines framed in the Memoranda and Articles of Association submitted to Bangladesh Bank at the time of incorporation. Islami Bank Bangladesh Limited started operation in the private sector in 1983 on a joint ownership basis, and had only 105 branches by June 1998.[3] The second Islamic bank in the country, Al Baraka Bank Bangladesh Limited, was launched in 1987 on joint ownership basis, and had 33 branches in 1998.[4] The third, Al Arafah Islami Bank Limited, was established in 1995 with full local initiative, and had 21 branches as at June 1998.[5] Social Investment Bank Limited went into operation in 1995, on joint ownership basis, and had seven branches by June 1998. The fifth Islamic bank is a branch of Faysal Islamic Bank of Bahrain E.C, and was established in Bangladesh in 1997. This is an Islamic banking branch operating in the foreign sector, holding 100% foreign capital.[6] Two branches of a conventional bank Prime Bank Limited also conduct their business on Islamic principles, but their separate balance sheets are not prepared for inclusion in Bank's global balance sheet. The thirty-nine conventional banks (including public, private and foreign banks) had 5952 branches in operation throughout the country by June 1998.[7]

Compared with the huge countrywide network of the conventional banks, the five Islamic banks have very limited influence on the banking arena as a whole. The expansion of Islamic banking is constrained, in particular, by the fact that the country's financial markets are all interest-based.

In a country with 87% Muslim population, where religious feeling is strong, the introduction of interest-free financial transactions attracted people to save and invest with these institutions. The increasing participation of the public is shown by the rising deposits in Islamic banks. Financial procedure and the introduction of products in line with the *sharīʿa* have played an effective and important role in mobilizing people's savings, and to some extent drove conventional banks to use the term "profit" instead of "interest" in their declaration and various documents. Yet the growth of Islamic banking in Bangladesh is still entirely dependent on private initiative. The Government has not pursued the initiative to establish Islamic banks in the public sector, or made any attempt to convert state-owned traditional commercial banks into Islamic banks. There are, however, more applications submitted to the Bangladesh Bank seeking a license to operate *sharīʿa*-compliant banks in the private sector.

IV. Role of Central Bank in Formulating Monetary Policy in Line with Islamic Banking

The central bank has the sole authority to issue currency and to manage the liquidity of the economy. Among the objectives of the monetary policy are to secure stability in the value of money, and regulate the banking system prudently. As a central bank, Bangladesh Bank was not aloof from the ongoing changes in the world financial system, especially in the country's own banking system. It issued a license for the establishment of the first Islamic bank in Bangladesh in 1983. The Bangladesh Government participated in establishing first Islamic bank, Islami Bank Bangladesh Limited, by taking a 5% share in the paid up capital. Taking the lack of Islamic financial markets and instruments or products in the country into consideration, Bangladesh Bank granted some preferential provisions for the smooth development of Islamic banking in Bangladesh, including the following:

1. Islamic banks in Bangladesh have been allowed to maintain their Statutory Liquidity Requirement (SLR) at 10% of their total deposit liabilities, instead of the 20% set for conventional banks. This provision facilitated Islamic banks to hold liquid funds for more investment, and thereby generate more profit.
2. Under the indirect monetary policy regime, Islamic banks have been allowed to fix their profit-sharing ratios and markups independently, in accordance with their own policy and banking environment. This freedom in fixing PLS ratios and markup rates provided scope for the Islamic banks to follow the principles of the *sharīʿa* independently.
3. Islamic banks have been permitted to reimburse 10% of their proportionate administrative cost on a part of their balances held with the Bangladesh Bank. This facility has given some scope for the enhancement of the profit base.

A. Role of Bangladesh Bank in Promoting Islamic Banking in Bangladesh

Though there is no Islamic Banking Act to control, guide and supervise Islamic banks in Bangladesh, some Islamic banking provisions have already been incorporated in the amended Banking Companies Act of 1991 (Act No. 14 of 1991).[8] Instead of setting up a separate department to control, guide, and supervise the operation of Islamic banks at its head office, Bangladesh Bank is conducting the inspection and supervision of the Islamic banks operation according to the regulations set down for conventional banks. The *Sharīʿa* Councils of individual banks are thus responsible for ensuring *sharīʿa* compliance within their own organizations, and the central bank examines only their reports. Moreover, the inspectors and supervisors of Bangladesh Bank are not familiar with the operational methodologies of Islamic banking. This is due to the fact that there is no separate department to look into this matter, and no concerted effort to devise separate inspection and supervision guidelines for Islamic banks.

B. Role of Bangladesh Bank Regarding Supervision and Regulation of Islamic Banks in Bangladesh

The role of Bangladesh Bank in supervising and regulating Islamic banks in Bangladesh is as follows:

1. Bangladesh Bank did not deposit any deposits with Islamic banks on the principles of *muḏāraba* in order to provide an opportunity to meet the shortfall of the deficit banks. Moreover, Al-Baraka Bank Bangladesh Ltd. was compelled by liquidity shortfall several times to borrow from Bangladesh Bank on the basis of "Bank Rate" which was a clear violation of Islamic principles. There is thus no mechanism to extend financial assistance to the Islamic banks on the basis of *muḏāraba* or *mushāraka* or any other mode of finance in lieu of Bank Rate.
2. Refinance facilities on the basis of PLS was not extended.
3. Islamic banks can open current accounts with the central bank to meet the obligations of other banks through Bangladesh Bank's clearing house. In case of overdraws, however, they have to pay interest to the Central Bank.

4. No separate regulations for Islamic banking have been adopted. Regulations for interest-based banking are equally applicable for the Islamic banks. Only a few relevant provisions have been incorporated in the Banking Companies Act of 1991 (amended 1995).
5. Liquidity requirements for Islamic banks are lower, at 10%, as against 20% of total deposit liabilities for conventional banks. There should, however, not be any liquidity requirements, since any loss in the principal amount of deposits is borne by depositors, as per the rules of *muḏāraba*. If this liquidity requirement is withdrawn, then Islamic banks will get a large amount of investable funds which in turn may find new areas of investment, and thereby raise profitability.
6. There are no Islamic financial instruments developed for Islamic banks to accommodate their excess liquidity, or to provide a new avenue for short-term investment. Bangladesh Bank is, however, actively considering introducing "Bangladesh Bank *Muḏāraba* Bond" on the principles of *muḏāraba maᶜa kafāla*, to provide an Islamic instrument for Islamic banks to invest their excess liquidity, and to mobilize savings from the general public.
7. Since 1994, the Bangladesh Bank Training Academy (BBTA) has conducted a weeklong training course on "Islamic Banking Methodology" to provide training on the *sharīᶜa* and Islamic banking to the personnel of Central Bank. Another training course on the same topic has been conducted since 1994 by the Bangladesh Institute of Bank Management (BIBM: the only apex training academy for the banking sector), to impart training on the basic techniques of Islamic banking to the employees of the entire banking sector. An Executive Development Program on Islamic Economics and Banking is also arranged frequently by BBTA for the senior officials of Bangladesh Bank.
8. In accordance with the suggestions put forward by an IMF study report,[9] Bangladesh Bank is complying with the following guidelines:
   (a) Some legal provisions have been incorporated in the amended Banking Companies Act of 1991.
   (b) The CAMEL rating framework is being used by the concerned department of Bangladesh Bank to analyze the operational risks of Islamic banks.
   (c) Information is being disclosed by the Islamic banks as per the format designed for the conventional banks. A workshop was held in Bangladesh Bank in 1995 on "Islamic Banking Inspection Methodology" to devise separate inspection methodology for Islamic banks. Follow-up research work is still underway.
   (d) Bangladesh Bank is pursuing prudential techniques about licensing procedures. It is recommended, however, that it follow IMF guidelines.
9. In some central banks, in Pakistan, Iran, and Malaysia in particular, Central *Sharīᶜa* Supervisory Boards/Councils have been established to investigate and monitor the operations of Islamic banks in accordance with the *sharīᶜa*. There is no Central *Sharīᶜa* Supervisory Board to monitor the functions of Islamic banks in Bangladesh. Instead, Bangladesh Bank has to depend on *sharīᶜa* certificates provided by the *Sharīᶜa* Councils of the respective Islamic banks.

It is notable, however, that Bangladesh Bank has accorded equal treatment to all banks in regard to supervision and inspection. In some cases, Islamic banks have even been given special provisions. This is insufficient, however; for smooth development and operation, Bangladesh Bank must devise separate regulatory and supervisory guidelines for Islamic financial institutions.

V. Origin and Features of Islamic Banking in Bangladesh

Bangladesh inherited an interest-based banking system, which was introduced in the Colonial era. Since its inception Bangladesh saw a new trend in banking both at home and abroad. Islamic banking was successfully tried in Egypt. Naser Social Bank was established after the Mit Ghamr model. During the seventies, Islamic Development Bank (IDB) and a number of Islamic banks were established at national levels. At home, Islamic groups were vigorously working for adoption of Islam as the complete code of life. They found Islamic banking ready for immediate introduction. Two professional bodies, "Islamic Economics Research Bureau" (IERB) and "Bangladesh Islamic Bankers Association" (BIBA), were taking practical steps to impart training on Islamic economics and banking to a group of bankers, and arranging national and international seminars to attract investors to establish Islamic bank in Bangladesh. Their activities were reinforced by a number of Muslim entrepreneurs working under the aegis of Muslim Businessman Society (MBS). The body concentrated mainly on mobilizing equity capital for the emerging Islamic bank. Due to their continuous and dedicated work, and active support from the Government, Islamic banking was established in the early eighties.

Like other commercial banks, Islamic banks mobilize deposits and produce loans. Their *sharīᶜa*-based mode of operation, however, is very different from that of traditional commercial banks. The five Islamic banks operating in Bangladesh are:

1. Islami Bank Bangladesh Limited (IBBL)
2. Al Baraka Bank Bangladesh Limited (AL-Baraka)
3. Al-Arafah Islami Bank Limited (Al-Arafah)
4. Social Investment Bank Limited (SIBL)
5. Faysal Islamic Bank of Bahrain EC (FIBB)

Besides these five, Prime Bank Limited opened two Islamic banking branches on 18 December 1995 and 17 December 1997, respectively, while Dhaka Bank Limited started operation with an Islamic counter in conjunction with conventional banking operations at its principal office at its inception in July 1995.

A. Islami Bank Bangladesh Limited

Islami Bank Bangladesh Ltd., which was incorporated on 14 March 1983, went into operation on 30 March 1983 and introduced a full package of banking services in August 1983. Islami Bank Bangladesh Limited is considered the first interest-free bank in Southeast Asia.

IBBL is a public limited company with limited liability under the Companies Act, 1913. It is a joint venture multinational bank, with 64% of its equity contributed by foreign sources. Local shareholders hold shares in the ratio of 36 to 64. In December 1997 the number of its shareholders stood at 6,863. Its shares are quoted in the two stock markets of the country, namely Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE). The shares are presently in high demand, and are sold at three times the face value. The bank's authorized capital is Tk 500 million. At present it has a paid-up capital of Tk 317.98 million and reserve fund of Tk 930.17 million.

The Bank is managed by a twenty-three member Board of Directors, elected by the shareholders. An executive committee consisting of eight directors and a management committee consisting of the top executives of the bank oversee its day-to-day functions. A representative from the *Sharīᶜa* Council also takes part in the committees. Powers and functions are distributed amongst these bodies. The bank has also a ten-member *Sharīᶜa* Council consisting of *fuqahā'*, Islamic economists, and a lawyer. The council gives decisions on Islamic issues, selectively audits the operation of bank branches each year, identifying deviations, and suggests means for purifying banking transactions.

B. Al-Baraka Bank Bangladesh Ltd.

The second Islamic bank in the country, Al-Baraka Bank Bangladesh Limited commenced business on 20 May 1987. It is incorporated under the companies Act of 1913, with a registered office in Dhaka. The bank is a joint venture of Al-Baraka Investment and Development Company (ABIDCO) of Jeddah, Saudi Arabia, a renowned international financial and business house; Islamic Development Bank; a group of eminent Bangladeshi entrepreneurs; and the Government of Bangladesh. The authorized capital of the bank is Tk 600 million divided into 600,000 ordinary shares of Tk 1,000 each. Initially, the paid-up capital of the bank was Tk 150 million. To increase the capital of the Bank to Tk 300 million, the bank offered right shares at a ration of 1:1 to the shareholders on 1 August 1992. Consequently, the paid up capital of the bank now stands at Tk 259.553 million shared by the different groups. The bank has been conducting its all banking operations with thirty-two branches spread all over the country. It is managed by a fifteen member Board of Directors elected by the shareholders. Since the Board of Al-Baraka Bank cannot meet frequently, the day-to-day affairs of the bank are managed by an Executive Council of seven directors. Like IBBL it has a *Sharīᶜa* Council which gives decision on issues relating to the *sharīᶜa*.

C. Al-Arafah Islami Bank Limited

Al-Arafah Islami Bank Limited was incorporated on 18 June 1995, and started operation as the third Islamic bank in the private sector on 27 September 1995. It has an authorized capital of Tk 1,000 million and a paid up capital of Tk 207.6 million. It renders all types of commercial banking services within the stipulations of the Banking Companies Act of 1991. The bank is managed by a twenty-three member Board of Directors. It also has a seven-member *Sharīᶜa* Council consisting of *fuqahā'*, lawyers, and Islamic economists. By August 1998, Al-Arafah Islami Bank had opened 21 branches.

D. Social Investment Bank Limited (SIBL)

Social Investment Bank Limited is the fourth Islamic bank established in Bangladesh. It was incorporated on 5 July 1995, and launched operations on 22 November 1995. It is a venture bank, owned by various international Islamic organizations and the Government of Bangladesh. At the operational level, the bank is committed to provide a linkage among the three sectors of the real economy: the formal sector, the informal sector, and the Islamic voluntary sector.

The authorized share capital of the bank is Tk 1,000 million divided into one million shares of Tk 1,000 each. At the end of June 1998, the paid-up capital of the bank stood at Tk 120 million. It is managed by a twenty-four member Board of Directors (including three foreign directors) and its sub-committee. The bank also has an eight member *Sharīᶜa* Council consisting of *fuqahā'*, Islamic economists, and lawyers. By June 1998, Social Investment Bank had opened seven branches within the country.

E. Faysal Islamic Bank of Bahrain EC, Dhaka, Bangladesh

Faysal Islamic Bank of Bahrain EC, Dhaka obtained permission to open a single branch in Bangladesh on 6 March 1997. The bank started functioning from 11 August 1997. The principal activity of the Bangladesh branch is to provide all kinds of commercial banking services to its customers. All functions of the bank are performed in strict adherence to the principles of the *sharīᶜa*. In order to ensure such conformity to the *sharīᶜa*, the Bank's operations are checked and monitored by its Religious Supervisory Board (RSB), to which the management reports periodically. The approval of the RSB must be obtained before commencing any new operations.

F. Other Foreign Islamic Banks with Branches Operating in Bangladesh

Three Pakistani banks (Habib Bank Limited, National Bank of Pakistan, and Muslim Commercial Bank Limited) also have a branch each in Bangladesh. Although these banks operate in compliance to the *sharīᶜa* in Pakistan, in Bangladesh they are operating as conventional banks, and are thus excluded from this study.

G. Islamic Banking in Conventional Banks

Two conventional banks, i.e. Prime Bank Limited and Dhaka Bank Limited, have commenced limited Islamic banking activities within their present conventional set-up. Prime Bank Limited has opened two Islamic banking branches; one in Dhaka (on 18 December 1995), and another in Ambarkhana, Sylhet (on 17 December 1997). Dhaka Bank Limited opened an Islamic banking deposit counter at its principal office, Dhaka, in 1995. Due to customer demand, however, the bank is considering establishing a full-fledged Islamic banking branch along with the traditional system.

Prime Bank Ltd. is the only bank in Bangladesh operating branches on both conventional interest-based banking, and *sharīᶜa*-based banking, though other traditional banks are being induced by its successful operations to open Islamic banking branches. The operation of Islamic banking branches of Prime Bank Limited are maintained separately from that of conventional branches. A *Sharīᶜa* Board has also been constituted in order to advise and provide guidance on Islamic banking operations. In order to avoid the interest elements of conventional banking a separate set of accounts is maintained by the bank.

VI. Resource Mobilization and Deployment of Funds by Islamic Banks in Bangladesh

A. Sources of Financial Resources

The sources of the financial resources of the Islamic banks consist of the paid-up capital, reserves, funds raised through borrowings from the Central Bank and Government and other banks (interbank borrowing), and non-bank financial institutions, and the issue of different types of Islamic financial instruments to attract the untapped savings of the people. The major part of their operational financial resources is, however, derived from deposits mobilized on the principles of *Al-Wadia* (safe custodianship) and *muḏāraba* (trust financing).

The paid-up capital of Islamic banks in Bangladesh consists of share-money subscribed by the individuals and institutions, local and in some cases foreign, which conforms to the nature of *mushāraka* principles of the *sharīᶜa*. Out of five Islamic banks, for three bank capital is composed of mixed sources both local and foreign; one, Al-Arafah, has full local capital while Faysal Islamic Bank's capital is contributed by overseas sources. Negotiable share certificates, which are issued by the Islamic banks time to time, are also transacted at the stock exchanges. The holders of shares have management rights (voting), and participate in the profit/loss of the bank. As per law, every Islamic bank has to maintain a reserve fund to offset any losses in investment. Before declaration of profit, a portion of profit goes to the reserve fund, after due provision for Zakat and taxation. In Bangladesh, the Islamic banks, besides maintaining the statutory reserve, have built up investment loss offsetting reserves by appropriating 10% of their annual investment profits.

To meet short-term financial needs or temporary liquidity shortfall, Islamic banks, as member scheduled banks, are entitled to borrow from Bangladesh Bank at the last resort. In Bangladesh, some Islamic banks hold large cash reserves, which earn no return, largely because they cannot invest them in interest-based Government Securities or Bangladesh Bank Bills. On the other hand, some other Islamic banks are experiencing shortfall in maintaining liquidity requirement due to inadequate deposit mobilization capability. In this situation, Bangladesh Bank did not allow any Islamic bank under liquidity shortfall to get funding from the central bank on the basis of the *sharīʿa*, but on the basis of Bank Rate which is essentially a floor rate of interest. Islamic banks use interbank borrowing arrangements to maintain some of their funds as deposits with each other, and also with other conventional banks on the basis of reciprocity. Financial resource mobilization through issuance of Islamic financial instruments is at a primary level. Only one Islamic bank, Islami Bank Bangladesh Limited, issued a single instrument called "*Muḏāraba* Savings Bond" (five years and eight years of maturity) in November 1996, as a part of savings mobilization.[10] Investments in Five Year *Muḏāraba* Savings Bond went up by 25% to Tk 329.45 million in June 1998, compared to an initial Tk 261.56 million in 1997. The investment in Eight Year *Muḏāraba* Savings Bond also went up by 48% to Tk 439.23 million in June 1998, as compared to the initial Tk 295.91 million in 1997.[11]

B. Deposit Mobilization Techniques in Islamic Banks

Generally Islamic banks mobilize their deposits through the Islamic principles *Al-Wadiah* and *muḏāraba*.

1. *Al-Wadiah* Current Accounts

When the principle of *Al-Wadiah* is employed, the bank receives funds and is authorized to use them for the benefit, and at the risk, of the bank. It undertakes to refund the amount on demand. Current accounts are generally managed using this principle. By opening an account of this sort, a depositor does not acquire any management (voting) rights on the bank, or on the funds deposited. Although Islamic banks do not pay profit on these deposits, depositors are guaranteed security and virtually unlimited transaction facilities. *Al-Wadiah* deposits are short-term, and undergo uncertain fluctuations.

2. *Muḏāraba* Savings Account

Interest-based banks pay a fixed interest rate on savings deposits, which are considered loans to the banks, and calculate a daily product. Under the interest-based banking system, therefore, the relation between bank and depositor is essentially that of a debtor and creditor. Depositors are provided with checkbooks, and are permitted to withdraw a certain amount of money weekly.

Muḏāraba savings accounts work on an entirely different principle. According to the principle of *muḏāraba*, the bank receives deposits with the exclusive right to manage the funds, and the profit is shared between the bank and the depositor at a preset ratio. Any loss not resulting from the negligence of the bank or its representatives is borne by the depositors. Profit-and-loss-sharing savings accounts and various term deposits employ this principle.

Generally, *muḏāraba* savings accounts are not for preset durations. Banks receive deposits subject to the investment of the money in any *sharīʿa*-approved venture, by applying a legitimate Islamic mode of financing. The depositor is termed the *s̱āẖib al-māl*, and the bank the *muḏārib*. The ratio of profit is determined at the time of contract. Profit generated from investment is distributed so that the *s̱āẖib al-māl* receives 60-80% (or any ratio agreed at the time of contract) of the profit, and the rest goes to the *muḏārib*. Since the ratio is preset, the bank cannot unilaterally change it; thus the relationship between bank and depositor is that of shareholders, not debtor-creditor. *Muḏāraba* depositors, despite being partners in profit and loss, are not partners in *total* profits and losses as in the case of bank shareholders. They are not entitled to a share in income generated through other financial resources. As per the *sharīʿa*, *muḏāraba* depositors cannot interfere in the activities of the bank, and have no right to take part in the management (voting) of the bank.

3. Term *Muḏāraba* Deposit Account

Interest-based banks receive different types of term or fixed deposits from the depositors. The duration of these deposits is generally for 3, 6, or 9 months, 1, 2, or 3 years, etc. The bank pays interest on these deposits at different fixed interest rates that vary with the duration; generally the longer the period, the higher the interest rate. Depositors are not generally allowed to withdraw their deposits before maturity, but can withdraw their money with interest after the maturity period.

Islamic banks also receive term deposit for a period of three months to three years on the principles of *muḏāraba*. The bank invests the money, earns profit, and shares it with the depositor as per the *muḏāraba* ratio agreed upon at the time of the contract. Depositors bear losses in proportion to their deposits. *Muḏāraba* term depositors, can, if they wish, redeposit their money under a new contract. No checkbook is issued against any term *muḏāraba* deposits.

The basic differences between the *muḏāraba* savings deposits account and term *muḏāraba* deposit account are the specificity of the duration, and weightage followed for the calculation of profit.

4. Special *Muḏāraba* Deposit Account

When an Islamic bank receiving deposits comes to an agreement with the depositors that the funds will be invested in specific business ventures (e.g. the fertilizer or salt business), in a specific sector (e.g. the industrial, textile, or export-import sector, etc.), or in some specific investment sector of the bank (e.g. real estate, shipbuilding, etc.), the deposit is termed a special *muḏāraba* deposit. Special *muḏāraba* depositors share only in the profit and loss of the business, sector or project for which they have deposited funds. They are not concerned with the profit-and-loss business of the bank as a whole.

5. Special Term *Muḏāraba* Deposit Account

Special term *muḏāraba* deposits specify business, project, or industry along with the duration of investment. The *muḏārib* or bank invests in the specified business for a specific period. The agreement for the investment terminates at the end of the period and the completion of the deal.

6. *Muḏāraba* Ratio Declared by Islamic Banks

Islamic banks declare *muḏāraba* ratios ranging from 65% to 75%. This ratio varies from bank to bank.

7. Profit Calculation Method of the Islamic Banks

Islamic banks in Bangladesh calculate profit for distribution on the basis of the *muḏāraba* ratio and weightage as given in the contract with the depositors. A hypothetical calculation may be as follows:

TABLE 1. DISTRIBUTION OF INVESTMENT INCOME

A.	Profit-and-loss-sharing deposits and Paid-up capital (Participating Fund)	70%
B.	Reserve fund	10%
C.	Management cost	20%
	Total	**100%**

DISTRIBUTABLE WEIGHTAGE

A.	Paid-up capital	1.00
B.	Profit-and-loss-sharing term deposits	1.00
	• 3-years period	1.00
	• 2-years period	0.90
	• 1-year period	0.80
	• 6-months period	0.75
C.	Profit-and-loss-sharing savings deposits	0.70
D.	Profit-and-loss-sharing short-term deposits	0.35

An example of the distribution of investment-income among the depositors according to the system discussed above is given below:

TABLE 2. HYPOTHETICAL EXAMPLE OF DISTRIBUTION OF PROFIT

Total investment income = Taka 2,600.00
Distributable profit = Taka 1,820.00 (70%)

SL. #	Participating Funds	Total Annual Deposits	Weightage	Weighted Product	Share in Distributable Profit	Rate of Profit
1.	Profit-and-loss-sharing term deposits					
	• 3 years	3,500.00	1.00	3,500.00	435.11	12.43%
	• 2 years	700.00	0.90	630.00	78.32	11.19%
	• 2 years	3,200.00	0.80	2,560.00	318.25	9.95%
	• 6 months	200.00	0.75	150.00	18.65	9.32%
2.	Profit-and-loss-sharing savings deposits	9,800.00	0.70	6,860.00	652.82	8.70%
3.	Profit-and-loss-sharing short-term deposits	400.00	0.35	140.00	17.40	4.35%
	Subtotal	17,800.00	—	13,840.00	1,720.55	—
4.	paid-up capital	800.00	1.00	800.00	99.45	12.43%
	Total	**18,600.00**	—	**14,640.00**	**1,820.00**	—

TABLE 3. APPROPRIATION OF INVESTMENT INCOME

1.	Profit payable to PLS depositors	1,720.55	
2.	Profit distributed to providers of paid-up capital	1,820.00	70%
3.	Management cost	520.00	20%
4.	Transfer to investment loss offsetting reserve	260.00	10%
	Total	**2,600.00**	**100%**

C. Fund Utilization by Islamic Banks in Bangladesh

The utilization of funds under the framework of Islamic banking has opened a new way of making investments conforming to the *sharīᶜa*. The term "investment financing" usually indicates loans and advances made by conventional banks, and their investment in bonds and securities on the basis on predetermined rates of interest. Since Islamic banks cannot lend on interest, they have devised different types of interest-free financing devices.

Islamic banks in Bangladesh primarily follow the Islamic principles of *Bayᶜ-murābaha̱*, *Bayᶜ-Muajjal*, *Bayᶜ-Salam* or *Salaf*, *ijāra*, *ijāra-wa-Iqtina* and hire-purchase, etc. The techniques are discussed below:

A. Markup-based Financing Techniques

1. Bayᶜ-Murābaha̱

The term "*murābaha̱*" is derived from the Arabic word *ribẖ*, which means profit. Thus the term "*Bayᶜ-murābaha̱*" means sale at an agreed profit. It is a contract between a buyer and a seller under which the seller sells certain goods, permissible under the *sharīᶜa*, to the buyer at cost, plus an agreed profit. The profit margin may be a percentage of the cost price or a lump sum. The purchaser may pay the price in cash, or he may be allowed to pay the amount within a fixed future period, as a lump sum or in installments.

The important features of *Bayᶜ-murābaha̱* are as follows:

1. Stock and availability of goods is the basic condition for signing the *Bayᶜ-murābaha̱* agreement. The bank must purchase the goods so that their ownership is established before the agreement is signed.
2. The bank bears the risk of the purchased goods until they are actually delivered to the client.
3. The bank sells and executes the agreement only after purchase of the goods.
4. The cost of the goods sold and the amount of profit added therewith are separately and clearly mentioned in the agreement. The profit margin may be a lump sum or a percentage of the purchase or cost price. The percentage of profit does not, under any circumstances, have any relation with time.
5. After the sale and execution of the agreement, the client becomes the owner of the goods and bears their risks.
6. *Murābaha̱* sale may be on the basis of cash or deferred payment. The price, once fixed as per agreement and deferred, cannot be increased.

It must be noted that the *Bayᶜ-murābaha̱* has various different forms, such as the consideration whether the promise is binding, or whether the commodity is received directly by the bank, through an agent, or is received directly by the client.

2. Bayᶜ-Muajjal *(Deferred Sale)*

Deferred sale in Arabic is known as *Bayᶜ Mu'ajjal* or *Bayᶜ Bithamin al Ajil*. It is held permissible, in a sales contract, to make provisions for an immediate delivery of goods while postponing payment. In this event, it is permitted to charge a higher price than the prevailing market price. In this case the bank procures certain goods permissible under Tiaras and the laws of the country, and sells them to the client at a price payable at a fixed future date, as a lump sum, or in fixed installments.

Important features of *Bay^c-Muajjal* are:

1. The bank's ownership of the goods must be established.
2. The bank is not bound to declare the cost of goods and profit markup separately.
3. This is a credit sale, in which the ownership of the goods is transferred to the client before payment is received; i.e. it is deferred for a fixed period of time. The bank may or may not retain possession of the goods for security.

3. Bay^c-Salam

This is a deferred delivery mechanism under which banks may finance purchases on a client's behalf. There is a distinction drawn between this and future trading, which is regarded as speculative and therefore prohibited. Under a forward purchase, the bank pays for the commodity being traded on behalf of the import agent or wholesaler, who agrees to repay the bank when he resells the merchandise to a retailer or final customer. The bank can pre-purchase the future output of the firms at an agreed price, specifying the goods and time/date of delivery. They cannot, however, sell the product until they have taken physical possession of the goods. Islamic banks are considering introducing financing of this mode.

4. Bay^c-Isti<u>s</u>nā^c

Islamic banks in Bangladesh are presently considering introducing *isti<u>s</u>nā^c* financing in their financing packages. While most jurists consider *isti<u>s</u>nā^c* as one of the divisions of *Salam* the Hanafi school of jurisprudence considers *isti<u>s</u>nā^c* an independent and distinct contract. The jurists of the Hanafi school define *isti<u>s</u>nā^c* as "…a contract with a manufacturer to make something," and "…a contract on a commodity on liability with the provision of work." The purchaser is termed the "*Mustaasnia*" (contractor), the seller "*Sania*" (maker or manufacturer), and the item under trade "*Masnooa*" (built, made). *Isti<u>s</u>nā^c* combines two distinctive traits:

(a) Its permissibility even though the subject of the contract does not exist at the time of contract (a property of *salam*).

(b) Its price is fiduciary and not necessarily advanced as in *salam* (a property of the ordinary absolute sale).

Because *isti<u>s</u>nā^c* involves labor as well as materials, it is akin to "*ijāra*," in which deference of payment is permissible.

<u>B. PLS-based Financing Techniques</u>

1. Mu<u>d</u>āraba

Islamic banks in Bangladesh do not practice *mu<u>d</u>āraba* mode of finance. The term refers to a contract between two parties in which one party supplies capital to the other party to carry out a trade, on the condition that the resulting profits be distributed in a mutually agreed proportion, while all loss is borne by the provider of the capital. *Mu<u>d</u>āraba* is also known as *Qirad* and *Muqaradah*. *Mu<u>d</u>āraba* is based on the cooperation of those who have capital with those who have expertise. The first party provides capital, and the other party provides the expertise with the purpose of earning "*<u>h</u>alāl*" (lawful) profit, which is divided in a previously agreed ratio. The capital owner may not have the time or the experience to turn over capital and trade with it. The agent (the *mu<u>d</u>ārib*) may not have the adequate capital to put to use his experience. This mode caters to the interests of both parties.

2. Mushāraka

Islamic banks in Bangladesh do not commonly practice *mushāraka* as an investment mechanic. A very small amount of investment funds has been extended through this mode.

The word *mushāraka* is derived from the Arabic word *sharika*, meaning "partnership." Islamic jurists point out that the legality and permissibility of *mushāraka* is based on the injunctions of the Holy Qur'ān, Sunna and *Ijma*' (consensus) of the scholars. It is notable that most Islamic banks are inclined to use various forms of *sharikat al-^{c}īnan* because of its built-in flexibility. At an Islamic bank, a typical *mushāraka* transaction may be conducted in the following manner:

One or more entrepreneurs approach an Islamic bank for the finance required for a project. The bank, along with other partners, provides complete financing. All partners, including the bank, have the right to participate in the project. This right can be waived. The profits are distributed according to an agreed ratio, which need not be the same as the capital proportion. Losses, however, are shared in the same proportions in which the partners provided the capital for the project.

C. Lease-based Financing Techniques

1. Ijāra *or Leasing*

Under this scheme of financing the bank purchases a real asset (possibly according to the specifications provided by the prospective client), and leases it to the client. The period of the lease, which may be from three months to five years or more, is determined by mutual agreement according to the nature of the asset. During the period of lease, the asset remains in the ownership of the bank, but physical possession and right of use is transferred to the lessee. After the expiry of the leasing period these rights revert to the lessor. The bank and the lessee agree upon a lease payment schedule based on the amount and terms of financing. The agreement may or may not include a grace period. According to the Islamic view, the maintenance of the asset during the leasing period is the responsibility of the owner of the asset, as the benefit (rental) is linked to the responsibility (maintenance). Islamic banks in Bangladesh are not currently employing this mode of investment.

2. Ijāra-Wa-Iqtina *or Hire-Purchase*

Hire-purchase or lease purchase, which ends with transfer of ownership, is a new innovation in Islamic banking. The bank does not maintain the assets, depending on market studies to ascertain the existence of a demand for them, but purchases the asset in response to a request from one of its customers to buy the asset through hire-purchase. At the end of the lease period the asset does not remain the property of the bank, as is the case in operations leasing, but transfers to the hire-purchaser. The bank calculates the total rent on the basis of the cost of the asset plus profit. The rent is paid in a predetermined period.

In practice, there are two basic forms of the contract through which the asset becomes the property of the hire-purchaser at the end of the hire-purchase period.

1. A hire-purchase contract with a promise to grant the asset to the hire-purchase after paying all the rental installments. The grant must be in a separate contract.
2. A hire-purchase contract with a promise to sell the asset to the hire-purchaser in exchange of a nominal or actual price, which the hire-purchaser pays at the end of the hire-purchase period after paying all the rental installments, agreed upon.

Islamic banks in Bangladesh have been following this mode of finance in extending finance for consumer durables and agricultural implements.

VII. Performance Analysis of Islamic Banks

Performance evaluation is an important pre-requisite for the sustained growth and development of any institution. It is customary to evaluate the pre-determined goals and objectives of commercial banks. With changing goals and objectives, the criteria for evaluation have changed over time. For the performance evaluation of the Islamic banking in Bangladesh, the "Banking Efficiency Model" must be taken into consideration.

Banking Efficiency Model criteria have been developed to measure the efficiency of the Islamic banking system. These five criteria are measured and expressed in terms of ratios.

The following discussion deals with the empirical testing of the findings from dynamic analysis to measure the overall efficiency and performance level of Islamic banks operating within a conventional banking set-up in Bangladesh. Primary data has been collected directly from the banks' concerned departments.

A. Productive Efficiency of Islamic Banks

1. Investment Opportunity Utilization Test

Under productive efficiency, it can be seen that Fund Utilization Rate (FUR) of IBBL went up progressively from 1989 to 1992, but fell to 0.75 in 1993. While it was more than 100% in 1996, it fell to 0.88 in 1997. Al-Baraka showed a higher FUR after 1989, due to its large non-performing assets, though normally considerably lower than the present rate. AIBL recorded 65% for 1996, and 75% for 1997, which also showed an increasing trend in fund utilization. SIBL also recorded 56% to 63%; PBL's Islamic branches showed figures of

48.70% in 1996, which fell to 30.23% in 1997, due to the opening of a new branch. FIBB also showed a low rate of 21%, due to investments in limited areas.

Deposit Mobilization Per Employee doubled for IBBL from 1988 to 1997, despite mixed trends during the period. ABBL and other Islamic banks also showed a rising trend. Fund Utilization Per Employee also showed the same trend for all banks.

Though fund utilization showed improvement, it was still below the optimal level, due to the state of the economy, competition among Islamic banks, and borrower preference for conventional banks.

2. Profit Maximization Test

All the four indicators of Profitability (i.e. Income-Expenditure Ratio, Profit-Expenditure Ratio, Profit-Loanable Fund Ratio, and Profit-Employed Fund Ratio) indicate that IBBL and Al-Arafah experienced a declining trend, while ABBL and SIBL incurred huge losses for several years.

The decline shown by the former two was due to the growing percentages of their investments which were converted into bad debts, which reduced their incomes, as well as the requirement to maintain bad debt provisions for classified loans. Of the latter two, ABBL incurred losses due to a huge amount of non-performing loans, while SIBL's losses were due to conflicts between the owners and management of the bank.

3. Project Efficacy Test

How far a bank can contribute effectively in running a project it finances can be determined by the level of linkage it can establish through its financing mechanism, which is:

1. Project selection criteria
2. Pre-financing appraisal of projects
3. Post-financing supervision
4. Built-in mechanical linkage of the bank to its financed projects

Discussion with the executives of the Islamic banks reveals that Islamic banks take utmost care to select efficient projects, but in most cases cannot supervise the post-financing situation. This is why borrowers look elsewhere, and sick projects affect the recovery of loans. The markup-based mechanism presently followed is comparable to that of conventional banks in ensuring the effectiveness of financed projects, since Islamic banks practice mostly trade-related modes of financing, which have little relevance to project financing.

4. Loan Recovery Test

It is evident from an analysis conducted by the central bank that the number of bad debts of Islamic banks is rising. The ratio of bad debts to total debts rose from 18% in 1996 to 20% in 1997.[12] New legal provisions providing means of overcoming acute overdue loan position are in the works.

5. Test of Elasticity in Loan Financing

The loan financing mechanism of Islamic banks is still not very elastic. Islamic banks in Bangladesh lack modes to meet call loan demands and the working capital needs of entrepreneurs. They also face problems in interbank borrowing due to a lack of suitable financing modes.

B. Operational Efficiency of Islamic Banks

The two criteria used to measure operational efficiency of Islamic banks are Per Employee Administrative Cost (PEAC), and Administrative Cost/Loanable Fund Ratio (ACLFR). The PEAC of all Islamic banks is increasing. PEAC for IBBL in 1996 was Taka 91,362.00, which reached Taka 188,807.00 in 1997. The ACLFR also shows an increasing trend. Since both ratios are increasing steadily, it can be seen that the banks are stable.

C. Allocative Efficiency of Islamic Banks

Allocative efficiency can be analyzed by examining the application of modes of financing, which show that short-term trade financing on the basis of markup is extensively used. The shares of *mushāraka* and *mu<u>d</u>āraba*, modes where profitability acts exclusively as an allocative device, in portfolio distributions are declining, however. Investment under *mushāraka* has declined, while there have been no *mu<u>d</u>āraba* investments at all. Islamic banks in Bangladesh cannot use *mu<u>d</u>āraba* financing as a tool for investment. The reasons for not using the PLS modes by the Islamic banks are:

a) Underreporting of profits by entrepreneurs to evade taxes affects the application of PLS modes, since both *mudāraba* and *mushāraka* are profit-sharing contracts between the bank and the entrepreneurs. The maintenance of proper accounting and declaration of the actual profit are essential. Underreporting is, unfortunately, a rule rather than an exception. As a result, entrepreneurs interested in *ribā*-free banking prefer to make their transactions through modes other than *mushāraka* and *mudāraba*. Islamic banks consider PLS financing risky, for the same reason.

b) For IBBL, 0.42% of its employed funds went to the agricultural sector in 1997. Financing by the other Islamic banks in the same sector stood at 0.13% for ALBB, 0.86% for SIBL, and nil for AIBL, FIBB and PBL, respectively.

The manufacturing sector got the highest importance in all Islamic banks. The ratio of investment to this sector was 43.64% (IBBL), 54.35% (ABBL), 33.00% (AIBL) and 27.35% (SIBL) respectively in 1997. Investment in the trade sector stood at second position, at 37.14% (IBBL), 6.17% (ABBL) and 55.44% (AIBL), while the transport sector received 13.71% (IBBL), 5.07% (ABBL), 2.23% (AIBL) and 95.45 (PBL). IBBL's investment in the agricultural and trade sector decreased from 0.57% and 45.36% in 1996, to 0.42% and 37.14% in 1997, while investment in manufacturing sector increased substantially from 33.42% to 43.64%. It is evident that most Islamic financing goes toward the manufacturing and business sector, while the vast agriculture sector is ignored.

This change in the pattern of financing by Islamic banks reflects disappointing results in the application of *mushāraka* financing. *Mudāraba*, another PLS mode of financing, has not yet been tried, due to an apprehension of the risks in the safe return of capital and profit. However, investment in *mushāraka* financing declined from 3.18% in 1996 to 2.61% in 1997 for IBBL, and from 2.11% to 0.86% for SIBL, while no other Islamic banks (except Al-Arafah, which invested 0.14% or Taka 2.51 million in 1997) made *mushāraka* investments during this period. It is thus evident that *mushāraka* investment is declining, and *mudāraba* investment is virtually nil.

D. Distributive Efficiency of Islamic Banks

Distributive efficiency is measured by three criteria; percentage shares of a bank's gross income going to its depositors (indicated by its profit-income ratio), the distribution of deposits and advances classified by account size, and the rural-urban classification of deposits and advances.

Profit-income ratio denotes the percentage share of income distributed to the depositors as profit. It is assumed that a high ratio indicates better distribution of income generated by financing. IBBL's ratio declined from 23.01% in 1996 to 12.47% in 1997, and Al-Arafah's rose from 9.16% to 31.10%. Al-Baraka's showed a negative trend as the bank has been maintaining provision for huge bad debts losses since 1990, and SIBL's ratio fell due to a conflict between the Chairman and the management till mid-1998. The overall situations of both banks have been improving recently, due to better loan discipline, and increased cooperation between the owners and managers. Al-Baraka's half-yearly balance sheet for the period ending June 1998 shows that the bank has been able to make a profit, and SIBL is working to reduce its losses. Al-Baraka's loss has been reduced from Taka 273.20 million in 1996 to Taka 162.12 million in 1997, while SIBL's loss has fallen from Taka 18.94 million to Taka 5.46 million.

The annual rate of growth of deposits in the Islamic banks stood at 20% for IBBL, 10% for ABBL, 300% for Al-Arafah, and 140% for SIBL. The two Islamic banking branches of Prime Bank Limited also made remarkable progress in mobilizing deposits. In 1996 they mobilized deposits from Taka 400.83 million to Taka 416.97 million. In 1997, this growth fell by Taka 12.74 million.

For IBBL, deposit accounts of Taka 10,000 and below represented 5.84% of the whole, while investment in them amounted to only 0.67%. For ABBL the figures were 9.04% and 0.001%; for AIBL 0.03% and 0.0001%; and for SIBL 0.01% and 0.01%. For deposits up to Taka 50,000, the ratios were 0.06% and 0.01% for IBBL; 0.05% and 0.001% for ABBL; 0.03% and 0.005% for AIBL; and 0.01% and 0.15% for SIBL. Fifty percent of the total deposits made to Islamic banks came from accounts amounting to Taka 300,000 or less, while investment in them was only 0.03%. Islamic banks in Bangladesh are thus following the current trend of transferring investable resources from low-income depositors to high-income borrowers, and thus creating greater income inequality.

It is evident from an analysis of the rural-urban classification of deposits and advances of a bank whether its allocation of financial resources has distributional implications. Since there was no data available, it proved impossible to conduct this analysis. According to the Quarterly Scheduled Banks Statistics, however, during April-June 1997, the total distribution of deposits by urban/rural areas revealed a ratio of 77:23, while the ratio of advances was 82:18.[13] Since the report treats the banking system as a whole, ignoring the operation of government-owned banks, will result in a much lower ratio. The urban bias in investment will be prominent in private sector banks, including Islamic banks, since their investment operation was designed to be urban-oriented.

E. Stabilization Efficiency of Islamic Banks

The entrepreneurs of Bangladesh are responsible for the huge amount of bad debts that have caused serious problems for Islamic banking. Several factors, including political intervention in the selection of borrowers, financial instability, and the government's inability to restore law and order (especially to frame laws for the recovery of bad debts) have caused the poor implementation of investment projects. In the case of Islamic banks, it may be concluded that full dependence on markup-based financing will not lead to stabilization efficiency. PLS financing may, however, attain this efficiency through collateral-free participatory-based banking.

VIII. ROLE OF *SHARĪᶜA* COUNCILS AND ISLAMIC INTERBANK MONEY MARKET IN BANGLADESH

The role of *Sharīᶜa* Councils or Boards in certifying the activities of Islamic banks is very important. They provide scholarly guidance in operations after conducting a practical examination of the bank's activities. Since an Islamic bank is, by definition, a financial institution which does not receive or pay interest in any form (*ribā an-nasī'a* or *ribā al-fadl*), and does not associate itself with any business repugnant to the *sharīᶜa*, careful scrutiny by Islamic experts is essential. When Islamic banks work alongside traditional banks, the need for *sharīᶜa* regulation is even more acute.

In Bangladesh, each Islamic bank (including the single conventional bank with Islamic banking branches) has its own *Sharīᶜa* Councils. The activities of the *Sharīᶜa* Councils are governed by each bank's *sharīᶜa* bylaws or rules and regulations.

A. Status of *Sharīᶜa* Councils of Islamic Banks

The *Sharīᶜa* Councils of Islamic banks serve a consultative rather than a supervisory function. For example, Section 123 of the Memorandum and Articles of Association of Islamic Bank Bangladesh Limited stipulates that "the Board of Directors of the bank may appoint from time to time consultative Body or Bodies specialized in the *sharīᶜa*, economic, financial and legal studies and may determine the terms of reference for such consultative Bodies."[14] Similarly, Al-Baraka Bank Bangladesh Limited stipulates in its Memorandum and Articles of Association that "the Board of Directors may appoint from time to time consultative or Advisory Body or Bodies of persons qualified in the *sharīᶜa* and/or banking, finance, industry, commerce, economics and other matters relevant for the efficient and effective functioning of the company and may determine the function of such Body or Bodies and the manner in which such functions shall be carried out."[15] Al-Arafah Islami Bank, in Section 158 of its Memorandum and Articles of Association also adopted some clauses about its *Sharīᶜa* Council.[16] Social Investment Bank Limited, in its Memorandum and Articles of Association includes a section (Section No. 104) on the *Sharīᶜa* Board, which states "On the licensing of the Social Investment Bank Limited, an (sic) *Sharīᶜa* Board shall be constituted with members from *Fuqahā'*, Lawyers and Economists to advise the Company on the operation of its business in order to ensure that they do not involve any element which is not approved by the *sharīᶜa*. The Board of Directors will determine the terms of reference for the *Sharīᶜa* Board."[17] The Prime Bank Limited has also constituted a *Sharīᶜa* Council to advise the bank in the operation of its branches in order to ensure compliance with the *sharīᶜa*.[18] The activities of the Bangladeshi branch of Faysal Islamic Bank of Bahrain E.C is monitored by a Central Religious Supervisory Board based in Bahrain. There is no separate Religious Supervisory Board in Bangladesh.

With the exception of Faysal Islamic Bank of Bahrain E.C., it is evident that the *Sharīᶜa* Councils/Boards are consultative only, and their decisions are not binding on the Boards of Directors or the Management of the banks.

B. Activities of *Sharīᶜa* Councils of Islamic Banks in Bangladesh

What functions do the *Sharīᶜa* Councils of Islamic banks fulfil? This question may be addressed by analyzing the minutes of the meetings and reports made for publication in the annual reports of the respective banks.

The *Sharīᶜa* Council of Islami Bank Bangladesh Limited is composed of ten members. A *Sharīᶜa* Secretariat assists the Council in facilitating its studies of different aims and matters. The *Sharīᶜa* Secretariat's primary function, including the *Muraqibs*, is to inspect some bank branches every year to verify its activities. The *sharīᶜa* inspection covers only one-tenth of the bank's branches each year. On the basis of its findings, the Council presents its comments recommendations for implementation of the *sharīᶜa*. The Council also provides the bank with a *Sharīᶜa* Certificate for inclusion in the bank's annual report.

It is evident from the reports of the *Sharīᶜa* Council of Islami Bank Bangladesh Ltd. from 1984 to 1997 that the bank did not follow the true mechanism of *Bayᶜ-murābaha* and *Bayᶜ-Muajjal* buying and selling, and a huge amount of "*Bayᶜ*" investment did not follow the guidelines of the *sharīᶜa*.[19] Thus, their "*Bayᶜ*" practices may be termed "Corrupted *murābaḫa*" and "Corrupted *Bay^c-Muajjal*." An analysis of the activities and reports of all other Islamic Banks' *Sharīᶜa* Councils also reveals a similar situation.

C. Coordination among *Sharīᶜa* Councils

At present, there is no cooperation between the *Sharīᶜa* Councils of the various Islamic banks in Bangladesh. Individual *Sharīᶜa* Councils takes decisions independently. There is no means of mutual discussions and the exchange of views on common issues. Thus the Councils follow their own individual reasoning, which in many cases raises questions about the sanctity of their decisions, particularly in cases where they issue two opposite *fatāwā* on the same issue. This creates confusion among ordinary people who wish to bank with them. Thus coordination between the Councils is essential.

D. *Sharīᶜa* Supervisory Board at the Central Bank

The central bank currently lacks a *Sharīᶜa* Supervisory Board to monitor the activities of the Islamic banks operating in Bangladesh. The advantages of the formation of a *Sharīᶜa* Supervisory Board at Bangladesh Bank gathered the attention of the concerned bodies, and it is hoped that a Central or Apex *Sharīᶜa* Board at the central bank will soon be established. Bangladesh Bank is currently considering establishing one at its head office, located in Dhaka. After the establishment of this Central *Sharīᶜa* Supervisory Board, it will be easier for Bangladesh Bank to guide, supervise and monitor the activities of the Islamic banks closely and accurately, and to foster coordination and cooperation among individual *Sharīᶜa* Councils.

E. Development of an Islamic Interbank Money Market in Bangladesh

An Islamic Money Market can easily be developed in Bangladesh, since the current Islamic banks have already gained a prominent position in the banking system, and their activities have been increasing and diversifying. This money market can be structured on the basis of *muḏāraba* mode of finance.

F. Inter-Islamic Bank Cooperation: Its Areas and Present Performance

In Bangladesh, a forum named "Islamic Banks Consultative Forum" (IBCF) was constituted by all banks practicing Islamic finance in March 1997, after a call from Bangladesh Bank to provide input on six areas, namely a) Formation of Islamic Money Market, b) Central *Sharīᶜa* Board, c) Islamic Banking Act, d) Islamic Insurance Company, e) New Financial Products in accordance with the *sharīᶜa*, and f) Constitution of Consortium/Syndication by the Islamic Banks for Large Financing with the cooperation from the central bank.[20] The Islamic Banks Consultative Forum decided at its first meeting, held on 30 March 1997, it would meet regularly, and at least once every quarter.[21] Previously, there was no arrangement for discussion among Islamic banks. Presently, however, IBCF is not fully active, and several executives have expressed their opinion in a meeting held in Bangladesh Bank that role of BB is necessary to activate it.[22] There is no event or program for exchanging and deputing employees, or initiating joint projects on syndication among the Islamic banks.

IX. Problems and Challenges of Islamic Banking in Bangladesh

A. Nature of the Problems and Challenges

Islamic banks all over the world have been facing a number of challenges, and Bangladesh is no exception. Islamic banks here have not yet been successful in devising an interest-free mechanism to place their funds on a short-term basis, and face a similar problem in financing consumer loans and government deficits. The risk in profit sharing appears to be so high that almost all Islamic banks in Bangladesh have resorted to techniques of financing which bring a fixed, assured return. As a result, there is genuine criticism that these banks have not abolished interest but have only changed the nomenclature of their transactions.[23] Third, Islamic banks do not have the legal support of the central bank, and lack the expertise and trained manpower to appraise, monitor, evaluate and audit the projects that they are required to finance. As a result, they cannot expand, despite having huge excess financial liquidity.

The implementation of interest-free banking in Bangladesh raises a number of macro-operational and micro-operational questions and potential problems, of which a partial list follows:

B. Problems Related to Macro-operation of Islamic Banks

1. Liquidity and capital
2. Valuation of bank assets
3. Financial stability

4. Ownership of banks
5. Lack of capital market and interest-free financial instruments
6. Insufficient legal protection
7. Control and supervision by the central bank on the basis of the *sharīᶜa*
8. Lack of unified *sharīᶜa* rulings
9. Absence of Islamic interbank money market
10. New banking regulations
11. Accounting principles and procedures
12. Shortage of supportive and link institutions
13. Shortage of skilled and trained manpower in the *sharīᶜa* and banking
14. Lack of cooperation among Islamic banks
15. The international financial and non-financial sector's lack of familiarity with Islamic products and procedures.
16. Severe competition in the financial sector
17. Economic slowdown and the political situation of the country
18. Inadequate track record of Islamic banking
19. Absence of infrastructure for international Islamic trade financing
20. Defaulting culture of the borrowers
21. Short-term asset concentration in the Islamic banks
22. Lack of courses on Islamic economics, banking and finance at the educational institutions
23. Lack of uniform operational procedure
24. Lack of specialized Islamic banks and non-bank financial institutions
25. Lack of consortium or syndication
26. Lack of harmonization of Islamic financial practices
27. Lack of inter-country study on the practical operations of Islamic banking
28. Lack of secondary securitization market
29. Lack of coordinated research work on Islamic economics, banking and finance
30. No apex training institute for Islamic banks

C. Problems Related to Micro-operation of Islamic Banks

1. Increased cost of information
2. Control over cost of funds
3. Markup financing and corrupted markup financing
4. Excessive resort to the *murābaḫa* mode of financing
5. Utilization of interest rate for fixing the profit margin in *Bayᶜ*-modes
6. Financing social concerns
7. Lack of positive response to the requirement of government financing
8. Failure of Islamic banks to finance high return projects
9. Sacrifice of allocative efficiency
10. Loss of distributive efficiency
11. Depression of profit
12. Lack of full-fledged *sharīᶜa* audit
13. Fraud, forgery or corruption
14. Minimum budget for research and development
15. Poor working environment
16. Issuance of letters of guarantee (L/G)
17. Minimum resort to PLS modes of financing
18. Lack of *sharīᶜa* manual or guidelines
19. Islamic investment risk analysis and measurement methodology
20. Non-exemption of stamp duty for purchasing property by banks
21. Lack of cooperation between Islamic banks and Islamic NGOs for extending microcredit
22. Lack of establishment of links with other training institutes and *sharīᶜa* supervisory bodies
23. Management laxity with *sharīᶜa* guidelines

It is evident from the list of problems that much operational work and research must be undertaken in order Islamic banks may flourish with the highest quality and strength.

X. THE FUTURE OF ISLAMIC BANKING IN BANGLADESH

A. Need for Reorganization of the Whole Financial System

A review of the problems of Islamic banking in general, and in Bangladesh in particular, poses a challenge for the survival and promotion of the system in Bangladesh. The implication is not that Islamic banks should never be floated within the conventional banking framework, but that the conventional banking system's operational mechanism needs to be re-examined and converted into PLS system, taking its beneficial impact on the economy into consideration. As long as Islamic banks are to operate within the conventional banking framework, however, the following recommendations need to be considered.

B. New Banking Philosophy for Islamic Banks

There seems to be a gap between the ideals and the actual practice of Islamic banks in Bangladesh. In their reports, booklets, bulletins and posters these banks express their commitment to the establishment of a just society free from exploitation. A close study shows that little progress has yet been achieved. Though this failure is attributed mainly to the pervasive influence of the conventional banking system itself, the laxness of the promoters of Islamic banking in realizing this objective is no less to blame. There needs to be a thorough review of the policies pursued by these banks for about a decade, and points of departure have to be identified in order to redesign their course of action.

C. Future Policy and Strategy

The promotion of the image of Islamic banks as PLS banks needs immediate attention. Strategies must be carefully devised in order to promote the banks simultaneously as Islamic and solvent. To this end, pilot schemes in selected areas must be introduced, to test innovative ideas with profit-and-loss sharing modes of financing as a major component. Islamic banks should clearly demonstrate by their actions that their banking practices are guided by profitability as a major criterion, thereby establishing that only Islamic banking practices ensures efficient allocation of resources and provide true market signals through PLS modes. Islamic banks should continuously monitor and disseminate the impact of their operations on the distribution of income, primarily between the bank and the other two parties, the depositors and the entrepreneurs, and then on different income groups in society. These presuppose the establishment of a fully equipped research academy in each Islamic bank.

D. Stepping up for Distributional Efficiency

This task is more challenging for Islamic banks, as they have to promote distributional efficiency in all dimensions together with profitability. Islamic banks have to be converted, step by step, into profit-and-loss sharing banks by increasing their percentage share of PLS investment financing. To accomplish this, Islamic banks ought to be selective in choosing clients for PLS financing. They should establish a direct functional relationship between the income of the depositors and the income of the bank and the entrepreneurs. The relationship improves as the share of PLS bank financing increases.

E. Promotion of Allocative Efficiency

Islamic banks can improve their allocative efficiency by satisfying social welfare conditions in the following manner. First, they should allocate a reasonable portion of their investable funds to social priority sectors such as agriculture (including poultry and fishery), small and cottage industries, and export-led industries such as garments and shrimp cultivation. Secondly, when the percentage shares of allocation of investable funds are determined among the sectors of investment financing, the criterion for the allocation of investment funds ought to be the profitability of the project. The criterion can be easily satisfied if more projects are financed under PLS modes.

F. Modern Banking Policies and Practices

In order to face the competition afforded by other banks and Islamic windows, Islamic banks must bring their functioning in line with modern business practices through the improvement and expansion of dealings in the banking sector. Thus it is necessary for them to provide comprehensive banking and investment services to clients, and to simultaneously take advantage of modern technological breakthroughs in areas such as electronic communication, computerization, etc.

G. Government and Central Bank Responsibilities

Considering the pro-development role of Islamic banking, the government ought to actively promote Islamic banking in Bangladesh. It should amend existing financial laws, acts, and regulations to create an environment conducive to the smooth operation of Islamic banks. The Bank Reforms Committee ought to be entrusted with the task of drafting an Islamic Banking Act. The government should also allow the establishment of Islamic insurance and other subsidiary companies, in order to facilitate their operation. Bangladesh Bank should develop Islamic monetary and saving instruments, and create a separate window for transactions with the Islamic banks, and a full-fledged Islamic Banking Department to analyze, supervise, monitor and guide Islamic banks, thereby facilitating their smooth development in the country.

H. Inter-Islamic Bank Cooperation and Perspective Plan

All Islamic banks should come forward to help each other and adopt a twenty year perspective plan, for the Islamization of the banking system of Bangladesh. To actualize this mission, they should immediately establish an Apex Research Academy and a Training Institute equipped with modern tools, books, and other accessories.

XI. CONCLUSION

Islamic banks can provide efficient banking services to the nation if they are supported with appropriate banking laws and regulations. This will aid them to introduce PLS modes of operation, which are very conducive to economic development. In order that the Islamic banking system fully utilize its potential, it is preferable that Islamic banks have the opportunity to work as the sole system in an economy, as studies show that Islamic banks cannot operate with full efficiency under a conventional banking framework. This decrease in efficiency is not due to mechanical deficiencies inherent within Islamic banking, but to the inefficient operation of the conventional banking system, which obstructs the operation of Islamic banks. This does not mean that the survival of Islamic banks operating within the conventional banking framework is threatened. Evidence from Bangladesh indicates that Islamic banks can survive even within a conventional banking framework by switching over from PLS to trade-related modes of financing.

Even under the conventional banking framework Islamic banks can operate with certain level of efficiency by applying PLS modes, the distinguishing feature of Islamic banking, to a reasonable extent. This has been possible in some Muslim countries where the management of Islamic banks was cautious about the possible effects of every policy measure, and were particularly cautious in selecting sectors or areas to concentrate operations in. Sudanese Islamic banks are a typical example. Islamic banks in Bangladesh have much to learn from the experiences of these successful Islamic banks.

Having considered the efficiency of Islamic banking and its beneficial impacts on the economy, government policy in Bangladesh should favor transforming the conventional banking system to an Islamic system. It is reasonable to assume that risks involved in *mushāraka* or *muḏāraba* financing are different from those involved in trade financing. It follows, therefore, that the prudential regulations of these transactions must be different.[24]

The determination of profit and loss in profit-and-loss sharing arrangements, and the treatment of costs and reserves in such accounting, needs to be addressed with utmost urgency. While Islamic banking is critical to materializing the economic objectives of Islam, it is not the whole of the Islamic framework. Compared to conventional banks, it is viable in isolation, but its full potential can only be realized by supplementing it with corresponding reforms in other spheres of life in general, and in the monetary and fiscal field in particular.

Finally, it may be mentioned that if the Islamic financial system, is to become truly liquid and efficient, it must develop standardized and universally (or at least widely) tradable financial instruments. The development of a secondary financial market for Islamic financial products is crucial if the industry is to achieve parity with the conventional system. It must also work to develop more transparency in financial reporting and accounting and, ideally, a form of Islamic GAAP.[25] Development in the wholesale and especially interbank and money markets, will be the key to Islamic finance growing outside its small current sphere of influence, and becoming a truly national invigorating force.

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APPENDICES

Appendix A: Third Forum Program of Events

Appendix B: Biographies of Speakers and Chairs

Appendix C: About the Harvard Islamic Finance Information Program

Appendix A

Third Forum Program of Events

Friday, October 1, 1999

7:30 a.m. **Registration, Austin Hall, Harvard University**

8:30 a.m. to 10:00 a.m. **Opening Session**

Introduction

Taha Abdul-Basser (Graduate Advisor, Harvard Islamic Society)

Welcome

Thomas D. Mullins (Executive Director, Harvard Islamic Finance Information Program)

Forum Chairman's Address

Samuel L. Hayes, III (Jacob Schiff Professor Emeritus, Harvard Business School)

Forum Opening Address

Mohamed Al Faisal Al Saud (Chairman, Dar Al-Maal Al-Islami Trust)
A Review of Islamic Finance

Keynote Speaker: The *Sharīʿa*

Nizam Yaquby (*Sharīʿa* Advisor)
Requirements to Be Fulfilled When Conventional Banks Set Up Islamic Banks, Windows, or Funds

Keynote Speaker: Islamic Economics

M. Nejatullah Siddiqi (Professor of Economics, King Abdulaziz University)
Islamic Finance and Beyond: Premises and Promises of Islamic Economics

10:00 a.m. to 10:30 a.m. **Break**

10:30 a.m. to 12:15 p.m. **Islamic Finance: Current Trends and Future Outlook**

Chairman: Samuel L. Hayes, III (Jacob Schiff Professor Emeritus, Harvard Business School)

I. Malcolm Burnett (President and Chief Executive Officer, HSBC Bank USA)
Emerging Trends and Opportunities in the Islamic financial Industry
David E. Moran (President, Dow Jones Indexes)
The Role of the DJIM Index in Islamic Finance
Abdullah Sulaiman Al Rajhi (Director and General Manager, Al Rajhi Banking and Investment Corporation)
Islamic Banks: Technology and Global Challenges and Opportunities

12:15 p.m. to 2:15 p.m. **Lunch**

2:15 p.m. to 4:00 p.m. Simultaneous Session A: *Sharīᶜa* Issues in Islamic Finance

Chairman: Nizam Yaquby (*Sharīᶜa* Advisor)

Gohar Bilal (Visiting Research Scholar, Harvard Islamic Finance Information Program)
Business Organizations under Islamic Law: A Brief Overview
Michael J.T. McMillen (Partner, King & Spalding)
A Rahn-ᶜadl *Collateral Security Structure for Project and Secured Financings*
Shaikh Abdul Hamid (Assistant Professor of Finance, New Hampshire College)
Investing in Equities: Some Issues from the Islamic Perspective

2:15 p.m. to 4:00 p.m. Simultaneous Session B: Islamic Economics and Finance

Chairman: M. Nejatullah Siddiqi (Professor of Economics, King Abdulaziz University)

Mahmoud A. El-Gamal (Professor [Chair] of Islamic Economics, Finance, and Management, Rice University)
An Economic Explication of the Prohibition of Ribā *in Classical Islamic Jurisprudence*
Mohammed Obaidullah (Associate Professor, Xavier Institute of Management)
Designing Islamic Contracts for Financing Infrastructure Development
Waleed El-Ansary (School of Islamic and Social Sciences)
Recovering the Islamic Economic Intellectual Heritage: Problems and Possibilities
Abdullah Yavas (Associate Professor of Business Administration, Penn State University)
Experimental Tests of the Homo Economicus*: The Implications for the Research on Islamic Economics*

2:15 p.m. to 4:00 p.m. Simultaneous Session C: Venture Capital and Partnership Finance

Chairman: Yahia Abdul-Rahman (Founder, American Finance House – LARIBA)

Ibrahim Warde (Lecturer, University of California, Berkeley)
The Revitalization of Islamic Profit-and-loss Sharing
Koshy Zacharia Karuvelil (Financial Controller, The International Investor)
Islamic Finance: Sustaining Success
Masudul Alam Choudhury (Professor of Economics, King Fahd University of Petroleum and Minerals)
Islamic Venture Capital: A Critical Examination
Mohammad S. Al Omar (Assistant General Manager, Kuwait Finance House)
Islamic Project Finance: A Case Study of the Equate Petrochemical Company
Rudy Yaksick (Principal, Financial Engineering and Risk Management)
The Islamic Commodity Trust: With Application to Crude Oil Forward Sales

4:00 p.m. to 4:30 p.m. Break

4:30 p.m. to 6:30 p.m. Simultaneous Session A: *Waqf* and Property

Chairman: Mahmoud A. El-Gamal (Professor [Chair] of Islamic Economics, Finance, and Management, Rice University)

Monzer Kahf (Formerly of the Islamic Development Bank)
Toward the Revival of Awqāf*: A Few* Fiqhī *Issues to Reconsider*
Khaled R. Al-Hajeri (Deputy Secretary General for Investment, Kuwait *Awqāf* Public Foundation)
Abdulkader Thomas (Chief Executive Officer, Al Manzil Islamic Financial Services)
Applying Waqf *Formula on a Global Basis*
M.A. Mannan (Founder Chairman, Social Investment Bank Ltd.)
*Cash-*waqf *Certificate: Global Opportunities for Developing the Social Capital Market in 21st-century Voluntary-sector Banking*
Abdel-Hameed M. Bashir (Assistant Professor of Applied Economics, Grambling State University)
Property Rights in Islam

4:30 p.m. to 6:30 p.m. Simultaneous Session B: Taxation, Ratings, and Capital Markets

Chairman: Saleh J. Malaikah (Chief Executive Officer, Al Baraka Investment and Development Company)

Robert W. Toan (General Counsel, Wafra Investment Advisory Group, Inc.)
Cross-border Ijāra*: A Case Study in the U.S. Taxation of Islamic Finance*
Andrew Cunningham (Vice President and Senior Credit Officer, Moody's Investors' Service)
Analyzing the Creditworthiness of Islamic Financial Institutions
Saiful Azhar Rosly (Associate Professor of Economics, International Islamic University)
Mohd. Azmi Omar (Dean of Kulliyyah of Economics and Management Science, International Islamic University)
Islamic Convertible Bonds: An Alternative to Bay^{c} al-'Inah *and Discounted* Bay^{c} al-Dayn *Islamic Bonds for the Global Islamic Capital Market*
A. Rushdi Siddiqui (Director, Islamic Index Group, Dow Jones Indexes)
Dow Jones Islamic Market Index: Transparency and Accountability in Islamic Asset Management

4:30 p.m. to 6:30 p.m. Simultaneous Session C: Islamic Finance around the World

Chairman: Benjamin C. Esty (Associate Professor, Harvard Business School)

Iqbal Ahmad Khan (Managing Director, HSBC Global Islamic Finance)
Developing the Country Framework for Islamic Finance
Yahia Abdul-Rahman (Founder, American Finance House – LARIBA)
Mike Abdelaaty (President, American Finance House – LARIBA)
Gary S. Findley (President, The Findley Company)
The Challenges of Offering a LARIBA Products and Services Window in an American Bank
Ramin Cooper Maysami (Assistant Professor, Nanyang Business School)
Islamic Banking and the Conduct of Monetary Policy: Lessons from the Islamic Republic of Iran
Md. Abdul Awwal Sarker (Joint Director, Research Department, Bangladesh Bank)
Islamic Banking In Bangladesh: Growth, Structure, And Performance

6:30 p.m. to 7:30 p.m. Tour of Harvard University

7:30 p.m.	Reception and Banquet

Opening Remarks

David Gordon Mitten (Faculty Advisor, Harvard Islamic Society)

Banquet Speaker

Muzammil H. Siddiqi (President, Islamic Society of North America)

HIFIP *DataBank* Presentation

Taha Abdul-Basser (Graduate Advisor, Harvard Islamic Society)

Appendix B

Biographies of Speakers and Chairs

MIKE ABDELAATY
President, American Finance House – LARIBA; Pasadena, Calif.

Mike Abdelaaty is President of American Finance House – LARIBA, a California finance company specializing in LARIBA-type transactions to meet the needs of individuals, professionals, and businesses. He possesses over twenty years of traditional banking experience, both locally and in the Middle East. Abdelaaty has held positions with Bank of America, The Sanwa Bank Limited and its subsidiary, Sanwa Bank California, and The Saudi Investment Bank. Abdelaaty received a B.S. and an MBA from California Polytechnic University, and has completed a three-year executive education program at the University of Washington's Pacific Coast Banking School. Abdelaaty has participated in the formation of two entities that offer the LARIBA style of banking and finance in the United States.

WALEED EL-ANSARY
School of Islamic and Social Sciences; Leesburg, Va.

Waleed El-Ansary is affiliated with the School of Islamic and Social Sciences. His previous experience includes stints at the World Bank, Hal Consulting and Investment Group, and the Paper and Plastic Education Research Foundation of New York. El-Ansary holds a B.A. from George Washington University and an M.A. in Economics from the University of Maryland. He is currently working on a Ph.D. in human sciences at George Washington University. A paper of El-Ansary's, *The Spiritual Significance of Jihad in Islamic Economics*, recently appeared in the American Journal of Islamic Social Sciences.

ABDEL-HAMEED M. BASHIR
Assistant Professor of Applied Economics, Grambling State University; Grambling, La.

Abdel Hameed M. Bashir is an Assistant Professor of Applied Economics at Grambling State University. His research interests are in Islamic banking and finance and economic development and growth. Bashir has an M.S. in Econometrics and Mathematical Economics from the London School of Economics and a Ph.D. from the University of Wisconsin, Madison. A recent publication of his, *Ethical Norms and Enforcement Mechanism in Profit-sharing Arrangements*, appeared in the Mid-Atlantic Journal of Business. Bashir is currently researching the political economy of the Islamic central bank.

TAHA ABDUL-BASSER
Coordinator of Software Development, Harvard Islamic Finance Information Program

Taha Abdul-Basser is Coordinator of Software Development at the Harvard Islamic Finance Information Program. He holds an A.B. from Harvard College and is currently working on a Ph.D. in Arabic and Islamic Studies in the Department of Near Eastern Languages and Civilizations at Harvard University. His areas of research include *'ilm al-balaghah*, *'usul al-fiqh*, and *fiqh al-mu'amalat*.

GOHAR BILAL
Visiting Research Scholar, Harvard Islamic Finance Information Program

Gohar Bilal is a Visiting Research Scholar at the Harvard Islamic Finance Information Program. She was previously a Visiting Scholar at the Islamic Legal Studies Program, where she did research on Islamic asset-backed securities. Before coming to Harvard, she headed the Corporate Finance and Investment Banking Division at Faysal Bank Limited in Karachi, Pakistan. She has also worked at Citibank N.A., Karachi (investment banking division) and Imperial Bank, Los Angeles (real estate finance). Bilal holds an M.S. in Construction Engineering and Management from Stanford University. In April 1997, Euromoney magazine named Bilal among the "Top 50 Women in the Finance World." Bilal is presently writing a book on Islamic asset-backed securities.

I. MALCOLM BURNETT
President and Chief Executive Officer, HSBC Bank USA; Buffalo, N.Y.

I. Malcolm Burnett is President and Chief Executive Officer of HSBC Bank USA, the U.S. commercial banking arm of HSBC Holdings Plc and a subsidiary of HSBC USA Inc. He is an HSBC Group General Manager and oversees all Group business activities in the United States. His former positions within HSBC, which he joined in London in 1966, include Group General Manager, COO of Marine Midland Bank (now HSBC Bank USA), and COO of The Hongkong and Shanghai Banking Corporation in Singapore. He has served in several Asian countries, including Hong Kong, Singapore, India, and Indonesia. Burnett is a graduate of the Wharton Executive Management Program at the University of Pennsylvania. He is a director of several holding companies and corporations and a member of several financial and community organizations.

MASUDUL ALAM CHOUDHURY
Professor of Economics, King Fahd University of Petroleum and Minerals, Dhahran, Saudi Arabia

Masudul Alam Choudhury is Professor of Economics at King Fahd University of Petroleum and Minerals. His research interest is in the area of epistemological problems of the Islamic socioscientific order, Islamic political economy, and the theory and application of these areas to economic, social, and scientific problems. He was formerly a Senior Economist with the Islamic Development Bank. Choudhury has a Ph.D. in Economics from the University of Toronto. He has authored 30 books and over 80 articles on Islamic economics, Islamic political economy, development studies, economic theory, institutionalism, and science and polity. Choudhury is presently researching a dynamic input-output model of trade and development for Islamic countries and writing *The Islamic Worldview* (London: Kegan Paul International, 2000, forthcoming). He is the editor of the journal *Humanomics*.

ANDREW CUNNINGHAM
Vice President and Senior Credit Officer, Moody's Investors' Service; London, England

Andrew Cunningham is a Vice President and Senior Credit Officer with Moody's Investors' Service. While he is now primarily concerned with European banks, he formerly analyzed Middle Eastern banks and was based in Moody's office in Cyprus. He was formerly a journalist writing about banking and finance in the Middle East, first for Middle East Economic Digest (MEED) in London and then for Middle East Economic Survey in Cyprus. Cunningham has a B.A. in Arabic and Islamic Studies from the University of Exeter. His publications include *Banking and Finance in the Middle East* (London: FT Financial Publishing, 1996); *Islamic Banking and Finance* (London: MEED, 1990); and *Gulf Banking and Finance* (London: MEED, 1989). His most recent publication is *Bank Credit Risk in Emerging Markets*, a special report published by Moody's in 1999.

BENJAMIN C. ESTY
Associate Professor of Business Administration, Harvard Business School

Benjamin C. Esty is an Associate Professor of Business Administration at the Harvard Business School, where he teaches the advanced corporate finance class and a variety of Executive Education programs. His current research focuses on how firms structure, value, and finance large-scale capital projects with a particular focus on project finance; he has written on a broad range of topics related to the financial services industry. He has worked at Booz-Allen & Hamilton, Bain and Company, and Commercial Mortgage Corporation of America, a start-up financial services company. Esty has a B.S. in Economics from Stanford University, an MBA from the Harvard Business School, and a Ph.D. in Economics from Harvard University. He has published in several academic journals, including the Journal of Banking and Finance and the Journal of Financial Economics, where he is an Associate Editor.

GARY S. FINDLEY
President, The Findley Company; Pasadena, Calif.

Gary S. Findley is President of The Findley Company and an attorney at law. The Findley Company is a bank consulting business in the western United States and consists of three entities. Gary Steven Findley & Associates is a law firm specializing in the organization, reorganization, merger, and acquisition of independent banks and other financial institutions. The Findley Reports is a banking publication and educational organization. The Findley Group is the consulting arm of the Findley organization with primary emphasis in strategic and capital development, facilitation of director and management retreats, management analysis, and regulatory compliance. Findley, a leading legal, economic, and management authority on banking, has written and published numerous articles and frequently serves as guest speaker on the topic of the California banking industry.

MAHMOUD A. EL-GAMAL
Professor of Islamic Economics, Finance, and Management, Rice University; Houston, Tex.

Mahmoud A. El-Gamal is the Chair of Islamic Economics, Finance, and Management and a Professor of Economics and Statistics at Rice University. He has held professorial positions at the University of Wisconsin, California Institute of Technology, and University of Rochester, in addition to working as an Economist at the

International Monetary Fund. El-Gamal has a B.A. in Economics and Computer Science and an M.A. in Economics from the American University of Cairo, an M.S. in Statistics from Stanford University, and a Ph.D. in Economics from Northwestern University on *Estimation in Economic Systems Characterized by Deterministic Chaos*. El-Gamal has research grants to study Islamic jurisprudence and its proofs, game theory, and the data of experimental economics. He has published extensively.

KHALED R. AL-HAJERI
Deputy Secretary General for Investment, Kuwait *Awqāf* Public Foundation; Safat, Kuwait

Khaled R. Al-Hajeri is Deputy Secretary General for Investment at the Kuwait *Awqāf* Public Foundation.

SHAIKH ABDUL HAMID
Assistant Professor of Finance, New Hampshire College; Manchester, N.H.

Shaikh Abdul Hamid is an Assistant Professor of Finance at New Hampshire College. He was formerly an assistant professor of finance at Northeastern University and Boston University. Hamid obtained his D.B.A. in Financial Economics from Boston University. His research interests are in the behavior of financial markets and forecasting market variables. He has presented papers in various international, national, and regional finance meetings. He has a number of published articles to his credit. “Investing in Equities: Some Issues from the Islamic Perspective” is his first article on Islamic finance.

SAMUEL L. HAYES, III
Jacob Schiff Professor Emeritus, Harvard Business School

Samuel L. Hayes, III, is Jacob Schiff Professor Emeritus at the Harvard Business School. He joined Harvard’s faculty in 1971, prior to which he was a tenured faculty member of the Columbia Business School. Hayes has a B.A. in Political Science from Swarthmore College and an MBA and D.B.A. from the Harvard Business School. Hayes has published in journals such as the Harvard Business Review, Accounting Review, and Financial Management. Hayes was a principal contributor to the Harvard Islamic Investment Study. He is the author or co-author of seven books, including *Islamic Law and Finance: Religion, Risk and Return* (The Hague: Kluwer Law International, 1998), which he co-authored with Frank E. Vogel of Harvard Law School. Hayes has consulted for a number of corporations, financial institutions, and government agencies, and is a member of HIFIP’s Advisory Board.

MONZER KAHF
Formerly of the Islamic Development Bank; Westminster, Calif.

Monzer Kahf was formerly a research economist at the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB), where he conducted many training courses at IDB, IRTI, commercial Islamic banks, and other institutions. He also collaborated with the OIC *Fiqh* Academy and was a member of several of its technical and methodological committees on the *sharīʿa* and economics. Prior to his term at the IDB, Kahf worked as a financial consultant; with the Islamic Society of North America; and as an auditor with the Syrian government. Kahf has a B.A. in Business from the University of Damascus and a Ph.D. in Economics from the University of Utah. He has organized and participated in many conferences worldwide on Islamic economics and has published over 25 books and booklets and more than 50 articles and papers on Islamic economics and finance.

KOSHY ZACHARIA KARUVELIL
Financial Controller, The International Investor; Safat, Kuwait

Koshy Zacharia Karuvelil is Financial Controller of The International Investor, where he handles financial and managerial accounting, tax structuring, and the international operations of the company. He was formerly Chief Accountant of Kuwait and Middle East Financial Investment Company. Karuvelil has an M.A. in Accounting and Commerce from Kerala University (India) and is a chartered accountant in the United Kingdom. He has spoken at international conferences in the U.A.E. and Belgium.

IQBAL AHMAD KHAN
Managing Director, HSBC Global Islamic Finance; London, England

Iqbal Ahmad Khan is Managing Director and Head of Global Islamic Finance for HSBC Group. He was formerly Managing Director of Citi Islamic Investment Bank and Global Head of Islamic Finance for Citicorp. Before that, Khan worked for the DMI Group’s subsidiary Islamic Investment Company of the Gulf, Bahrain. He was also a member of the Management Committee of the DMI Group. Khan has a B.Sc. in Physics and Chemistry and an M.A. in Political Science and International Relations, both from Aligarh Muslim University. He serves on the Board of the International Association of Islamic Banks, and is also a member of the Consultative Committee for the Islamic Credit and Investment Export Corporation, a subsidiary of the Islamic Development Bank. Khan is a founding member of HIFIP's Operating Board.

SALEH J. MALAIKAH
Chief Executive Officer, Al Baraka Investment and Development Company; Jeddah, Saudi Arabia

Saleh J. Malaikah is the Chief Executive Officer of Al Baraka Investment and Development Company and Al Tawfeek Company for Investment Funds Ltd. He is also a member of the Board of Directors for the Al Baraka Group. He has taught at King Fahd University of Petroleum and Minerals since 1983 and is now an Associate Professor of Finance and Investment there. Malaikah has a Ph.D. in Business Administration, Finance, and Investment from the University of Michigan. He has participated in the establishment and management of several companies in the investment, construction, and industrial sectors. In 1997, Malaikah received the "Deal Maker of the Year" award from the Islamic Banking and Finance forum in Dubai.

M.A. MANNAN
Founder Chairman, Social Investment Bank Ltd.; Dhaka, Bangladesh

M.A. Mannan is Founder and Chairman of Social Investment Bank Ltd. Prior to this, he worked at the Islamic Development Bank as an Economist and at King Abdulaziz and Georgetown Universities as a Professor. He has nearly 40 years of experience working in Islamic banking, finance, and economic planning. Mannan holds M.A. and Ph.D. degrees in Economics from the University of Michigan. A prolific writer, his publications include *Islamic Economics: Theory and Practice* (Boulder: Westview Press, 1987); *The Frontiers of Islamic Economics* (Delhi: Idarah-i Adabiyat-i Delli, 1984); and *Economic Development and Social Peace in Islam* (London: Ta Ha and Bangladesh Social Peace Foundation, 1989).

RAMIN COOPER MAYSAMI
Assistant Professor, Nanyang Business School; Singapore

Ramin Cooper Maysami is an Assistant Professor at the Nanyang Business School, where his research focuses on Islamic banking and finance, regulation of financial institutions, derivative securities, and entrepreneurship. He also heads the Islamic Banking Research Unit of the Asian Commerce and Economics Studies Center and is the Deputy Head of the Central Banking Policies Research Unit at Nanyang. He was formerly an Assistant Professor of Financial Economics at the University of Illinois. Maysami has a Ph.D. in Economics from Iowa State University. He has published several papers in international refereed journals on each of his research interests.

MICHAEL J.T. MCMILLEN
Partner, King & Spalding; New York, N.Y.

Michael J.T. McMillen is a partner in the New York office of King & Spalding, focusing on Islamic finance and international and domestic project finance, leasing, and structured finance. He was formerly a partner with White & Case and spent three years in Jeddah with the law office of Hassan Mahassni. He is an international project financing expert that has worked on some of the largest and most innovative project financings in the world, has extensive transactional experience in the field of Islamic finance, and has developed many Islamic financial products in Saudi Arabia and the Gulf. McMillen received his B.B.A from the University of Wisconsin, his M.D. from the Albert Einstein College of Medicine, and his J.D. from the University of Wisconsin.

DAVID E. MORAN
President, Dow Jones Indexes; New York, N.Y.

David E. Moran is President of Dow Jones Indexes, where he oversees the marketing and distribution of the indexes and related products that provide international investors with benchmarks on international equity markets. He was formerly Vice President/Law and Deputy General Counsel for Dow Jones & Company. Prior to joining Dow Jones, Moran was an associate with Patterson, Belknap, Webb & Tyler, a New York City law firm. Moran has a B.A. from Harvard College and a J.D. from the University of Virginia Law School. He is a member of the New York State Bar Association and the Association of the Bar of the City of New York. Moran is currently serving a one-year term as chairman of STOXX, Ltd., an index creator that is a joint venture of the German, Paris, and Swiss stock exchanges and Dow Jones.

THOMAS D. MULLINS
Executive Director, Harvard Islamic Finance Information Program

Thomas D. Mullins is Executive Director of the Harvard Islamic Finance Information Program and Associate Director of Harvard University's Center for Middle Eastern Studies (CMES). He is also the Executive Director of Contemporary Arab Studies at the CMES and was Chair of the Harvard Islamic Investment Study. Mullins directs new program development and external affairs at the CMES. He has over thirty years of experience in the international oil industry in Europe and the Middle East. His interests include geopolitical and strategic studies and Islamic finance. Mullins holds a B.A. from the University of Pennsylvania. His graduate studies were at the American University of Beirut and the Harvard Business School.

MOHAMMED OBAIDULLAH
Associate Professor, Xavier Institute of Management; Bhubaneswar, India

Mohammed Obaidullah is an Associate Professor of Finance at the Xavier Institute of Management. His areas of interest include Islamic finance, securities markets, and infrastructure finance. He is the author of *Indian Stock Markets: Theories and Evidence* (Hyderabad: Institute of Chartered Financial Analysts of India, n.d.). Obaidullah has published research in journals such as *Chartered Accountant*, *Islamic Economic Studies*, *Journal of Objective Studies*, and *Securities Industries Review*. He is the Project Director of the School of Islamic Business Education and Research, coordinates the activities of the online Islamic Banking and Finance Net, and edits the *International Journal of Islamic Financial Services*.

MOHD. AZMI OMAR
Dean of Kulliyyah of Economics and Mgmt. Science, International Islamic University; Kuala Lumpur, Malaysia

Mohd. Azmi Omar is Dean of the Kulliyyah of Economics and Management Science and an Assistant Professor of Business Administration at International Islamic University Malaysia (IIUM). His academic and professional interests include financial management, investment analysis and financial statement analysis, Islamic business management, and Islamic accounting, auditing and banking practice. He is also a Product Development Consultant for SPTF. He was formerly with Bank Bumiputra Malaysia Bhd. before joining IIUM. Omar has a B.S. in Finance and a Diploma in Banking Studies from MARA Institute of Technology, an MBA from Northern Illinois University, and a Ph.D. in Finance from the University of Wales. Omar is the author of several publications and research papers and consults several Malaysian commercial banks and finance companies on interest-free banking.

MOHAMMAD S. AL OMAR
Assistant General Manager, Kuwait Finance House; Safat, Kuwait

Mohammed S. Al Omar is Assistant General Manager of Kuwait Finance House and heads its Investment Sector. From 1993 to 1997, he was Manager of the International Real Estate Department at KFH. Prior to joining KFH, he held several key positions in the International Real Estate Department of Pearl Investment Company in Kuwait and the United States. Al Omar received his B.S. in Business Economics from Chapman Collage in Orange, California, in 1986. He attended an Executive Managers course and the General Management Program 3 at the Harvard Business School. In 1995, he spoke at the First Islamic Conference in New York organized by Harvard University and ABANA.

YAHIA ABDUL-RAHMAN
Founder, American Finance House – LARIBA; Pasadena, Calif.

Yahia Abdul-Rahman is Founder of American Finance House – LARIBA, which has been offering LARIBA (Islamic) financing and financial services since 1987. He has over 30 years of experience in international banking, project financing, and the oil and gas industry, and has held positions at Salomon Smith Barney, Atlantic Richfield, and the Industrial Bank of Kuwait. Abdul-Rahman has a B.S. from Cairo University and an M.S. and Ph.D. from the University of Wisconsin, Madison, all in Chemical Engineering, and an M.A. in International Management and Finance from the University of Texas, Dallas. He is the author of *LARIBA Bank – Islamic Banking, Foundation for a United and Prosperous Community*.

ABDULLAH SULAIMAN AL RAJHI
Director and General Manager, Al Rajhi Banking and Investment Corporation; Riyadh, Saudi Arabia

Abdullah Sulaiman Al Rajhi is Director and General Manager of Al Rajhi Banking and Investment Corporation (ARABIC). His other positions within ARABIC have included Deputy General Manager for Investments and Foreign Relations and First Deputy General Manager. Al Rajhi has a degree in Business

Administration. A member of the well-known Al Rajhi business family in the Middle East, he is a member of the Board of Directors of several other Saudi business entities.

SAIFUL AZHAR ROSLY
Associate Professor of Economics, International Islamic University; Kuala Lumpur, Malaysia

Saiful Azhar Rosly is an Associate Professor in the Department of Economics at International Islamic University Malaysia, where he teaches Islamic economics as well as Islamic banking, finance, and investment. He holds a B.Sc. and an M.A. in Economics from Northern Illinois University and a Ph.D. in Economics from the National University of Malaysia. Saiful's ongoing research includes Islamic financial instrument product design (such as Islamic convertible bonds) and analyzing the spending behavior of Muslim consumers and businesses. He is also an Islamic banking consultant to local Malaysian banks. Saiful has written a weekly column on "Business and Islam" for the *Sun* daily since 1994, and has been published in several refereed journals.

MD. ABDUL AWWAL SARKER
Joint Director, Research Department, Bangladesh Bank; Dhaka, Bangladesh

Md. Abdul Awwal Sarker is Joint Director of the Internal and Islamic Economics Division at the Research Department of Bangladesh Bank. He was formerly a Lecturer in Economics at Kaunia Degree College and Lalmanirhat Govt. College in Bangladesh. He has also worked as a Senior Assistant Vice President at Al Baraka Bank Training Academy. Sarker has a B.A. and M.A. in Economics from Rajshahi University (Bangladesh) and an M.Sc. in International Banking from Loughborough University. He is a member of several professional societies, has been a guest speaker at several training institutes, and has presented papers at professional meetings.

MOHAMED AL FAISAL AL SAUD
Chairman, Dar Al-Maal Al-Islami Trust; Geneva, Switzerland

Mohamed Al Faisal Al Saud is Chairman of Dar Al-Maal Al-Islami Trust and Chairman of the International Association of Islamic Banks. The DMI Trust consists of several banks throughout the world, including Faysal Islamic Bank of Bahrain, Islamic Investment Company of the Gulf (Bahrain, Bahamas, Sharjah, Jeddah), Faisal Islamic Bank of Egypt, Faysal Bank Ltd. (Pakistan), Al Faysal Investment Bank Ltd. (Pakistan), Faisal Finance (Turkey), and Faisal Finance (Switzerland) S.A. Al Saud has worked as an Officer at the Saudi Arabian Monetary Agency and is a founder of the Islamic Development Bank. He became the owner of Iceberg Transport International Ltd. and the Islamic Investment Company in 1977. Al Saud received his B.B.A from Menlo University. Al Saud set up Al Manara Schools, the largest private school network in Saudi Arabia.

M. NEJATULLAH SIDDIQI
Professor of Economics, King Abdulaziz University; Jeddah, Saudi Arabia

M Nejatullah Siddiqi is Professor of Economics at the Center for Research in Islamic Economics at King Abdulaziz University. He was formerly Professor of Islamic Studies and Director of the Institute of Islamic Studies at Aligarh Muslim University. Siddiqi has a Ph.D. in Economics from Aligarh Muslim University. He has supervised Ph.D. dissertations at Aligarh Muslim University, Umm al-Qura University, Imam Muhammad bin Saud University, and Sokoto University. Siddiqi has been the recipient of the King Faisal Islamic International Prize for Islamic Studies. He is the author of dozens of books, including *Muslim Economic Thinking* (Leicester, U.K.: The Islamic Foundation, 1981), *Banking Without Interest* (Leicester, U.K.: The Islamic Foundation, 1983), and *Role of the State in the Economy: An Islamic Perspective* (Leicester, U.K.: The Islamic Foundation, 1996). He is often an invited speaker at international conferences.

MUZAMMIL H. SIDDIQI
President, Islamic Society of North America; Plainfield, Ind.

Muzammil H. Siddiqi is President of the Islamic Society of North America and the Director of the Islamic Society of Orange County, California. He has worked with many Islamic organizations worldwide, including the Muslim Students Association of the U.S. and Canada, the Muslim World League Office, and the Islamic Center of Washington, D.C. Siddiqi received his early education at Aligarh Muslim University and Darul Uloom Nadwatul Ulama (Lucknow). He has a higher degree in Arabic and Islamic Studies from the Islamic University of Madinah, an M.A. in Theology from Birmingham University, and a Ph.D. in Comparative Religion from Harvard University. Sididqi is a member of the *Fiqh* Council of North America and a founding member of the Council of Mosques in the U.S. and Canada. He often participates in interfaith dialogues with Jews and Christians and conducts a weekly religious radio program. Siddiqi is Vice President of the Academy of Judaic-Christian and Islamic Studies in

California and a member of both the Supreme Islamic Council of Egypt and the Supreme Council of Mosques in Makkah.

A. RUSHDI SIDDIQUI
Director, Islamic Index Group, Dow Jones Indexes; Princeton, N.J.

A. Rushdi Siddiqui is the Director of the Islamic Index Group at Dow Jones Indexes. He is the creator of the Dow Jones Islamic Index (DJIM) and is responsible for constructing additional DJIMs, establishing licensees, marketing, seminar/conference presentations, and interfacing with *sharīʿa* scholars. Siddiqui's previous work experience includes Vice President of a Wall Street investment bank, marketing officer at a commercial bank, Chief Operating Officer for an alternate fuel vehicle technology concern, and founder of a consulting firm. Siddiqui has a B.S. from New York University, an MBA from Baruch College, and a J.D. from Albany Law School of Union University. He is a lecturer at New York University's School of Professional Education. Siddiqui has published over 20 articles in international magazines and has presented papers at international conferences.

ABDULKADER THOMAS
Chief Executive Officer, Al Manzil Islamic Financial Services; New York, N.Y.

Abdulkader Thomas is General Manager of the United Bank of Kuwait Plc. His prior experience includes working as a Vice President and Manager at Sumitomo Bank, Los Angeles, where he managed $1 billion in assets, Gulf Riyadh Bank, and Citibank, Bahrain. Thomas has been the Publisher of the American Journal of Islamic Finance (AJIF) since 1991. He participated in the publication of the memoirs of Ahmed El-Naggar, a founder of the modern Islamic banking movement. He has spoken at numerous Islamic finance conferences.

ROBERT W. TOAN
General Counsel, Wafra Investment Advisory Group, Inc.; New York, N.Y.

Robert W. Toan is General Counsel of and Director of Structured Finance at the Wafra Investment Advisory Group. He is also a partner in the New York-based law firm of Hughes Hubbard & Reed LLP, specializing in international taxation, financial transactions, and cross-border leasing. Toan was formerly a partner of the international law firm of Baker & McKenzie. Toan received his J.D. and LL.M. in Taxation from New York University Law School. He is the author of numerous articles on international taxation and speaks widely on international tax and financial topics. He is a member of the Editorial Supervisory Board of the International Tax Journal.

FRANK E. VOGEL
Custodian of the Two Holy Mosques Assistant Professor of Islamic Law, Harvard Law School

Frank E. Vogel is Custodian of the Two Holy Mosques Assistant Professor of Islamic Law and Director of the Islamic Legal Studies Program at Harvard Law School, where he has taught since 1987. His research and teaching focuses on Islamic law and the law of the Muslim world. He has a B.A. in Applied Mathematics from Harvard College, a J.D. from American University, and a Ph.D. in law and Middle Eastern studies (Islamic law) from Harvard University. Vogel's publications include *Islamic Law and Finance: Religion, Risk and Return* (The Hague: Kluwer Law International, 1998), which he co-authored with Samuel L. Hayes, III of the Harvard Business School. Vogel is on the Advisory Board of HIFIP.

IBRAHIM WARDE
Lecturer, University of California; Berkeley, Calif.

Ibrahim Warde is a lecturer at the University of California, Berkeley, and an international consultant specializing in global financial issues. Warde has written over 30 monographs and articles on international finance. He was previously a research fellow at BRIE (The Berkeley Roundtable on the International Economy), where he did extensive research on the Silicon Valley economy and business practices. He is a graduate of France's Ecole des Hautes Etudes Commerciales and holds a Ph.D. in Political Science from U.C. Berkeley. Warde is the author of *Islamic Finance in the Global Economy* (Edinburgh University Press, 1999).

RUDY YAKSICK
Principal, Financial Engineering and Risk Management; Concord, Mass.

Rudy Yaksick is the Founder and Principal of Financial Engineering and Risk Management, a research and consulting firm. He was formerly a senior consultant to the Saudi Arabian Monetary Agency, where he designed and implemented the Kingdom's first investment-management accreditation program, and has worked at Chase

Manhattan Bank, Boston University, and Clark University. Yaksick has a B.A. in Economics from the University of Pittsburgh and an M.A. in Economics from Boston College. He is completing his Ph.D. dissertation at the University of Pennsylvania on the economics of uncertainty. Yaksick has several academic and professional publications in the area of financial engineering, and has delivered papers at many international finance conferences.

NIZAM YAQUBY
Sharīᶜa *Advisor*; Manama, Bahrain

Nizam Yaquby is a renowned *sharīᶜa* scholar and advisor to numerous Islamic banks and companies, including Abu Dhabi Islamic Bank, Islamic Investment Company of the Gulf, Arab Islamic Bank, and Dow Jones Indexes. He pursued traditional Islamic studies in Mecca, India, and Morocco under the guidance of scholars including Abdullah Al-Farisi and Muhammad Saleh al-Abbasi. Yaquby has a B.A. in Economics and Comparative Religion from McGill University and is a Ph.D. candidate in Islamic Law at the University of Wales. Yaquby has published several books on Islamic law and is a frequent speaker at Islamic conferences.

ABDULLAH YAVAS
Associate Professor of Business Administration, Penn State University; University Park, Penn.

Abdullah Yavas is an Associate Professor of Business Administration at Penn State University. His teaching and research focus on real estate, applied microeconomic theory, the economics of information and uncertainty, and experimental economics. He was formerly Assistant Professor at Penn State and has spent time as an academic at the International Black Sea University (Tbilisi, Georgia), the University of Michigan, Bogazici University (Istanbul), and the University of Illinois. Yavas has a B.A. from Bogazici University and a Ph.D. in Economics from the University of Iowa. He has written many journal articles, is a member of several academic organizations, edits or referees for several professional publications, and is a frequent speaker at academic and other conferences.

Appendix C

About the Harvard Islamic Finance Information Program

Thomas D. Mullins
Executive Director

S. Nazim Ali
Director of Operations

Introduction

The Harvard Islamic Finance Information Program (HIFIP) is now in its fourth year of operation as an academic research program on the field of Islamic finance and economics at Harvard University. Established by Harvard's Center for Middle Eastern Studies (CMES) and with the support of the Islamic Investment Company of the Gulf (IICG) Bahrain in December 1995, it has since then grown to develop relationships and support from throughout the Islamic financial community.

Harvard University has sponsored several related initiatives: the Islamic Legal Studies Program (Harvard Law School) was established for the study of Islamic law in 1991; the Harvard Islamic Investment Study (CMES, Harvard Law School, Harvard Business School) was completed in 1996; and Vogel and Hayes' *Islamic Law and Finance: Religion, Risk and Return* was published in 1998. The establishment of HIFIP, however, fills the need for a more comprehensive and focused look at the field of Islamic finance and economics.

HIFIP Objectives

The Harvard Islamic Finance Information Program was established for and operates with the following objectives in mind:

1. to become the premier information provider and clearinghouse of Islamic finance and economics;
2. to create and develop the HIFIP *DataBank*;
3. to promote research and development in Islamic finance and economics and sponsor research projects; and
4. to promote greater awareness of Islamic finance and economics through conferences and seminars.

HIFIP Activities

In addition to organizing the Harvard University Forum on Islamic Finance, HIFIP has also been responsible for a variety of information management and research projects. The Program has released and continually updates the HIFIP *DataBank*, the world's first comprehensive software information tool on Islamic finance and investment. The *DataBank* at this point has the equivalent of over 12,000 pages of information in nine component databases ranging from industry data to published research to religious literature and more.

The Program also offers and hosts a variety of research opportunities. It has initiated a visiting scholars program for research projects at HIFIP, sends HIFIP researchers on research projects and internships in the Islamic financial industry, and responds to research and information referral requests worldwide. These opportunities for research at and through HIFIP have the further benefit of attracting university students to the field of Islamic finance and granting them valuable exposure to the industry.

Institutional Relationships

In order to successfully undertake these activities, HIFIP has had the cooperation of various research bodies (e.g., Islamic Research and Training Institute of the Islamic Development Bank), banking and regulatory institutions (e.g, World Bank, Accounting and Auditing Organization for Islamic Financial Institutions), and other secondary information providers (e.g., Islamic Bankier, Reuters) in the field. The Program has also had the crucial financial support of institutions throughout the Islamic financial community (please see our list of member institutions). These relationships not only allow HIFIP to better study the field of Islamic finance, but also enhance its role as an information clearinghouse for a more informed and connected Islamic financial community.

NEW DEVELOPMENTS

As HIFIP continues and expands on its current research and information service capabilities, it is also embarking on new projects. Our latest web initiative will bring a significantly expanded Web site, making it a forum for greater connectivity with the Islamic financial community. An abridged Web version of the HIFIP *DataBank*, presently accessible only on CD-ROM, will be available online, providing HIFIP members with access to the complete *DataBank* and all users with access to an abridged web version. Finally, a new membership structure that differentiates institutions by financial ability will allow for greater access to the benefits of the Program.

MEMBERS OF THE HARVARD ISLAMIC FINANCE INFORMATION PROGRAM

1.	ABC Islamic Bank	Manama, Bahrain
2.	Abu Dhabi Islamic Bank	Abu Dhabi, United Arab Emirates
3.	American Finance House – LARIBA	Pasadena, California
4.	Azzad Asset Management	McLean, Virginia
5.	Albaraka Investment & Development Company	Jeddah, Saudi Arabia
6.	Al Baraka Islamic Bank	Manama, Bahrain
7.	Citi Islamic Investment Bank	Manama, Bahrain
8.	Crescent Capital Management	Chicago, Illinois
9.	Dar Al-Maal Al-Islami Trust	Geneva, Switzerland
10.	Faisal Finance Institution	Istanbul, Turkey
11.	Faisal Islamic Bank of Egypt	Cairo, Egypt
12.	First Islamic Investment Bank	Manama, Bahrain
13.	HSBC Investment Bank	London, England
14.	The International Investor	Safat, Kuwait
15.	iHilal.com	Dubai, United Arab Emirates
16.	Islamic Research and Training Institute, Islamic Development Bank	Jeddah, Saudi Arabia
17.	Kuwait Finance House	Safat, Kuwait
18.	National Commercial Bank	Jeddah, Saudi Arabia
19.	Rice University	Houston, Texas
20.	Saudi Economic and Development Company	Jeddah, Saudi Arabia
21.	Shamil Bank of Bahrain	Manama, Bahrain
22.	Universiti Brunei Darussalam	Bandar Seri Begawan, Brunei Darussalam

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