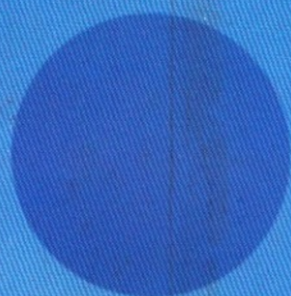
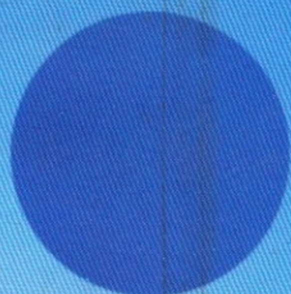
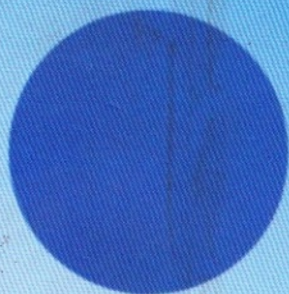
Journal of Islamic Economics Banking and Finance







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JOURNAL OF
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Volume 3, Number 1, January - June 2007

Editor

M. Kabir Hassan, Ph.D.

ISLAMI BANK TRAINING AND RESEARCH ACADEMY (IBTRA)
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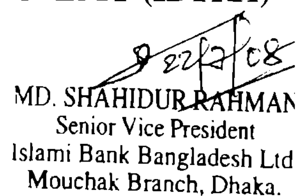

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Note to Contributors

The Journal of Islamic Economics and Finance is published twice a year by the Islami Bank Training and Research Academy (IBTRA), Dhaka. It is a refereed journal and publishes articles in areas of both Conventional and Islamic Economics, covering theoretical and applied aspects of Economics, Finance, and Banking, as well as problems of economic development, in particular of Bangladesh and other developing Islamic countries. While sending articles for publication in the journal, the contributors are requested to follow the following rules :

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2. The author should not mention his name and address on the text of the paper. A separate sheet bearing his full name, affiliation, mailing address and telephone number, if any, and the title of the paper should be sent along with the main paper.
3. Articles submitted for publication in the Journal must not have been accepted for publication elsewhere.
4. Tables, graphs and maps may be used in the article. The title and source(s) of such tables, etc. should be mentioned.
5. If the Editorial Board is of the opinion that the article provisionally accepted for publication needs to be revised, shortened, or particular expressions therein need to be deleted or rephrased, such opinions will be communicated to the author for appropriate action. The author may also be requested to recast any article in response to the comments made thereon by the reviewers.
6. The numbering of footnotes will be consecutive, and the footnotes themselves will be placed at the end of the article.
7. Articles, not accepted for publication, will not be returned to the author.
8. A token honorarium of BDT 7500 will be paid for each published article.

References :

In the list of references at the end of the article, the entry in the case of articles should be in the following manner:

Siddique, H. G. A., "Export Potentials of Ready-made Garments Industry: A Case Study of Bangladesh", The Dhaka University Studies, Vol. 2, No. 1, 1982, pp. 1, 66-67.

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Book Review:

New books (on Islamic economics, finance and banking, as well as on issues and problems of economic development) will be reviewed in the Journal on request. Authors/publishers may send two copies of each book to the editor for purpose of review.

All communications should be addressed to the Editor.

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Editor's Note

The Volume 3, Number 1, January-June 2007 issue of the Journal of Islamic Economics, Banking and Finance contains five articles on Islamic Economics, Banking and Finance. As you may have noticed, we have changed the name of the journal to better reflect the growth of Islamic banking and its impact on socioeconomic development of many countries. Acknowledging the difficulty of getting quality and scholarly work on Islamic economics, banking and finance, I have solicited five articles from well-known scholars-both Muslim and non-Muslim- on various aspects of this emerging field of study: from meaning of riba to project financing to corporate governance to challenges facing the industry and short– term money market management in Islamic finance. As such, I have taken the liberty of choosing the articles, which have gone through many revisions by the authors themselves.

In this issue, I am more interested in applied islamic finance rather than theoretical debate on this matter, even though I did not resist the temptation of putting one of our article on "Riba and Islamic Banking" to set the tone to layman who may not otherwise familiar with the concept of riba and its meaning and impact on Islamic Banking. Abu Umer Farooq Ahmad and M. Kabir Hassan in their article examines the meaning and debate on Riba from the classical and modernist schools of thought with appropriate references from the Quran and Hadiths. They explore the inner beauty of Islamic finance and explains the differences between Islamic and Conventional Banking. They stress that any form of riba is strictly prohibited in Islam.

Michael McMillen in his article "Sharia-Compliant Project Finance: An Overview including Structures," explains techniques and structures involved in Islamic Project financing. Iistisnaa, ijara, mudaraba, murabaha and sukuk financing vehicles are acceptable ways of Islamic project finance. Revenue streams from Islamically acceptable projects consistent with the tenets of Shariah can be accomplished in a number of ways. Such project financing mechanisms can channel a large sum of short-term capital into long-term infrastructure projects and thus help developing Muslim countries in their economic development. By providing basic social goods such as power, water,

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transport, and communications services, infrastructure projects fit comfortably with the social responsibility ethos that is an essential feature of Islamic finance. In addition, limited recourse or non-recourse project financing structures are forms of asset-based financing that seem entirely consistent with Islamic law. When the complex financial structures that constitute these arrangements are stripped away, what is apparent is that project investors are sharing in the asset and cashflow risks of projects in ways that financiers are required to do under Islamic law.

Wafik Grais and Matteo Pellegrini in their article "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options," examines corporate governance (CG) challenges and suggests options to address them. Corporate governance for Islamic financial institutions is similar in all aspects with conventional financial institutions except in case of Shariah governance to make them consistent with Islamic legal principles of contracting and acceptable and unacceptable business activities.

They discuss three cases of distress of IIFS. The authors discuss interests of various stakeholders in islamic financial services industry including those depositors holding unrestricted investment accounts. It raises the issues of independence, confidentiality, competence, consistency and disclosure that may bear on pronouncements of consistency with Islamic finance principles. It also discusses the agency problem of depositors holding unrestricted investment accounts. The authors advocates for a governance system for the IIFS which combines internal and external procedures by relying extensively on on transparency and disclosure of market relevant information.

Zamir Iqbal in his article "Challenges Facing Islamic Financial Industry," discusses the challenges facing the Islamic financial services industry. Islamic finance began three decades ago but now has spread to investment banking, project finance, capital markets, insurance, wealth management, and micro-finance. Although, Islamic finance has survived well despite the obstacles and skepticism of the critics, it continues to face many challenges. The author argues that at the present pace of growth and weak infrastructure, the industry will face challenges in achieving sustainable growth. On the contrary, if necessary policy measures are not taken, the industry may be adversely affected. The immediate need is to develop instruments that enhance liquidity;

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to develop secondary, money, and inter-bank markets; and to perform asset-liability and risk management. Its future growth and development will depend largely on the nature of innovations introduced in the market.

Asyraf Wajdi Dusuki in his article "Commodity Murabahah Programme (CMP): An Innovative Approach to Liquidity Management," provides a case study of Islamic liquidity management as it is practiced in Malaysia. Liquidity management is critical in banking industry in general. It takes center stage in Islamic banking, because lack of shariah-compliant money market instruments forces islamic banks to sit with excess liquidity. Shortage of liquidity on the other hand may cause crisis and financial instability in the banking industry. In order to help the islamic financial services industry, the Central Bank of Malaysia recently introduced commodity murabahah based on tawarruq concept. This instrument, in addition to other islamic money market instruments based on inah-based principle, certainly will help the Islamic banks to manage their funds more effectively, and will certainly appeal to investors who were otherwise uncomfortable with inah-based instrument and will be more global in nature by tapping the Middle eastern funds.

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Riba and Islamic Banking

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Abstract

The Prophet admonished riba in its all forms in his farewell Pilgrimage speech. The article examines the principles of riba and how it fits within the realm of Islamic economics, as it is exemplified by the Prophet in his Sunnah and as it is described in the Holy Qur'an. Consecutive verses of the Qur'an and its interpretations through the hadiths of Prophet are also portrayed in the article. Referring to a debate saying the modernists claim that what is prohibited in al-Qur'an is the form of riba referred to the then prevailing practice of lending in the pre-Islamic era, the authors boldly ruled out the logic saying that any increase over and above the principal should be riba, and as such it is unlawful. The modernists also raised some debatable issues like-'difference between riba and usury' and 'individual and institutional riba'. All these claims are defeated with sufficient Shari`ah references. While responding the issues stated earlier, the authors categorically explored the inborn beauties of Islamic Banking as well as disclosed the distinctions between Islamic and Conventional Bank. The authors, in a nut shell, stress on the point in this paper that any form of riba is strictly avoided in the Islamic Banking System.

1. Introduction

The last sermon in the farewell Hajj given by the Prophet Muhammad (pbuh) is considered to be the Magna Carta for the mankind. It was very short and powerful speech and culmination of his life-long preaching of the religion Islam. He basically mentioned three important points in his speech: a. Basic belief of one Allah; b. Rule of Law and morality; c. Rule of Justice. He put emphasis on economic justice by declaring *riba* haram, and declaring the sanctity of life, wealth and property. In his farewell speech regarding interest, the Prophet (pbuh) said: "Allah has forbidden you to take usury (interest); therefore all interest obligations shall henceforth be waived. Your capital is yours to keep. You will neither inflict nor suffer any inequity. Allah has judged that there shall be no interest". In this essay, we examine the principles of *riba* and how it fits within the realm of Islamic economics and banking, as it is exemplified by the Prophet in his Sunnah and as it is described in the Holy Qur'an.

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2. *Riba:* It's Prohibition in the *Shari`ah*

Riba is an Arabic word, derived from the verb *raba* that literally means 'to grow' or 'expand' or 'increase' or 'inflate' or 'excess'.[1] The same literary meaning has occurred in many places of *al-Qur'an* as well.[2] It is, however, not every growth or increase, which falls in the category of *riba* prohibited in Islam. It is generally translated into English as "usury" or "interest", but in fact it has a much broader sense in the *Shari`ah. Riba* in the *Shari`ah*, technically refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity.[3] In *fiqh*[4] terminology, *riba* means an increase in one of two homogeneous equivalents being exchanged without this increase being accompanied by a retur.[5] The term *riba* is, however, used in the *Shari`ah* in two senses. The first is *riba al-nasi'ah* and the second is *riba al-fadl.*6 Some Muslim scholars attempt to define *riba* which seems to be closer to the sense implied in the verses of the *Qur'an* and *ahadith* related to it. They define *riba* as an increase or excess which, in an exchange or sale of a commodity, accrues to the owner (lender) without giving in return any equivalent counter-value or recompense to the other party.[7]

In the pre-Islamic and early Islamic era, *riba* signified the increase of money in consideration for an extension of the term of maturity of a loan. The pre-Islamic and early Islamic Arabs used to pay the money on loans and received

1. Al-Raghib Al-Isfahani, Al-Husain, *Al-Mufradat Fi Gharaib* Al-Qur'an, Cairo, 1961, pp.186-187. The same meaning is also unanimously indicated in all classical Arabic Dictionaries and in the commentaries of *al*-Qur'an as well.
2. Al-Qur'an, 30:39; 23:50; 2:265,276.
3. Chapra, M. Umar, *Towards a Just Monetary System,* Leicester, 1986, pp.56-57.
4. Muslim jurisprudence based on the Qur'an and the *Sunnah* and secondarily on *ijma`* and *ijtihad.*
5. Al-Jaziri, `Abdal-Rahman, *Kitab al-Fiqh `ala al-Madhahib al-`Arba`ah,* Beirut, undated, p.245.
6. *Riba al-nasi'ah* is the *riba* which the Prophet referred to when he said: "There is no *riba* except in *nasi'ah*" or waiting (Bukhari, *Kitab al-Buyu`, Bab Bai` al-Dinar bi al-Dinar nasa'an;* also Muslim, *Kitab al-Musaqat, Bab Bai` al-Ta`am Mithlan bi Mithlin).* While the authority for the definition of *Riba al-Fadl* lies in what the Prophet said in more than one occasion: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt – like for like, equal for equal, and hand to hand; if the commodities differ, the you may sell as you wish, provided that the exchange is hand-to-hand" (Muslim, *Kitab al-Musaqat, Bab al-Sarf wa Bai` al-Dhahab bi al-Waraq Naqdan;* also in Tirmidhi).
7. Haque, Zia-ul-, *Islam and Feudalism: The Moral Economics of Usury, Interest and Profit,* Kuala Lumpur, 1995, p.16. See also, Joseph Schacht, *Encyclopedia of Islam,* 1939 edition, under 'Riba'.

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a certain sum leaving the principal sum untouched. When the maturity date expired, they would claim the principal sum from the debtor; if it was not possible for the debtor to repay, they would increase the principal sum and extend the term. Thus, there were transactions with a fixed time limit and payment of interest, as well as speculations of all kinds that formed an essential element in the trading system of the pre-Islamic era. A debtor who could not repay the debt i.e., money or goods, with the accumulated interest at the time it fell due was given an extension of time during which to pay, but at the same time the sum due was doubled. This is referred to clearly in *al-Qur'an*,

"O you who believe! Do not devour *riba* multiplying it over, and observe your duty to Allah that you may prosper" (3:10).

3. The Prohibition of *Riba* in the *Qur'an*

The prohibition of *riba* in *al-Qur'an* developed gradually and appeared in four revelations. The first revelation was revealed in Makkah before the prohibition of *riba* for which the verse paved the way. It says:

"And whatever you lay out with the people in order to obtain an increased return, this increases you nothing with Allah, but whatever you give in alms, seeking Allah's pleasure, it is those who receive multiplied recompense", [Chapter *al-Rum* (The Romans) 39].

he second revelation was revealed in Madinah, which mentions *riba:*

"Because of the sinfulness of the Jews, We have forbidden to them certain good things that were permitted to them, and for their hindering many from Allah's Way. And for their taking *riba,* though they were forbidden, and that they devoured people's wealth in falsehood, and We have prepared for the unbelievers among them a grievous chastisement" [*Al-Nisa`* (Women), 160-161].

This revelation created some misunderstanding among the scholars as to whether the prohibition is directed to Muslims or to the Jews in Madinah. The argument that the prohibition is directed to Muslims rather than the Jews seems to be stronger as because the discontentment with *riba* first occurred while Prophet Muhammad (pbuh) was still in Makkah and there were very few Jews in Madinah at that time. Besides, the Jews in Madinah were mostly involved in the agricultural sector and not in the commercial sector.

An express of prohibition follows in Chapter *'Al `Imran* (The Family of Imran), which mentions *riba* and bans it for the first time: "O you who believe!

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Do not devour *riba* multiplying it over, and keep your duty to Allah that you may prosper" [3:130].

This was the first verse revealed in Medina to impose a ban on *riba.* In interpreting this verse, the exegetes agreed that expression 'multiplying it over' does not restrict the ban but expresses *riba* which people were accustomed to practise, assuming that this matter of multiples of multiples is no more than a description of state of affairs and not a condition relevant to the imposition.[8]

The prohibition of *riba* was intensified in Chapter *al-Baqarah* (The Heifer). The verses in question, the last to be revealed in Madinah concerning the prohibition of *riba* reads as follows:

"Those who devour *riba* will not stand except as one whom Satan has driven to madness by his touch will stand. That is because they say: 'Trading is like *riba*', and Allah has allowed trading and forbidden *riba.* So to whoever takes the admonition from his Lord, then he desists, he shall be pardoned for the past, and his affair is committed to Allah, but whoever reverts, those are the inhabitants of the Fire, to dwell therein forever. Allah will deprive *riba* of all blessing, and will give increase for deeds of charity; for Allah does not love any ungrateful sinner. Surely those who believe and do righteous deeds and establish prayer and pay alms, they shall have their reward with their Lord, and they shall have no fear, nor shall they sorrow. O you who believe! Keep your duty to Allah, and relinquish whatever remains from *riba* if you are indeed believers. But you do not, then be warned of a war from Allah and His Messenger, yet if you repent you shall have your capital fairly. And if the debtor is in difficulty grant him time until it is easier for him to repay, but if you are able, write off the debt as an act of charity, it would be better for you, if only you knew. And guard yourself against a Day in which you will be brought back to Allah, then every soul shall be recompensed in all fairness for what it has earned, and none shall be dealt with unjustly". [2:275-281]

In these verses *riba* is severely condemned and prohibited in the strongest possible terms. As instructed by *al-Qur'an* (in verse 280), creditors are urged to deal justly and fairly with debtors. In the event of debtors unable to pay their debt, the creditors are asked: (a) to give up even for claims arising out of the past on account of *riba,* (b) to give time for payment of principal if a debtor is in financial difficulties or, (c) to write off the debt altogether as an act of charity.

8. Qutb, Sayyid, *Fi Zilal* Al-Qur'an, Beirut, 1997, p.60.

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Thus, the verses mentioning *riba* show that all unlawful accumulation of wealth at the expense of others is condemned, and many different practices either by individuals or nations are covered by this ban. The principle is that any profit that human beings seek should be through their own exertions and not through the exploitation of others. *Al-Qur'an* regards *riba* as a practice of unbelievers, it demands, as a test of belief, that it should be abandoned.

The above-mentioned verses prohibiting *riba* make no distinction between production and consumption loans. However, it may be suggested that this was because at that time loans were taken only for consumption purposes. Though much more research is needed, a good deal of documentary evidence has been adduced in recent years to show that loans for production purposes did exist during the time of the Prophet.[9]

It has been shown that Arab traders at that time had close ties with the political and economic life of Middle Eastern countries where loans for production purposes had been common for hundreds of years. Historical records also show that on account of political conflicts between Rome and Persia, Arab traders of Makkah often worked as the *via media* for Roman trade with China, Indonesia, India, and Eastern Africa in the period close to the time of the Prophet. It is difficult to imagine, therefore, that loans for production purposes were absent in such conditions. Most of the commentaries on above mentioned verses relating to *riba* that have come down to us from scholars close to the time of the Prophet also make it explicit that loan transactions for business purposes involving *riba* did exist at that time.[10]

However, the absolute prohibition of *riba* in *al-Qur'an* is a command to establish an economic system from which all forms of exploitation are eliminated, in particular, the injustice of the financier being assured of a positive return without sharing the risk, while the entrepreneurs, in spite of their management and hard work, is not assured of such a positive return. The prohibition of *riba* in *al-Qur'an* is therefore, a way to establish equity between the financiers and entrepreneurs. So, any attempt to treat the prohibition of *riba* as an isolated religious injunction and not as an integral part of the Islamic economic order with its overall ethos, goals and values is bound to create confusion.

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9. Al-Afghani, Sa`id, *'Aswaq al-`Arab Fi al-Jahiliyyah Wa al-Islam*, Beirut, 2nd ed., 1975, p.15.
10. See in this connection, Sayyid Qutb, *Tafsir 'Ayat al-Riba*, Beirut: Dar al-Buhuth al-`Ilmiyyah, undated.

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4. The Prohibition of *Riba* in the *Sunnah*

Al-Qur'an neither defines *riba* nor provides any detailed explanation about *riba.* The *hadiths* that deals with the subject are numerous, although sometimes the content of a particular *hadith* is slightly different from one narrator to another. So it will be sufficient to mention only some of them. The term *'riba'* is considered by *al-Qur'an* as *'riba al-nasi'ah"*[11] or delayed payment interest whereas the *hadith* explains *'riba al-fadl'* or increase interest.[12] The former refers to the time allowed to the borrower to repay the loan in return for addition or financial increment whether it is a fixed or a variable percentage of the principal, an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition for the loan. While the latter occurs when an item, available at the place of sale, is sold for an item, which is not available at the place of sale, even if the two items are exchanged for equal quantity in order to avoid increase interest. Equality in exchange of both items is not a condition here, owing to their dissimilarity. In practice, the *hadith* discusses both types of *riba* - *al-nasi'ah* and *al-fadl* - but its role in regard to the first kind is one of enforcement of Allah's commandment and assertion of what is banned.

The view on *riba al-fadl* is laid down in a number of *hadiths,* but the following is the most famous and accepted one, "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, the like for the like, hand to hand (i.e., immediate sale), (but) if the kinds differ, then sell as you may like it from hand to hand".[13]

Another *hadith* is one narrated by Abu Sa`id al-Khudri from the Prophet who said: "Do not sell gold for gold, except when it is like for like, and do not increase one over the other; and do not sell silver for silver except when it is like for like, and do not increase one over the other; and do not sell what is away (from among these) for what is ready".[14]

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11. *'Nasi'ah'* is elated to the verb *nasa'a,* meaning to 'postpone', 'defer' or 'wait'.
12. The first time the Prophet dealt with *riba al-fadl* was when the tribe of Thaqif claimed repayment of its debt from the tribe of Mughira, a debt which remained from the pre-Islamic *riba.* The Prophet told the Thaqif that the Qur'an had ordered the abandonment of the remnants of pre-Islamic *riba.* The second time the Prophet dealt with the subject during his farewell pilgrimage. He said, "Every *riba* is abolished, and the first *riba* I abolish is ours-`Abbas Ibn `Abd al- Muttalib's *riba* - (i.e. the Prophet's relatives' *riba*). It is all abolished". See, Ahmad al-Baihaqi, *Al-Sunan al-Kubra,* Haidarabad, 1854, Chapter: 5, Hadith: 275.
13. Prominent Muslim jurists - Ahmad, Bukhari, Muslims and others related this *hadith.*
14. Bukhari, op. cit., Kitab al-Buyu`, Bab Bai` al-Fiddah bi al-Fiddah; also, *Sahih Muslim, Sunan al- Tirmidhi, Sunan al-Nasa'i* and *Musnad* of Ahmad.

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Therefore, if gold, silver, wheat, barley, dates and salt are exchanged against themselves they should be exchanged on the spot and be equal and alike. Of the six specified commodities, gold and silver unmistakably represent commodity money whereas the other four represent staple food items. Muslim jurists have debated the question of whether *riba al-fadl* is confined only to these six items or if it can be generalised to include other commodities. Given the wide use of gold and silver as commodity money, the general conclusion is that all commodities used as medium of exchange enter the field of *riba al-fadl.* With respect to the other four items there is a difference of opinion among the Muslim scholars. However, the important point is, firstly that these considerable differences are a normal phenomenon in Islamic jurisprudence; and secondly, and much more importantly, in spite of these differences, the opinion of the majority of Muslim jurists is by no means likely to justify *riba al-nasi'ah* or *riba al-fadl.* All Muslim jurists are unanimous in their condemnation of *riba* and are backed by both *al-Qur'an* and the *hadith,* the main sources of the Islamic *Shari`ah.* A legal ruling issued by the Islamic scholars in the second conference of Islamic Researches Academy in 1965 practically and unequivocally, provides strong support for the complete agreement on the ban on *riba.*[15]

Later, the *Fiqh* Academy of the Organaisation of Islamic Conference (OIC) supported the restrictive interpretation of *riba*, which had been adopted by the early jurists, condemning all interest-bearing transactions as void.[16]

5. Modernists Versus Conservatives' Views[17] on *Riba*

The origin of one part of the controversy between the modernists and the conservatives' views on *riba* dates back to early Islam, and it revolves around the question of what kind of *riba* the Qur'an really prohibited. Was it *riba al-*

15. Ahmed, Osman Babikir, *The Contribution of Islamic Banking to Economic Development: The Case of The Sudan,* Ph.D. Thesis: Department of Economics, The University of Durham, 1990, p.32.
16. Al-Omar, Fuad and Abdel-Haq Mohammed, *Islamic Banking: Theory, Practice and Challenges*, London: Zed Books Ltd., 1996, p.8.
17. The term 'modernists' is referred to in this study some contemporary Muslim scholars like Fazlur Rahman (1964), Muhammad Asad (1984), Sa`id al-Najjar (1989), Sayyid Tantawi (1997) and others for whom it appears that prohibition of *riba* is due to the exploitation of the needy, rather than the concept of the interest rate itself. Keeping this in view, many of them attempt to differentiate between various forms of *riba* practised under the conventional banking system, advocating the lawfulness of some and rejecting others. While conservatives' views are referred to the traditional interpretation of *riba* which stresses on the point that any kind of interest falls under the banning of *riba.*

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nasi'ah, which involves lending and borrowing, or *riba al-fadl,* which involves buying and selling?[18] One view is that in the early period of Islam, the Qur'anic injunctions against *riba* was understood to apply to loans in money and food, and anything beyond that is accepted to be later development.[19] Another authoritative view is that *riba al-fadl* has its origin in the *hadith,* and concludes that no attempt to define *riba* on the basis of the *hadith* has really been successful.[20] A more recent contribution claims that *riba* in both sales and loans existed before Islam, and *al-Qur'an* clearly implies that. Furthermore, the *hadith,* and the juristic formulations, therefore, are elaborations and extensions of the basic Qur'anic concept. It is also argued that *riba al-fadl* is merely a consequence of *riba al-nasi'ah,* since money can always be transformed into commodities.[21]

The controversy in its contemporary form turns on the definition of *riba* itself, whether the *riba* merely attached to profits obtained through interest-bearing loans involving exploitation of the economically weak by the strong and resourceful, or through all kinds of loan irrespective of the purposes; whether the prohibition is the form of *riba* practised in the pre-Islamic period; whether it prohibits usury but not interest or it prohibits the charging of interest altogether; whether it relates to loans for consumption or investment in a business venture; whether it prohibits nominal or real interest; whether the prohibition applies to compound or simple interest; and whether the ban relates to the borrower as individual or institution. According to the modernists' trend towards *riba,*[22] extra charges are permitted where they are used:

1. for the purposes other than exploiting the weak people of the community by the strong;
2. for loans that are similar to what were practised in the pre-Islamic period;
3. for the present form of interest-based banking transactions but not for usurious transactions transactions;
4. for business investment but not for consumption loans;
5. for the loss suffered by the creditor due to inflation;

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18. Haque, Zia-ul, *Islam and Feudalism: The Moral Economy of Usury, Interest and Profit,* op.cit, pp.67-114
19. Schacht, Joseph, *An Introduction to Islamic Law,* Oxford, 1964, p.147
20. Rahman, Fazlur, "Riba and Interest", *Islamic Studies,* No.1, March 1964, p.30
21. Haque, Zia-ul, *Islam and Feudalism: The Moral Economy of Usury, Interest and Profit,* op. cit., p.102.
22. Rahman, Fazlur, *Islam and Modernity: Transformation of an Intellectual Tradition,* Chicago: The University of Chicago Press, 1982, pp.30-33.

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6. for simple interest but not for compound interest; and
7. for institutional credit.

As opposed to this rather pragmatic viewpoint, the conservatives view forbids every form of fixed and predetermined interest.[23] They regard the levy of any fixed amount in excess of the principal lent prohibited by *al-Qur'an.* According to this view, since interest, however exorbitant or reasonable, is additional to the principal borrowed, it is a form of *riba* and therefore does not comply with *al-Qur'an.* Thus, *riba,* is defined as any predetermined fixed return for the use of money. Three main reasons are stated for strict condemnation of *riba* in Islam:[24]

1. *Riba* reinforces the tendency for wealth to accumulate in the hands of a few, and thereby diminishes human beings concern their fellow men.
2. Islam does not allow gain from financial activity unless the beneficiary is also subject to the risk of potential loss; the legal guarantee of at least nominal interest would be viewed as guaranteed gain.
3. Islam regards the accumulation of wealth through interest or usury as selfish compared with accumulation through hard work and personal activity.

Several modernists and conservatives' views in regard to the *riba* along with their arguments are discussed below:

5.1. *Riba* is prohibited for exploitation and injustice

Modernists tend to emphasise the moral aspect of the prohibition of *riba,* and argue that the rationale for this prohibition as formulated in *al-Qur'an* was injustice and hardship.[25] They also find some support for their views in the works of some early scholars like Imam Razi[26] and Ibn Qayyim[27] for whom it appears that what is prohibited is the exploitation of the needy, rather than the interest itself. Many writers of this trend attempt to differentiate between

23. Conservative views are expressed by among others Qureshi, *Islam and the Theory of Interest,* Lahore, 1991, p.100; Mannan, *Islamic Economics: Theory and Practice,* Delhi, 1980, p.218.
24. Karsten, Ingo, *Islam and Financial Intermediation,* Washington D.C., IMF Staff Papers, 1982, p.111.
25. Al-Qur'an, 2:279.
26. Al-Razi, Fakhr al-Din, *Al-Tafsir al-Kabir,* vol.7, Tehran, undated, p.94.
27. Ibn al-Qayyim, Muhammad, *A`lam al-Muwaqqi`in 'An Rabbil `Alamin,* vol.2, Cairo, 1955, p.157.

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various forms of interest practised under the conventional banking system, advocating the lawfulness of some, while rejecting others.[28]

As opposed to this view, it might be argued that the rationale for the prohibition of *riba* in *al-Qur'an* is to establish an economic system from which all forms of injustice and exploitation are eliminated, in particular, the injustice of the financiers being assured of a positive return without putting any effort or sharing in the risk,[29] while the entrepreneurs, in spite of their management and hard work, is not assured of such a positive return. The prohibition of *riba* is therefore a way to establish justice between the lenders and borrowers.[30]

5.2. What is prohibited is pre-Islamic *Riba*

It has been claimed by some modernists that what is prohibited in *al-Qur'an* is the form of *riba* referred to the then prevailing practice of lending in the pre-Islamic era. Charging *riba* is found to be peculiar to pre-Islamic times and Arab territory. The debtor had to pay a fixed amount above the principal to the creditor for the use of money loaned for a certain period. This additional amount, which could be more than double the principal sum due, was prohibited by the Qur'anic injunction. According to this view, the first increase in a termed loan is lawful, but if, at maturity date, it were decided to postpone that maturity date against a further increase this would be prohibited. This view is apparently based on the reports came in *tafsir* (the commentary on *al-Qur'an)* of Ibn Jarir al-Tabari in relation to how *riba* was practised in the pre-Islamic period.[31] However, it does not explicitly and openly suggest that *riba* is acceptable without any qualification.

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28. Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking,* Cambridge, 1992, p.34
29. So far inflation is concerned; Islam unequivocally stresses justice in all measures of value. Hence, inflation, which brings continuous and significant erosion in the real value of money, is not compatible with the Islamic emphasis on balance and equilibrium. However, it was suggested that in the current world-wide inflationary climate, the Islamic imperative of socio-economic justice could be satisfied by indexation, or monetary correction, of all incomes and monetary assets. This proposal was given by Dr. Sultan Abu 'Ali in a seminar organised by the King Abdul Aziz University, Jeddah in October 1978, and was followed by a heated discussion by a committee of economists and Shari`ah scholars. For a detailed discussion in this regard, see Mohammad Ariff (ed.), *Monetary and Fiscal Economics of Islam,* Jeddah, 1982, pp.145- 186. Also Rafiq Y. Al-Masri, *Al-Jami` Fi 'Usul al-Riba,* Damascus, 1991, pp.237-239
30. Al-Omar, Fuad and Abdel-Haq Mohammed, *Islamic Banking: Theory, Practice and Challenges,* op. cit., p.9
31. Al-Tabari, Muhammad Ibn Jarir, *Jami` al-Bayan Fi Tafsir* Al-Qur'an, vol.6, Beirut, 4th ed., 1980, p.27

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The critics of this view assert that the verse 130 of the chapter 3 in *al-Qur'an* is the first stage of the prohibition of *riba,* and that the term *'ad`afan muda`afatan'* (doubling and redoubling i.e., compound) mentioned in the verse is only explaining what the Arabs practiced, not that *riba* charged would be lawful if the amount were not doubled. Moreover, in their view, the last *riba*-related verses available in the chapter 2 (275-8) have clearly indicated that any increase over and above the principal should be *riba,* and as such it is unlawful. In this opinion, the later revealed verse overrides the previous verse. This applies to all kinds of *riba* – simple, compound, fixed or variable.[32] This view is also confirmed by an authentic *hadith* reported by al-Tabari and other expounders of the Qur'anic Exegesis where the Prophet says:

"Allah has decreed that there should be no *riba;* and each and every *riba (Kullu riban)* that was in period of *Jahiliyyah* (pre-Islamic) is under my two feet and I am making a beginning by remitting the amount of *riba* that my uncle Abbas has to receive".[33]

5.3. Interest Versus Usury

Another controversy on *riba* is due to the Qur'anic injunctions against *riba* whether it is 'interest', or 'usury'.34 Modernists asserted that the *riba* which is prohibited, and on which there is consensus of opinion, is 'interest' when it equals the principal or more; but not 'usury'. The different interpretations of this divine prohibition is traceable to the time of 'Umar Ibn al-Khattab in the first century of the Islamic period, who was quoted as saying:

"The last to be revealed was the verse of usury and the Prophet demised without having made a clear pronouncement on the question of usury. Therefore, give up usury and anything resembling it".[35]

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32. Saeed, Abdullah, *Islamic Banking and the Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation,* Leiden, 1996, p.43.

33. Ibn Kathir, 'Isma`il, *Tafsir al-*Qur'an *al-'Azim,* 1982, vol.1, pp.327-331 with reference from *Muslim* and *Abu Dawud;* Al-Tabari, Ibn Jarir, *Jami` al-Bayan,* vol. 6, op. cit., p.27; Al-Jassas, Ahmad, *Ahkam al- Qur`an,* vol.1, undated, p.558.

34. See A. S. Hornby, *Oxford Advanced Learner's Dictionary,* New York, 2000. p.1433. It defines 'Usury' as 'the practice of lending money to people at unfairly high rate of interest'. So, an excessive rate especially above the rate fixed by the Government is a usurious rate of interest.

35. Ahmad, Al-Imam, *Al-Musnad,* 'Bab al-Riba', vol.2, p.239; Ibn Majah, *Al-Sunan,* Kitab al-Tijarah, vol.2, p.764.

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It should be noted that in this translation the word 'usury' is used rather than 'interest', though it is not clear whether 'Umar, by saying this, did mean 'usury' or 'interest' by *riba.* However, some modern English commentators of *al-Qur'an*, like Muhammad Asad,[36] have used the term 'usury' for *riba.* This interpretation comes close to the argument that a modern capitalist would make in favour of charging a positive rate of interest on a business loan under uncertainty with varying degrees of risk. Abdullah Yusuf Ali, who also translates *riba* as 'usury' in his brilliant English translation and commentary on the Qur'an, gives the most clear-cut case in favour of interest within the structure of modern credit and banking systems. He states:

"The definition I would accept would be: undue profit made, not in the way of legitimate trade, out of loans of gold and silver, and necessary articles of food, such as wheat, barley, dates, and salt (according to the list mentioned by the Holy Apostle himself). My definition would include profiteering of all kinds, but exclude economic credit, the creature of modern banking and finance".[37]

This position, however, is rejected by several modern writers, like Mawdudi,[38] on the subject of *riba.* These writers generally interpret *riba* to mean 'interest' rather than 'usury'.[39] They also argue that neither in Judaism nor in Christianity, had the distinction between the two terms - 'interest' and 'usury' - been recognised, let alone accommodated, until the Renaissance in Europe.[40] In Islam also there is no room for arguing that *riba* refers to 'usury' and not 'interest', because the nature of its prohibition is strict, absolute and unambiguous.[41] In additions, they refer to several *hadiths* in support of their view that the Prophet prohibited the taking of even a small gift, service or

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36. Asad, Muhammad, *The Message of The Qur'an,* Gibraltar, 1984, pp.61-62.
37. Ali, A. Yusuf, *The Holy Qur'an: Text, Translation and Commentary,* Lahore, 1975, p.111, n.324.
38. Mawdudi, Abul 'A`ala, *Towards Understanding the Qur'an,* Leicester, 1988. pp.213-286.
39. See, for example, Shaikh M. Ahmad, *Economics of Islam: A Comparative Study,* 2nd ed., Lahore, 1958; Anwar Iqbal Qureshi, *Islam and the Theory of Interest,* op.cit., M. Nejatullah Siddiqui, *Banking Without Interest,* Leicester, 1997; and S. A. Siddiqui, *Public Finance in Islam,* Lahore, 1962.
40. Al-Masri, Rafiq Yunis, *Masrif al-Tanmiyah al-Islami,* op.cit., p.81.
41. Al-Jaziri, `Abd al-Rahman, *Kitab al-Fiqh `ala al-Madhahib al-'Arba`ah,* op.cit., p.245.
42. See for instance, the *hadith* narrated by Anas Ibn Malik- a companion of the Prophet- on the authority of al-Baihaqi in his *al-Sunan*: The Prophet said: "When one of you grants a loan and the borrower offers him a dish, he should not accept it; and if the borrower offers a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favours mutually.

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favour as a condition for the loan, in addition to the principal.[42]" Defending 'Umar's interpretation of *riba* they say that his words can, by no means, be interpreted to have narrowed down the prohibition of *riba* where his utterance "give up usury and anything resembling it" is in conformity with another saying of the Prophet "Leave what is doubtful in favour of what is not doubtful."[43] The degree of care in such circumstances, as they say, is more enhanced especially in face of the grave nature of *riba*, which is condemned outright by the Prophet.[44] They rejected Abdullah Yusuf Ali's definition arguing that *al-Qur'an* does describe one form of *riba* as undue increase, but *riba* was never defined as undue profit, neither in *al-Qur'an,* nor by the Prophet. According to their view, *riba* includes any material benefit above the capital sum lent, which a lender may derive from a borrower. Banks do not lend money for blessings, nor do they charge interest for the purpose of recovering losses sustained through inflation. They do it for profit. So, "economic credit, the creature of modern banking and finance" as they claim, is most definitely *riba,* regardless of whether the interest-rate is high or low or compound or simple. Thus, according to these writers, any attempt to differentiate between 'interest' and 'usury' in order to allow the former is an alien concept to the *Shari`ah.*

5.3. Consumption Loans Versus Investment Loans

Some modernists tend to differentiate between 'consumption loans' and 'investment loans', and argue that *riba* on consumption loans is unlawful, but it is lawful on investment or production loans.[45] The basis of the Qur'anic injunctions against *riba,* as they claim, is that those who borrow are assumed to be in need of such loans for purposes of maintaining some minimum standard of living. Therefore, *al-Qur'an* intended to prevent the exploitation of the economically weak people of the society, as well as to discourage excessive consumption. On the other hand, in the case of loans for business investment it is argued that the basic reason for the banning of *riba* is that it generates income

43. Bukhari, *Sahih al-Bukhari,* Kitab al-Buyu`, vol.3, p.4; Al-Darimi, *Al-Sunan,* Kitab al-Buyu`, p.337.

44. Musleh-Uddin, Mohammad, *Insurance and Islamic Law,* New Delhi, 1982, p.96.

45. See for instance, Muhammad Abu Zahra, *Buhuth Fi al-Riba,* Kuwait: Dar al-Buhuth al-`Ilmiyyah, 1970, p.52.

46. Noorzoy, M. Siddieq, "Islamic Laws on Riba (Interest) and their Economic Implications", *International Journal of Middle East Studies,* vol.14, 1982, p.4.

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without labour on the part of the lender.[46] They present some historical records to support this view as saying that in the early years of Islam borrowing for trade or commercial purposes was not practised, rather sharing and partnership were the only ways to increase the stock of capital. Furthermore, it is argued that seventh century Arabia knew mostly loans for consumption or distress purposes and not productive ventures. Therefore, *riba* charge on business loans is not forbidden in Islam.

On the opposite side of this view, orthodox writers, however, go to some length to disprove this contention. They argue that even if some kind of *riba*-based transactions were not practised at that time when this rule was made, it is still subject to that same rule. To support their view, they reason that when Qur'anic injunction came against *khamr* or alcoholic beverage, many of the drinks which are common today did not exist. Yet every one agrees that they are still prohibited. In addition, proponents of this view, questioning the historical evidence mentioned by the supporters of the modernists' view, present some other historical evidence to show that commercial loans were indeed common in the early Islamic society.[47] In favour of this view, an Egyptian scholar Shaikh Abu Zahrah pointed out that:

"There is absolutely no evidence to support the contention that the *riba* of *al-Jahiliyyah* (pre-Islamic *riba*) was on consumption loans. In fact the loans for which a research scholar finds support in history are production loans. The circumstances of the Arabs, the position of Makkah and the trade of Quraish, all lend support to the assertion that the loans were for production and not consumption purposes".[48]

The proponents of this conservative view also claim that in applying the Qur'anic injunctions against *riba* the Prophet himself did not make any distinction between consumption and production loans. Hence, according to this view, the prohibition of *riba* is deemed applicable to both the categories, and it is irrelevant whether it relates to loans for consumption or productive purposes.[49]

5.4. Nominal Versus Real Rate of Interest

47. Habibi, Nader, *The Economic Consequences of the Interest-Free Islamic Banking Systems*, Ph.D.Thesis: Michigan State University, 1987, pp.14-15.
48. See M. Abu Zahrah, *Buhuth Fi al-Riba*, op. cit., pp.53-54.
49. Huq, M. Azizul, "Prohibition of Interest and Some Common Misgivings", in Ataul Hoque (ed.), *Readings in Islamic Banking*, Dhaka, 1987, pp. 42-43.

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Another controversy between modernist and conservative views on *riba* turns around its interpretation under inflationary and deflationary conditions. Modernists contend that although the Prophet was aware of the effect of inflation,50 there is no *hadith* on *riba* that considers the effects of inflation and deflation on loan transactions. In fact, Inflation reduces the real purchasing power of money, whereas deflation increases its purchasing power. Therefore, the proponents of modernists view suggest that in an inflationary economy, an interest rate which will correct the loss suffered by the creditor due to inflation could be justified by allowing an increase or interest to compensate for the loss of purchasing power of money. In support of this view, they argue that by means of the indexation of loans, i.e., by allowing interest up to the ceiling of inflation no real predetermined benefit is allowed to the lenders; rather this simply allows the lenders to retain the real value of their monetary asset intact. Inflation erodes the monetary asset of the lenders for no fault of their own.[51] Although Islam urges justice to the borrowers it does not approve of injustice to the lenders. Inflation undoubtedly does injustice to the *riba*-free lenders by eroding the real value of Benevolent Loan – a loan extended without either interest or profit sharing.[52] The outright prohibition of nominal interest indeed increases to cater for inflation would act as a disincentive to lend money which will have negative economic ramifications. So, it has been suggested that suitable interest and discount rate be devised to neutralise the effects of rising and falling prices.

The opponents of this view have, however, dismissed the arguments they set out on several grounds, maintaining that all kinds of increase related to loans transactions irrespective of nominal or real rate of interest, would be contrary to the Qur'anic injunctions against *riba*, and must be accepted as they stand. It is argued that the use of interest to neutralise inflation would tantamount to using a bigger 'evil' to fight a smaller one, and Islam does not encourage the introduction of new 'evils' to fight existing ones.[53] The general verdict of the Muslim jurists has so far been against indexation of loans as it involves an assured positive return on loans even though it is only in monetary and not real

50. Ali, S. A., *Economic Foundations of Islam,* Lahore, 1964, pp.22-23.
51. Huq, M. Azizul, "Prohibition of Interest and Some Common Misgivings", in Ataul Hoque (ed.), *op.cit.,* pp.45-46.
52. Chapra, M. Umer, *Towards a Just Monetary System,* op.cit., p.40.
53. Huq, M. Azizul, "Prohibition of Interest and Some Common Misgivings", in Ataul Hoque (ed.), op.cit., p.46.
54. Chapra, M. Umer, *Towards a Just Monetary System,* op.cit., p.40.

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terms.[54] Hence, the question of nominal or real rate of interest does not arise; rather being *riba* any increase or interest should be considered unlawful. Moreover, the best conformity to the norm of socio-economic justice emphesised by Islam is price stability and not indexation of loans and assets.

5.5. Compound Versus Simple Interest

The proponents of modernists view towards *riba* say that its prohibition applies to compound and not to simple interest. In support of their argument they put forward the Qur'anic verse wherein it has been enjoined upon the believer not to devour usury, doubling and quadrupling. Besides other contention the opponents refer them to the Qur'anic verse which was revealed after the verse referred to by the modernists and which contains the words "And if you repent, then you have your principal (without interest)."[55] This verse clearly states that no more than principal is allowed to the creditor, which is further supported by the Prophet's declaration in his sermon on the occasion of the Farewell pilgrimage; "All *riba* is abolished, but you have your capital, wrong not and you shall not be wronged".[56] They contend that the same words "Wrong not and you shall not be wronged" appeared first in the Qur'anic verse (2:279) and then repeated in Prophet's saying to point out that neither would the debtor be tyranised over by being compelled to pay anything in addition to the principal nor the creditor suffers a loss in his or her principal.[57] Thus, no question of simple or compound interest can arise.

5.6. Individuals Versus Institutions

Some modernists contend that the larger financial institutions like banks and other institutions as exist today were not available at the time of the Prophet and hence bank interest and other institutional interest does not cover the prohibition of *riba,* the prohibition does cover only individuals. It is also viewed that taking *riba* by an individual from such institutions should not be prohibited because an individual cannot exploit a larger organisation like a bank, as they claim.[58]

55. Al-Qur'an, 2:279.
56. Ibn Hisham, Abu Muhammad Abdul Malik, *Al-Sirah al-Nabawiyyah,* vol. 2, Beirut, 1996, p.603.
57. Al-Tabari, Muhammad Ibn Jarir, *Jami` al-Bayan Fi Tafsir* Al-Qur'an, op.cit., 1980, p.28.
58. Khan, Abdul Jabbar, "Divine Banking System", *Journal of Islamic Banking and Finance,* winter 1984, pp.30-32.

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As opposed to this view, it has been argued that if a modern bank is compared with individuals it is found as an institution, which borrows to lend. Thus, banks are institutions act as borrowers and lenders of funds, and in the process of borrowing and lending they receive and pay *riba*. The Qur'anic prohibition of *riba* is general in nature having universal application as it does not make any distinction between an institution and an individual in this regard. So, giving and taking *riba* by individuals or institutions fall under the same Qur'anic injunctions without any exemption. Furthermore, business institutions in present form though not necessarily were prevalent at that time, some of these business houses used to practise *riba* as a part of their business. The prohibition of *riba* was applied to them as well.

In spite of these varying opinions, the modernists so far have failed to have much impact on contemporary debate on *riba*. Their views towards prohibition of *riba* have been met by some neo-revivalist critics, like Sayyid Qutb[59] and Mawdudi [60] with both economic and scriptural counter arguments, and their position has been undermined as they could not present a consistent theory of *riba* on the basis of the rationale of prohibition specified in *al-Qur'an*. Furthermore, the global rise of Islamic banking institutions inspired by neo-revivalist thinking on the issue of *riba*, which views that 'any interest is *riba*, and as such is prohibited.

6. Principles of Islamic Banking and Finance

Islam categorically prohibits its followers from dealings that involve *riba*.Yet Muslims need banking services as much as anyone and for many purposes: to finance new business ventures, to buy a house, to buy a car, to facilitate capital investment, to undertake trading activities, and to offer a safe place for savings. Muslims are not averse to legitimate profit and Islam encourages people to use money in Islamically legitimate ventures, not just to keep their funds idle. Keeping this in view, the hallmark of Islamic banking is the prohibition of *riba* or interest, and there is now a general consensus among Muslim economists that *riba* is not restricted to usury but encompasses interest as well. The principles of Islamic banking and finance enshrined from *al-Qur'an* and Prophetic *Sunnah* are quite simple and can be summed up as follows:[61]

59. For a survey of arguments on interest see, Sayyid Qutb, *Tafsir 'Ayat al-Riba*, op.cit., also *Fi Zilal al- Qur'an*, op.cit

60. For more details see, Abul 'A`ala Mawdudi, *Al-Riba*, trans. Muhammad `Asim al-Haddad, Beirut, 1970

61. Nida'ul Islam Magazine, "Principles of Islamic Banking", issue No.10, November-December 1995.

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6.1. Any predetermined payment over and above the actual amount of principal is prohibited.

Islam allows only one kind of loan and that is *qard hassan* (literally known as benevolent loan), whereby the lender does not charge any interest or additional amount over the money lent. Traditional Muslim jurists have construed this principle so strictly that, according to one commentator "this prohibition applies to any advantage or benefits that the lender might secure out of the *qard* or loan such as riding the borrower's mule, eating at his/her table, or even taking advantage of the shade of his/her wall".[62] The principle derived from the quotation emphasises that associated or indirect benefits are prohibited.

6.2. The lender must share in the profits or losses arising out of the enterprise for which the money was lent

Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business instead of becoming creditors. As defined in the *Shari`ah*, Islamic finance is based on the premise that the provider of capital and the user of capital should equally share the risk of business ventures, whether those are industries, farms, service companies or simple trade deals. Translated into banking terms, the depositor, the bank and the borrower should all share the risks and the rewards of financing business ventures. This is in sharp contrast to the interest-based commercial banking system, where all the pressure is on the borrower: who must pay back the loan, with the agreed interest, regardless of the success or failure of the bank financed venture.

The principle, which thereby emerges is that Islam encourages investments in order that the community may benefit. However, it is not willing to allow a loophole to exist for those who do not wish to invest and take risks but rather content with hoarding money or depositing money in a bank in return for receiving an increase on these funds for no risk (other than the bank becoming insolvent).

6.3. Making money from money is not Islamically acceptable

As Islam views money as a medium of exchange; a way of defining the value of a thing; it has no value in itself, and therefore should not be allowed to give rise to more money, via fixed interest payments, simply by being put in a bank or lent to someone else. The human effort, initiative, and risk involved in a

62. Al-Masri, Rafiq Yunis, *Al-Jami` Fi 'Usul al-Riba*, op. cit., 1991, p.256.

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productive venture are more important than the money used to finance it. Muslim jurists consider money as potential capital when it is invested in business. Accordingly, money advanced to a business as a loan is regarded as a debt of the business and not capital and, as such, it is not entitled to any return (i.e. interest). Muslims are encouraged to purchase and are discouraged from keeping money idle as such hoarding money is regarded unacceptable. In Islam, money represents purchasing power, therefore, cannot be used to make more purchasing power (money) without undergoing the intermediate step of it being used for the purchase of goods and services.

6.4. *Gharar* (deception) and *Maisir* (gambling) are also prohibited

The word *gharar* is sometimes interpreted as meaning 'uncertainty' rather than deception. With regard to *gharar,* Islamic Law is clear that it should not be present in contractual agreement. One cannot for example sell what one does not own, because this is regarded as a form of deception. Similarly, one cannot sell an item of uncertain quality, an unborn calf for example, since the buyer and the seller do not know exactly what it is that they are trading. As far as *maisir* is concerned, it is regarded in Islam as one form of injustice in the appropriation of others' wealth[63] and therefore has much in common with the concept of *riba.* The act of gambling, sometimes referred to betting on the occurrence of a future event, is prohibited and no reward accrues for the employment of spending of wealth that an individual may gain through means of gambling. Under this prohibition, any contract entered into, should be free from uncertainty, risk and speculation. Contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions.[64] Also, parties cannot predetermine a guaranteed profit. This is based on the principle of 'uncertain gains', which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal plus an amount to take into account inflation. The rationale behind the prohibition is the wish to protect the weak from exploitation. Therefore, options and futures are considered as unIslamic and so are forward foreign exchange transactions because rates are determined by interest differentials.

However, none of the above implies that a contract can be deemed invalid on the basis that the future outcome is not known. The future is always unknown

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63. Al-Qur'an, 2:219.
64. Ahmad, Abu Umar Faruq, "Legislations and Issues on Islamic Banking in Bangladesh", paper presented at the *First International Forum on Islamic Economics, Finance and Business for Young Scholars,* Langkawi, April 18-20, 2006.

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from man's point of view. But not knowing whether one shall make a profit as a result of entering into an investment contract is not the same as the lack of knowledge that exists where the subject matter of the investment contract itself is uncertain.[65]

A number of Islamic scholars disapprove the indexation of indebtedness to inflation and explain this prohibition within the framework of *qard hasan*. According to those scholars, the creditor advances the loan to win the blessings of Allah and expects to obtain the reward from Allah alone. However, there are number of transactions are treated as exceptions to the principle of *gharar* such as *bai` mu'ajjal* or sales with deferred payment, *bai` al-salam* sales with delivery of commodities and *ijarah* or leasing. However, there are legal requirements for the conclusion of these contracts to be organised in a way, which minimises risk.[66]

6.5. Investments should only support practices or products that are not forbidden or even discouraged by Islam.

Investments, according to the rules set by the *Shari`ah* should not be made for the products which are forbidden or even discouraged in Islam. Trade in alcohol, for example would not be financed by an Islamic bank; a real-estate loan could not be made for the construction of a casino; and the bank could not lend money to other banks at interest.

In summary, Islamic banking and finance stands for a system of equity-sharing and stake-taking. It operates on the principle of variable return based on actual productivity and performance of the projects, specific or general, individual or institutional, private or public. Economic cooperation may assume as many forms as may be desired, but the principle remains one of equity and reward sharing and not of simple loan-interest relationship as in the conventional banking system.

7. Islamic and Conventional Banking: A Comparison

Banking in the form in which it exists today is comparatively of recent origin. Before the advent of modern banking, direct finance, where the owner of capital deals directly with the user of capital, was the customary mode of transference of funds from savers to investors. With the progress of trade and

65. El Diwany, Tarek, *The Problem With Interest*, London, 1997, pp.143-144.

66. Ahmad, Abu Umar Faruq, "Problems of Islamic Banking in Bangladesh", paper presented at the Islamic Economics Research Bureau, Dhaka, Bangladesh, January 21, 2001.

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industry and increased financing requirements of productive enterprises, direct finance proved an inadequate mechanism for such transference and banks emerged on the scene to undertake financial intermediation between savers and investors. Furthermore, in modern times, they emerged as organisations that engage in any or all of the various functions of banking, i.e., receiving, collecting, transferring, paying, lending, investing, dealing, exchanging, and servicing money and claim to money both domestically and internationally.[67] In its more specific sense, however the term bank refers to institutions providing deposit facilities for the general public.

Perhaps the most striking feature in the structure of modern banking and finance is the use of credit institutions of accumulated wealth. Loans based on deposit funds provide financial support of the varied business and industrial enterprises in which men engage. Through credit, the accumulations of wealth, represented by bank deposits, have become a dynamic force in the modern world. Banking systems not only make the actual value of their deposit services available to society, but they have also multiplied the effective use of such funds by a system of discount and reserve which is of a comparatively recent origin.[68] Commercial banks perform all these functions and are considered to be the chief product of this age.

Therefore, the banks occupy very important position in a modern economy. Through the process of financial intermediation between savers and investors they exert immense employment and income generation effects, which ultimately help in economic advancement and social welfare. Another social welfare aspect of banks is through the provision of a return to the depositors, who are mainly small savers and include such weaker sections of the society such as widows, disabled orphans and the aged who could otherwise make no profitable use of their savings. Furthermore, the banks are manufactories of credit,[69] which serves the community and keeps the wheels of commerce and industry revolving. By offering opportunities for investment and safe custody of deposits, they stimulate the habit of saving, and discourage hoarding or the unproductive use of surplus wealth, thus promoting investment and the growth of capital. A wise banking policy may go a long way towards mitigating the shocks of an economic crisis, while a banking system, if badly constructed or badly handled, is capable of inflicting great harm on trade and industry and may even upset the whole economy.

67. Woelfel, Charles J.' *Encyclopedia of Banking and Finance,* Chicago, 1993, p.69.
68. *Ibid.*, p.151.
69. Kniffin, W.H., *How to Use Your Bank,* New York, 1937, p.31.

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The philosophical foundation of an Islamic financial system, where banking is the most developed part of this system goes beyond the interaction of factors of production and economic behaviour. Whereas the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social and religious dimensions, to enhance equality and fairness for the good of society as a whole. The similarities between the two systems are that in an Islamic system, banks, although controlled by the rules of the *Shari`ah,* essentially perform the same functions as those in a conventional system; that is, they act as administrators of the economy's payments system and as financial intermediaries.[70] They are needed in both systems for the same reason – for the exploitation of imperfections in financial markets. These imperfections include imperfect divisibility of financial claims, imperfect information, transaction costs of search and acquisition, diversification by the surplus and deficit units, and existence of expertise and economies of scale in monitoring transactions.[71] Financial intermediaries in an Islamic system which operate in accordance with the *Shari`ah* can reasonably be expected to exhibit economies of scale with respect to these costs, as do their counterparts in a conventional system. Just as in the latter system, the Islamic depository financial intermediaries transform the liabilities of business into a variety of obligations to suit the tastes and circumstances of the surplus units.

Due to the nature of their operation, on the other hand, there are a lot of differences between Islamic and conventional banking. Contrary to Islamic banking, conventional banking has been defined as "accepting, for the purpose of lending or investing, deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise".[72] The Islamic banking has been defined by the International Association of Islamic Banks (IAIB) as "The Islamic Bank basically implements a new banking concept in that it adheres strictly to the rules of Islamic *Shari`ah* in the fields of finance and other dealings. Moreover the Bank functioning in this way must reflect Islamic principles in real life. The Bank should work towards the establishment of an Islamic society. Hence, one of its

70. Ahmad, Abu Umar Faruq, *Islamic Banking in Bangladesh,* unpublished LLM Thesis: University of Western Sydney, Australia, 2003.
71. Iqbal, Zubair and Mirakhor, Abbas, *Islamic Banking,* Washington D.C., 1987, p.3.
72. Meenai, Anwar Ahmed, "Islamic Banking – Where Are We Going Wrong?" *New Horizon,* London, February 1998, p.3.

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primary goals is the deepening of religious spirit among the people."[73] Thus, it is evident that Islamic banking is different from conventional banking in terms of its mission and objectives. Therefore, obligations of Islamic banking toward society are greater than conventional banks, for the following reasons:

a) Islamic banking has certain philosophical missions to achieve. That is, since Allah is the Creator and Ultimate Owner of all resources, institutions or persons have a vicegerency role to play in society. Therefore, Islamic banks are not free to do as they wish; rather they have to integrate moral values with economic action.

b) To provide credit to those who have the talent and the expertise but cannot provide collateral to the conventional financial institutions, thereby strengthening the grass-root foundations of society; and

c) To create harmony in society based on the Islamic concept of sharing and caring in order to achieve economic, financial and political stability.

Conventional banking is essentially based on the debtor-creditor relationship between the depositors and the bank on the one hand, and between the borrowers and the bank on the other. Interest is considered to be the price of credit, reflecting the opportunity cost of money.

In Islamic banking, on the other hand, since a loan is considered to be given or taken, free of charge, to meet any contingency, the creditor should not take advantage of the borrower. When money is lent out on the basis of interest, more often it happens that it leads to some kind of injustice. The first Islamic principle underlying such kinds of transactions is that "Deal not unjustly, and you shall not be dealt with unjustly". [2:279]

Hence, commercial banking in an Islamic framework is not based on the debtor-creditor relationship.

The second principle regarding financial transactions in Islam is that there should not be any reward without taking a risk. This principle is applicable to both labor and capital. As no payment is allowed for labor, unless it is applied to work, there is no reward for capital unless it is exposed to business risk.[74]

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73. IAIB (The International Association of Islamic Banks), *Directory of Islamic Banks and Financial Institutions*, Jeddah, 2001.

74. Ahmad, Ausaf, "The Evaluation of Islamic Banking" in *Encyclopedia of Islamic Banking*, London, 1995, p.17.

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Thus, financial intermediation in an Islamic framework has been developed on the basis of the above two principles. Consequently financial relationships in Islam have been participatory in nature. The institution of interest is thus replaced by a principle of participation in profit and loss. That means a fixed rate of interest is replaced by a variable rate of return based on real economic activities.[75]

The distinct characteristics which provide Islamic banking with its main points of departure from the traditional interest-based commercial banking system are: (a) the Islamic banking system is essentially a profit and loss sharing system and not an interest banking system; and (b) investment (loans and advances in the conventional sense) under this system of banking must serve simultaneously both the benefit to the investor and the benefit of the local community as well.

Conventional banking	**Islamic banking**
1. The functions and operating modes of conventional banks are based on man-made principles.	1. The functions and operating modes of Islamic banks are based on the principles of Islamic *Shari`ah*.
2. The investor is assured of a predetermined rate of interest.	2. In contrast, it promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).
3. It aims at maximising profit without any restriction.	3. It also aims at maximising profit but subject to *Shari`ah* restrictions.
4. It does not deal with *zakah*.	4. In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to collect and distribute *zakah*.
5. Lending money and getting it back with interest is the fundamental function of the conventional banks.	5. Participation in partnership business is the fundamental function of the Islamic banks.
6. Its scope of activities is narrower when compared with an Islamic bank.	6. Its scope of activities is wider when compared with a conventional bank. It is, in effect, a multi-purpose institution.
7. It can charge additional money (compound rate of interest) in case of defaulters.	7. The Islamic banks have no provision to charge any extra money from the defaulters.

75. Mangla, I. Y., and Uppal, J. Y., "Islamic Banking: a Survey and Some Operational Issues", *Research in Financial Service*, vol. 2, 1990, pp.179,185,215.

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8. In it very often, bank's own interest becomes prominent. It makes no effort to ensure growth with equity.	8. It gives due importance to the public interest. Its ultimate aim is to ensure growth with equity.
9. For interest-based commercial banks, borrowing from the money market is relatively easier.	9. For Islamic banks, it is comparatively difficult to borrow money from the money market.
10. Since income from the advances is fixed, it gives little importance to developing expertise in project appraisal and evaluations.	10. Since it shares profit and loss, Islamic banks pay greater attention to developing project appraisal and evaluations.
11. Conventional banks give greater emphasis on credit-worthiness of the clients.	11. Islamic banks, on the other hand, give greater emphasis on the viability of the projects.
12. The status of a conventional bank, in relation to its clients, is that of creditor and debtors.	12. The status of Islamic bank in relation to its clients is that of partners, investors and trader.
13. A conventional bank has to guarantee all its deposits.	13. Strictly speaking, an Islamic bank cannot guarantee all its deposits.

The distinguishing features of the conventional banking and Islamic banking may be shown in terms of a box diagram as under.

In spite of the differences mentioned above between the Islamic and Conventional banks, both have something in common. Since Islamic banks do not rent money, and therefore do not charge interest, they have developed some investment techniques such as *bai` murabahah, musharakah* and *mudarabah* in order to invest money and make profit. In any of these techniques, profitability and installment of repayment are identified beforehand. In additions, some Islamic banks practice certain forms of leasing.[76] Many of the services handled by conventional banks and not related to interest, such as letters of credits, collections, foreign exchange, financial advising etc., are performed by Islamic banks. Some Muslim banks handle a large percentage of the Islamic bank's money in the commodities markets. If it is considered that banks and financial institutions measure their success in terms of Returns on Assets (ROA), the commodity transaction can be developed to achieve the goals of the parties

76. Ahmad, Abu Umar Faruq and Hassan, M. Kabir, "The Time Value of Money Concept in Islamic Finance", *American Journal of Islamic Social Sciences,* Herndon, USA, 23, 66-89.

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concerned – the Islamic bank, the conventional bank and the client of the conventional bank.[77]

8. Socioeconomic Consequences of Islamic Banking

The possible socioeconomic consequences of Islamic banking have been the subject matter of extended discussion in recent literature mainly on the basis of presumption that PLS modes of financing of Islamic banking will have a dominant role while the other modes would be used sparingly.[78] The major focus of discussion has been on the possible impact of Islamic banking on the following specific areas.

a) Impact on Saving and Investment

Concerns have been expressed in the literature on Islamic banking that adoption of an interest free system may have an adverse effect on saving because of increased uncertainty in the rate of return.[79] Muslim economists have argued that the actual income would depend on a number of factors such as the form of utility function and its risk properties, for example, the degree and the extent of risk aversion, the degree to which future is discounted, whether or not increased risk is compensated by higher return, and finally the income and substitution effects of increased uncertainty.[80] It has further been argued that the move to an Islamic interest free system, under certain conditions, could lead to increased rates of return on savings. Consequently, the increased level of uncertainty that could result from adoption of PLS based system could be compensated for by an increased rate of return on savings, leaving the overall level of savings unchanged or perhaps even leading to an increase in savings.[81]

As regard to the possible impact of Islamic banking on the level of investment, Muslim economists pointed out that both the demand for investment funds and

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77. Qasim, M. Qasim, "Islamic Banking, New Opportunities for Cooperation Between Western and Islamic Financial Institutions", in Butterworths (eds.), *Islamic Banking and Finance,* London, 1986, p.19-20.
78. Ahmad, Abu Umar Faruq and Hassan, M. Kabir, "Regulation and Performance of Islamic Banking in Bangladesh", *Thunderbird International Business Review,* 49, 2007.
79. Pryor, Fredric L., "The Islamic Economic System", in *Journal of Comparative Economics,* vol.19, 1985, p.197.
80. See, Zubair Iqbal, and Abbas Mirakhor, *Islamic Banking,* op. cit., pp.5.
81. Haque, Nadeem ul and Abbas Mirakhor, "Optimal Profit-Sharing Contracts and Investment in an Interest Free Economy", in Mohsin S. Khan and Abbas Mirakhor (eds.), *Theoretical Studies in Islamic Banking and Finance,* Houston, 1987, pp.141-166.

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the supply of investment funds are likely to show an increase consequent to replacement of interest based banking by PLS based banking. The demand for investment funds is likely to increase, as a fixed cost of capital is no longer required to be met as a part of the firm's profit calculations.[82] The marginal product of capital can, therefore, be taken up to the point where maximum profits are obtained without the constraint of meeting a fixed cost of capital. The supply of investment funds is likely to increase as PLS based bank are enable to undertake the financing of a larger number of risky projects on account of an enhanced risk absorbing capacity.[83]

b) Impact on the Rate and Pattern of Growth

Several scholars have pointed out that the expected favourable impact of PLS based banking on the level of investment would impart a distinct growth orientation to the economy.[84] The increased availability of risk capital under the Islamic system would promote technological innovation and experimentation, which would be another plus factor for growth. Islamic banks are also expected to influence the pattern of growth through appropriate selectivity in their financial operations to ensure that the process of growth is broad based and an optimal use of bank resources is made for purposes, which rank high in Islamic socioeconomic objectives.

c) Impact on Allocative Efficiency

Allocative efficiency of a financial system based on an Islamic framework of profit sharing has been an area of major concern in the literatures of many Muslim economists.[85] It has been pointed out that Islamic banking would be more efficient in allocating resources as compared to the conventional interest based system. This position is defended on the basis of the general proposition that any financial development that causes investment alternatives to be compared to one another, strictly based on their productivity and rates of return,

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82. Ahmad, Abu Umar Faruq, "Islamic Banking in Bangladesh: Legal and Regulatory Issues", paper presented at the Sixth Harvard University Forum on Islamic Finance, May 8-9, Cambridge, MA.

83. For some important contributions on the subject, see the study by Nadim ul Haque and Abbas Mirakhor mentioned in the preceding note and also M. Umer Chapra, *Towards a Just Monetary System,* op.cit., pp.111-117, and M. Nejatullah Siddiqi, *Issues in Islamic Banking,* op.cit., pp.88-89.

84. See, for example, M. Umer Chapra, *Towards a Just Monetary System*, op. cit., pp.122-125.

85. See, especially, M. Anas Zarqa, "Capital Allocation, Efficiency and Growth in an Interest-Free Islamic Economy", in *Journal of Economics and Administration,* 1982, pp.43-55.

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is bound to produce allocative improvements, and such a proposition is the cornerstone of the Islamic financial system. Muslim scholars emphasised in their writings that non-existence of interest does not mean that discounting as a technique of computing the present value of future cash flows cannot be used in an interest free economy. It has further been pointed out that interest rate is not the proper discount factor under conditions of uncertainty even in interest based economies. Under conditions of uncertainty, the rate of return on equity is the proper discount rate. Since the real world is a world of uncertainty, and no real investment in any economy can be undertaken without facing risks, cash flows of such investment should be discounted not by a riskless interest rate but by the true opportunity cost of venture capital.[86]

d) Impact on the Stability of the Banking System

It has been argued in the writings on Islamic banking by some writers that a switch over from interest based banking to PLS based banking would impart greater stability to the banking system. In the interest based system, the nominal value of deposit liabilities is fixed and no assurance that all the loans and advances will be recovered. Shocks on the assets side, therefore, lead to divergence between assets and liabilities, and the banking system can suffer a loss of confidence in the process, leading to banking crises. On the other hand, in the PLS based system, the nominal value of investment deposits is not guaranteed, and shocks to the assets positions are promptly absorbed in the values of investment deposits. This minimises the risk of bank failures and enhances the stability of the banking system.[87]

e) Impact on the Stability of the Economic System

Muslim scholars in their literature on Islamic banking have taken note of apprehensions expressed in certain circles that replacement of interest by PLS may make the whole economic system highly unstable as disturbances originating in one part of the economy will be transmitted to the rest of the economy.[88] Such apprehensions are viewed by them to be lacking in substance

86. For an elaboration of this theme, see M. Anas Zarqa, "An Islamic Perspective on the Economics of Discounting in Project Evaluation" in Ziauddin Ahmad et al (eds.), *Fiscal Policy and Resource Allocation in Islam,* 1983, pp.203-234.

87. See Mohsin, S. Khan, "Islamic Interest Free Banking: A Theoretical Analysis", in Mohsin S. Khan and Abbas Mirakhor (eds.), *Theoretical Studies in Islamic Banking and Finance,* 1987, pp.15-35.

88. See S. N. H. Naqvi, *Ethics and Economics: An Islamic Synthesis,* Leicester, 1981, p.136.

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and they suggest, on the contrary, that elimination of interest, coupled with other institutional features of an Islamic economy, will tend to enhance stability. It has been pointed out that interest based debt financing is a major factor in causing economic instability in capitalist economies. When the interest-based banks for example, find the business for what they sanctioned loans are beginning to incur losses, they reduce assistance and call back loans, which results in closing down that business. This increases unemployment, which leads to further reduction in demand, and the infection spreads. Islamic banks, on the other hand, are prepared to share in losses, which reduces the severity of business recession and enables the productive enterprises to tide over difficult periods without a shut down. Islamic banking has, therefore, to be regarded as a promoter of stability rather than instability.[89]

8. Conclusions

The basic objective of Islamic banking, as emphasised in the *Handbook of Islamic Banking* (HIB),[90] is to provide financial facilities by developing financial instruments that conform with the Islamic rules and norms, the *Shari`ah.* The Handbook mentions: "the primary goal of Islamic banking is not to maximise the profit as the interest-based banking system does, but rather to render socio-economic benefits to the Muslims".[91]

In additions, Islamic banking conforms to philosophical underpinning of Islam. Since Allah is the creator and ultimate owner of the universe, institutions or human beings have a vicegerency role to play in society. Therefore, banking institutions have to integrate moral values with economic action. Money and other resources are thus social tools to achieve optimum social good and welfare.

In view of the above, the objectives of Islamic banking are to promote, foster and develop the application of Islamic principles, law and tradition to the transaction of financial, banking and related business affairs services and to promote products based on Islamic principles. As discussed earlier in this study, Islam is a complete code of life and as such prescribes the manner in which all actions of a Muslim ought to be conducted. Therefore, conducting worldly affairs, including banking, in the manner prescribed by the *Shari`ah* is an obligation of a Muslim is viewed as an act of worship.

89. See M. Anas Zarqa, "Stability in an Interest-Free Islamic Economy: A Note", *Pakistan Journal of Applied Economics,* winter 1983, pp.181-188.
90. HIB (Hand Book of Islamic Banking), IAIB, Jeddah, 1982, vol.5, p.153.
91. *Ibid.*, pp.153-55.

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These objectives have truly reflected in the functions of Islamic bank as determined by the International Association of Islamic Banks (IAIB) in the following few sentences:

"The Islamic Bank basically implements a new banking concept in that it adheres strictly to the rules of Islamic *Shari`ah* in the fields of finance and other dealings. Moreover, the Bank functioning in this way must reflect Islamic principles in real life. The Bank should work towards the establishment of an Islamic society. Hence, one of its primary goals is the deepening of religious spirit among the people".[92]

The objectives and philosophies of Islamic banking are thus in line with the revelations in *al-Qur'an* and the *hadith,* and it is expected to be guided by these philosophies. Establishing the right philosophies is important for any Islamic banking or financial institution mainly for two reasons.

Firstly, these philosophies will be used by the management or policy makers of Islamic banks in the process of formulating corporate objectives and policies.

Secondly, these philosophies serve as an indicator as to whether a particular Islamic bank is upholding true Islamic principles or not. In this connection, it needs to be emphasised that while the *riba* is prohibited in Islam, earning or profit on investment in trade and business is permitted and encouraged provided that the related risks and gains are not one-sided but balanced. So, from the religious perspective, the establishment of an Islamic bank is considered to be a righteous move having its involvement in legitimate trade; and for paving the way to perform banking business in line with the *Shari`ah.*

Eliminating *riba* in the banking system is an indispensable part of Islamic business principles. Management and staff of this system are bound to conduct their business with conformity to Islamic business principles in addition to the normal objective of profit maximisation. These principles include honesty, justice and equity as ordained by Allah and practiced by Allah's Prophet. In the process of conducting business, Islamic banking seeks to balance between earning and spending with a view to maximise social benefit. It should be emphasised that in Islam earning should be lawful. In terms of spending wealth, it demands its followers to spend for the welfare of the people and not to waste nor use it in illegitimate ways. Islamic banks' relationship with their clientele is not that of a lender and borrower but that of a business partner.

92. Ali, Manzoor, "Islamic Banking: Concept and Practice", *Pakistan & Gulf Economist,* January 1985, p.13.

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Several Muslim scholars have emphasised the point that since Islamic banks are committed to work on the basis of a completely different philosophy, they should have a pronounced orientation towards channeling resources to poorer sections of society so as to improve their economic well being in line with the Islamic socio-economic objectives.

It may be argued that some of the objectives and functions of Islamic banking system, as stated above, are the same as those under conventional banking system. Though there may be an apparent similarity, there is in fact a significant difference in emphasis, arising from the divergence in the commitment of the two systems to spiritual values, socio-economic justice and human brotherhood as the goals and objectives in Islam are inviolable part of the ideology and the faith.

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Shari'ah-Compliant Project Finance : An Overview, Including Structures

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Abstract

This paper suggests ideas as to way to harmonize principles from two disciplines (project finance and Islamic finance) that were born in the same period, grew independently and in different environments (particularly as regards risk-reward paradigms and principles), and, of necessity, are now converging. Transactional implementation will require refinements to the myriad complexities of a broad range of different projects in a manner that serves the business needs of a wide array of participants, each having a unique perspective and each subject to a unique set of constraints, some of them being difficult to harmonize with the perspectives and constraints of other participants. The hope is that this process will be viewed as a creative opportunity whose realization will enhance awareness and knowledge of both economic systems (interest-based and Islamic) and of the fundamental cultural, moral, ethical and religious principles that guide the existences of people. As the history of both modern project finance and modern Islamic finance has taught us, the process is highly creative and enjoyable to all involved, and all shares the rewards.

1. Introduction

Intimately connected with the development and implementation of a large capital-intensive project of almost any type at almost any location in the world is consideration of some "project finance" alternative. Regionally, and

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particularly if one is focused on the Middle East, Malaysia, Indonesia, Africa, and other jurisdictions within the Organization of the Islamic Conference (the "*OIC*"), the concept of "Islamic finance" is also becoming of relevance for these types of projects. Project finance and Islamic finance are both relatively recent developments, and both emerged at the same time, commencing in the 1970s, although quite independently. Each evolved from a confluence of factors: some of the causative factors were shared and overlapping; others were unique to either project finance or Islamic finance. The development of project finance and Islamic finance took somewhat different paths from the mid-1970s to the present. But these paths are now converging.

A number of factors are driving the convergence. One group of factors relates to capital accumulations that are occurring in oil and gas producing regions within the OIC, particularly the Middle East. Governments, financial institutions and individuals are all experiencing these accumulations. Large portions, historically high portions, of that capital are being invested in industrial, real estate, and infrastructure projects. At the same time, many countries desire to diversify their capital or industrial base and encourage greater involvement by Western[2] private financial institutions. This is particularly true in the area of large, capital-intensive projects. Another, quite independent, set of factors relate to the development of the field of Islamic finance, or financing in accordance with the principles and precepts of Islamic

2. Bowing (reluctantly) to customary usage, the terms "conventional" and "Western", and correlative terms, are used in this article to refer to techniques, practices and jurisdictions in which interest-based financing (rather than *Shari'ah*-compliant financing) is the predominant form (and whatever the degree of presence of Islâm in those jurisdictions). Variations as between and among Western jurisdictions are ignored. This article also adopts, quite intentionally, and by way of general shorthand, a rather vague and elastic conception of "the Middle East" that generally includes the Arabian peninsula and predominantly Muslim areas of North Africa and is sometimes inclusive of Pakistan and Turkey despite the offense that may render to more scholarly conceptions. Unless otherwise expressly noted, differences as between and among these diverse jurisdictions are also disregarded. Similarly, variations as between and among the different *madhahib* (schools of Islamic jurisprudence) are ignored unless otherwise specifically noted (see, e.g., note 19). Despite the foregoing, it is vitally important that the richness of diversity that is Islâm be ever borne in mind. "Islam [is] an entity which the Western world has always found it convenient to treat as a monolith in order to compensate for a failure to investigate its variety. Perhaps we might suggest, adopting de Saussure's well-know categories, that Islam, like other faith systems, clearly stipulates what might constitute its *langue* – the canonical texts that lay down the basis for its principles, but that the *parole*, the actual application in such areas as the differences between the tenets of the Sunnî and the Shîcî communities and the practices of Sufism and popular Islam, present us with a staggering variety of beliefs and rituals which reflect the world-wide scope of the faith." Allen (2000), at 11.

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Shari'ah (the "*Shari'ah*"). After centuries of dormancy, Islamic finance has entered a period of "transformation and innovation"[3] and is growing rapidly, in OIC jurisdictions and in the North America and Europe.

This convergence of project finance and Islamic finance means that *Shari'ah*-compliant financing structures will be of immediate and long-term import to both Muslim and non-Muslim participants, in both OIC and Western jurisdictions, and with respect to the complete range of projects (including industrial, real estate and infrastructure projects).

This article first surveys the history, evolution and characteristics of project finance. It then briefly considers some fundamentals of the nature of *Shari'ah*-compliant finance. The article then addresses different types of *Shari'ah*-compliant project finance structures. These structures are of two general types, those that employ conventional interest-based loans and financing elements and those that do not make use of any form of conventional interest-based financing. Different structural alternatives within each of these categories are discussed.

2. Project Finance

2.1. The Emergence of Project Finance Techniques

Prior to 1969, governments of less developed countries financed infrastructure and other major projects largely by resort to international development banks of different types. Commencing in 1969, these governments began accessing the Eurocurrency markets, and Eurocurrency borrowings increased dramatically during the ensuing years as these governments sought to expand their industrial bases and develop necessary infrastructure.[4] Typical loans to these governments were balance-of-payment or budget-based loans. These loans were made by commercial banks to the government treasuries or non-state development banks to meet budgetary shortfalls or to provide for foreign currency needs. Disposition of the loan proceeds was left totally to the discretion of the government or development bank. Commercial bank lenders

3. DeLorenzo & McMillen (2006), at 136-154, discusses the history of modern Islamic finance from the 1970s to the present. Consider, also, McMillen (2007 – WILJ). *See, also*, Wilson (2002). *Consider*, Henry & Wilson (2004), containing numerous essays addressing different elements of the origin and growth of modern Islamic finance, including Soliman (2004), which challenges some conventional positions. Compare Hegazy (2007) and, especially at 5-16, Ray (1995).

4. See Rauner (1983), at 146-56, for a summary of the origins and development of project finance in the period from and after 1969.

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had little or no control over those dispositions. Credit analysis by commercial banks focused on macroeconomic and political factors rather than project-specific credit and underwriting criteria. Repayment of those loans was dependent upon both (a) general economic conditions and considerations and (b) the management abilities and trustworthiness of the borrower government or development bank. Obviously, this type of lending arrangement entailed considerable risk for the commercial bank lenders. To address some of these risks, the commercial bank lenders restricted the eligible borrower base to the wealthiest and most stable countries. The result was a concentration of loans to Mexico, Brazil and a small number of other nations.[5] But these lending patterns did not address the growing borrower demand across the entire spectrum of countries as a result of oil-related deficits, a global recession, declining terms of trade for some nations, and growing pressures to expand industrial and infrastructure development.

Commercial bankers started to search for alternative financing techniques that would allow them to (i) focus their credit analysis and risk assessments on discrete economic activities and entities (*i.e.*, customary completion, operations, business and profitability risks of a specific, identified project), (ii) allow lenders to have control over the activities of the borrower entities, particularly in respect of planning, management and operations (the control was obtained pursuant to negotiated terms of the relevant loan agreement with the government or development bank), and (iii) have a specific source for repayment of the loans (a specific project cash flow or a specific government entity or export credit agency, rather than a general governmental source). The techniques that were developed were the predecessors of what is today known as project finance. In the early stages (prior to 1975), "true" project finance loans were made to governments to cover some portion of the costs of a discrete, identified project or to cover a portion of the costs of imported capital goods (with the bulk of the costs being financed by government export credit agencies), and repayment of these loans was dependent upon the success or failure of the specific project. The commercial banks also made loans in respect of specific identified projects that were guaranteed in some manner, such as by a government or export credit agency. These were termed "pseudo" project finance loans as recourse was not limited to the specific project under consideration. Both types of lending arrangements have survived as project financing techniques and structures have evolved, and the blend in any given

5. See, Rauner (1983), at 149-50, and sources cited therein.

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transaction will depend upon the lender's assessment of the economic, political and legal feasibility of the project.

At about the same time, trends in the extraction and exploitation of natural resources changed dramatically throughout the world. Traditional sources of natural resources began to experience depletion, oil prices increased dramatically, and the prices of minerals and other natural resources also increased markedly. Improvements in extraction and exploitation technologies lowered the per-unit costs of production and made extraction of low-grade deposits commercially viable for the first time. Concomitantly, however, the sizes and locations (and, thus, the related costs) of these projects also increased dramatically. For example, many of these projects were located in geographic locations that were difficult to access and had a dearth of skilled indigenous labor. Major energy and mineral companies, which developed or had access to the new technologies, expressed a desire to provide extraction and exploitation services. Governments were willing to allow these private companies to participate in natural resource projects, but also imposed requirements on these companies for "mid-stream" and "down-stream" diversification projects in addition to the "up-stream" extraction projects, thereby further increasing size and cost considerations. The private companies were unable to undertake these massive transactions on their own, particularly because exposure size, and the notably enhanced political, economic and operational risks associated with these projects, had a pronounced detrimental effect on the credit ratings of these companies. Additionally, local host country factors precluded or dissuaded these private companies from undertaking many of these projects. For example, host country foreign investment restrictions precluded the private companies from controlling the operations of the projects, which resulted in an unwillingness of these companies to infuse the necessary capital. And the limitations of small, unsophisticated host country capital markets made it difficult to obtain the local participation and local capital that was mandated by host country laws and regulations.

2.2. Project Finance: Definition and Essential Characteristics

The solution to many of the foregoing issues was the development of financing techniques that shifted repayment and financing risk away from the sponsors and their general corporate credit. Those techniques could not be purely non-recourse as that would shift all risks to the banks, which was unacceptable to the banks. These techniques also had to be responsive to the political, cultural and legal requirements of a wide range of host countries. In addition, they had

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to be sensitive to the size, complexity, and cost parameters of these projects as well as the involvement of many and varied participant entities, each performing a unique function in the design, engineering, financing, construction, and on-going operation of the project.

The body of principles and structures that has evolved to address the panoply of issues and risk/reward and responsibility allocations relating to the financing of the construction and operation of these projects is generally subsumed within the concept of "project finance". Commonly used conventional definitions of "project financing" are focused on the productive capabilities of an economic unit (*i.e.,* the project) and the needs and preferences of the debt participants in financing the construction and operation of such units, with the impact on the equity participants being implied by the debt structure. In general terms, a "project financing" is the 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 debt and to those cash flows and the other assets comprising the economic unit as collateral security for the loans.[6] Often, it is an "off balance sheet" method of financing from the vantage of the operator and sponsors of the project, thusly minimizing the direct credit risk to the sponsor company.

The lender's cost of funds for a given project is reflected in the interest rate it charges for a particular project financing. That rate will depend upon the lender's assessment of the allocation of each of the risks attendant upon that particular financing: risk is the essence of every aspect of a project financing. Frequently, no matter what the ultimate risk allocation, the interest rate cost for a project financing is higher than the rate of a recourse corporate borrowing. The extent of the differential depends upon the specifics of the risk analysis and risk allocations. Project financing techniques and structures have evolved such that the risks of a given project are carefully analyzed and packaged into "bundles" that are distributed among the various project participants according to the ability of each to control, and thus bear, a particular set of risks. The risk analysis entails both risk splitting and risk allocation so as to reduce overall risk.[7] Through the use of project finance techniques and structures some risks are reduced, and most are allocated to the parties most capable of managing those risks.

6. *See, e.g.*, Nevitt (1983).

7. See Loke (1998), which discusses the identification, bundling, allocation and management of project finance risks (although legal risks are not discussed in detail). This article focuses on risks associated with each phase of a typical project financing transaction and includes discussion of credit support and collateral security arrangements.

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Project financing techniques have been applied to, and become the primary financing techniques and structures for, a broad range of economic units throughout the world. Examples include: power generation, transmission and distribution assets; upstream, midstream and downstream assets in the oil and gas industries: desalination plants; petrochemical, paper, mining, and manufacturing projects; airports, bridges, toll roads, rail systems, rail cars, vessels, aircraft and other transportation projects; telecommunications systems and satellites; public and private real estate projects; computer systems and equipment; and a complete range of infrastructure projects.[8]

2.3. Western Interest-Based Underpinnings

The range of project financing techniques and structures is broad. All of these techniques and structures have some common elements, however. Those common elements pertain to risk identification, analysis, allocation and management. And risk identification, analysis, allocation and management is structured, in a project financing, to achieve fairness and equity as among the project participants (in accordance with their respective abilities to control and manage particular risks), and do so with the greatest degree of transparency, predictability, certainty and stability.[9] However, fairness, equity, transparency, predictability, certainty and stability are matters of individual perception based

8. The literature on the application of project financing techniques and structures in different industries and geographic locations is voluminous. See, e.g., Ambinder, de Silva & Dewar (2000), Amison (1995), Andrade & de Castro (1998-99), Andrade & de Castro (1998-99), Bertoletti & Cunha (2004), Bowers (1998), Calkoen (1997), Campos (1997), Coles (2000-01), Cook (1996), Crothers (1995-96), Delescluse (2004), Ferguson (2001), Forry (1995), Forster (1996), Frilet (2000), Kerr (1995-96), Kim (2006), Malinasky (1996), Marshall (1995), McCormick (1998), McMillen (2008), McMillen (2008 – PGIF), McMillen (2007 – IBH), McMillen (2007 – IF), McMillen (2004 – AM), McMillen (2003 – FHF), McMillen (2003 - MEER III), McMillen (2003 - MEER II), McMillen (2002 – MEER), McMillen (2000 – FILJ), McMillen (2000 – THF), Mears (1998), Mehta (1998), Miller (1994 – I), Miller (1994 – II), Prutzman & Jiang (1994), Regan (2006), Schena (2005), Silva (1998), Sin (1991), Singh (1998), Soutar & Hanson (1996 – I), Souar & Hanson (1996 – II), Sozzi, (1996), Stephenson, Rojas & Owner (2000), Stephenson, Rojas, Hernández, Mates & Borbolla (2004), Stuber & Semionato (1996), Toy (1994), Vitale (2000-01), Wiley (1998), Williams & Castillo-Bernaus (2001), Yzaguirre (1997-98), and Zhang (2000).

9. Transactional participants in a project financing engage in extensive efforts to identify, analyze, allocate and manage risk. Among the different types of analysis, for example, are (a) a risk analysis to identify and allocate all construction, operation, ownership and financing risks, (b) an economic analysis focusing on realizable rates of return for equity investors, which will include extensive feasibility studies, (c) a financial analysis, to assess the cash flow and debt service adequacy, which will also be addressed in the feasibility study, and (d) a legal analysis, to ascertain project and financing viability under existing applicable legal frameworks and to identify necessary

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upon the past experience of the individual transactional participants and are also matters of systemic context. Existing project financing techniques have been developed in Western interest-based (*ribâ*-based) economic and legal systems (such as the United States, Europe and Japan).[10] The reasons for this include (a) the dominance of the Western interest-based economic system over the last few centuries, (b) the predominance of United States and European financial institutions, lawyers and accountants in the development and refinement of the most widely used project financing techniques, (c) the refinement and exportation of Anglo-American law, (d) the relative infancy of modern Islamic finance, (e) the lack of familiarity with the operation of legal systems in the Middle East and other OIC jurisdictions, and (f) the general lack of knowledge of, and familiarity with, the *Shari'ah*. Those perceptions are also influenced by the existence of "standardized" practices and structures, including "standardized" contracts, applicable to many of the activities that

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accommodations. The foregoing will cover environmental risks (such as product market risks, political and country risks, risks associated with the existing legal and regulatory structure, and the necessity or desirability of recourse to international courts or arbitral bodies), construction risks (including those pertaining to cost overruns, delays in completion, performance deficiencies, increased financing costs, and political interference), operating risk considerations (including operating cost overruns, feedstock or raw materials availability, off-taker performance, transportation methods and costs, foreign exchange availability and convertibility, project performance deficiencies, political interference, and long-term market movements), and, of course, financing risks. *See, e.g.*, Loke (1998), at 41-75, and Rauner (1983), at 156-81.

10. *Ribâ* concepts relate to any excess paid or received on principal, or an increase in price or return, particularly an increase that is in some manner a function of time. The literature on *ribâ* is extensive and the debate regarding *ribâ* remains vigorous. Noel Coulson (Coulson (1984), at 11) provided a formulation that included "the illegality of all forms of gain or profit which were unearned in the sense that they resulted from speculative or risky transactions and could not be precisely calculated in advance by the contracting parties." As to different the types of *ribâ*, consider *ribâ al-fadl* (relating to unequal spot trades in specified commodities), *ribâ nasa'/nasi'a* (relating to credit transactions in specified commodities), *ribâ al-jahiliyya* (relating to deferment and increase of price), and *da/ wa ta/ajjal* (relating to discounting upon prepayment). These are discussed, among other places, in Fadel (2007). A comprehensive treatment of *ribâ* is provided in the legal opinion of Justice Muhammed Taqi Usmani in *The Text of the Historic Judgment on Riba, 23 December 1999*, available online at http://www.albalagh.net/Islamic_economics/riba_judgement.shtml (last visited on November 18, 2007). The judgment based upon that opinion, and others, is set forth in the *Order Of The Supreme Court's Appellate Bench In Riba Case*, 9. REVIEW OF ISLAMIC ECONOMICS 155-94 (2000), which is reprinted at http://www.financeinislam.com/article/11/1/435 (last visited on November 18, 2007). *See, also,* Vogel & Hayes (1998), at 71-95, Saleh (1992), at 11-43, Comair-Obeid (1996), at 43-57, Algaoud & Lewis (2007), at 38-48, Seniawski (2000-01), and Sharawy (2000), Ansari-pour (1994), Ansari-pour (1996), Abdus-Shahid (1984), Uthman (1998), at 83-91, and al-Awani & El-Ensary (1998). And consider El-Gamal (2000). Histories, including comparatives histories, of usury, include Lewis (2007), Noonan (1957), and Klein (1994-95).

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comprise a project financing.[11] Those standardized practices, structures and contracts have evolved, have become "standardized", because of the economic efficiencies that they facilitate, particularly with respect to risk allocation, risk coverage, and minimization of transactional costs. Of course, most of those standardized practices, structures and contracts were developed in, and have evolved within, a Western interest-based paradigm.

The consequence of this Western orientation is that the risk allocations and implementing techniques and structures take little, if any, cognizance of variances that are necessary to achieve compliance with the *Shari'ah*. They take no cognizance of the conflict of certain Islamic principles with the fundamental debt-leverage principle of Western project financing, namely *Shari'ah* prohibitions on the payment or receipt of interest and other aspects of the doctrines of *ribâ* and *gharar*.[12]

Increasingly, however, it is necessary to implement techniques and structures that are sensitive to risk allocations and systemic and institutional constraints of both *Shari'ah*-compliant participants and participants that are not constrained by the Shari'ah. Project financings are increasingly international, involving participants from a wide range of diverse jurisdictions, each with different legal, regulatory, institutional, tax, accounting, underwriting, "accepted practice" and other constraints. Western participants in *Shari'ah*-compliant transactions will continue to include parties that proceed from, and are focused on, structures, methodologies and documents that proceed from a Western interest-based perspective. These transactions will also include

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11. Although project participants strive to achieve the greatest possible degree of standardization under the circumstances, the size and complexity of many projects makes overall standardization difficult to obtain. The participants will then seek to achieve standardization in discrete segments of the project. For example, construction contractors will utilize engineering, procurement and construction contracts for a given type of project that have a standardized core, with variation being introduced to address project-specific factors. Standardization may be greater in one industry than another. Thus, there is greater standardization in the implementation of a real estate project in North America or Europe than in the implementation of a petrochemical project in Africa, the Middle East, China or India. Loan agreements for electricity projects are considerably less standardized for electricity generation projects than for commercial or residential real estate projects, if only to facilitate securitization of the real estate financings.

12. With respect to *ribâ* concepts, see note 10, *supra*. *Gharar* concepts focus on risk and uncertainty with respect to the subject matter of the contract, matters such as the deliverability, quantity or quality of such subject matter, and ambiguity with respect to consideration or the terms of the contract. Consider, in particular, Vogel & Hayes (1998), at 87-93. *See, also*, the discussion of risk (and not, specifically, *gharar*) in Fadel (2001).

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participants that proceed from a different set of principles and precepts: those embodied in the *Shari'ah*. Thus, in many cases, *Shari'ah*-compliant project financings will require the use of structures, methodologies and documents that allow both Muslim and non-Muslim, particularly Western, parties to operate within a sphere of transparency, predictability, certainty and stability that is acceptable to both types of parties.

3. *Shari'ah* -Compliant Financing

3.1. The *Shari'ah* and Premises of Islamic Finance

Islamic finance is concerned with the conduct of commercial and financial activities in accordance with the *Shari'ah*. The word "*Shari'ah*", in its early usages, referred to the path by which camels were taken to water, to the source of life. In later, and current, times it refers to "the way" or "the path" by which a Muslim is to conduct his or her life, in every aspect of life.[13] Thus, the *Shari'ah* is comprised of, and embodies, religion, ethics, morality and

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13. The *Shari'ah* is the perfect, immutable, divine law as revealed in the text of the *Qur'ân* and the *sunna*. *Fiqh* ("understanding", from *faqaha*, "to understand") is the sum of human comprehension of that divine law and is given effect in the practical rules of the *Shari'ah* as determined by the *Shari'ah* scholars. The primary methodology used in this determinative effort is *ijtihâd* (literally, "effort"), or legal reasoning, using, as the primary sources, the "roots of the law" (*u°ûl al-fiqh*). The primary sources of law, in Islamic orthodoxy, are (a) the *Qur'ân* (the divine word of Allâh), (b) the *sunna* (the practices and examples, the dicta and decisions, of the Prophet Mohammed), (c) *ijmâc* (consensus, most particularly the consensus of the community of scholars), and (d) *qiyâs* (analogocial deductions and reasoning). *Hadîth* are the textual records of the Prophet's *sunna*, as determined by skilled juristic scholars. For a recent discussion of *ijtihâd* in modern Islamic finance, see al-Awani & El-Ansary (1998).

An interesting and helpful etymological and historical review of the development of the term "*sunna*" as an element of *fiqh* is Ansari (2004) at 215-38 (the term *hadîth* is treated at 211-15). Ansari notes the etymological root (SNN) as originally referring to the "flow and continuity of a thing with ease and smoothness", such as the manner in which water flowed easily away when poured on a person's face. The sense of a "way" or "course" that was easily tread and traversed arose from this usage and "derivatives of SNN were employed with reference to the course across which winds blew or along which water flowed" (at 215). The connotations of ease and facility then gave rise to usage, most notably in ancient Arabic poetry, in reference to admirable aspects of the human face, particularly brightness and polish, smoothness and shape. Thereafter, there was an extension to human behavior: "'*Sunna* began to mean, therefore, 'a way, course, rule, mode, or manner, of acting or conduct of life, and became an equivalent of *sîra*'", while still retaining the concepts of ease and smoothness (at 216-17, footnotes omitted). "*Sunna* therefore signified, *inter alia*, a mode of behavior which a person could adopt without difficulty. This seems to be the background in which the term *sunna* developed a nuance of moral appropriateness and normativeness." (at 217) Ansari observes that there are sixteen references to *sunna* in the *Qur'ân*, most of which are references to the *sunna*

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behavioral admonitions[14] as well as those that are more customarily recognized as legal requirements: it is "the 'Whole Duty of Man'[;] [m]oral and pastoral theology and ethics; high spiritual aspiration and the detailed ritualistic and formal observance which to some minds is a vehicle for such aspiration and to others a substitute for it; all aspects of law; public and private hygiene; and even courtesy and good manners... ."[15] It is in part divine revelation, in part human example, and in part human understanding, ratiocination and reason.[16] And it is, in part, law as that term may be understood more broadly and conventionally.[17] As a body of divine law that has developed over 1400 years, it is mature and comprehensive, although it is framed as principles and precepts rather than specific injunctions and, in the commercial and financial context, is

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of Allâh (which he notes to be literary innovation of the *Qur'ân*) and none of which are references to the *sunna* of the Messenger of of Allâh. However, the *Qur'ân* is clear that the conduct of the Prophet is conduct *par excellance*, thus supporting the concept of the *sunna* of the Prophet in the early years of Islâm.

A range of accessible introductions to the history and methodology of Islamic jurisprudence includes: Vesey-Fitzgerald (1955), at 85-112; Schacht (1955); Vogel & Hayes (1998), particularly at 23-70; Hallaq: (2004); Coulson (1964), especially at 1-73; Schacht (1950), Hallaq (2005), Hallaq (1997); Williams (1994), especially at 7-108; Kamali (2003); Usmani (1998); Abdal-Haqq (1996); Melchert (1998); Hallaq (2001), Hallaq (1985-86); Weiss (1977-78); Kourides (1972); and Souaiaia (2004-05). Quraishi (2006) presents an interesting discussion of the "schools" of jurisprudence and their bases and modes of analysis of the *Qur'ân* and the United States Constitution, including summaries of how the different *madhahib* endeavor upon *ijtihâd*. *See, also,* al-Hibri (1998-99) and Moghul (1999).

14. Thus, for example, it contains religious, moral and ethical prohibitions such as the impermissibility of engagement in the manufacture, distribution or consumption of alcohol or pork, pornography (including its manifestations in cinema and music), gambling and games of chance (and related activities), *ribâ* (and thus interest-based finance), non-mutual insurance, and other activities.

15. Vesey-Fitzgerald (1955), at 85-86.

16. While the *Shari'ah* is the subject of voluminous scholarship, the *Shari'ah* as applied in Islamic finance is largely oral, although there is a growing body of literature and *fatâwâ*. *See, e.g.*, DeLorenzo & McMillen (2006), at 136-50. An exception to the predominance of oral formulations as they pertain to financial matters is the *Majelle* (*Majalat al-Akham al-Adliyah*), which is a codification of civil law following a Western model that was originally prepared by Ottoman scholars of the Hanafi *madhab* for use throughout the courts of the Ottoman Empire circa 1839 CE/1285 AH; see the Majelle: Hooper and the Majelle: Tyser. *Consider, also,* Onar (1955), at 292-308. A summary of some provisions of the *Shari'ah* as applied in commerce and finance is contained in al-Zuhayli (2003).

17. The extent to which the *Shari'ah* constitutes secular law, enforceable as such in the secular legal system, varies considerably from one jurisdiction to another as a function of the extent to which the *Shari'ah* is incorporated into the secular body of law of the specific jurisdiction. Thus, in the United States and the United Kingdom, where the *Shari'ah* is not incorporated into the secular law, it is a body of commands that are not sanctioned by the state unless such commands are incorporated into the secular law in some permissible manner, such as by incorporation in a contract that is enforceable under secular law. See, McMillen (2007 – CJIL), at 434-67, and McMillen (2006 – CMLJ), at 151-66.

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somewhat undeveloped in its application to modern transactions as a result of the centuries-long dominance of conventional interest-based finance. The *Shari'ah*, being applicable to all aspects of human endeavor and existence, by definition is applicable to commercial and financial matters. Being comprehensive, it constitutes a code that is applicable to all aspects of commercial and financial matters. Thus, it will (and does) address sales (*bay*), leasing (*ijâra*), options, suretyship, transfer of obligations (*hawala*), mortgages and pledges (*rahn*), deposits for safekeeping (*emanet*), loans, gifts (*hiba*), joint ownership and joint ventures (*s̲harikât*, *mushâraka* and *mud̲âraba*), guarantees, and virtually every other aspect of law as anyone familiar with the common law or the civil law will know the law.[18] And like any other mature body of law, application of the principles is detailed and complex and subject to variations in interpretation, particularly as among the different *madhahib* (schools of Islamic jurisprudence).[19]

As noted above, the underlying principles of project finance have been developed in the West and are firmly based upon Western interest-based principles of finance and the related risk-reward structure. Money is viewed not only as a medium of exchange and a measured store of value, but as a commodity in and of itself; an asset that can itself earn money. A central element of the conventional model is interest, the accretive earnings on money with the passage of time, or additional amounts in excess of the principal (*i.e.*, *ribâ*). That risk-reward structure, including the centrality of interest, finds further voice in contractual and legal terms with respect to financial realization on investments and collateral, including matters of payment preference.

18. For examples of these legal principles and precepts, see the *Majelle:* Hooper, the *Majelle:* Tyser, and Al-Zuhayli (2003).

19. Given its breadth and complexity, and analogously to any mature body of law, comprehension of nuance frequently is difficult for the lay person. Additionally, compliance is a matter of individual conscience. As such, different *madhahib* have arisen over the course of history. A historical summary of the development of the *madhahib* is Schacht (1955). The four main Sunnî schools, and those having the greatest impact on modern Islamic finance, are referred to as Hanafî, Hanbalî, Mâlikî and Shâfi'î. Each *madhhab* (meaning "path" or "road to go") is a body of juristic opinions and a related methodology of how to use text, tradition and reason to understand pure *Shari'ah*. Historically, the different *madhahib* frequently interpreted and applied the *Shari'ah* differently to different factual or structural situations, and there have been variations even within individual schools. Thus, scholars that have specialized in the study of the *Shari'ah* play a prominent role in the interpretation and application of the *Shari'ah*, particularly in the field of Islamic finance. These scholars are the primary means by which the general principles and precepts of the *Shari'ah* are applied as specific legal injunctions. Islamic banks and financial institutions, some higher net worth families and individuals, and, increasingly, sponsors and developers of *Shari'ah*-compliant funds and investment products

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Islamic finance is premised quite differently, as is the *Shari'ah* when considered as a body of law: the risk-reward conception is fundamentally different.[20] These differences are of more than academic interest to the finance practitioner; they must be addressed in all multi-jurisdictional Islamic finance transactions. Core premises in Islâm look more to profit and loss sharing. Thus, trading and partnership or joint venture arrangements are more appropriate risk-reward paradigms. Rewards without commensurate risk, and preferential rewards, are not permitted. *Ribâ* is impermissible under the *Shari'ah*; it is both a reward without commensurate risk and a preferential reward to one party (a debt provider). The interest-based debtor-creditor paradigm is rejected, although debtor-creditor constructs are acceptable (if arising as a result of *Shari'ah*-compliant arrangements). For the most part, predetermined fixed returns are not permissible. Guarantees or assurances of return of capital and return on capital are not permissible. Further, the use of money as a commodity is not acceptable under the *Shari'ah*. Money is not an asset that can itself earn money. It is a measured store of value and a medium of exchange. Every

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have retained one or more *Shari'ah* scholars, comprising a *Shari'ah* board, to assist in making the relevant determinations. The boards oversee the complete range of investment practices, and the principles, methodology and operational activities, of the entity or individual that has retained that particular board. Each board will certify, pursuant to *fatâwâ*, *Shari'ah* compliance of a given fund, structure or instrument, usually on a confidential basis on behalf of the retaining party or entity. As a result, Islamic finance tends to develop in a rather disjointed fashion, without coordination across markets or *madhahib*. A different trend is exemplified by the existence and prestige of *Shari'ah* boards of institutions such as AAOIFI, the Fiqh Academy (*Majma' Al-Fiqh Al-Islami*) of the OIC (*Munazammat Al-Mu'tmar Al-Islami*), the Islamic Jurisprudence Institute (*Al-Majma' Al-Fihi Al-Islami*) of the Islamic League (*Rabitat Al-'Alam Al-Islami*), the Islamic Development Bank, Bank Negara Malaysia, and Suruhanjaya Sekuriti, Securities Commission, of Malaysia, among others. The precise role of a *Shari'ah* board varies from entity to entity; it is a function of the unique relationship between the individual *Shari'ah* board and its related retaining entity. As a general matter it can be said that a *Shari'ah* board will perform a number of different roles, including, typically, the following: (a) participation in product development and structuring activities; (b) review and approval of the fund or entity structure and its objectives, criteria and guidelines, and issuance of a *fatwâ* in respect thereof; (c) review and approval of disclosure and offering documents, and issuance of a *fatwâ* in respect thereof; (d) review, approval and oversight of investment and business operational structures and methodology, and issuance of a *fatwâ* in respect thereof; (e) on-going review, oversight and approval of transactional or operational variances or applications to unique or changing circumstances; and (f) annual audits of the operations of the fund or entity and issuance of an annual certification of *Shari'ah* compliance. *See, e.g.*, DeLorenzo & McMillen (2006), at 139-47, DeLorenzo (2001), Yaquby (2001), DeLorenzo (2004), DeLorenzo (undated – GFC), DeLorenzo (undated – DJIMI), McMillen (2006 – CMLJ), at 138-43, McMillen & Kamalpour (2006), and Hegazy (2005).

20. Consider, for example, Fadel (2001), Dar, Harvey & Presley (1998), Warde (2000), Mirakhor & Zaidi (2007), Haneef (2005), and Moghul (2007).

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financial transaction must involve a tangible asset (leaving aside certain exceptions, such as intellectual property). Application of these principles precludes the sale and purchase (at least at a premium or discount) of pure financial instruments that do not represent interests in tangible assets, such as mortgage loans (which also include *ribâ* elements), debts (including receivables, which frequently include *ribâ* elements) that have been divorced from underlying assets, and derivatives.[21]

The methodology and historical tradition of Islamic jurisprudence are also factors that have no counterpart in conventional finance. They have resulted in the development of a system of "nominate contracts" that form the base, and provide structural constraints, for the development of *Shari'ah*-compliant products and instruments.[22] The nominate contracts are defined contracts or structures (such as different *ijâra* structures, the *istisna'a* (also *'istisnac*), the *mudâraba*, different *shari'ah/mushâraka* structures, the *salam* and different sales structures, etc.), and they are defined with relative rigidity. While it is no longer imperative to adhere to the precise historical form of the relevant nominate contract, it now being permissible to combine different nominate contracts as "building blocks" in composite structures,[23] the historical forms continue to work as significant constraints on the nature and structure of *Shari'ah*-compliant structures and instruments.

3.2. The Development of Islamic Finance

Since the 1970s, but particularly since the 1990s, there has been a renewed interest in Islamic finance.[24] The number and types of *Shari'ah*-compliant investments has expanded exponentially, as has the dollar volume of compliant

21. Derivatives are a particularly vexing, and strenuously debated, issue in the field of Islamic finance. Practitioners in the field of Islamic finance are currently focused on the development of *Shari'ah*-compliant structures to achieve some of the economic benefits of derivatives, as well as to allow transactional integration with conventional Western derivatives markets.

22. See Coulson (1984), and DeLorenzo & McMillen (2006), at 132-50.

23. See DeLorenzo & McMillen (2006), at 143-50.

24. See DeLorenzo & McMillen (2006), McMillen (2007 – WILJ), McMillen (2006 – CMLJ), McMillen & Kamalpour (2006), McMillen (2000 – FILJ), McMillen (2000 - THF), and, acknowledging some of the limitations on the growth of *Shari'ah*-compliant project finance, Babai (1998). *See, also,* Ebrahim (1998), Obaidullah (2000) Husain (2002), and Al Omar (2000). The breadth of practical interest is indicated by, among many other articles and publications, the vast range of articles contained in Second Harvard Forum (1998), Third Harvard Forum (2000), Fourth Harvard Forum (2002), Ali (2005) (which derives from the Sixth Harvard University Forum on Islamic Finance), Ali (2008) (which derives from the Seventh Harvard University Forum on Islamic Finance), Hassan &

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investments. The expansion continues to the present and is expected to accelerate over the foreseeable future.

Before the 1990s (and certainly before the 1970s), there were relatively few Islamic banks and financial institutions, there were relatively few *Shari'ah* scholars with knowledge and practical experience in financial and commercial transactions, the focus was primarily on the deposit side of Islamic banking, discourse took place primarily in the Arabic language, and the dominant *Shari'ah*-compliant financing structures were based strictly upon the nominate contracts and financing structures that were developed in the earliest years of Islam. Commencing in the 1970s, and increasingly from the 1990s to the present, there were a number of profound changes in the field of Islamic finance, virtually all of which are ongoing. Among them are the following:

(a) renewed focus on Islamic banking and finance, including investment activities both within and outside OIC jurisdictions, initially as a result of increased oil wealth but now much more broadly motivated;

(b) a movement of focus away from the deposit side of Islamic banking to the investment side and the larger realm of Islamic finance;

(c) a significant number of Islamic and conventional multinational banks, investment banks and financial institutions, as well as Western asset managers, lawyers, accountants and other professionals, entered the field of Islamic finance;

(d) *Shari'ah* scholars gained significant practical experience in an expanding range of financial and commercial transactions of increasing complexity;

(e) a significant increase in discourse on Islamic finance in the English language;

(f) a group of *Shari'ah* scholars made a decision and undertook concerted efforts to move toward consensus (*ijmâc*), which had the effect of reducing (although not eliminating) differences between *madhahib*;

(g) the shortage of *Shari'ah* scholars ensured that some of the key individuals in the movement toward consensus sat on multiple Boards, thus moving the entire industry toward greater harmony, uniformity and consensus;

Lewis (2007), Archer & Abdel Karim (2007), Archer & Abdel Karim (2002), Jaffer (2004), and the articles cited in note 1. As a small sampling of the many articles on Islamic finance in the popular press, see Arnold (2007), Euromoney (2007 – Bond), Euromoney (2007 – Banks), Al-Hilal (2007 – *Sukuk*), Thomas (2007), Robinson (2007), Wright & Yuniar (2007), Roy (2007), and Oakley (2007).

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(h) a transformative move away from the historical rigidity in the use of static nominate contract and early *Shari'ah*-compliant structures towards the use of nominate contracts and accepted structures as building blocks that may be constituted and constructed creatively in new combinations;

(i) significant internationalization and globalization necessitating that *Shari'ah* compliance be achieved in harmony with a various secular legal systems;

(j) AAOIFI was created and generated uniform standards for accounting for Islamic financial institutions and transactions;

(k) IFSB was created and is undertaking the development of uniform standards for capital adequacy, prudential banking standards, corporate governance, capital markets activities and securities laws; and

(l) a broad range of other coordinative entities were established, with particular focus, to date, on Islamic banking.

Prior to the late 1990s, in accordance with the preferences of transactional participants and the state of development of *Shari'ah* principles as applied to commerce and finance, most *shari'ah*-compliant investments focused on a limited number of areas, particularly real estate and private equity. This focus minimized the *Shari'ah* issues that had to be addressed by investors and *Shari'ah* scholars, particularly in jurisdictions that took no cognizance, economically or legally, of the *Shari'ah*. Investments were on a property-by-property or entity-by-entity basis. As experience was acquired - and it was acquired rapidly - investments became increasingly complex, in legal structure and in terms of the *Shari'ah* considerations that had to be addressed, in most instances for the first time. Commencing in the late 1990s and early years of the 21st century, tax efficient fund structures became the dominant form. Western interest-based banks and, later investment banks, began moving into the Islamic finance field around 2004 (a few were involved earlier, but those were exceptions). These entities have considerable experience with investment fund structures and securitization structures, and they have begun to focus on opportunities in these fields.

Shari'ah-compliant real estate funds emerged in the mid-1990s, and the number of such funds multiplied markedly after the dot.com slide. Initially, they invested in United States residential real estate projects, beginning with multi-family housing and moving on to single-family developments, gated

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communities, golf course communities and other projects.[25] Commencing in late 2002 and early 2003, real estate funds in the United States began investing in single tenant, credit tenant leased, commercial office and warehouse properties with remaining lease terms longer than the expected hold periods. These investments were *ijâra*-based (lease-based) acquisition financing investments rather than construction investments, and thus of longer tenor. These funds were designed to move into the strong United States commercial real estate markets during a growth period and in a manner that minimized the *Shari'ah* issues with respect to prohibited business activities by tenants (only a single tenant and its lease need be reviewed and re-leasing issues were avoided). *Shari'ah*-compliant commercial real estate funds began to focus on Europe in late 2003 and 2004. At the same time, in both the United States and Europe, investment began in multi-tenant properties and a wide range of other properties (hotels, outpatient treatment centers, hospitals, etc.). The movement to Europe was based upon the economics of European real estate investments and the increasing competition with conventional investors in the United States. The movement toward multi-tenant properties was driven by (i) increased familiarity of fund managers and fund investors with the *Shari'ah* compliance issues, (ii) the shrinking pool of single tenant properties, (iii) recognition of "permissible impurity" concepts as a result of the issuance of 1998 *fatwã* to the Dow Jones Islamic Market Indexes® and acceptance of "cleansing" and "purification" concepts, and (iv) increased sophistication of *Shari'ah* scholars in addressing complex multi-tenant issues. The last two points are especially important because they have had spill-over effects into the realm of re-leasing issues. Resolution of those issues is opening the real estate funds markets to *Shari'ah*-compliant investments in multi-tenant properties where leases expire and are renewed or replaced by new leases.

25. Among the primary factors that drove the emphasis on residential funds were the following: *first*, the *Shari'ah* rules prohibiting tenants of *Shari'ah*-compliant investments from engaging in prohibited business activities are not applicable to individual residential tenants; *second*, the development of workable *Shari'ah*-compliant *istisna'a* (*'istisnac*) – *ijâra* (construction – lease) financing structures in the United States; *third*, the flexibility of the United States legal system in accommodating financing and investment structures that were both *Shari'ah*-compliant and used conventional interest-based financing in a manner that met the underwriting standards and criteria of conventional banks; *fourth*, the short-term nature of construction financing was desirable to Middle Eastern investors; and *fifth*, the boom in the United States real estate markets during this period. *See*, McMillen (2000 – FILJ), McMillen (2003 – FHF), McMillen (2003 – MEER II) and McMillen (2003 – MEER III).

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Many large office buildings and complexes have tenants that engage in prohibited business activities, such retail branch banks, restaurants that serve alcohol, or grocery stores that sell pork and wine and beer. In the purest case, the entire building or complex would be an impermissible investment. However, the *Shari'ah* scholars have taken a pragmatic view. Rules are now being developed that would allow investment in these properties for certain impermissible uses, such as those just mentioned.[26] For example, if the branch bank serves a retail market, there are insufficient other banking opportunities in the defined area, and the branch bank occupies a small percentage of the property (say, 1% or less), some *Shari'ah B*oards will permit the property acquisition and allow renewal of the lease to that branch bank. The development of these rules as to *de minimus* impermissible tenancies is greatly expanding the universe of properties available for investment and is likely to enhance the development of these funds.

Some of the most important developments, from the vantage of project finance, relate to the development of *sukuk.* Early real estate and private equity transactions were financed privately by commercial banks. As pooled investment vehicles were created (usually off-shore investment funds) and transactional volume expanded dramatically, cross-collateralized private commercial loans were utilized. None of these transactions (or the related investment funds) was financed through the debt or equity capital markets. Conventional Western capital markets were unavailable, largely because of lack of familiarity with *Shari'ah*-compliant financing techniques. There were no Islamic capital markets, debt or equity. Constraints were such that *Shari'ah*-compliant investors could not even invest in the equity securities of entities listed on the major stock exchanges of the world, with some rare exceptions. *Shari'ah*-compliant capital market participation was practical or possible prior to the late 1990s.

shari'ah-compliant access to the equity capital markets began in approximately 1999.[27] Shari'ah-compliant access to the debt markets occurred later, commencing in the period of 2001 to 2003 with seminal *sukuk*

26. These developments derive from the recognition of some permissible impurity (see the discussion in note 27 and the accompanying text and McMillen (2007 – WILJ)), and from the development of various methodologies for cleansing or purification (*see, e.g.*, Elgari 2002).

27. In 1998, a monumental *fatwâ* was issued by a prominent *Shari'ah* supervisory board, that of the Dow Jones Islamic Market IndexesSM (the "*DJIMI*"), and the DJIMI began operations in 1999. That *fatwâ* established a series of tests to determine whether a *Shari'ah*-compliant investor could make an investment in an equity security of a company that was not totally in compliance with the *Shari'ah*.

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offerings.[28] *Sukuk* are defined, in common parlance, as Islamic bonds and Islamic asset securitizations. The early *sukuk* issuances, and all but a few of the *sukuk* issuances to the date of this writing, are bond structures (rather than securitization structures), and the overwhelming percentage of the issuances involve sovereign credits (although the volume of corporate bond-type issuances is increasing rapidly). At the same time, another monumental *fatwâ* was issued, by the *Shari'ah* board of the Accounting and Auditing Organization for Islamic Financial Institutions ("*AAOIFI*"), the preeminent accounting and auditing authority for the Islamic finance industry. This *fatwâ*, AAOIFI *Shari'ah Standard No. (17), Investment Sukuk* (the "*AAOIFI Sukuk Standard*"),[29] approved standards for *sukuk*, including both bond and securitization structures.[30] Realizing the potential for *sukuk* as a backbone element of an

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Of course, most companies in the world are not in compliance with the *Shari'ah* (some are engaged in prohibited businesses or activities; most either pay interest on indebtedness or receive interest from deposits or investments). These tests acknowledged, and sanctioned, on a conditional basis, a degree of impurity. Recognition of permissible impurity, at least as a temporary matter, led to the development of various "cleansing" or "purification" mechanisms. These mechanisms were, and are, operative after the occurrence of a transaction, activity or development that is impermissible under the *Shari'ah* and are designed to allow the occurrence of the transaction, but address the impure consequences of that occurrence. Thus, for example, if some interest were obtained in violation of *ribâ* doctrines, that interest could be donated to charity to cleanse or purify the transaction. That *fatwâ* opened the equity capital markets to *Shari'ah*-compliant investors, despite the lack of purity in compliance. And it also had profound effects on private equity investment as scholars began to develop rules for direct equity investment in entities that were not purely *Shari'ah* compliant. As noted in the text, it has also had profound effects on *Shari'ah*-compliant real estate investing. The *fatwâ* and the various tests are discussed in *Guide to the Dow Jones Islamic Market Index, June 2007, Dow Jones Indexes*, available at http://www.djindexes.com/mdsidx/ index.cfm? event= showIslamic Links (last visited on November 13, 2007), Yaquby (2001), Siddiqui (2007), and Siddiqui (2004). *See, also*, Moran (2000).

28. *Sukuk* had been issued prior to 2001, but on an isolated and inconsistent basis. *See*, Adam & Thomas (2004) and Adam and Thomas (2005). *See, also*, McMillen (2006 – CMLJ), McMillen (2008), McMillen (2007 – IFSB), McMillen (2007 – WILJ), McMillen & Kamalpur (2006), Adam & Thomas (2004), Adam & Thomas (2005), and Haneef (2005).

29. *AAOFI Sukuk Standard - Shari'ah Standard No. (17), Investment Sukuk*, Shari'a Standards 1425-6 H / 2004-5 (Accounting and Auditing Organization for Islamic Financial Institutions 2004).

30. The AAOIFI *Sukuk* Standard provides for 14 eligible asset classes. In broad summary, they are securitizations: (a) of an existing or to be acquired tangible asset (*ijâra* (lease)); (b) of an existing or to be acquired leasehold estate (*ijâra*); (c) of presales of services (*ijâra*); (d) of presales of the production of goods or commodities at a future date (*salam* (forward sale)); (e) to fund construction (*istisna'a* (construction contract)); (f) to fund the acquisition of goods for future sale (*murabaha* (sale at a markup)); (g) to fund capital participation in a business of investment activity (*mudâraba* or *mushâraka* (types of joint ventures that are hereinafter discussed)); and (h) to fund various asset acquisition and agency management (*wakâlah* (agency)), agricultural land cultivation, land management and orchard management activities. The parenthetical in each of the foregoing indicates the relevant *Shari'ah* structure. *Consider, also*, with respect to AAOIFI accounting standards generally, Archer & Abdel Karim (2007).

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Islamic capital market, the Islamic Financial Services Board ("*IFSB*") began to focus on capital markets and the legal infrastructure issues.[31] In 2006, with initial reports made in 2007, the IFSB focused on the development of an effective legal framework for Islamic finance, with special emphasis on those elements of the legal infrastructure that relate to *sukuk* issuances.

Bond structure *sukuk* issuance has accelerated since 2003. With this acceleration in issuances, and as more sophisticated issuances were attempted, it became clear that the legal infrastructure of many jurisdictions within the OIC was an impediment to the growth of the capital markets. Lawyers were unable to opine on critical legal matters. And, as a result, international rating agencies were unwilling to rate issuances that did not involve, ultimately, a sovereign credit.

While the volume of bond structure *sukuk* issuances (and corporate *sukuk* issuances) increased, securitization *sukuk* have not been issued (with only the rarest of exceptions). This has been due to a range of factors, including critical legal issues, the inability to obtain satisfactory legal opinions, and the resulting inability to obtain ratings from major rating agencies.[32] But the winds of change are starting to be felt. In 2006, a rated securitization structure *sukuk* was issued. The asset base for this *sukuk* was oil and gas royalties in the Gulf of Mexico.[33] Because the transactional and contractual structure was governed by United States law, the legal issues that precluded the issuance of asset-backed

31. Since its inception in 2002, the IFSB had directed its efforts in respect of standard-setting for the Islamic finance industry to the implementation of Basle II, capital adequacy matters, prudential standards, and related matters. Consider, for example, the following standards of the IFSB: Guiding Principles of Risk Management for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services, (December 2005), Capital Adequacy Standard for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services, (December 2005), Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Mutual Funds), (December 2006), Exposure Draft No. 5: Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Mutual Funds, (December 2006), and Exposure Draft No. 4: Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Mutual Funds), (December 2006). The foregoing IFSB publications are located at http://www.ifsb.org/index.php?ch=4&pg=140 (last visited on November 27, 2007). One of the initial reports to the IFSB in respect of capital markets, McMillen (2007 – IFSB), addressed three (of five) matters: securities and capital markets laws; trust concepts in OIC jurisdictions; and enforceability of the *Shari'ah* (two other matters, bankruptcy and *Sharîcah* boards, were addressed in separate reports).

32. See McMillen (2007 – WILJ), McMillen (2006 – CMLJ), McMillen (2006 – CJIL), McMillen (2008), McMillen (2007 – IFSB), and DeLorenzo & McMillen (2006).

33. East Cameron Gas Company US$ 182,000,000 Investment Trust Certificates (Sukuk) (which is described in SUKUKINSIDER, Issue 01, available at http://www.securities.com/doc_pdf?pc=

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securitization *sukuk* were avoided. The Islamic finance industry began to glimpse the future of securitization *sukuk*. And in July 2007, a rated securitization (a *sukuk* constituting a residential mortgage-backed security ("*RMBS*")) was issued with respect to properties in Dubai, United Arab Emirates.[34]

Sukuk structures provide strong opportunities for integration into Islamic project financings, and it is to those structures that this article next turns.[35]

4. *Shari'ah*-Compliant Project Finance

For both analytical and practical purposes, the primary distinguishing characteristic of *Shari'ah*-compliant project financing structures is whether or not they involve a conventional interest-bearing debt component. Transactions have used both types of structures, and this article will consider both types of structures.

Although there is a trend away from structures that incorporate conventional

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IG&sv=IFIS&doc_id=116285870&auto=1&query=east%3Acameron%3A&db=en_1y_d&hlc=ar&range=365&sort_by=Date and http://www.failaka.com/downloads/SukukInsider001.pdf (in each case, last visited on November 13, 2007)).

34. The Tamweel ABS CI (1) Ltd, a RMBS *sukuk*, was issued on July 30, 2007, and is described in Moody's Tamweel Report (2007). Moody's Investors Service expressed no opinion as to the degree of *Shari'ah* compliance, and considers *Shari'ah* compliance only to the extent that such compliance affects the credit risk of the transaction. For the same reasons noted in connection securitization *sukuk*, there have been no true conventional asset securitizations from the Middle East. A conventional "*CMBS*" (commercial mortgage-backed security) achieved provisional ratings in June 2007: UAE CMBS Vehicle No. 1 Limited ("*UAE CMBS No. 1*"). A description of this CMBS is contained in Moody's CMBS No. 1 Report (2007). A representative of Moody's Investors Service International has indicated to the author that the UAE CMBS No. 1 issuance occurred at the end of July 2007, although the author has not located independent confirmation of that issuance.

35. This article will not address in detail the *Shari'ah* principles that are applicable to Islamic finance, including project finance transactions. For summaries of some of those principles, see the sources cited at note 1. Suffice it to say that, at the most basic level, the *Shari'ah* prohibits investments in, and the conduct of, businesses whose core activities: (a) include manufacture or distribution of alcoholic beverages or pork products for human consumption and, in the case of certain *Shari'ah* boards, tobacco and firearms; (b) have a significant involvement in the businesses of gambling, brokerage, interest-based banking or impermissible insurance; (c) include certain types of entertainment elements (particularly pornography); (d) have impermissible amounts of interest-based indebtedness or interest income (*i.e.*, prohibited business activities). Some *Shari'ah* boards interpret the entertainment exclusion more broadly and include essentially all cinema and music because of pornography elements of these industries. Hotels are often included in prohibited business activities because of the presence of alcohol in the bars and minibars. Entities that have prohibited business activities may not be tenants in properties owned and leased by a *Shari'ah*-compliant investor. These prohibitions have a fundamental influence on the nature of a *Shari'ah*-compliant fund or product and the types of business objectives it may pursue. And, of course, the *Shari'ah* prohibits *ribâ*, which will generally be interpreted to mean, in the transactional context, the payment or receipt

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interest-bearing debt into a *Shari'ah*-compliant transaction, these structures are still common (and still predominant). They are likely to remain in widespread use for the foreseeable future, if only because of the involvement of Western banks in providing financing. The most common transactions using interest-bearing debt are (a) those involving a single *Shari'ah*-compliant tranche in an otherwise conventional financing,[36] and (b) those in which conventional debt is provided to a separate special purpose entity that is related to the *Shari'ah*-compliant investors solely through Shari'ah-compliant contractual arrangements. Each of these involves a "bifurcated" structure, although the nature of the bifurcation is a bit different for each of these structures. What both of these structures do have in common is that they are both built around the use of some variant of an *istisna'a* (construction) contract structure or an *ijâra* (lease) structure or both (most often an *istisna'a-ijâra*) for a portion of the overall project. Thus, it is useful to understand the basics of *istisna'a* and *ijâra* structures before proceeding to analysis of the single tranche built off of those structures. And as will be apparent as one progresses through this discussion,

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of interest, directly or indirectly. Specific rules in the leasing context relate to the requirement that the lessor of property must maintain the integrity of the leased property. Thus, the lessor may not pass structural maintenance (and correlative obligations such as the maintenance of casualty insurance) to the lessee in a lease (*ijâra*), which precludes the use of "triple net leases" that are standard in Western project financings. In the area of partnerships and joint ventures, there are numerous principles that address allocation of work, profits and losses as among the partners and joint venturers. For example, as general statements: all distributions of profits and losses must be pro rata; and preferred stock is not permissible. With respect to principles applicable to *muḏâraba* arrangements, see section 4.6 of this article, and with respect to those applicable to *mushâraka* arrangements, see section 4.7 of this article. The *Shari'ah* developed in Middle Eastern societies that were heavily focused on trading activities. As a result, the *Shari'ah* principles applicable to all types of sales are especially well refined and demarcated. Leasing, in fact, is treated as a type of sale – sale of the usufruct of property. With only limited exceptions, one can sell only tangible assets. Debt cannot be sold above or below par if it does not represent an interest in a defined tangible asset or intellectual property and there are numerous other limitations on the sale of debt, quite apart from the preclusive if *ribâ* elements are involved. Sales of financial instruments that do not represent an ownership interest in tangible assets or intellectual property are also precluded or strictly limited. Further, one cannot sell property that one does not own. In addition, there are very particular rules addressing delivery, receipt, ownership, allocation of risk, downpayments and virtually all other aspects of sales transactions that must be considered in operating *Shari'ah*-compliant businesses. *Shari'ah* principles preclude gambling and gambling related investments. Uncertainty principles (*gharar*) preclude most types of insurance, although the unavailability of *takâful* (*Shari'ah*-compliant insurance) has led to some practical accommodations to this prohibition. In the view of many *Shari'ah* scholars, the *Shari'ah* also precludes the provision of guarantees for compensation; a guarantee must be a nonfinancial charitable transaction in the strictest sense. Obviously, these principles significantly affect financing structures.

36. One of the earliest non-real estate transactions of this type was the Equate petrochemical project in Kuwait, which is summarized in Al Omar (2000).

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each of the structures that incorporate conventional interest-bearing debt is rather easily converted to a purely *Shari'ah*-compliant structure if a *sukuk* issuance is substituted for the conventional debt.

After considering some *istisna'a* and *ijāra* based structures, the article will examine a few generic examples of the most common joint venture structures that are purely *Shari'ah* compliant: structures based upon the *mushâraka* and the *muḏâraba*. To date, the most frequently used *Shari'ah*-compliant joint venture structure has been the *mushāraka*. Its use is predominantly in the Middle East and Southeast Asia and most transactions using this structure do not involve Western financial institutions.[37] Participation by a Western interest-based participant will require that participant to consider risk allocation from the perspective of the *Shari'ah*-compliant participant.

4.1. Bifurcated *Ijâra* Financing Structures

Elemental to many of the *Shari'ah*-compliant project finance structures is the *ijâra*, or *Shari'ah*-compliant lease, financing structure. An *ijâra*[38] is a lease of an object or services involving the transfer of the usufruct or *manfa'a* (the use of an object or the services of a person) for a rent consideration.[39] The nature of the *manfa'a* must be precisely defined, the rental consideration must be for a fixed value, whether payable in a lump sum or installments,[40] and the term of the *ijâra* must be precisely determined. Both the rent and the term must be clearly ascertained and designated in the *ijâra*.[41] The rent must be specified as a fixed sum for the rental term. However, the rent may escalate or diminish during the rental term so longs as the amounts of such escalation and/or decrease are specified and known to both parties.[42] The lessor is responsible for structural maintenance of the assets and correlative obligations (such as

37. There is a notable exception to this statement: real estate development, construction and acquisition transactions in the United States and Europe. There have been many of these transactions, and most make use of an *istisna'a-ijâra* structure or a "quadratic partnership" structure but also includes conventional debt. *See*, Husain (2002), at 143, McMillen (2000 – FILJ), and McMillen (2000 (THF), for discussions of some of the reasons and some of the transactions.

38. *Majelle*: Hooper, at articles 404-611, *Majelle*: Tyser, at 60-90 (articles 404-611); Al-Zuhayli (2003), at 381-434.

39. Al-Zuhayli (2003), at 386-88, summarizes the positions of some of the different *madhahib*.

40. *Majelle* : Hooper, at articles 466-79; Majelle : Tyser, at 68-70 (articles 466-79); Al-Zuhayli (2003), at 289-409.

41. *See*, *Majelle* : Hooper, at articles 450, 454, 464, and 484-96; *Majelle*: Tyser, at 66, 68, and 71-72 (articles 450, 454, 464, and 484-96).

42. Variable rate leasing arrangements are now widely accepted if properly structured. *See*, McMillen: Project Finance Structures, at 1254 and footnote 100, with respect to a methodology by which periodic rate adjustments are incorporated in a *Shari'ah*-compliant *ijâra*. *See*, *also*, Al-Zuhayli (2003), at 386-7.

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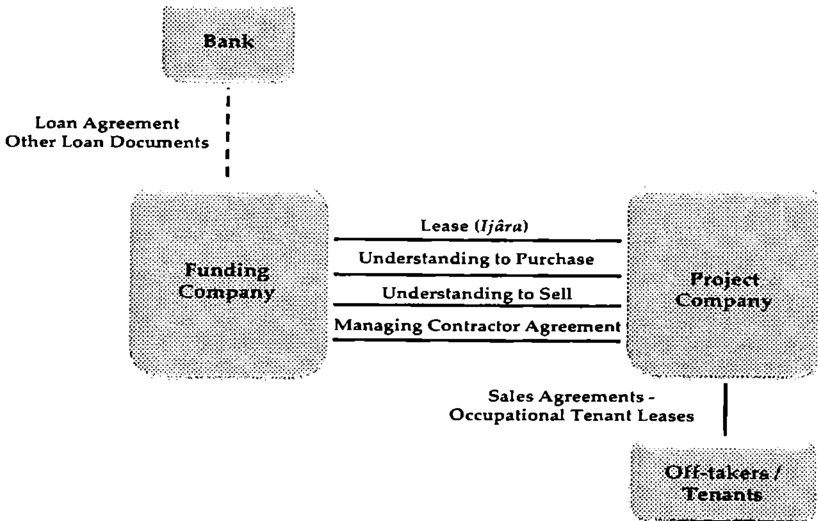
casualty insurance) and these obligations may not be passed to the lessee pursuant to the *ijãra*.[43] The lessor is entitled to rent as long as the lessee has the enjoyment of the leased assets as specified in the *ijâra*.

Figure 1 sets forth a diagram of a basic *ijâra* financing structure (without

Figure 1: Generic *Ijâra* Financing Structure



collateral security elements). This structure is used in a wide range of transactions, including, notably, financings of real estate projects, petrochemical projects, electricity projects and other infrastructure projects.[44] It is widely used not only in OIC jurisdictions, but also in North American and European transactions, and is thus familiar to Western financiers. Frequently, it is the core structural element of the financing, but is supplemented with other *Shari'ah*-compliant elements, such as an *istisna'a* arrangement and a *murabaha* working capital arrangement. Subsequent to the completion of construction of a project, it is the primary (usually the sole) repayment mechanism for the financing.

43. *See*, *Majelle*: Hooper, at articles 513-21 and *Majelle*: Tyser, at 75-76 (articles 512-21) (option for defect), and Al-Zuhayli (2003), at 416-7.

44. The structure is also a base for private equity transactions. In acquisition transactions of different types, it is often used without supplementation by other *Shari'ah*-compliant elements (such as an *istisna'a* or *murabaha* structure). See McMillen (2000 – FILJ), McMillen (2000 – THF), McMillen (2003 – FHF), McMillen (2003 – MEER III), McMillen (2003 – MEER III), and McMillen (2002 – MEER) for more complete descriptions of early versions of this structure.

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The *Shari'ah*-compliant investors infuse funds into the Project Company.[45] This is frequently accomplished by way of capital contributions and loans from the investors. Those funds, together with funds made available by the Bank pursuant the Loan Agreement, are used by the Funding Company to pay for the construction (or acquisition) of the project.

The Funding Company is a special purpose entity established expressly for the project financing transaction. Frequently, it is owned by a corporate service company; much less frequently, it is owned by investors other than the *Shari'ah*-compliant investors.[46] The Funding Company will hold title to the assets comprising the project. As noted in the previous paragraph, it will be the borrower under a conventional interest-bearing loan with the Bank.

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45. In many real estate transactions, and some infrastructure and industrial project financings, the developer may also be an investor in the Project Company. In those transactions, the developer frequently contributes the land for the project as a capital contribution, realizing any appreciation on land values in so doing. In such cases, the land may be leased to the Funding Company and then subleased back to the Project Company. This generic example does not illustrate ownership of the Project Company by the *Shari'ah*-compliant investors (which will be true in all cases) or such a contributing developer. The precise method by which the *Shari'ah*-compliant investors infuse their investment funds into the Project Company will depend upon applicable tax characterizations and the appropriate tax minimization strategies. The attendant infusion structure, which is often a fund established in a tax-efficient jurisdiction, is not shown.

46. This article assumes ownership by a corporate service company. In such as circumstance, the Funding Company may be (although it need not be) characterized as a "disregarded entity" for income tax purposes, particularly in jurisdictions such as the United States of America. In that case, it is relatively easy for the Project Company to be treated as the "owner" of the project for income tax purposes, thus being entitled to depreciation and other tax benefits. In addition, any income or loss incurred by the Funding Company will belong to the Project Company. This, in turn, allows cash and income flows to be structured such that the Funding Company is a "net zero" income and loss entity. In European jurisdictions, and many OIC jurisdictions, it is significantly more difficult to treat the Funding Company as a disregarded entity; the Funding Company is then a taxable entity, which has significant ramifications for structuring cash and income flows for the transaction. To achieve tax efficiency, excess income (over debt service) will have to be infused into the Funding Company to absorb any net loss in the Funding Company. The cash component of that infusion will have to be returned to the Project Company owners (i.e., ultimately, the *Shari'ah*-compliant investors) in a tax-efficient jurisdiction. This has effects on the structure of the ownership of the Funding Company and entails the use of consulting, management and other agreements in the tax efficient jurisdiction. If the Funding Company is owned by investors with a true economic interest, structuring of rent flows, risk allocations, and a wide range of other matters is rather dramatically affected.

    A quite distinct issue relates to payment of rent during the construction period, when the asset has not yet been completed. This is addressed at note 88, *infra*, and related text, in connection with the Bahrain Financial Harbour Sukuk. For the moment, the discussion assumes away this issue, focusing on fully completed assets.

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The Funding Company will lease the project assets to the Project Company pursuant to the Lease (*Ijâra*).[47] This basic rent payable by the Project Company to the Funding Company under the Lease (*Ijâra*)[48] will be structured to be exactly equivalent to the debt service payable by the Funding Company to the Bank under the Loan Agreement (and related documents).[49] Further, the transaction must be structured such that any default on the Lease (*Ijâra*) (and related documents, as hereinafter discussed) will constitute an event of default under the Loan Agreement (and related documents). That is relatively easy to achieve by inserting an event of default in the Loan Agreement (a "*Loan Event of Default*") to the effect that any default under the Lease (*Ijâra*) and related documents (a "*Lease Event of Default*") will also constitute a Loan Event of Default. The obverse is more difficult to achieve because applicable *Sharîc'ah* precepts preclude having one of the Lease Events of Default being the occurrence of a Loan Event of Default. The earliest structures achieved the desired result by mirroring, with precision, the representations, warranties, covenants and other provisions of the Loan Agreement in the Lease (*Ijâra*) and related documents.[50] This was a tedious and costly process and other more expeditious methods of achieving this result have since been developed.

The Understanding to Purchase is a *Shari'ah*-compliant sale and purchase agreement that may be characterized, in general terms relevant to conventional concepts, as a "put option" that allows the Funding Company[51] to cause the Project Company to purchase the assets comprising the project, in whole or in

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47. This article presents summaries of the main documents and a few of the relevant issues. The specifics of the Lease (*Ijâra*) and the related documents and relevant structuring issues are discussed in more detail in McMillen (2000 – FILJ, McMillen (2000 – THF), McMillen (2003 – MEER III), McMillen (MEER II), and McMillen (2002 – MEER).

48. As a practical matter, most project financings make use of complex account structures and lock-box structures. In such cases, the Project Company will pay rent (and amounts due under the Understanding to Purchase and the Understanding to Sell, which are discussed below) into defined accounts, and a range of agreements (that are not here discussed) will direct the application of amounts from each of the accounts to the appropriate party.

49. This assumes that the Funding Company is a disregarded entity or is not to have any income in excess of its expenses, and subject to the various considerations referenced in note 46.

50. The methodology was very much akin to that used in fractional undivided interest leveraged leases where one lease could not cross default to the others, but it was imperative that all leases defaulted simultaneously (just as it is imperative that the Loan Agreement and the Lease (*Ijâra*) and related arrangements default simultaneously).

51. As discussed below in the discussion of the Managing Contractor Agreement and the collateral security arrangements, the decision to exercise rights under the Understanding to Purchase is made by the Bank rather than the Funding Company, and is given effect by the Funding Company.

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part, under certain defined circumstances. The purchase price (or strike price) is equal to the amounts outstanding under the Loan Agreement from time to time. Those circumstances always include a Lease Event of Default (and, without direct reference or incorporation, a Loan Event of Default). They may also include other circumstances, which will functionally duplicate any other mandatory prepayment provisions in the Loan Agreement.[52] The purchase price is initially paid by the Project Company to the Funding Company pursuant to the Understanding to Purchase; the Funding Company then uses those funds to make payment under the mandatory prepayment provisions of the Loan Agreement.[53] The necessity of this Understanding arises because of a number of factors, most importantly the *Shari'ah* principles and precepts that prohibit acceleration of future rents under an *ijâra*, even in default scenarios. The Understanding to Purchase provides a functional equivalent, procedurally and economically, to acceleration of the indebtedness under the Loan Agreement.

The Understanding to Sell is a *Shari'ah*-compliant sale and purchase agreement that may be characterized, in general terms relevant to conventional concepts, as a "call option" that allows the Project Company to cause the Funding Company to sell the assets comprising the project under certain defined circumstances. The sale price (or strike price) is equal to the amounts

52. Examples of mandatory prepayments include the following: In an industrial project financing, financing terms are developed around an agreed financial model, and that model assumes operation of the project at defined levels. If the assumed performance standards are not met at completion of construction (say, the equipment does not perform to assumed standards), the financing will be adjusted (downsized) in accordance with performance testing and the adjustment may be effected pursuant to mandatory prepayments (usually, there will also be a readjustment of the debt service amortization schedule under the Loan Agreement, and thus a readjustment of the rent schedule under the Lease (*Ijãra*); the readjustment under the Lease (*Ijãra*) is a complicated matter given the *Shari'ah* constraints described in the text associated with notes 38-43, *supra*). In a real estate condominium or single family home project, the sale of condominiums or individual homes will entail mandatory prepayments coincident with the early sales. Thus, 100$ of the sale proceeds may be applied to mandatory prepayments for the first block of sales, with the percentage of sale proceeds to be applied to prepayments decreasing with subsequent blocks of sales. In all projects, there will frequently be mandatory prepayments in connection with failures to maintain financial covenants (such as loan-to-value/rent-to-value or interest/rent coverages) or decreases in collateral values.

53. But, see, note 46, *supra*. Partial purchases, which are the characterization for *Shari'ah* purposes, are problematic under, and often directly conflict with, secular tax, asset transfer and collateral security and recordation laws and regulations, and require careful structuring. Most often, a partial purchase will entail no immediate transfer of title in respect of the underlying assets.

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outstanding under the Loan Agreement from time to time. Those circumstances always include each circumstance that is permissible as a voluntary prepayment right under the Loan Agreement. This functionally allows the Project Company to cause prepayment of the financing, in whole or in part, at the discretion of the Project Company. Depending upon the nature of the transaction, this mechanism would allow the Project Company to sell subsets of the assets comprising the project from time to time. Such a right is frequently embedded in condominium projects, single family home projects, and other projects involving discrete groupings of separately functional assets. The sale price is initially paid by the Project Company to the Funding Company pursuant to the Understanding to Sell; the Funding Company then uses those funds to make payment under the voluntary prepayment provisions of the Loan Agreement.[54]

Shari'ah principles and precepts applicable to leasing preclude the lessor from passing structural maintenance obligations (and correlative obligations) to the lessee pursuant to the Lease (*Ijâra*), thereby precluding "triple-net" leasing that is so common in Western financial arrangements. To bring the *Shari'ah*-compliant financing transaction into harmony with existing Western markets, a mechanism is invoked to shift the structural maintenance obligations (and correlative obligations) to the entity that is the lessee. This occurs in the Managing Contractor Agreement. The entity that is also the lessor hires the entity that is also the lessee to perform structural maintenance and to undertake defined correlative obligations.

The Managing Contractor Agreement contains a second set of provisions that address the making of decisions and determinations and the direction of actions by the Funding Company. Basically, these provisions provide that any decision or determination to be made by the Funding Company (a) with respect to the Lease (*Ijâra*) and the Understanding to Purchase will be made by the Bank, and (b) with respect to the Loan Agreement and related documents will be made by the Project Company. The result is the removal of the Funding Company from

54. But, see, note 46, *supra*. The conflict between the partial purchase, for *Shari'ah* purposes, and secular tax, asset transfer and collateral security and recordation laws and regulations is not necessarily as great under the Understanding to Sell as it is with respect to the Understanding to Purchase. In certain circumstances where the Understanding to Sell is exercised, there is usually an immediate transfer of title in respect of the underlying assets. This is the case, for example, where individual condominium units or houses or lots are sold to third parties before the financing is retired in full. If there is no third-party sale of assets, the conflict may be as great as it is with respect to the Understanding to Purchase. The conflict will persist where there is no immediate asset transfer.

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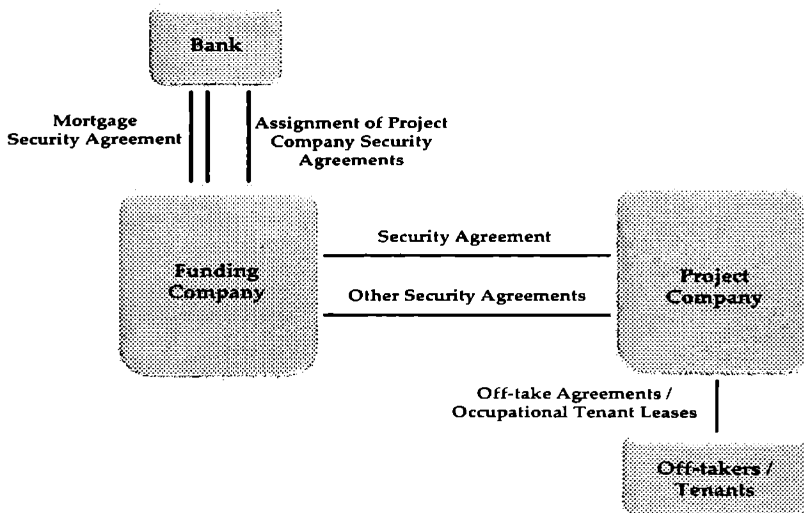
decision-making. Of course, nothing is quite so simple as we would like. Frequently, the Bank is not willing to make these decisions and determinations on behalf of, or to direct actions by, a third party entity (the Funding Company). This reluctance may relate to liability concerns or internal institutional practices. Similarly, for *Shari'ah* reasons, the Project Company is unable to make decisions and determinations and have responsibilities in respect of the Loan Agreement and related conventional interest-bearing arrangements. Harmonization of these positions with the principle stated in the first two sentences of this paragraph entails some careful structuring and drafting, but is achieved in the Managing Contractor Agreement.

Figure 2: Generic Collateral Security Structure: *Ijâra*-Based Financing



Collateral security structures are "a", if not "the", most important element of project financings. Collateral security structures are closely tailored to the specifics of the project being financed. Thus, it is not possible to comprehensively treat all of the variations, and the discussion here will focus on general principles applicable to the types of structures that are encountered in *Shari'ah*-compliant financings. Figure 2 sets for a generic depiction of the collateral security structure for an *ijâra*-based financing. It is apparent to experienced financing lawyers, that the bifurcated collateral security structure is very similar to the collateral security structure of a leveraged lease or synthetic lease transaction.

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The Project Company will enter into a series of Security Agreements with the Funding Company pledging essentially every asset of the Project Company to the Funding Company.[55] The collateral subject to these security arrangements will include, on a case-by-case and highly negotiated basis, among other things, proceeds of product sales, rents and proceeds, accounts and reserves, licenses, intellectual property rights and technology rights, and contractual rights under construction contracts, operating agreements and sales agreements.[56] The entirety of the collateral security provided by the Project Company to the Funding Company is collectively referred to as the "*Project Company Collateral*". These assets are pledged to secure the obligations of the Project Company pursuant to the Lease (*Ijâra*) and the Understanding to Purchase and the payment and performance obligations of the Project Company pursuant to the Understanding to Sell after the time of exercise of the Understanding to Sell if those obligations are irrevocable. They are not provided in respect of the various obligations under the Managing Contractor Agreement because those rights are drafted to be self-effecting and, in accordance with the terms of that agreement, include variations and limitations arising in the different default contexts. The Project Company is not permitted to pledge its assets directly to the Bank to secure the conventional loan financing.

The collateral security arrangements between the Funding Company and the Bank are essentially identical to any other conventional loan arrangement. All of these security interests will secure the obligations of the Funding Company to the Bank under the Loan Agreement and related documents. The Funding Company will grant a first mortgage or deed of trust on the real property (land and buildings) project assets to which it holds estate, right, title or interest directly to the Bank. The Funding Company will also grant to the Bank security interests in any other assets with respect to which it has any right, title or

55. There may be a limited group of "excepted payments" that are not so pledged. Those exceptions are the subject of precise and detailed negotiations with the financing parties. The exceptions are mirrored (with structural adjustments) in the security agreements between the Funding Company and the Bank.

56. The exact terms of these grants of security interests (the term "pledge" is used generally, and imprecisely, in this article, in deference to its relationship to the Arabic term "*rahn*", which means both "mortgage" and "pledge") are tailored in many details and are subject to the nature of the assets, including such matters as restrictions contained in the underlying contracts and agreements and the precise nature of, and limitations on, any granted rights. Certain "excepted rights", as negotiated, are carved out of the assignments to effect the foregoing and other factors, and are also mirrored (with structural adjustments) in the security package provided by the Project Company to the Funding Company.

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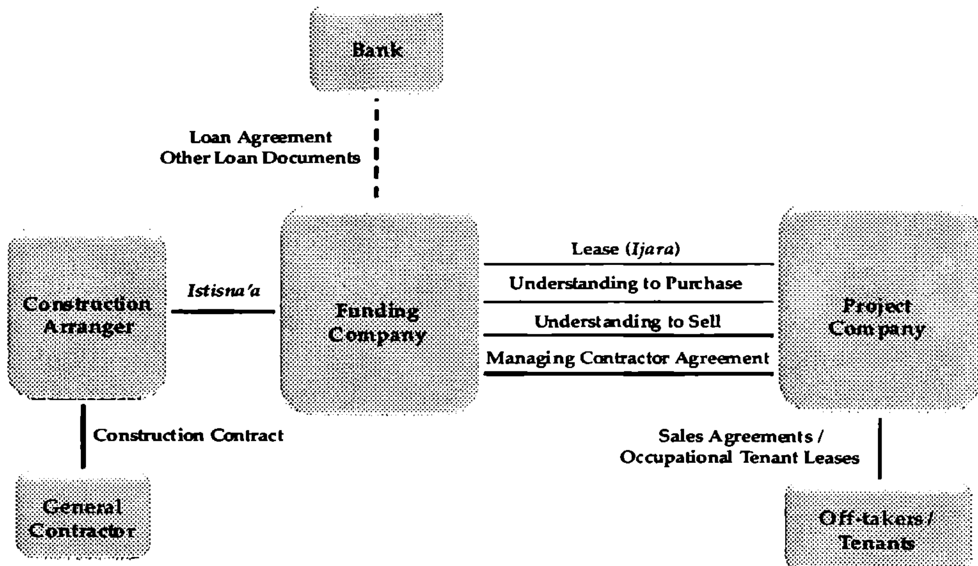
interest (and this will include all of the various categories noted above with respect to collateral provided by the Project Company). Finally, the Funding Company will collaterally assign to the Bank all of the rights the Funding Company has in Project Company Collateral.

The last assignment is of particular note. The rights of the Funding Company in respect of the Project Company Collateral are not exercisable absent a Lease Event of Default. If the Lease Events of Default do not match, precisely, the Loan Events of Default and there shall be a Loan Event of Default but no Lease

Figure 3 Generic: *Istisna'a - Ijara* Structure



Event of Default, the Bank can find itself in the quite difficult position of not being able to realize on the Project Company Collateral. Specifically, it may not be able to obtain the direct benefit of product sales proceeds and occupational tenant rents.[57]

57. Of course, mandatory account and lock-box structures are designed to minimize disruption of disharmonies such as these. However, they are not total palliatives and the Bank may be precluded from removing the Project Company (the real party in interest) from the transaction, particularly under the laws of OIC jurisdictions. This is a most unsatisfactory result from the vantage of the Bank. And it undermines one of the two key elements of the definition of conventional project financing.

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4.2. Bifurcated *Istisna'a-Ijâra* Structures

A generic *istisna'a-ijâra* structure is set forth in Figure 3. This structure has also been used frequently in North America with a wide range of assets and is familiar to many Western financiers and construction contractors.[58] The structure is comprised of the *ijâra* structure described in the preceding section along with an *istisna'a* structure. The discussion in this section will focus on the additional elements of the structure and the differences between the *istisna'a-ijâra* and the previously discussed *ijâra* structure.

An *istisna'a* is a construction contract.[59] The *mustasne'* (a client requiring the construction of an asset) orders from a *sane'* (constructor) an asset meeting certain specifications (the *masnou'*), with asset delivery to be within a specified period of time.[60] The *mustasne'* will be required to pay the purchase price of that asset if the asset is manufactured or constructed within the specified time period and meets the agreed-upon specifications.[61] The *sane'* need not construct the asset itself; it may locate the asset in the market and purchase it for delivery to the *mustasne'* or it may cause another party to construct the asset. If the original *sane'* causes another *sane'* to manufacture or construct, the original *sane'* remains liable to the original *mustasne'* for the delivery of the *masnou'*. If the Funding Company were not used in the structure, and no conventional loan were made, the banks (or a special purpose entity) would be the original *sane'* and would contract with another *sane'* (the end *sane'*) for the construction of the asset.[62] The amount to be paid for the *masnou'* must be fixed. That price may not be altered unless the specifications of the *masnou'* are altered.[63] The *mustasne'* may sell the *masnou'* to a third party.

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58. To the author's knowledge, this structure was first used in the United States in 2000. The original structure has since been simplified and modified so as to substantially reduce transactional costs. The development and structure of the initial United States transactions are discussed in detail in McMillen (2000 – FILJ), at 1237-60, McMillen (2004 – AM), at 214-23, McMillen (2003 – FHF), McMillen (2003 – MEER III), McMillen (2003 – MEER II), McMillen (2002 – MEER), and McMillen (2000 – MEED).
59. The term "*istisna'a*" (*'istisnac*) (rather than, for example, "*bina*") is used for construction contracts, although a more literal usage of the term "*istisna'a*" would be limited to manufacturing contracts.
60. *Majelle*: Hooper, at articles 338-92; *Majelle*: Tyser, at 49-57 (articles 338-92), and Al-Zuhayli (2003), at 165-231. Of course, the type of asset must itself be permissible under the *Shari'ah*. Thus, it may not fall within any of the categories of prohibited business activities.
61. There are a variety of *Shari'ah* principles applicable to the specification of type, quality and quantity. The purpose of these principles is to avoid unknown elements (*jahala*) and deceit (*gharar*). *See, for example*, article 390 of the *Majelle*: Hooper and *Majelle*: Tyser, at 57 (article 390).
62. Such a back-to-back arrangement is customarily referred to as an "*istisna'a* – parallel *istisna'a*" transaction and is discussed below. The terms of the *istisna'a* and the parallel *istisna'a* are usually identical, except for the amount and timing of payment. This, of course, is a long-accepted purely *Shari'ah*-compliant transaction.
63. This is an important principle in considering the structuring of change orders.

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The method by which the *Shari'ah*-compliant investors infuse funds into the Project Company is essentially the same as that described in the preceding section, although investment by the project developer is more common in a construction project. As noted in Figure 3, two special purpose entities are established, each of which is owned by a corporate service company: the "Funding Company" and the "Construction Arranger".[64] The Funding Company will hold legal title to the project being constructed. The Funding Company must obtain sufficient funds to construct the project. These funds are derived from two sources: the contribution by the Project Company of all funds received from the *Shari'ah*-compliant investors; and the conventional interest-bearing loan from the Bank.

The Project Company negotiates the Construction Contracts with the General Contractor. However the Construction Contracts are executed by the General Contractor and the Construction Arranger. It is at this point that the *Shari'ah*-compliant structure becomes relevant.[65] The Funding Company and the Construction Arranger will enter into the *Istisna'a*, a *Shari'ah*-compliant construction contract. The Construction Contracts with the General Contractor are attached to the *Istisna'a*, usually as exhibits. The disbursement mechanism in the conventional Loan Agreement (including conditions precedent to disbursements) will be mirrored in the *Istisna'a*, although the *Istisna'a* will speak in terms of milestone completion payments rather than loan disbursements. In terms of documentary obligations, funds will be distributed to the Funding Company who will pay them over to the Construction Arranger who, in turn, will pay them to the General Contractor. In practice, the Bank usually makes payment directly to the General Contractor.

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64. In many, if not most, cases, the General Contractor is not willing to enter into an *Istisna'a* (or doing so would be prohibitively costly). Often, this is because General Contractors use standardized construction contracts and are avidly averse to modifying them. The Construction Arranger is a structural modification designed to reduce transactional costs. The Construction Arranger is not necessary in a transaction in which the General Contractor is willing to enter into an *Istisna'a* Agreement and it is not prohibitively costly to negotiate that agreement. In such a case, the Project Company or the Funding Company could enter into the *Istisna'a* Agreement and the Construction Arranger would be unnecessary. In many jurisdictions, there are licensing issues with respect to general contractors and it is necessary to ensure that the Construction Arranger falls outside those licensing requirements.

65. The presence of the *istisna'a* in the structure illustrated in Figure 3 is a bit anomalous given that the Funding Company is already party to a non-compliant interest-bearing loan. Its presence was a preference of the *Shari'ah* board involved in the initial transactions.

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As the project is constructed, it is leased to the Project Company pursuant to the Lease (*Ijâra*).[66] This enables the Project Company to operate the project and utilize operating revenues to pay rent under the Lease (*Ijâra*). The lease rate is generally equal to the debt service on the conventional loan.[67] Thus, the Funding Company will use its lease rentals to pay its debt service obligations to the Bank.

4.3. The Single-Tranche *Ijâra*-Based Structure

The earliest attempts to incorporate *Shari'ah*-compliant elements in Middle Eastern project financings involved the insertion of a single *Shari'ah*-compliant tranche into an otherwise conventional, interest-based financing.[68] The *Shari'ah*-compliant tranche is usually effected using an *istisna'a* and/or an *ijâra* structure.

In single-tranche transactions, a portion of the project assets are isolated. In an *istisna'a*-based structure, construction financing is provided pursuant to an *istisna'a* applicable to the isolated assets, and the remainder of the project is financed with conventional interest-bearing debt. The payments of the *mustasne'* to the *sane'* constitute the basis, directly or indirectly, of the repayments to the financing bank providing the *Shari'ah*-compliant tranche. In an *ijâra* tranche structure (which is probably more common), construction of the isolated assets is often conventionally financed or financed pursuant to an *istisna'a* and the assets are then leased to the Project Company pursuant to an *ijâra* as previously discussed. The rent payments by the Project Company are the basis for repayment of the *Shari'ah*-compliant tranche. In some transactions, the *ijâra* constitutes the second leg of a sale and leaseback transaction.[69]

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66. Under a strict construction of the *Shari'ah*, there can be no lease until the asset has been constructed to a point where it has economic sufficiency. In transactions subject to that construction, an Agreement to Lease is also executed. In such a case, the Lease (*Ijâra*) is also executed at the inception (commencement of construction) and is operative with respect to all provisions except the rent payment provisions. The Agreement to Lease has the effect of activating the rent provisions of the Lease (*Ijâra*) when the project as the requisite degree of economic sufficiency so as to allow for the payment of rent. Recent transactions, such as the Bahrain Financial Harbour *Sukuk* discussed in section 5, have included a "forward lease" concept to address this issue in a different manner. The rents payable under the forward *ijâra* may be refundable (at least to some extent) if there are difficulties in achieving completion and rent adjustments may be necessitated by change orders.
67. But, see, note 46, *supra*.
68. *See, e.g.*, Al Omar (2000), and Duncan, Desai & Rieger (2004), referencing early single-tranche transactions.
69. The Equate petrochemical transaction, discussed in Al Omar (2000), is one such example. The Islamic component of the transaction itself consisted of two tranches.

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Triggers, rights and remedies under the conventional loan agreement and the *istisna'a* or *ijâra* documents must be harmonized to ensure co-equal and *pari passu* treatment of the conventional tranches and the *Shari'ah*-compliant tranches. These are particularly difficult issues, both conceptually and in terms of drafting. The project is usually a single integrated and indivisible whole. In most project financings it will be a necessity that both sets of documents default simultaneously lest a part of the project be subject to remedies or strictures while another group of assets is not subject to remedial action.[70] Similarly, it is generally unacceptable to have one set of financiers not being paid while the other set of financiers is being paid from revenues of what is for all practical purposes one integrated project. Other examples relate to the sharing of proceeds upon the exercise of remedies.

Even in the instance where there is absolute harmony with respect to events of default and the exercise of remedies and where all of the assets are sold as an integrated whole, it is unlikely that the assets allocated to one portion of the financing (say, the *ijâra*) will have a collateral value equal to the amounts secured under that portion. Both compliant and conventional financiers will demand participation on a *pro rata* basis, which means there will almost certainly be collateral sharing among them. Thus, some of the assets subject to the *ijâra* are in essence pledged to secure a *ribâ*-based financing, and vice versa. The compliant and noncompliant portions end up securing one another.[71] Further, there are significant issues of which group of financiers will control the exercise of remedies, and related issues of priority of the respective interests in any remedy proceeding. The interests of the conventional and *Shari'ah*-compliant tranches and related financiers may be significantly different, particularly if a portion of the assets backing the *Shari'ah*-compliant

70. Consider, for example, the issue of late payment interest and similar costs and penalties. In the Equate petrochemical project, it was recognized that "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." Al Omar (2000), at 263. In that transaction, loss of profit to the provider of the *Shari'ah*-compliant tranches as a result of late or delayed payment was addressed by building that element of lost profit into subsequent rent payments.

71. Such was the case in the Equate petrochemical project, where the assets relating to the *Shari'ah*-compliant *ijâra* were assigned to the common collateral pool and were made available to both the conventional and the *Shari'ah*-compliant financiers. However, those assets were only allowed to secure principal due to the conventional financiers, not interest due to such financiers. See Al Omar (2000), at 262. Conversely, insurance on the entirety of the project was made available to all financiers, including those providing the *Shari'ah*-compliant tranches. See, Al Omar (2000), at 263 and 264.

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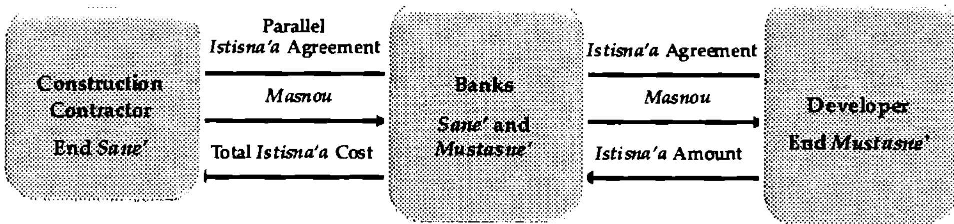
tranche is not fully available to the conventional tranches (for example, where the assets backing the *Shari'ah*-compliant tranche are available to support only principal–not interest–payments due to the conventional tranches). Complicated intercreditor arrangements will be structured to address these and similar issues, and those intercreditor arrangements will themselves stress *Shari'ah* compliance (and have given rise to extensive debate among Islamic scholars, financiers and investors).

Figure 4: Generic *Istisna'a* – Parallel *Istisna'a* Structure



4.4. *Istisna'a* – Parallel *Istisna'a* Structures

A project financing structure that is frequently used in the Middle East and Southeast Asia, and that involves no conventional debt, is comprised of two *istisna'a* contracts. The structure has not been used with any frequency in transactions involving non-Islamic banks (whether Western or resident in those jurisdictions) because of concerns about bank liability and legal issues (as well as underwriting matters). This *istisna'a* – parallel *istisna'a* structure is illustrated in Figure 4.[72]

72. Collateral security structures are not shown. Conceptually, they are not significantly different from that illustrated in Figure 2 or from those used in other *Shari'ah*-compliant or conventional interest-based financings (although it will secure a different type of obligation). The Banks will have direct rights to the construction arrangements by virtue of being a party signatory to the *istisna'a* and the parallel *istisna'a*. They will have a mortgage and security interest over the project and over the cash flows, accounts and personal property of the Project Company. There may also be environmental

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The original (or end) *mustasne'* (the Developer) will request the Banks, as the original *sane'*, to finance the construction of the project pursuant to the *Istisna'a* Agreement. In accordance with accepted *Shari'ah* principles, the Banks will act as *sane'* in the Parallel *Istisna'a* Agreement with the Construction Contractor, the end *sane'*. The terms of the *Istisna'a* Agreement and the Parallel *Istisna'a* Agreement will be identical except as regards payment. Pursuant to the Parallel *Istisna'a* Agreement, the Banks will make payment to the Construction Contractor on a current installment basis[73] while the obligation of the Developer to pay the Banks for construction will be on a deferred installment basis and will include a profit amount for the Banks. Of course, all required elements for a valid *istisna'a* agreement must be satisfied with respect to both the *Istisna'a* Agreement and the Parallel *Istisna'a* Agreement. For example, the agreements will have to be adherent to the *Shari'ah* principles and precepts pertaining to pertaining to conformity to agreed specifications, options of inspection, delivery, and defects, particularly latent and nondiscoverable defects. The drafting should incorporate inspection rights and appropriate waivers of liability to address these principles and should be precise as to the time and liabilities associated with delivery of the *masnou'* (the project). For example, it is prudent to require ongoing inspections of the work by the original *mustasne'* (the Developer) with failure to so inspect, or negligence in inspecting, relieving the Bank of liability. Incorporation of periodic delivery and acceptance concepts will also limit liability exposures.

One of the liability issues that has impeded the use of this structure arises as a result of a critical imperative of *istisna'a* structures: the Banks will be obligated to the Developer on the *Istisna'a* Agreement regardless of whether the Construction Contractor performs on the Parallel *Istisna'a* Agreement. The *Istisna'a* Agreement and the Parallel *Istisna'a* Agreement are entirely separate and distinct agreements and there will be no privity between the Developer, as the original or end *mustasne'*, and the Construction Contractor, as the end-*sane'*. Careful structuring and drafting is necessary to address the liability exposure of the Banks. However, there are acceptable means of addressing these issues. These include (a) damage limitation provisions in the *Istisna'a*

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indemnities, construction and completion guarantees and other similar collateral security as is customary in project financings. The collateral security package will secure the obligations of the original *mustasne'* (the Developer) to make payments and perform its obligations under the *istisna'a* agreement.

73. The drafting of the parallel *istisna'a* will then incorporate funding conditions and similar "draw request" provisions similar to those in a conventional financing.

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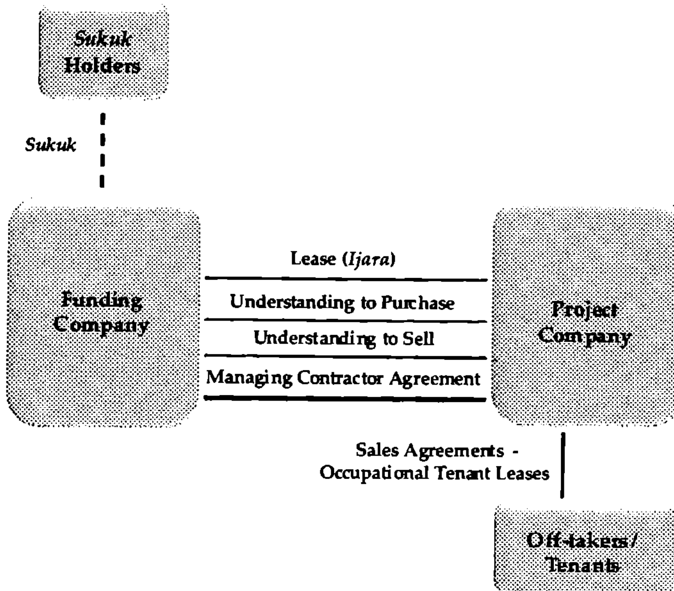
Agreement that limit the damages payable by the Banks to the Developer in circumstances where there was a default on the Parallel *Istisna'a* Agreement (although these provisions usually do not make direct reference to the Parallel *Istisna'a* Agreement), and (b) provisions for extension of performance periods where the Parallel *Istisna'a* Agreement is not performed in a timely manner (again, usually without direct reference to the parallel *Istisna'a* Agreement).

Figure 5: Generic *Sukuk al-Ijara* Financing Structure



4.5. *Sukuk al-Ijâra* Structures

A slight variation to the bifurcated *ijâra* structure discussed in section 4.1 of this article will eliminate the need for conventional debt. This variation makes use of the *sukuk al-ijâra* as a substitute for the conventional debt. Many of the *Shari'ah*-compliant real estate transactions in North America and Europe have involved conventional interest-bearing debt provided by conventional banks and have been structure using the bifurcated *ijâra* structure, but also in anticipation of the possible substitution of the *sukuk al-ijâra* for the conventional debt with minimal structural change and low transaction costs. Those transactions have also been structured to allow a conventional bank or financial institution to hold the *sukuk al-ijâra* and syndicate or participate that

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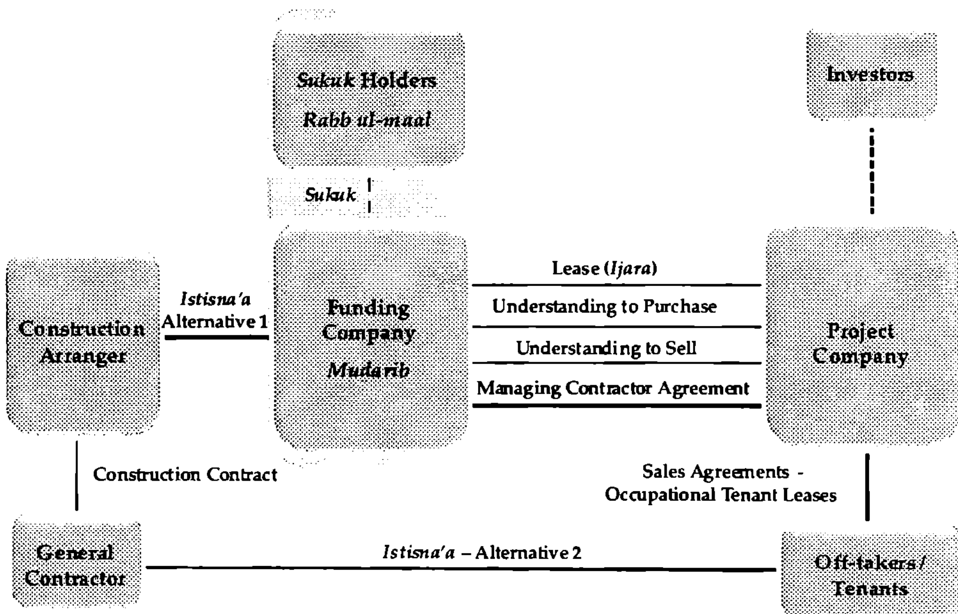
holding in accordance with existing underwriting criteria of those banks and financial institutions and in accordance with existing conventional banking regulations. The *sukuk al-ijâra* is illustrated in Figure 5.

It is apparent that the only structural change is the substitution of the *Sukuk* Holders for the Bank (compare Figure 1). If the *Sukuk* is to be publicly offered or privately placed, the Funding Company (and the Project Company) will have to comply with relevant securities laws, and the Funding Company will have to be constituted as an issuer trust or issuer special purpose entity integrating relevant fiduciary and trust concepts (or a separate issuance vehicle will have to be established). However, the structure is also amenable to having a conventional Bank (the Bank in Figure 1) be the sole (or sole initial) *Sukuk* Holder on terms quite similar to those that would otherwise be incorporated in a conventional loan. Such a transaction could be structured as a "loan" for

Figure 6: Generic *Sukuk al-Mudaraba* Structure



regulatory purposes in Western jurisdictions and a "*sukuk*" for *Shari'ah* purposes. Exploration of these possibilities should further facilitate the acceptance of *Shari'ah*-compliant financing techniques in Western jurisdictions, and also allow for implementing transactions at a lower level of transaction costs.

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4.6. *Mu*d*âraba* Structures

The *mu*d*âraba* is, and has long been, a preferred method of project financing under the *Shari'ah,* although it has not been frequently used in modern project financings. A generic *mu*d*âraba* structure is set forth in Figure 6.[74] This illustration depicts a *sukuk* financing, rather than a bank financing. However, as with the bank *ijâra– sukuk al-ijâra,* the structures are easily interchangeable. To tie the generic structure more closely to configurations used in current project financings, this illustration also incorporates the *istisna'a-ijâra* structure.

A *mu*d*âraba* is a profit-sharing partnership defined by the nature of the contributions of the *mu*d*ârib* and the *rabb ul-maal* to the partnership.[75] One party (the bank or the *sukuk* holders) acts as the *rabb ul-maal* (the capital provider), which may be provided in cash or in kind (with the rules of the different *madhahib* varying as to the particulars of in-kind contributions). The other party (the developer) acts as the *mu*d*ârib* (the manager) and contributes services (but, in the classical formulation, no capital in cash or in kind). There may be more than one *rabb ul-maal* and more than one *mu*d*ârib.* The *mu*d*âraba* capital must be known and designated in a definite currency, although it may include debt for which a *mu*d*ârib* or another person is liable.[76] The agreement of the parties will govern the timing of, and conditions applicable to, the making of capital contributions; thus, capital infusions may be structured to be periodic (resembling, for example, lending structures for a construction financing). The business of the *mu*d*âraba* may be specifically limited or it may be unrestricted. A *mu*d*âraba* may be limited as to scope, time, activities, and other factors. Customary business practices guide the powers of the *mu*d*ârib* to the extent not otherwise specified in the *mu*d*âraba* agreement. In the project finance context, the developer constructs and operates the project using capital provided by the banks or *sukuk* holders. The *mu*d*âraba* does not

74. More complex structures may be used to secure effective use of tax benefits (as where the Project Company is the intended tax owner of the project). See section 5 of this article which discusses the Bahrain Financial Harbour Sukuk and some of its primary structural features, such as investment of the proceeds of the *sukuk* issuance pending periodic application to construction payments. See, McMillen (2008) for a discussion of other structural alternatives.

75. With respect to the *Shari'ah* principles applicable to the *mu*d*âraba*, see *Majelle*: Hooper, at articles 1404-30, and *Majelle*: Tyser, at 233-36 (articles 1404-30), and Al-Zuhayli (2003), at 497-521. *See, also,* Usmani (1999 – ALQ), at 212-17. The *mu*d*âraba* is quite similar to the Roman *commend* and may have been derived from the early Islamic version, the *qirâd*. See Udovitch (1969 – OC).

76. The debt might include, for example, debt owed by a third party to the *rabb ul-maal*, or it might be debt owed by the *mu*d*ârib* to the *rabb ul-maal*. Use of debt capital is not discussed in this article.

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necessarily, and need not, correspond to an existing secular legal category (such as a partnership). This renders the *muḏâraba* a particularly flexible business form, especially in multi-jurisdictional transactions. It may be established with respect to a defined group of assets, as distinct from the legal form of organization of a business. Thus, for example, the *muḏâraba* may focus on a single production line rather than the entirety of the business (all production lines within the same company). Allocation of expenses and revenues will then be determined with respect to the single production line.

A defining characteristic of the *muḏâraba* is that losses from the operation of the *muḏâraba* must be borne by the *rabb ul-maal* absent infringement, default, negligence, or breach of contract provisions by the *muḏârib*. The *muḏârib* suffers the loss of its services, and therefore no loss of capital (unless the *muḏârib* has also contributed capital to the *muḏâraba*).

Profit, in a *muḏâraba*, is that amount which exceeds the *muḏâraba* capital provided by the *rabb ul-maal*. Loss (*wadee'ah*) is the amount by which the *muḏāraba* capital is decreased or diminished. Certain *muḏâraba* expenses are deducted from the *muḏâraba* funds prior to distribution of profits, although the *muḏârib* is expected to bear many expenses. The presumption, as a *Shari'ah* matter, is that the *muḏârib* is responsible for operational expenses, including the purchase, transportation, storage, sale, and collection activities of a business. However, some types of expenses may be allocable to the *muḏârba* itself. This is a matter that is usually determined in consultation with the *Shari'ah* board and the resulting determination will be embodied in the *muḏâraba* agreement. The *muḏâraba* agreement may also specify required reserves, which may be treated as expenses of the *muḏâraba*. Examples include reserves for taxes, insurance, and bad debts. The *muḏârib* will be responsible for collecting the debts owed to the *muḏāraba*, whether the *muḏârib* realizes a profit or loss as a result of its activities.[77]

Profit allocations must be specified at the inception of the contract. It is permissible to provide for different percentages of profit distribution when the profit exceeds certain levels, thresholds, or amounts.[78] There can be no

77. The *Shari'ah* principles applicable to bad debts, valuation of debts, write-offs of bad debts, allocation of surplus upon collection of a debt formerly written off, and ultimate attribution of bad debts (to the *rabb ul-maal*) are not discussed in this article but will be a significant factor in drafting the documentation for a *muḏâraba* transaction.

78. These principles find application in many *Shari'ah*-compliant financings with non-Muslim Western investors where partnership and operating agreements include "hurdles" and preferences with varying rates and allocations between and among the joint venturers.

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predetermined or conclusive profit allocation to any of the parties and arrangements allocating all profit to a single party are impermissible; profits must be distributed in accordance with fixed ratios. Consistent with this principle, guarantees may not be taken for the purpose of securing the *mu<u>d</u>âraba* capital; return of capital may not be assured or guaranteed. However, guarantees may be taken by the *rabb ul-maal* to secure the ultimate repayment of the capital, minus losses plus profits, and/or to secure the *rabb ul-maal* against infringement, default, negligence, or breach by the *mu<u>d</u>ârib*. Profits may only be paid after the *rabb ul-maal* has received a return of its capital (including a retrieval of previous losses). Thus, any periodic distributions of profit during the period of the *mu<u>d</u>âraba* are considered tentative and are subject to the final accounting upon liquidation of the *mu<u>d</u>âraba*.[79] As a general matter, assets purchased by the *mu<u>d</u>ârib* in effecting the business of the *mu<u>d</u>âraba* are deemed owned by the *rabb ul-maal*. Therefore, the *mu<u>d</u>ârib* is not entitled to a share of the profits until those goods are sold and profit is realized. More recently, *tandeed* concepts, actual and constructive, have been applied to allow determinations as to allocation of returns to both the *mu<u>d</u>ârib* and the *rabb ul-mall* upon termination of the joint venture, even if all assets have not been sold or disposed (based upon constructive sale concepts). Obligations of the *mu<u>d</u>ârib* may also be secured by a mortgage or pledge (*rahn*). Upon the termination of the *mu<u>d</u>âraba*, the *mu<u>d</u>ârib* is obligated to return the *mu<u>d</u>âraba* capital, plus profit and minus loss, to the *rabb ul-maal*. Failure to do so results in liability on the *mu<u>d</u>ârib*, including as a usurper. Any profits made by the *mu<u>d</u>ârib* through the use of assets after the capital should have been returned to the *rabb ul-maal* will be payable over to the *rabb ul-maal*.

The *mu<u>d</u>ârib* and the *rabb ul-maal* may agree upon methodologies for determinations as to the occurrence of infringement, default, negligence, or breach for which the the *mu<u>d</u>ârib* may be held liable for the return of the *mudaraba* capital. Default or breach by the *mu<u>d</u>ârib* of the provisions of the *mu<u>d</u>âraba* agreement, and exceeding authority, will result in liability for the *mu<u>d</u>ârib*.[80] And, under the *Shari'ah*, usage and practice standards will apply to the activities of the *mu<u>d</u>ârib* and failure to carry out certain activities or exercise the requisite standard of care will result in liability to the *mu<u>d</u>ârib*.

79. *See, for example*, Fadeel (2007), at 98. The application of this principle is difficult in practice as clawbacks that are effected some time (say, years, or in a different tax year) after a distribution raise significant tax (and other) issues and may be inconsistent with global market practices.

80. Consider the reports of the *mu<u>d</u>âraba* agreements of Abbas Bin Abdul Muttaleb as an example: His agreements stipulated, with respect to travel, that the *mu<u>d</u>ârib* would not be permitted to "travel by sea, nor through valleys, nor by a riding animal" and violation would make the *mu<u>d</u>ârib* liable for repayment of the entire capital.

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The *rabb ul-maal* generally may not participate in the management or service component. The contract establishing the *mudâraba* may, and usually does, specify in detail the terms under which the partnership will operate. The *mudâraba* may be free or limited; most are strictly limited. The *mudâraba* agreement may specify those matters that require the consent of the *rabb ul-maal. Shari'ah* boards usually require *rabb ul-maal* consent if the *mudârib* desires to contribute money to the *mudâraba* and mix that money with the money of the *rabb ul-maal. Shari'ah* boards will usually allow *rabb ul-maal* consent rights that are akin to those provided to limited partners in limited partnership structures, such as those pertaining to changes in the fundamental business of the venture or the fundamental terms of the joint venture arrangement, sale of all or substantially all of the assets of the venture, bankruptcy declarations, and similar "minority shareholder" rights provisions. In publicly offered *sukuk al-mudâraba* transactions, the *sukuk* holders frequently have relatively limited consent rights; the consent rights closely resemble those afforded conventional bond or asset backed securities holders and depend upon the nature of the transaction. Similarly, covenants in a *sukuk al-mudâraba* transaction are quite similar in many ways to those in an equivalent conventional transaction.[81] Thus, for example, the agreement will address the permissible purposes of the partnership, consent rights, use of funds, positive and negative covenants, incurrence of indebtedness, permissible expenses, permissible and required reserves, representations and warranties, profit and loss allocation, and infringement, default, negligence or breach. It is important to note that each contractual element is the subject of extensive *Shari'ah* precepts and principles. However, as a general statement, with careful structuring and drafting, it is possible to create a *mudâraba* arrangement that gives the financiers most (not all) of the protections that they have in a conventional financing. The *mudâraba* is a partnership arrangement and does expose the financiers to a different risk profile than they have in conventional financings. Some examples may be illustrative and re-emphasize some of the important principles.

The primary difference between a *mudâraba* arrangement and a conventional interest-based financing arrangement with respect to profits and losses (*i.e.*, the *mudârib* developer is not liable for failure to return the capital (except in

81. While many, if not most, covenant requirements will be the same in a conventional and a *Shari'ah*-compliant transaction, there are many important differences as a result of applicable *Shari'ah* principles. For example, a *mudâraba* agreement would not be able to require return of capital or a specified return or amount of profit within a specified period.

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specified situations) gives rise to misunderstandings and considerable restructuring (in the minds of the conventional participants). Western participants are quite unaccustomed to the idea that the relationship between the financiers and the developer is one of partnership, not preferred payment as in a conventional financing.

Losses from the operation of the *mudâraba* must be borne by the *rabb ul-maal* absent infringement, default, negligence or breach of contract provisions by the *mudârib* Developer. The *rabb ul-maal* suffers the loss of its capital, and the *mudârib* suffers the loss of its work and efforts. This allocation of losses is a particularly difficult point for conventional interest-based financiers in a project financing. The primary means of addressing this in transactions involving interest-based financiers have focused on the contractual provisions pertaining to infringement, default, negligence and breach. In the case of *mudârib* infringement, default, negligence or breach, the *mudârib* may be held liable for the return of the *mudâraba* capital. Default under, or breach of the terms of, the *mudâraba* agreement may give rise to *mudarib* developer liability. So will exceeding of contractual authority by the *mudârib* or failure to exercise requisite care in the performance of responsibilities.

Careful drafting of the *mudâraba* agreement can significantly narrow the area of consternation and controversy. The scope of the *mudârib*'s authority, responsibilities, obligations, liabilities and ability to act in a wide range of situations, as well as the nature of infringement, default, negligence and breach, can be addressed in a manner quite similar to conventional partnership and loan agreements (but so as to be responsive to relevant *Shari'ah* principles).

4.7. *Mushâraka – Murabaha* Structures

Another structure that is purely *Shari'ah* compliant and involves no conventional debt is one based upon the use of a joint venture (*Sharikat mahassa* or *mushâraka*). The term *mushâraka* derives from the same root as *sharikat* or *al-sharika*. *Al-sharika* is a broad term which, based on its meaning of "sharing", and in the commercial and financial realm, encompasses various joint ownership arrangements (*Sharikat ul-milk*) and partnerships for profit effected by mutual contract (*Sharikat ul-'aqd*).[82] *Sharikat ul-'aqd* are divided into: (a) partnerships in which all partners invest capital in a commercial enterprise (*Sharikat ul-amwaal*); (b) partnerships in which the partners jointly undertake to provide services and distribute the fees in an agreed ratio

82. *Majelle*: Hooper, at articles 1045-1403, *Majelle*: Tyser et al., at 166-232 (articles 1045-1403), and Al-Zuhayli (2003), at 447-81, set forth various *Shari'ah* principles applicable to the *sharikât* (*mushâraka*). The *mushâraka* and the various types of *sharikât* are discussed in Usmani

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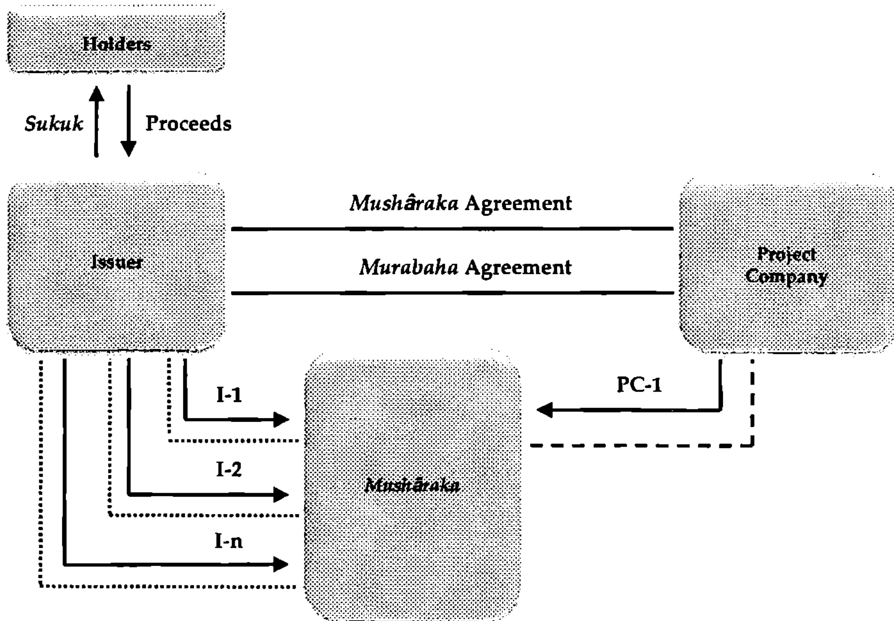
(*Sharikat ul-a'mal*); and (c) partnerships in which the partners, having made no capital investment, purchase an asset (usually a commodity) on a deferred basis and sell the asset on the spot market, with the profits being distributed in an agreed ratio (*Sharikat ul-'aqd*). *Mushâraka*, a term which has only recently come into use in the field of Islamic finance, is a subset of the *sharikat* referring, primarily, to *sharikat ul-amwaal* and, occasionally, to *sharikat ul-a'mal*. A generic *mushâraka* transactional structure is graphically depicted in Figures 7 and 8, again focusing on the *sukuk* structure: the *sukuk al-mushâraka*. Figure 7 focuses on the formation and funding of the *mushâraka*, and Figure 8 is directed to the repayment of the financing.

Figure 7: *Sukuk al-Mushâraka* Formation and Funding



(1999 – ALQ), at 203-12. The general rules in respect of partnership profit and loss under Hanafî jurisprudence are summarized in Udovitch (1969 – CT), at 5: "To summarize: According to Hanafî law, liability in partnership corresponds to investment in all cases; profit follows any ratio stipulated in the contract, except in the case of credit partnership where it, too, follows the investment." Udovitch's discussion of the credit partnerships, in Udovitch: Credit, is particularly interesting. He discusses various long-accepted credit devices, such as *al-bay' bit-ta'-khîr* (deferred payment for goods sold), *salam* (advances for future delivery), *hawala* (transfer of debt, novation), and *suftaja* (letters of credit). He also speaks to the credit partnerships accepted by the Hanafî *madhab* in which the capital of the partnership consists of only credit, not of cash or merchandise. These partnerships are the *sharikât al-mafâls* (partnership of the penniless) and *sharikât al-wujûh* (partnership of those with good reputations).

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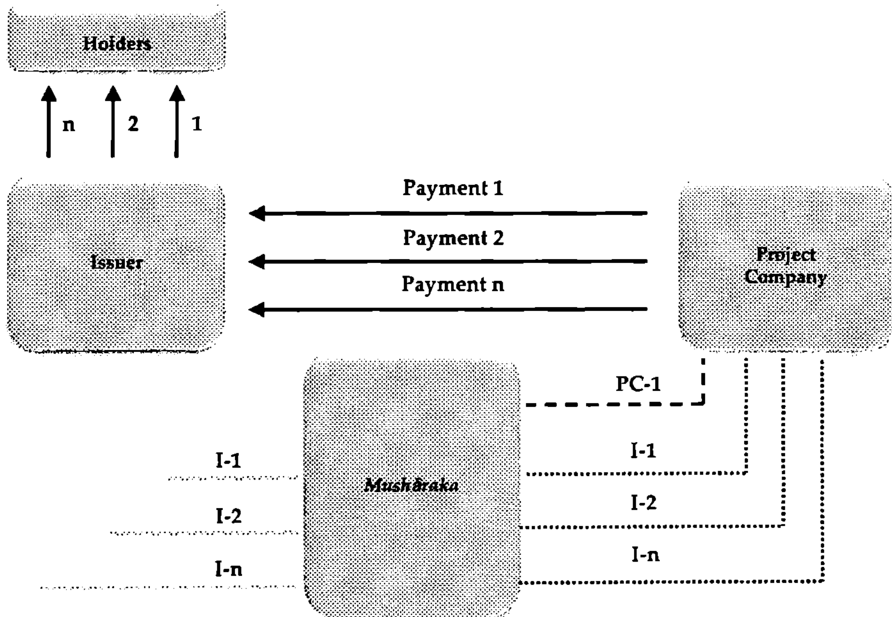
The members of the joint venture are the bank financiers or *sukuk* holders and the project developer and operator. Figure 7 illustrates an Issuer member of the *mushâraka* and the Issuer is funded by a *sukuk* issuance. The Issuer provides financing by making capital contributions to the joint venture (the *mushâraka*) and acquiring joint venture interests (*hissas*). These capital contributions are made periodically (say, monthly) as construction financing is required and subject to satisfaction of conditions precedent that are quite similar to those in any conventional financing (such as completion of monthly or other periodic construction milestones). This capital is used to make payments in respect of construction and operation. These periodic contributions are designated I-1 through I-n in Figure 7. The developer/operator frequently contributes assets as its capital contribution. This may include land, its rights under various project documents (construction contracts, supply and offtake agreements, etc.), its rights under permits, and cash. This contribution is usually required to be made prior to the time the Issuer makes its contributions. The Project Company contribution is designated as "PC-1" in Figures 7 and 8.

Figure 8: ***Sukuk al-Mushâraka*** **Payment**



The repayment of the financing provided by the *Sukuk* Holders (through the Issuer, who is the actual member of the *mushâraka*) is effected by periodic (say,

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quarterly) sales of the *hissas* acquired by the Issuer to the Project Company pursuant to a *murabaha* (deferred payment sale at a mark-up) arrangement.[83] This is depicted in Figure 8 by the disconnection of *hissa* ownership by the Issuer (designated "I-1" through "I-n") and transfer of ownership of those *hissas* to the Project Company. This transfer is made each time a payment is made by the Project Company to the Issuer (designated as "Payment 1" through "Payment n"). The Issuer will use the proceeds of each such payment to make payments on the *Sukuk* to the Holders. Upon payment in full, all *hissas* will be owned by the Project Company. The structure (with modifications) allows for participation by both Islamic banks and conventional Western banks. The structure is relatively simple, involving only two primary agreements: (a) the *mushâraka* (*sharikat mahassa*) agreement; and (b) the *murabaha* agreement. This structure has been recently used in a number of Middle Eastern *sukuk* issuances.

Management of the *mushâraka* is established in the *mushâraka* agreement, in accordance with the desires of the partners. This affords the partners considerable flexibility in allocating management responsibilities between and among partners; joint rights of management are frequent and usual. Historically, the presumption was that all partners would participate in the management of the *mushâraka*. If all partners participate in the management of the *mushâraka*, each partner is treated as the agent of all other partners (akin to general partnership concepts in Anglo-American law). Given the contractual basis of the *mushâraka* and the degree of latitude afforded the partners in agreeing as to operational matters, partnership agreements and operating agreements are useful models for structuring *mushâraka* arrangements.

There are significant differences between the *madhahib* regarding the rules applicable to capital contributions, especially as to the permissibility and effect of in-kind contributions. However, the schools all seem to agree that capital, once contributed, is the property of the *mushâraka* (rather than any individual partner) and inures to the benefit of all partners.[84] The *madhahib* are also unanimous on the view that a partner may not assume liability for the capital of another partner, including by way of guarantee. Guarantees may be taken by

83. This structure was used in a 1997-98 financing in the Saudi Arabian electric sector. See, McMillen (2000 – FILJ), at 1232-1236. Applicable *Shari'ah* principles with respect to a *sharikat* are set forth in the *Majelle*: Hooper, at articles 1045-1403, *Majelle*: Tyser, at 166-232 (articles 1045-1403), and Al-Zuhayli (2003), at 447-81.

84. Contrast the classical formulation on this point with respect to a *muḏāraba* in which the property is deemed owned by the *rabb ul-maal*.

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the partners to secure the ultimate repayment of the capital, minus losses plus profits, and/or to secure the partners against infringement, default, negligence, or breach by the managing partners. Absent agreement to the contrary in the *mushâraka* agreement, and again akin to general partnership concepts under the common law, the liability of each partner is unlimited.

Profit and loss definitions are largely the same as with *muḏâraba*, with some fundamental differences. In current practice, profit allocations may be in any ratio agreed by the partners. Profits may be allocated in accordance with a points system, and that points system may be structured to take cognisance of the amount of capital contributed and the period of participation of that capital in the venture. That position has long been accepted by the Hanbalî and Hanafî *madhahib*, although the Hanafî *madhab* modified the position if, pursuant to their agreement, one or more partners did not participate in management; in that case, participation of that partner in the profits of the *mushâraka* would be limited to the ratio of that partner's contributed capital. The Mâlikî and Shâfi'î schools historically required that profit distributions be in accordance with ratios of contributed capital. Profit from a specific period or operation may not be allocated to a specified partner, nor may a lump sum be allocated to a specific partner. In the majority view, losses, up to the amount of a partner's capital contribution, must be distributed in accordance with the relative capital contributions of the partners. There are *Shari'ah* precepts applicable to purchases and sales of interests (*hissas*) from one partner to another (as well as applicable *murabaha* precepts) that are critical in the implementation of this type of structure.

The *mushâraka* structure raises a number of *Shari'ah* issues that are currently the subject of debate among *Shari'ah* scholars. These issues relate to (a) the times at which the *murabaha* agreements may be executed and priced, (b) the pricing of the *hissas* that are periodically resold to the Project Company (developer/operator), and (c) profit and loss allocations among the members of the joint venture.

A threshold issue in the debate relates to the timing of execution of the *murabaha* agreements for the sale and purchase of the *hissas*. As a general matter, there are three different positions with respect to when the *murabaha* agreement(s) may be executed, and different scholars have adopted each of the positions: (i) a comprehensive single agreement, or all agreements, at the inception of the transaction (*i.e.*, at formation of the joint venture); (ii) a comprehensive single agreement, or all agreements, at completion of construction; and (iii) a *murabaha* agreement with respect to each group of

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hissas at the time of completion of each milestone,[85] effectively requiring multiple *murabaha* agreements, one executed at the time of each capital contribution. Alternatives (ii) and (iii) entail risks that the agreements may not all be executed, a difficult position for financiers. One of the reasons for differences of opinion among *Shari'ah* scholars relates to compulsory sales issues. A selling partner (the Issuer, on behalf of the *Sukuk* Holders or financiers) would be obligated to sell if the buying partner (the Project Company developer/operator) elects to purchase, but the buying partner cannot be compelled to purchase.

A closely related issue relates to the establishment of the purchase price for the *hissas* being sold pursuant to the *murabaha* transaction. Specifically, at what point may the price for each *hissa* purchase be established. The positions of the *Shari'ah* scholars vary, with some scholars taking each of the following positions with respect to establishment of the *hissa* sale price: (A) the price for each and every (say, quarterly) sale may be established at the inception of the entire transaction (*i.e.*, at formation of the joint venture) for each *hissa* sale and purchase transaction as a negotiated price; (B) the price for each (say, quarterly) sale must be established at the time of that sale, often based upon the fair market value of the project at that time rather than a predetermined "financing price"; and (C) only at completion of the construction, as a comprehensive and fully inclusive fair market value can only be determined at that time. The majority position seems to be the first position, allowing a negotiated price (which may be a fixed or floating rate) to be established for all sales transactions at the time of formation of the joint venture. Others take the position that fair market value can only be determined upon completion of the project. The focus on fair market value relates to the argument that a sale price that is in excess of the market price would represent a disproportionate share of the *mushâraka* profit and would thus be prohibited by the *Shari'ah*. Another line of discussion focuses on the compulsory nature of the *hissa* purchase and sale.

Issues pertaining to allocations of profits and losses (particularly in the construction phase) arise under both the *Shari'ah* and local secular law, especially joint venture law and tax law. The parties clearly desire that the Issuer (financiers) not be allocated any profits, and not be liable for any losses,

85. The *Shari'ah* scholars also have differing views on what constitutes a valid "milestone" that may give rise to a permissible purchase of *hissas*. Some scholars require completion of the entire project; others are at the other end of the spectrum and allow discretionary groupings of construction activities.

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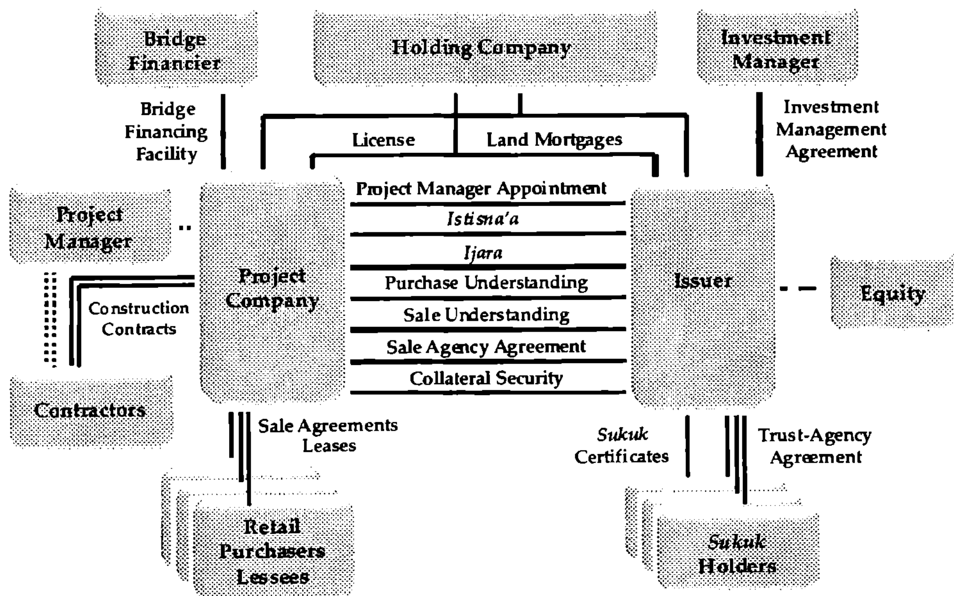
during the construction phase. In many construction projects, these issues will be of little practical consequence (with possible exceptions for tax considerations), assuming that completion ultimately occurs, although this varies greatly from jurisdiction to jurisdiction. In other cases, those allocations may themselves cause a recalculation of, or be included in the calculation of, the sale price of the *hissas* in the *murabaha* phase of the transaction.

Careful structuring is required in the implementation of any *mushâraka* transaction. That structuring must include precise discussions with the *Shari'ah* scholars advising on the transaction with respect to each of the foregoing matters, among others.

5. Bahrain Financial Harbour *Sukuk*

The July 2005 Bahrain Financial Harbour *Sukuk* provides an example of a recent *Shari'ah*-compliant financing (involving no conventional debt) that combines a number of the structural elements described in this article, most notably *istisna'a*, *ijâra* and *sukuk* concepts. The structure also includes a *Shari'ah*-compliant interim investment mechanism and a *Shari'ah*-compliant bridge financing facility. Figure 9 provides a graphic summary of the overall

Figure 9: Bahrain Financial Harbour *Sukuk*



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documentary structure of the project financing transaction. A more detailed discussion of this structure is presented elsewhere,[86] and the purpose here is to allow the reader to explore how the foregoing structures might be incorporated, with modifications, into a full-scale project financing. That exploration will inevitably include consideration of how the structures must be modified, under both secular law and the *Shari'ah*, and what additional structuring may be required in an actual project financing transaction.

The project is comprised of the "Financial Centre Development Phase" of the Bahrain Financial Harbour Project in Manama, Kingdom of Bahrain. *Sukuk* Certificates were issued and the proceeds of the issuance serve as the basis for financing the construction of the project. Pending application to construction costs, those proceeds are invested with the Investment Manager in *Sharicah*-compliant investments. The variable rate *Sukuk* Certificates were registered, certificated and transferable. Each *Sukuk* Certificate represents a fractional undivided beneficial ownership interest in the trust assets (essentially the project, proceeds of investments, proceeds from sales or rentals of project components or space, certain insurance proceeds, and related contracts), and the sole recourse of the *Sukuk* Holders is to the trust assets.

For present purposes, there are a few notable features. One such feature pertains to the use of the *ijâra* and the *istisna'a* between the Issuer (equivalent to the Funding Company) and the Project Company and the fact that the Project Company entered into the Construction Contracts. The *ijâra* is an "advance lease" and there were payments of "advance rentals" in respect of uncompleted portions of the project (with customary rent being payable with respect to completed portions).[87] This raises interesting questions (resolved in the structure) as to what happens in the circumstance that construction does not reach full completion. Another feature relates to the investment of *sukuk* issuance proceeds pending application in respect of construction costs and the availability of the advance rentals to pay construction costs. Yet another feature

86. See, McMillen: *Sukuk* and Secondary Markets, *supra* note 1.

87. As noted above (note 66), a number of issues arise during the early stages of construction with respect to rent payments on the *ijāra* where physical assets have not yet been constructed to the point of economic sufficiency. In the *istisna'a - ijāra* structure, this issue is addressed through the Agreement to Lease. The advance rent under a forward lease speaks to this issue, but also raises other *Shari'ah* issues, most notably whether the *sukuk* may trade above or below par value prior to construction of the physical assets to the state of required economic sufficiency. Many, if not most, *Shari'ah* scholars take the position that trading of the *sukuk* certificates is not permissible prior to that time. This issue was addressed in the Bahrain Financial Harbour *Sukuk* offering by noting the issue and leaving the *Shari'ah* determination to the individual certificate holders.

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relates to funds available to repay the *Sukuk* Holders: these include the proceeds of sales of retail units and space and rents from the leasing of space, the *Shari'ah*-compliant revolving bridge facility, and proceeds from the investment of *sukuk* issuance proceeds. And consider the implications of the feature, implied in Figure 9 from the existence of the Trust-Agency Agreement, whereby the Issuer was constituted a trustee and agent on behalf of the *Sukuk* Holders, here under applicable trust laws of the Kingdom of Bahrain.

6. Conclusion

This focus of this article is the different types of techniques that are available to effect large, complex infrastructure and project financings that are purely or partially compliant with the *Shari'ah*. Clearly, there will be increasing demand for the implementation of these structures. Capital is flowing into the oil producing countries within the OIC, especially in the Middle East. Those countries, and others, are upgrading existing infrastructure, embarking on expansion of infrastructure conceptions, and attempting to broadly diversify away from oil and gas chains: witness the development activities in Abu Dhabi, Bahrain, Dubai, Saudi Arabia, Sharjah, and Qatar, among others. More and more projects are entering (or will soon enter) the construction phase. The size, complexity and scope of these projects will require cooperative, knowledgeable participation by both Western and *Shari'ah*-compliant participants. It will require just and fair allocation of risks among these participants. Each group of participants has fundamentally different conceptions of economic reward based upon fundamentally different conceptions of risk participation. Western financiers are accustomed to preferential receipt of their economic reward (interest and principal). Under the *Shari'ah*, a preference of this type is impermissible *ribâ*; the risks of the transaction or undertaking are not adequately shared by the participants. The challenge is to develop and implement structures that permit involvement of both types of participants without violation of the *Shari'ah* and in a manner that satisfies the competing economic, institutional, political, legal, regulatory and accounting constraints to which each of the participants is subject. To remain competitive, Western financial institutions as well as Islamic financial institutions will need to be fully conversant with these types of financing structures.

This article is intended to provide an introduction to the fundamental concepts and structures that must be mastered in order to achieve the requisite degree of cooperation. It has attempted to suggest ideas as to way to harmonize principles

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from two disciplines (project finance and Islamic finance) that were born in the same period, grew independently and in different environments (particularly as regards risk-reward paradigms and principles), and, of necessity, are now converging. Transactional implementation will require refinements to the myriad complexities of a broad range of different projects in a manner that serves the business needs of a wide array of participants, each having a unique perspective and each subject to a unique set of constraints, some of them being difficult to harmonize with the perspectives and constraints of other participants. The hope is that this process will be viewed as a creative opportunity whose realization will enhance awareness and knowledge of both economic systems (interest-based and Islamic) and of the fundamental cultural, moral, ethical and religious principles that guide the existences of people. As the history of both modern project finance and modern Islamic finance has taught us, the process is highly creative and enjoyable to all involved, and the rewards are shared by all.

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Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options

Wafik Grais and Matteo Pellegrini

Abstract

This paper reviews Institutions Offering Islamic Financial Services (IIFS) corporate governance (CG) challenges and suggests options to address them. It first points out the importance of CG for IIFS, where it would require a distinct treatment from convention CG and highlights three cases of distress of IIFS. It then dwells on prevailing CG arrangements addressing IIFS' needs to ensure the consistency of their operations with Islamic finance principles and the protection of the financial interests of a stakeholders' category, namely depositors holding unrestricted investment accounts. It raises the issues of independence, confidentiality, competence, consistency and disclosure that may bear on pronouncements of consistency with Islamic finance principles. It also discusses the agency problem of depositors holding unrestricted investment accounts. The paper argues for a governance framework that combines internal and external arrangements and relies significantly on transparency and disclosure of market relevant information.

The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the view of the World Bank, its Executive Directors, or the countries they represent.

Introduction[1]

Good governance is crucial to the ability of a business to protect the interests of its stakeholders. These interests may extend beyond the purely financial to the stakeholders' ethical, religious, or other values. In the case of an institution offering Islamic financial services, stakeholders expect its operations to be carried out in compliance with the principles of *Shariah* (Islamic Law). A corporate structure that enables such an institution to implement good governance through *Shariah*-compliant operations is therefore essential[2].

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Islamic finance helped sustain economic growth throughout the Muslim world during the middle Ages. After a long period of lull, the last three decades witnessed its revival, notably after the first oil price shock of 1973-74. Beyond the surge in liquidity, its reemergence was prompted by the introduction of innovative Islamic financial products and a demand by Muslim populations for financial services compatible with their religious beliefs. More recently, the industry has received a new impetus that can be ascribed to a number of factors: the uneven performance of Western financial markets, a perception of increased risk for Gulf Cooperation Council capital in traditional financial markets, a renewed surge in oil prices, an expressed demand from Muslimcommunities in Western countries, and the development of managerial skills necessary for providing Islamic financial services.[3] The global Islamic financial services industry now includes 284 institutions offering Islamic financial services (IIFS) operating in 38 countries, both Muslim and non-Muslim.[4]

Initially, IIFS developed without being clear about the legislative and regulatory framework that applied to them.[5] However, their conceptual foundations and operational practices have specific features that pose challenges to regulators and call for solutions beyond the simple extension of existing legislation and regulation applying to institutions offering conventional financial services (ICFS). Consequently, a number of countries have established laws and regulations for IIFS, and international bodies have been created to adapt conventional standards and harmonize practices.[6]

This paper reviews IIFS' corporate governance (CG) challenges and suggests options to address them. Four main concerns motivate this attention to the CG of IIFS: (i) CG is important for economic development; (ii) the assets of IIFS are significant and growing, (iii) sound CG may be more critical for financial than other organizations, and (iv) the CG vulnerabilities of IIFS may not have received adequate attention in conventional CG frameworks.[7]

The activities of IIFS impact the welfare of more than 20% of the world's population, mostly in developing countries.[8] In certain financial systems, IIFS may channel more than 20% of financial flows. Moreover, IIFS provide access to financial services to social groups that would otherwise hesitate to use them. For both ICFS and IIFS, sound CG creates an enabling environment, which rewards banking efficiency, mitigates financial risks, and increases systemic stability.

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Islamic capital markets, mutual funds and insurance services are also developing, but are not covered here. These figures were reported in a press release by CIBAFI dated May 8, 2005, ("CIBAFI Raises the Glance toward IIFS Growth with a Unique Statistic-Based 10-Year Strategic Plan").

In a review of the impact of corporate governance on economic development, Claessens (2003) identifies four areas in which empirical evidence points to the positive effects of good CG on the performance of firms. First, it facilitates access to external finance. Lenders and other investors are more likely to extend financing to a business if they are comfortable with its CG arrangements, including the clarity and enforceability of creditor rights. Second, good CG tends to lower the cost of capital, by conveying a sense of reduced risk that translates into shareholders' readiness to accept lower returns. Third, good CG is proven to lead to better operational performance. Finally, it reduces the risks of contagion from financial distress. In addition to reducing the internal risk through raising investors' risk perception and willingness to invest, it increases the robustness and resilience of firms to external shocks.

The second motivation, namely, the importance of CG arrangements for financial institutions, arises out of the fiduciary nature of their activities and the likely asymmetry in access to information.[9] In essence; a financial institution is a fiduciary trustee, which is entrusted with the assets of investors. It is therefore obliged to act in their best interests when holding, investing, or otherwise handling their property[10]. This is crucial in banking institutions, where the scope for informational asymmetries is likely to be greater than in other firms. It is difficult for an outsider to control or evaluate bank managers, given the latter's ability to influence boards, alter the risk composition of assets, or hide information on loan quality.[11] The opacity of the banking system inevitably reduces the effectiveness of a competitive environment by itself to ensure good CG, as takeovers can rarely take place when insiders have an informational advantage.[12]

Nevertheless, some Islamic scholars argue that IIFS should be immune to these flaws. They contend that IIFS have better CG because the moral code of Islam induces stakeholders to behave ethically.[13] Nevertheless; the commitment of concerned stakeholders to Islamic religious principles cannot be taken for granted. The Nobel Laureate Albert O. Hirschman contended that "under any economic, social, or political system, individuals, business firms, and organizations in general are subject to lapses from efficient, rational, law-abiding, virtuous, or otherwise functional behavior".[14] Islamic financial institutions are no exception. Indeed, IIFS are no less prone to suffer from

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breaches of fiduciary responsibilities or the consequences of asymmetric information. The history of Islamic finance shows that cases of CG failures have features in common with conventional banking scandals, such as collusion of the board with management, external and internal audit failure, neglect of minority shareholders' interests, imprudent lending, and excessive risk taking by management. [15]

The third motivation of this paper is that the practices of IIFS raise specific CG challenges. While a number of problems are common to all financial institutions, and can be mitigated by existing regulations, two broad sets of CG issues are specific to IIFS.[16] The first arises from the need to reassure stakeholders that the institution's activities fully comply with the precepts of Islamic jurisprudence.[17] Ultimately, the core mission of an Islamic financial institution is to meet its stakeholders' desire to conduct their financial business according to *Shariah* principles.18 There must, therefore, be CG mechanisms to assure them that the necessary safeguards are in place. The same stakeholders also need to be assured that the firm will nonetheless actively promote their financial interests, and prove to be an efficient, stable, and trustworthy provider of financial services. In practice, depositors and borrowers need to feel confident that the types of liabilities and assets that IIFS deal with are competitive and offer a risk-return trade-off acceptable to their clients. This combination of requirements of *Shariah* compliance and business performance raises specific challenges and agency problems, and underlines the need for distinctive CG structures.[19]

The following section begins with a review of three cases of IIFS distress. They illustrate issues specific to IIFS, such as failure to comply with the *Shariah*, capture of the institution by special interests, and weak public policy. Section II considers IIFS' emphasis on stakeholders' value and the relevance to such institutions of CG arrangements based on shareholder value. Section III identifies shortcomings in prevailing CG arrangements in protecting stakeholders' ethical interests in IIFS and offers suggestions to address vulnerabilities. Section IV reviews stakeholders' financial interests and arrangements to protect them. Section V presents the conclusions of the paper.

1. Three Cases of Distress

Three cases illustrate possible CG weaknesses in IIFS.[20] The first relates to the failure to ensure compliance with stakeholders' religious beliefs. The other two

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cases show how poor CG structures, both internal and external, can affect investors' finances, particularly those of the relatively unprotected unrestricted investment account (UIA) holders, as well as the stability and sustainability of the Islamic financial industry.

A central feature of the CG of an Islamic financial institution is ensuring *Shariah* compliance. To reassure stakeholders, the institution generally sets up a *Shariah.*

supervisory board (SSB) or retains the services of *Shariah* advisors that certify the *Shariah* compliance of the financial transactions. However, the ability of the SSB or the *Shariah* advisors to fulfill the mandate may be constrained by the volume of activity, their access to monitoring systems, the complexity of financial transactions, or the extent of their independence.[21] These factors may have been at play during the collapse of the Bank of Credit and Commerce International (BCCI), which involved several IIFS. Five IIFS deposited significant resources with the BCCI, a leading CFS business, with the understanding that they would be invested in commodity contracts, in compliance with *Shariah* principles.[22] However, following the failure, Price Waterhouse, BCCI's auditor, reported that "there is no evidence to suggest that the bank actually entered into any commodity contracts".[23] The discovery was important, given the level of exposure of the concerned IIFS in the BCCI. Reportedly, one of the IIFS involved had 25% of its assets placed with the BCCI.[24] The size of exposure suggests a weak due diligence process in the verification of *Shariah* compliance. More generally, the case illustrates the limits a SSB may face in discharging its mission.

The 2001 collapse of Ihlas Finance House (IFH) of Turkey illustrates the consequences of capture by special interests in an environment of weak internal and external checks. The largest of the Turkish IIFS, with over 40% of the sector deposits, IFH was liquidated by the Turkish Banking Regulation and Supervision Agency because it had illegally appropriated almost $1billion, virtually the entire value of the deposit base, through connected lending to shareholders, concealed by the rapid growth of deposits. Concentrated ownership and control had permitted an incentive system biased in favor of shareholders. When the bank was liquidated, the misappropriation of funds was so large that the bank was unable to pay back its 200,000 depositors.[25]

IFH, like other Turkish Special Finance Houses, was not covered by deposit insurance.[26] The failure created panic among UIA holders that threatened to bring down other IIFS in the country. In spite of the reported sound

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fundamentals of the sector, and assurances by Turkish regulators as well as the Association of Special Finance Houses on the good health of the system, runs eroded 63% of total deposits in IIFS within the first quarter of 2001.[27] Compounding the IFH failure was the inability of IIFS to manage liquidity in the absence of *Shariah*-compliant secondary markets. Overall, the failure of IFH revealed the contagion risks to the financial stability and reputation of other IIFS because of poor CG.

The 2003 failure of the Patni Cooperative Credit Society of Surat in India provides an example of how weakness in the external institutional environment can affect the governance of IIFS. External CG, includes the legal, regulatory and conflict resolution framework. As an example, the Reserve Bank of India Act, by requiring that deposit-taking institutions maintain interest-bearing accounts with the central bank, effectively prevents the functioning of IIFS as deposit taking businesses.[28] Most IIFS have chosen the organization form of a cooperative and, as such, face two sets of conditions that magnify the challenges of their operations. Firstly, they can operate only in the state in which they are licensed, as prescribed by the Cooperative Societies Act.[29] Secondly, they have to observe conventional prudential standards on capital adequacy, income recognition, and asset classification and provisioning, all of which extend to financial cooperatives. The cumulative effect of these conditions complicates the intrinsic challenge of liquidity management for IIFS, given their exclusion from conventional money markets. They also limit the potential scale of the firms' activities and affect their competitive position.[30] The management of the Patni Cooperative may therefore have been induced to take excessive risks, resulting in an unsustainable level of non-performing loans.[31]

II. Shareholders' versus Stakeholders' Value: Corporate Governance in Islamic and Conventional Financial Institutions

Widely publicized mismanagement scandals have focused attention on the relevance of CG for the protection of the rights of shareholders' as well as of other stakeholders.[32] Misconduct in financial businesses not only creates widespread investment losses, but also shakes investors' confidence, and raises doubts about the stability of the international financial system. Equally important, they damage the value of all other stakeholders, such as creditors, suppliers, consumers, employees, and pensioners, and of communities at large. They affect the livelihoods of the victims of the businesses' financial distress.[33]

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The consequences of weak CG in a financial institution are, therefore, not only financial, but also entail heavy costs in social and human terms. In contrast, sound CG facilitates access to external finance, improves the firms' operational performance, enhances systemic financial stability, and contributes to the welfare of the community.

Over time, growing concerns about the impact of business performance on groups other than shareholders have led to measures to protect stakeholders being superposed on what continues to be essentially a shareholder value based framework. Conventional CG does not yet offer an analytical framework to internalize stakeholders' protection within the objectives of the firm. It adopts a pragmatic approach that offers rules that may not necessarily be consistent with the incentives driving whoever controls the business. The conceptual difficulty of conventional CG in fully integrating the interests of non-shareholding stakeholders diminishes its ability to design incentives that can be adapted to IIFS. Indeed, the latter have always assigned a much higher priority than CFS firms to non-financial interests as well as given more weight to the interests of non-shareholding stakeholders.

The cornerstone of CG arrangements for conventional businesses is the protection of shareholders' rights. From this perspective, the question is how to secure the rights of ownership once the investors' financial resources have been relinquished. The answer to this question may lie in the configuration of incentives for managers, control retention by owners, and the reliability of the legal system.[34] Shleifer and Vishny (1996) argue that "corporate governance deals with the agency problem: the separation of management and finance". They then point out that "the fundamental question of corporate governance is how to assure financiers that they get a return on their financial investment". While the reference to finance and financiers may also include creditors, the primary focus of their review is on shareholders' protection. Indeed the distinction of management and finance is targeted at the separation of ownership and control. Thus, the major feature of shareholders' value based CG is the design of incentives that lead managers to pursue the maximization of shareholders' value.

Conventional CG does not overlook stakeholders other than shareholders. Shleifer and Vishny (1997) acknowledge the impact of corporate decisions on multiple stakeholders. Such awareness is generally either based on agnostic empirical observations or social responsibility considerations. For example, Tirole (1999) holds that "managerial decisions do impact investors, but they also exert externalities on a number of natural stakeholders who have an innate

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relationship with the firm". He follows up by asking "why (one) should ignore the natural stakeholders and favor the investors, who are "stakeholders by design", by giving them full control rights and by aligning managerial compensation with their interests".

Trying to internalize, through incentives, stakeholders' value in the decision-making process of corporations is a daunting challenge. Tirole (1999) examines whether the managerial incentives and control structure in a shareholder value framework can be adapted to include other stakeholders' interests. Managerial incentives are difficult to design if the firm's objective shifts from the maximization of shareholders' value to that of the "aggregate welfare of the stakeholders". The latter has no clear widely accepted measure or market value. Accordingly, it does not provide a foundation for linking incentives with performance. Falling back on a profit-based compensation system is likely to lead to biased decisions, as managers would pursue profitability at the expense of other objectives. Sharing control among stakeholders with heterogeneous interests in a joint venture would seriously impede its efficacy.[35] Similarly, relying on enlarging management's fiduciary duty to various stakeholders may leave it with too much power to pursue its own objectives.[36] Thus, trying to design managerial incentives to accommodate stakeholders' interests is more complex than might at first appear.

Public policy overcomes the limitations of available analytical frameworks to deal with stakeholders' value by adopting pragmatic approaches. The outcome is arrangements that generally strengthen transparency and limit blatant misconduct. Standards have emerged and principles have been codified, with significant contributions notably by the OECD and the BCBS. The OECD defines CG as "a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate Governance *also provides the structure through which the objectives of the company are set,* and the means of attaining those objectives and monitoring performance are determined".[37] This definition provides important attributes of CG and emphasizes transparency. However, it does not directly deal with the intrinsic issue of the business objectives that should guide the distribution of rights and responsibilities within the corporation. Indeed, the objectives of a corporation's founders', whether these are the increase of shareholders' value or the pursuit of stakeholders' interest, can be expected to affect such a distribution and shape the institutional structure and systems. In particular, the distribution of rights

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and responsibilities among shareholders and other stakeholders would be driven by the interests of whoever establishes the corporation and subsequently controls it.

Stakeholders' value is central to the IIFS, and is generally incorporated in mission statements (Annex II).[38] A selection of mission statements suggests that IIFS focus on two broad sets of objectives: (a) compliance with *Shariah* principles, and (b) provision of excellent services. *Shariah* compliance appears to fall into three categories. The first one and most widely understood includes the conduct of financial business in accordance with the prohibition of *Riba'* and *Gharar*.[39] The second appears to cover the furthering of Islam's social objectives, in particular the promotion of social benevolence.[40] In this regard, the Central Bank of Jordan states in its Banking Law that one of the objectives of Islamic banking is the provision of "services aimed at reviving social solidarity organized on the basis of mutual benefit".[41] The third aspect of *Shariah* compliance is the development and promotion of an integrated Islamic financial system, or the "eventual institution of an elaborate and comprehensive banking system based on the rules of Islamic *Shariah*".[42] Subsumed under the set of *Shariah* objectives of providing excellent services are: (a) service to the community as a whole, referring primarily but not exclusively to the Muslim community (*Ummah*); (b) promoting the interests of related parties, including shareholders, depositors, and employees; and (c) the developing the professional and ethical qualities of management and staff.[43]

IIFS' CG arrangements are mostly modeled along those of the conventional shareholder corporation, in spite of the explicit mandate to promote social welfare and pursue stakeholders' value. This configuration leads to a distribution of rights and responsibilities that essentially leaves control with shareholders. The most notable variation in CG structure is the presence of a *Shariah* board of scholars and a *Shariah* review unit that ensure compliance with the Islamic law. *Shariah* compliance decisions affect all IIFS stakeholders. In addition, internal stakeholders such as investment account holders, and external governance structures such as accounting would perhaps be distinctive features of an Islamic financial institution Nevertheless, IIFS' CG practices and structures are mainly fashioned along those of a CFS firm. (Figure I).[44]

Since IIFS' configurations mostly identify shareholders as the residual claimants of the institutions, the internalization of stakeholder value may in the short-term require solutions that do not necessarily reflect the incentives enshrined in the firm's governance system and processes. However, the identification of IIFS' mission as the promotion of the welfare of all stakeholders should lead to the gradual adaptation of ownership

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structures to permit the alignment of governance arrangements with the incentives of all stakeholders.[45]

Table I- Shareholders versus Stakeholder Centered CG Issues

Model	Control	Fiduciary Duty	Firm's Objective
Shareholders Centered	With shareholders	To shareholders	Maximize shareholders' wealth
Stakeholders Centered	Stakeholders have right to practice in decisions	To all stakeholders	Promote the interests of all Stakeholders
IIFS Current Practice	With shareholders	-To all stakeholders -To board of Shariah scholars	-Compliance with Islamic *Shariah* -Excellence of service to all stakeholders
IIFS Options	Stakeholders have right to practice in decisions	-To all stakeholders -To board of Shariah scholars	-Compliance with Islamic Shariah -Excellence of service to all stakeholders

Source: Derived from Boatright, J.R. (2002) and extended to include IIFS

III. Shariah Compliance and Stakeholders' Ethical Interests

The Governor of the Bahrain Monetary Agency conveyed the sense of IIFS' roots in stating that "Islamic banks have grown primarily by providing services to a captive market, people who will only deal with a financial institution that strictly adheres to Islamic principles".[46] This pledge to conduct activities in accordance with *Shariah* principles entails that IIFS would: (i) not engage in interest-based debt transactions, (ii) not conduct a purely financial transaction disconnected from real economic activity[47], (iii) not participate in a transaction where there is exploitation of any party, and (iv) not participate in activities regarded as harmful to society. Failure of individual institutions to ensure compliance would entail a reputational risk for the Islamic finance industry.[48] To mitigate such risk, IIFS have created CG structures and processes that reassure stakeholders on the *Shariah* compliance of all transactions. A widely adopted approach is to have independent bodies certify such compliance.

Each Islamic financial institution has in-.house religious advisers, collectively known as *Shariah* Supervisory Board (SSB), as part of the internal governance structure of the institution.[49] In some countries, authorities have created oversight arrangements, such as *Shariah* boards or Islamic banking departments within supervisory agencies. These usually operate in conjunction with private independent market agents familiar with Islamic finance.

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SSBs' tasks may vary according to provisions stipulated in the articles of association of the institution or by national regulators. Corporate charters would entrust SSBs with ex-ante monitoring and the calculation of *Zakat*. International and national regulators often publish guidelines for SSBs, which refer to their general duty to ensure *Shariah* compliance of transactions and, less frequently, provide guidelines on competences, composition and decision-making (Table II).[50]

In principle, SSBs' prerogatives lie in five main areas: certification of permissible financial instruments through *fatwas* (ex-ante *Shariah* audit), verification of transactions' compliance with issued *fatwas* (ex-post *Shariah* audit), the calculation and payment of *Zakat*, disposal of non-*Shariah* compliant earnings, and advice on the distribution of income or expenses among the bank's shareholders and investment account holders.[51] Each SSB issues a report to certify the *Shariah* compliance of all financial transactions. This report is usually an integral part of the institution's annual report.

Table II- Regulations on Internal Shariah Advisory**

Country	SSB terms of reference	SSB Composition	SSB decision-making	SSB appointment & dismissal	SSB Fit & Proper Criteria
Bahrain	√	√	unspecified	√	√
DIFC*	√	√	unspecified	√	√
Indonesia	√	unspecified	unspecified	√	√
Jordan	√	√	√	√	unspecified
Kuwait	√	√	√	unspecified	unspecified
Lebanon	√	√	unspecified	√	unspecified
Malaysia	√	unspecified	unspecified	unspecified	√
Pakistan	√	√	unspecified	√	√
Philippines	√	√	unspecified	unspecified	√
Thailand	√	√	unspecified	√	√
U.A.E.	√	√	unspecified	√	unspecified

* Dubai International Financial Centre

** Annex III details the legal bases and the provisions of these regulations

Source: Official country websites and central bank Annual Reports

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In addition to *Shariah* boards, most IIFS, particularly those complying with AAOIFI standards, have established another internal Shariah review structure, namely, *Shariah* Review units.[52] These units are independent of other departments or are an integral part of the Internal Audit and Control Department. The array of tasks that they perform is parallel to that of audit departments: reviewers generally use all necessary powers to ascertain that all financial transactions implemented by management comply with SSB rulings.[53] In some instances *Shariah* review units have exclusive competence on ex-post facto monitoring.[54] These units and SSBs face similar challenges, relating, in particular, to independence, and competence.

Beyond internal arrangements, the broader *Shariah* governance framework may include features put in place by regulators, as well as the provision of financial information services to persons outside the institution. Among regulatory arrangements, centralized SSBs are the most noteworthy in relation to *Shariah* governance. While there are significant differences across countries, centralized SSBs are usually concerned with ex-ante monitoring, mostly understood as standardization of *Shariah* interpretation, and ex-post monitoring of *Shariah* compliance. They are also concerned with issues relating to upholding *Shariah* compliance, and offer arbitration and recourse to settle *Shariah* disputes between members of the same SSB.[55]

Table III- External Shariah CG institutions by country*

Country	Centralized SSB or High Shariah Authority or Fatwa Board	Islamic Rating Agency
Jordan	No	√
Malaysia	√	√
Sudan	√	No
Bahrain	No†	No†
Kuwait	√	No
Pakistan	√	No
U.A.E.	√	No
Indonesia	√	No

* Annex IV details the names and powers of these departments/authorities.
† Bahrain is the seat of the IIFM and the IIRA that respectively set standards for Islamic jurisprudence and rate Islamic instruments onan international scale.

Source: Official country websites and central bank Annual Reports

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Private mechanisms for the external monitoring of *Shariah* compliance are limited. In particular, private rating agencies have not yet developed the necessary skills or found enough incentives to monitor IIFS' *Shariah* compliance. "Islamic rating" has so far been the exclusive domain of government-sponsored organizations such as the IIRA and the Malaysian Rating Corporation. Likewise, other external actors with an interest in Islamic finance, such as financial media and external auditors, are still generally less concerned with assessments of *Shariah* compliance.[56]

The functioning of SSBs raises five main CG issues: independence, confidentiality, competence, consistency and disclosure. The first issue concerns the *independence* of the SSB from management. Generally, members of an SSB are appointed by the shareholders of the institution, represented by the board of directors to which they report. As such, they are employed by the institution, and their remuneration is proposed by the management and approved by the board. The SSB members' dual relationship with the financial institution, as providers of remunerated services and as assessors of the nature of operations, could create a conflict of interest.

The issue of *confidentiality* arises from the practice of *Shariah* scholars often sitting on the SSBs of several IIFS, thereby gaining access to proprietary information of possibly competing institutions.

The third issue is *competence*. In performing their function, *Shariah* scholars are expected to be familiar with Islamic law and to have financial expertise. In practice, very few scholars are well-versed in both disciplines.

The fourth issue is the *consistency* of judgment across IIFS, over time or across jurisdictions, within the same institution. Such consistency would help to promote the customer's confidence in the industry and the enforceability of contracts. Conflicting opinions on the admissibility of specific financial instruments or transactions would hurt business confidence and market efficiency.[57]

Finally, *disclosure* of all information relating to *Shariah* advisory functions would strengthen the credibility that the offered services are essentially distinct from conventional ones and, furthermore, promote market discipline.

A SSB within an IIFS has the advantage of being close to the market. A competent and independent SSB, empowered to approve new *Shariah* conforming instruments, would facilitate innovation within the firm. In issuing

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its fatwas, the SSB could be guided by standardized contracts and practices that could be harmonized by an international standard-setting self-regulatory professionals' association. Such an approach could ensure consistency of interpretation and enhance the enforceability of contracts before civil courts. Review of transactions would mainly be entrusted to internal review units, which in collaboration with external auditors, would be responsible for issuing an annual opinion on the *Shariah* compliance of the transactions. This process would be sustained by reputable agents, like rating agencies, stock markets, financial media, and researchers that would channel signals to market players. Such a framework would also enhance public understanding of the requirements of *Shariah,* and lead to a more effective participatory role by the stakeholders in the activities of the institution.

IV. Stakeholders' Financial Interests

Given that the core mission of a financial institution is to enable its stakeholders to pursue their financial interests, the CG arrangements for IIFS cannot underestimate the importance of having a framework that credibly protects these interests while not breaching their values. We focus attention here on three main categories of stakeholders, namely, shareholders, depositors, and borrowers.

The prevailing organizational structure of IIFS is that of a shareholding company. Their CG arrangements, therefore, appear similar to those of businesses offering conventional financial services, with the conventional focus on agency problems between shareholders and management (Figure I).58 However, they may not have effectively incorporated incentives to protect other stakeholders' financial interests, in particular those of unrestricted investment account (UIA) holders.

Generally, IIFS offer three broad categories of deposit accounts: current, unrestricted investment, and restricted investment.[59] Each category raises some CG issues, but those of unrestricted investment account (UIA) holders may be the most challenging. Essentially, it is the asymmetry between the extent of these depositors' participation in bearing investment risks and of their ability to influence the operations of the institution.

UIA holders are often the most important category of IIFS depositors. They enter into a *mudaraba* contract with the financial institution to manage their

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funds.[60] The institution places these funds in investment pools, and profits on investments, if any, are distributed at maturity according to the profit and loss sharing (PLS) ratio specified in the contract. The UIA holders, and not the IIFS, bear the risk of a poor performance of the investment pool, except for misconduct on the part of the financial institution.[61] Thus, UIA holders are stakeholders akin to shareholders. They are principals entrusting their resources to an agent, the financial institution's management with the significant difference that, in their case, the agent is appointed by another principal, namely, the shareholder.

The IIFS practice of commingling shareholders' and depositors' resources in investment pools can raise the possibility of conflict of interest. The management's discretion in the configuration of the pools and in the investments made from them, can result in differential treatment of various stakeholders. Moreover, the practice may reduce the transparency of IIFS' compliance with their clients' investment objectives. Accordingly, regulatory authorities may need to prescribe disclosure rules, and possibly firewalls and sanctions for breaches. This is of paramount importance to UIA holders, whose funds are normally common-pooled with those of shareholders.

IIFS generally create reserve funds to smooth the returns to UIA holders or protect their principal in case of adverse developments in the performance of the investment portfolio.[62] IIFS consider these funds important to deal with competitive pressure from ICFS and other IIFS. While in principle, returns to UIA holders are supposed to vary according to IIFS performance, poor returns may induce UIA holders to transfer their funds to a better performing institution. To mitigate such a risk, IIFS set up profit equalization reserves and use them in periods of poor performance to complement the returns that would be due to UIA holders. The reserves are fed by retaining earnings to UIA holders in periods of high returns on investment. Similar arrangements help the IIFS protect the principal of UIA holders. A special risk investment reserve is used for compensating a loss of principal resulting from poor investment results. The use of profit equalization and risk investment funds raises issues pertaining to the governance of these funds and the protection of UIA holders' rights. In particular, the practice of profit equalization may convey an inaccurate view on the actual performance of the financial institution, compounding the asymmetry of information available to UIA holders and management.

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Widely available and affordable financial information can enhance the effectiveness of official and private monitoring of financial businesses' performance. It promotes transparency and supports market discipline, two important ingredients of sound CG to protect stakeholders' financial interests. Financial information may be particularly important for IIFS because of the private equity nature of UIAs and the assumption that UIA holders have more at stake than conventional depositors. UIA holders could therefore be expected to have a heightened interest in directly monitoring the institution's performance. However, this requires an institutional infrastructure that facilitates the production of accurate financial information, the availability of agents that can interpret and disseminate it, as well as arrangements to protect its integrity. On all these counts, the Islamic financial industry may be facing challenges. The existing limited infrastructure reduces the role that information flows can play in promoting competition and market activities that would induce managers to adopt sound CG practices.

Of particular relevance to the *financial information infrastructure* is a chart of accounts for businesses to organize and produce credible financial statements. To enable IIFS to achieve this, the accounting profession has developed standards, at both the national and international levels. An increasing number of countries have adopted the International Financial Reporting and Accounting Standards (IFRS) in the wake of an apparent consensus to promote international convergence. However, these standards are designed for conventional businesses, including ICFS. As for IIFS' case, their practice of setting up reserve funds to smooth profit distribution and protect the UIA holders' principal, and the commitment to distribute *Zakat,* are among the features that make the IFRS not wholly suitable for IIFS. This led to the establishment in the early nineties of AAOIFI, which developed standards specific to IIFS.[63] While there has been some progress through using AAOIFI's standards, the accounting pillar of the financial information infrastructure for IIFS continues to present challenges. Wherever IFRS are the only rule, they may not generate financial statements correctly reflecting the IIFS' performance, and may instead give a false sense of reliability. Where AAOIFI standards prevail, they would enable the accounting system to deal adequately with IIFS specificities. However, they may make cross-sector comparisons difficult.

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Table IV- Country Approaches to Accounting and Auditing Standards for IIFS

Country	AAOIFI standards (adopted-adopted/recommended/ adapted) or national IIFS specific standards	Non-IIFS specific standards
Bahrain	√	
DIFC	√	
Egypt		√
Indonesia	√	
Jordan	√	
Lebanon	√	
Malaysia	√	
Philippines		√
Qatar	√	
Saudi Arabia	√*	
Sudan	√	
Syria	√	
Thailand		√
Turkey		√
USA		√
UK		√

* The Saudi Arabian Monetary Agency recommended IIFS to seek guidance from AAOIFI FAS incompiling their statements, but requires IFRS

Source: Official country websites and central bank Annual Reports

The *provision of financial information* on IIFS continues to be limited. Investors and analysts may not be entirely familiar with the nature of IIFS and with AAOIFI standards, but the action of market forces has already brought about substantial progress. For instance, leading international rating agencies now monitor and rate IIFS and are acquainted with AAOIFI prescriptions.64 They have also tailored their rating mechanisms to the risk profile of Islamic banks.[65] However, the absence of a consensus on internationally accepted and standardized accountancy practices for IIFSs reduces the ability to make comparisons across markets, and may reduce consistency in ratings.[66]

Overcoming these financial information challenges should promote a *competitive environment* for IIFSs, and thereby enhance the contribution that competition can bring to sound IIFS CG.[67]

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There are three alternative approaches to empowering and protecting UIA holders. Rights that normally belong to equity-holders could be extended to UIA holders. Or, moving in the opposite direction, UIA holders could be granted full debt-holding status and the protection it carries. Alternatively, the *sui generis* status of UIA holders could be maintained, provided that specific governance structures for the protection of UIA holders' interests are in place.

The first option would be the extension of shareholders' rights and duties to UIA holders. Given their equity-like investment, it may be argued that UIA holders should be on an equal footing with shareholders and thus be granted the right to have a voice by electing board representatives. This measure would increase their ability to air their demands and concerns with management. It would also satisfy these depositors' demand for greater involvement in the strategic management of the IIFS.[68]

If extending shareholders' rights to UIA holders is deemed impractical, depositors' protection may be an alternative option. However, the moral hazard argument against deposit insurance schemes would need to be addressed. Furthermore, the PLS nature of investment accounts prevents the application of deposit insurance in its present form, and a *Shariah*-compliant version would need to be developed.

The third option would be to create new governance structures that cater to the specific needs of UIA holders. One possibility is to elect a special representative or body that would act as an intermediary and, if necessary, expose wrongdoings. Such a policy would provide the key rationale for the creation of a permanent institutional channel to facilitate information flows from and to UIA holders. However, the creation of a new agent would bring with it additional agency problems and the risk of multiplying rather than diffusing the asymmetries of information to which UIA holders are subject.

Concerns on potential conflicts of interest should lead regulators to emphasize a transparent conduct of business. In this regard, smoothing of returns to UIA holders as currently practiced appears to be a significant obstacle to transparency. The practice of smoothing of returns introduces a veil of opacity between depositors and the firm, whereas, in all circumstances, an IIFS should be fully transparent in the use of funds. AAOIFI FAS 11 provides clear principles and guidelines on this issue. In particular, it requires IIFSs to disclose the shares of the actual profits and of the funds from the profit equalization reserve in the returns they receive.[69] In addition, each IIFS needs

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to adopt clear provisions regulating contributions to these funds and their disclosure in financial statements and annual reports.[70]

Overall, internal and external CG structures can complement each other in strengthening stakeholders' protection. Internally, the protection of minority shareholders and provisions for increased disclosure need attention, but can be addressed by the application of existing rules. The commingling of resources, balancing UIA holders' risks and rights, and the utilization of reserve funds need concrete actions to enhance the soundness of the internal CG frameworks of IIFS.

Externally, recognizing the specificity of IIFS within the broader institutional infrastructure, would contribute to greater transparency. Whichever regulatory approach is chosen, it can be guided by two rules of thumb. First, regulators need be flexible and to work with IIFS in order to become acquainted with the needs of the industry and be able to develop acceptable regulatory frameworks. Secondly, private self-regulatory initiatives can provide channels to market discipline and may be as important in Islamic finance as in a conventional financial system. In jurisdictions where regulations result in constraints on Islamic finance, IIFS need to evaluate which licensing status is best suited to their need for protecting stakeholders' interests. Regulatory authorities and market participants ought to become well versed in the nature and implication of the rules adopted, and thus help to promote market discipline without placing an undue burden on the IIFS. The existence of an infrastructure, such as IIFS-adapted accounting and auditing standards, that would permit the production of timely and reliable financial information, would complement the role of public authorities and reputational agents.

V. Conclusions

Poor CG can carry heavy financial costs for IIFS' stakeholders, as it would for other corporations. In addition, poor governance in IIFS would undermine their credibility as financial businesses offering services in compliance with *Shariah*. Given the fledgling nature of the sector and its ethical foundations, the effects of a CG failure could be particularly damaging. While international standards applicable to conventional financial businesses can offer useful inspiration for IIFS CG, their simple extension to IIFS would not be effective in providing safeguards for IIFS stakeholders. The ongoing efforts of national

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and international bodies to address these issues focus on the existing shareholding corporate structure of IIFS. They generally do not address the issue of the nature of the corporate structure that would be best adapted to the founding principles of Islamic finance, the services it would offer, and the competition it would face. It would seem, however, that no single model of corporate governance is likely to prevail, as the effectiveness of any framework would depend on the socio-economic context and the specific needs of each jurisdiction.

Confidence in the consistency of business practices with *Shariah* can emanate from a SSB as is currently the case. The financial competence of SSB members and their independence would need strengthening. The availability of *Shariah* compatible guiding principles whose interpretation has broad international acceptability can be helpful. An international self-regulatory *Shariah* financial scholars' association may help to reconcile the requirements for innovations with the need for broad standards. Business confidence would be strengthened through credible expectations of enforceability of contracts. Ex-post verification of *Shariah* compliance could be handled by internal review units, and certified by external auditors and reputation agents.

Protecting the interests of UIA holders has developed into one of the main challenges of IIFS CG. Their status of quasi-shareholders, bearing investment risks but not having a voice, has led to a number of arrangements. They include profit equalization reserves, investment risk reserves, special board committees, or special supervisory attention.

Shortcomings in current practices may require a combination of solutions. In particular, the protection of stakeholders' financial priorities calls for attention to the protection mechanisms for "weak voice" stakeholders, including minority shareholders, the position of UIA holders, transparent use of reserves, disclosure of policies and structures, and the soundness of regulatory and broader institutional controls. Strengthened arrangements that would lead to the emergence of reputational agents that can exert market discipline would be most helpful. The synergies between regulation, arrangements at the corporate level and the actions of market reputational agents could help enhance CG soundness.

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Foot Notes.

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2. Annex I provide a glossary of Arabic terms.
3. According to the General Council of Islamic Banks and Financial Institutions (CIBAFI), total assets have roughly doubled in the period 1998-2001, soaring from $134 to $261 Billion. Source: http://www.islamicfi.com (last visited April 04, 2005).
4. IIFS refers to a firm offering Islamic financial services, and includes finance houses, that offer retail commercial and investment services. This paper does not deal with *Takaful* (insurance) companies.
5. For example, in some cases the general prudential regime was extended to IIFS without recognizing any specific feature. In other cases, IIFS registered as non-bank commercial businesses. For an introduction to the principles and instruments of Islamic finance as well as regulatory arrangements applying to IIFS, refer for instance to El-Hawary, Grais, and Iqbal (2004).
6. These include the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA), the International Islamic Financial Market (IIFM) and the Liquidity Management Center (LMC). Rather than seeking to replace existing regulation, these bodies propose solutions whenever conventional regulation fails to address the distinctiveness of the Islamic financial industry.
7. CG is here understood as a set of systems and processes for ensuring proper accountability, probity and transparency in the conduct of an organization's business as well as in the relationships between different stakeholders. The definition of CG will be expanded in Section III.
8. According to www.adherents.com, Muslims represent 22% of the world population (as of April 04, 2005).
9. Dewatripont and Tirole (1993) argue on the contrary that financial firms present no specific externality that differentiates them from other firms and that would justify the need for stricter regulation of financial institutions.
10. In some countries, the fiduciary nature of banking is enshrined in law. For instance, the General banking Law of the Philippines states that the "fiduciary nature of banking requires high standards of integrity and performance" (Republic Act No. 8791). Also refer to Macey and O'Hara (2003) for an explanation of why fiduciary duties of directors should be extended to stakeholders other than shareholders in the case of financial firms.
11. Caprio and Levine (2002), Morgan (2002).
12. In general, the disciplining power of competition is hindered in banking by limited product market competition as banks construct long-term relationships with customers. Even if product markets were fully Competitive, capital markets would still ill-function due to

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waves of irrational optimism and pessimism that result in shareholders looking at immediate revenues rather than the long-term ability of firms to pay dividends. For more see Levine (2004) and Prowse (1998).

13. Sarker (1999).
14. Hirschman (1970).
15. For some examples of IIFS CG failures, refer to section II.
16. We refer to OECD Principles of CG and BCBS Standards for Enhancing CG for Banking Organizations. This presents the additional advantage of favoring the integration of IIFSs into global markets. This position is also supported by international standard setters like the IFSB and AAOIFI.
17. Islamic jurisprudence is also known as *Fiqh*. It covers all aspects of life: religious, political, social and economic. It is mainly based on interpretations of the *Quran* and *Sunna* (sayings and deeds of the prophet).
18. For a glossary of terms, please refer to Annex I
19. This paper focuses on those financial issues specific to IIFS, such as the existence of investment accounts, profit-smoothing instruments and poor ring-fencing of funds provided by different stakeholders.
20. Other notable examples, not mentioned in this chapter, include the Kuwait Finance House engulfment in the Souk al Manakh crash (1986-87); the liquidation of the International Islamic Bank of Denmark due to excessive financing exposure to a single client (1986); and the failure of the Islamic Money Management Companies in Egypt (1988-89).
21. Section IV expands on the challenges of *Shariah* CG.
22. The IIFS in question were the Faisal Islamic Bank of Egypt, the Dubai Islamic Bank, the Khartoum-based Tadamon Islamic Bank, the Qatar Islamic Bank and Kuwait Finance House, as reported by *The Asian Wall Street Journal*: "BCCI Creditors Granted More Time" (April 9, 1992).
23. As reported in the *Washington Post*: "Exposing BCCI Faults: Audit, Testimony Show Disregard for Rules" (August 12, 1991).
24. *Financial Times*: "BCCI Shutdown. Response Muted from Islamic Institutions" (August 8, 1991)
25. Starr and Yilmaz (2004).
26. IIFS investment deposits cannot in principle be insured because this would insulate UIA holders from credit and market risks, thus violating the risk-sharing nature of investments, prescribed by *Fiqh* jurists.
27. Starr and Yilmaz (2004).
28. To acquire bank status, Indian IIFS would be required to maintain a deposit account with the central bank, on which they would earn interest. A strict interpretation of this rule forces them to opt for the status of non-banking financing company to preserve their Islamic (interest-free) nature. For more, refer to Khan (2001). Regulations applying to IIFS in India are currently under review.

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29. Bagsiraj (2002), and Kahn (2001).
30. Ramesha (2003). There is also a different school of thought that maintains that prudential standards conceived for shareholding financial companies can be applied to financial cooperatives with no negative impact on the performance of the latter.
31. For more refer to Bagsiraj (2002). As of the final drafting of this paper, no decision has yet been taken on the liquidation by Patni bank by the Reserve Bank of India.
32. At the end of 2004, the insurance industry was the target of accusations by Eliot Spitzer, New York's Attorney General, for price-fixing, bid-rigging and undisclosed payments. See *The Economist* "Reprehensible - The Insurance Industry" (October 23, 2004).
33. These would be stakeholders with a contractual relationship with the firm. The notion of stakeholder could be extended to parties who do not have a contractual relationship with the firm and who would be affected by the externalities of its decisions. For example, communities downstream of a new dam project may be affected by biodiversity damage to their environment.
34. The choice of the distribution and use of owners' control may be affected by the extent to which ownership is atomistic or concentrated. However, while the protection of minority shareholders' rights compounds the difficulties stemming from the agency problem, the conceptual framework remains the same.
35. Hansmann (1996) quoted in Tirole (1999). However some may consider this a much lesser evil than the outcome of decisions emanating from undivided control by shareholders.
36. "Management can almost always rationalize any action by invoking its impact on the welfare of some stakeholder". See Tirole (1999).
37. OECD (2004)
38. Annex II compares the mission statements of 22 leading IIFS and ICFS.
39. Compliance with *Shariah* principles appears explicitly in almost all IIFS mission statements. The explicit reference to *Riba'* or *Gharar* is less frequent. *Riba'* is mentioned in the mission statement of Dubai Islamic Bank. Islamic Bank of Thailand mentions "not being tied with interest".
40. The social nature of Islamic finance emerges most clearly in the practices of *Zakat* and *Qard Hassan. Zakat* is a tax on wealth while *Qard Hassan* are zero-return beneficence loans to be made to the needy. See for example the goals of ABC Islamic Bank (E.C.) and Dubai Islamic Bank. Badr-Forte Bank of Russia mentions "social justice and harmony". Meezan Bank limited of Pakistan refers to the "implementation of an equitable economic system, providing a strong foundation for establishing a fair and just society for mankind".
41. Article 50a of the Banking Law of Jordan, Law No. 28 of 2000, as amended by Temporary Law No.46 of 2003. Available at www.cbj.gov.jo/
42. See the mission statements of Badr-Forte Bank of Russia, Al Baraka Islamic Bank (Bahrain), and Faisal Islamic Bank of Egypt.
43. This is referred to as "maximizing our clients and shareholders value" (Al Baraka Islamic Bank), "achieve optimum and not maximum profits, for the mutual benefit of customers and the bank" (Dubai Islamic Bank), "constantly strive to protect (its) shareholders'

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interest" (Bank Islam Malaysia Berhad), or "optimizing the stakeholders' value" (Meezan Bank limited Pakistan).

44. IIFS operate mostly in jurisdictions where legal protection could be strengthened. The prohibition of *Riba'* and *Gharar* translates into risk-sharing arrangements that may leave stakeholders in uncertainty as to the security of their assets. Furthermore undivided control with shareholders can create biased decision-making, see Tirole (1999)
45. Table I provides a simplified contrast of the issues in shareholder and stakeholder centered perspectives of CG and expands on positive and normative illustrations of CG in IIFS.
46. As reported by *Middle-East-Online.com* on February 17, 2004. http://www.middle-east-online.com/english/bahrain/?id=8922=8922&format=0 (last visited April 11, 2005)
47. This concept is sometimes referred to as "materiality".
48. In a survey of depositors' preferences, Chapra and Ahmed (2002) show that 81.7% of surveyed depositors in Bahrain would withdraw funds from their Islamic bank and chose an alternative Islamic bank, should failure to comply with to *Shariah* emerge. In the case of Bangladesh, the percentage is 46.6. In Sudan, it raises to 94.6.
49. They exist in all Islamic countries with the exception of Iran, where compliance of the whole banking system with *Shariah* is guaranteed and monitored by the central bank.
50. We here mention only those countries where authorities have implemented laws, acts or issued circulars and regulations on internal *Shariah* Supervisory Boards. Annex III details the legal bases and the provisions of these regulations.
51. A *Fatwa* is a religious edict or proclamation. It is a legal opinion issued by a qualified Muslim scholar on matters of religious belief and practice.For more, see Briston and El Ashker (1986) and Abdel Karim (1990). For an explanation of *Zakat* refer to footnote 40.
52. In AAOIFI member countries and banks adhering to the organization, internal *Shariah* review is prescribed by Governance standard 3. In Pakistan, it is regulated by Annexure-III to IBD Circular No. 02 of 2004.
53. In this respect, the role of the internal review unit is limited to a complementary ex-post monitoring. This makes its task secondary, if more focused and defined, to that of the SSBs, which are the ultimate arbiters in matters of *Shariah* compliance.
54. This is the case of large IIFS where the SSBs may not be able to assess large volumes of transactions. Therefore, separate *Shariah* control departments have been established. This seems to be the case in al Rajhi Banking and Investment Corporation and Dubai Islamic Bank.
55. Annex IV presents names and powers of these organizations. It focuses in particular of the powers of central SSBs.
56. A notable exception is the multiplication of Stock Market Islamic Indices whose major contribution is the identification of *halal* investments *Halal* conveys goodness and by extension has taken the meaning of "permissible".
57. A typical example is the financing of leisure activities, which is regarded as *haram* only by some Fiqh scholars. Moreover, Islamic jurisprudence is based on different schools of thought that may vary from country to country (the *Shiah* branch and the Sunni branch, which in turn includes the *Madhahib, Shafie, Hanafi, Hanbali and Maliki* traditions).

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58. Concentrated ownership in private IIFS, or state ownership in others point to the need to pay attention to the protection of small shareholders and that of state assets respectively.
59. Most IIFS also offer savings accounts. However, they usually fall in either the category of term investments or in that of current accounts. We therefore only distinguish between investment deposits and current account deposits.
60. The case of *Wakalah* UIAs, which are based on an agency relationship with the IIFS earning a flat fee, rather than a share of profits, is not considered here.
61. This risk-sharing feature has led some to argue that UIA are not liabilities for the IIFS and accordingly they should not be required to meet the same capital requirements as ICFS. In particular, the credit and market risk would fall on depositors, while the bank would only be subject to operational risk.
62. These reserves are generally known as Profit Equalization Reserves (PER) and Investment Risk Reserves (IRR). We follow AAOIFI's definition in Financial Accounting Standard (FAS) 11.
63. AAOIFI's standards are mandatory for the following markets: Bahrain, Jordan, Sudan, Qatar, and Dubai International Financial Center. Syria is considering their adoption. The standards are used as guidelines in Saudi Arabia, Kuwait, Malaysia, Lebanon, and Indonesia. Most Islamic banks' *Shariah* supervisory committees use AAOIFI standards as guidelines.
64. These are Fitchratings, Capital Intelligence and Moody's Investors Service. Capital Intelligence was the pioneer in rating and analyzing IIFS. It now covers 21 IIFS across 8 countries.
65. Capital Intelligence uses the same categories to rate IIFS and ICFS, falling namely in 6 areas: regulation and supervision, operating environment, franchise strength, management quality, financial fundamentals, and external support. However, given the nature of IIFS, the analytical focus is adjusted. For instance, liquidity risk management may be more important in rating IIFS than in rating ICFS given the lack of *Shariah*-compliant secondary markets.
66. For example, as we can see onn table IV, AAOIFI's standards are not broadly endorsed by regulatory agencies.
67. Grosfeld and Tressel (2001) provide evidence that competition has an important complementary effect where good CG mechanisms are already in place.
68. In a survey of IIFS consumers' preferences, Chapra and Ahmed (2002) record an interest by depositors to be involved in the strategic management of the bank
69. Some IIFS have already established the practice of distinguishing between profit distribution and the amount of reserve distributed.
70. Decisions pertaining to PER and IIR should ideally be left to the business. However, concerns over maintaining the UIA holder principal and the systemic consequences that losses may provoke have led some regulators to intervene. For instance, the Banking Law of Jordan as amended in 2003 establishes a minimum deduction of 10% on earnings to be invested in an investment risk fund in order to cover losses in mutual investment accounts. Such minimum deduction may be increased by the CB (Art. 55).

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Annex I: Glossary of Arabic Terms

Amana (Demand deposits)	Deposits held at the bank for safekeeping purpose. They are guaranteed in capital value and earn no return.
Fatwa	Legal opinion issued by a qualified scholar on matters of religious belief and practice.
Fiqh (Islamic jurisprudence)	It refers to Islamic jurisprudence that covers all aspects of life: religious, political, social and economic. *Fiqh* is mainly based on interpretations of the *Qur'an* and *Sunna* (sayings and deeds of the prophet).
Fiqh al-Muamalat	Islamic Commercial Jurisprudence.
Gharar	Literally, uncertainty, hazard, chance or risk. Technically, sale of a thing which is not present at hand; or the sale of a thing whose consequence or outcome is not known; or a sale involving risk or hazard in which one does not know whether it will come to be or not, such as fish in water or a bird in the air.
Halal	That which is permissible according to *Shariah* Law.
Haram	Unlawful according to the *Shariah*. It indicates transactions which are not permissible under Islamic law.
Hibah	Literally gift. A gift awarded voluntarily in return for a loan. (Service charge)
Ju'ala	A party pays another a specified amount of money as a fee for rendering a specific service in accordance to the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements and trust services.
Kifala	It is a pledge given to a creditor that the debtor will pay the debt, fine, or liability. A third party becomes surety for the payment of the debt if unpaid by the person originally liable.
Mudaraba (Trustee finance contract)	*Rabb -al- mal* (capital's owner) provides the entire capital needed to finance a project while the entrepreneur offers his labor and expertise. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by *rabb-al-mal*. The liability of the entrepreneur is limited only to his time and effort.
Murabaha (Mark–up financing)	The seller informs the buyer of his cost of acquiring or producing a specified product. The profit margin is then negotiated between them. The total cost is usually paid in installments.
Musharaka (Equity participation)	The bank enters into an equity partnership agreement with one or more partners to jointly finance an investment project. Profits (and losses) are shared strictly in relation to the respective capital contributions.
Quran	Islamic scriptures believed by Muslims to be God's revelation to the Prophet.
Riba'	Literally, an excess or increase. Technically, an increase, which in a loan transaction or in exchange of a commodity, accrues to the owner

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	(lender) without giving an equivalent counter value or recompense in return to the other party.
Shariah (Islamic Law)	The Islamic Law extracted from the *Qur'an* and *Sunna* (sayings and deeds of the Prophet).
Sunna	Deeds of the Prophet.
Takaful	Arabic name for insurance based on *Shariah* rules. An Islamic Insurance is a collective protection scheme. It literally means solidarity. *Takaful* reflects solidarity and is akin to mutual insurance.
Umma	Community of the faithful within Islam
Wadiah	A safe custody contract between the depositor (customer) and the custodian (bank).
Wikala	An Agency contract which may include in its terms a fee for the agent. Same contract can also be used to give a power of attorney to someone to represent another's interests.
Zakat	Religious tax to be deducted from wealth to be paid to the needy.
Compiled from El-Hawary, Grais, and Iqbal (2004) and the glossary of the IIFM website (www.iifm.net).	

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Annex II: Mission statements of IIFS and ICFS

IIFS	Mission statements, objectives or vision	ICFS	Mission statements, objectives or vision
Jordan Islamic Bank, Jordan	(The bank's goals are) commitment to providing banking services based on compliance with the rules and principles of the glorious Islamic *Shariah* in all our activities to serve our community as a whole, and commitment to equally serve the interests of all related parties including shareholders, depositors, and employees. (website)	*Mizuho Financial Group, Japan*	(Our) (...) basic principles of the consolidation are: 1) offer a wide range of the highest quality financial services to our customers 2) maximize shareholders' value and, as the leader of Japan's financial services industry, earn the trust of society at large, 3) offer attractive and rewarding job opportunities for employees (...)
Bank Islam Malaysia Berhad	The Corporate Mission of the Bank is to seek to operate as a commercial bank functioning on the basis of Islamic principles, providing banking facilities and services to Muslims and the whole population of this country, with viability and capability to sustain itself and grow in the process. (The Bank's) Corporate Objective is to provide its customers with Islamic Banking facilities and services of the highest possible quality; to attain viability and sufficient level of profitability to sustain growth; to develop and foster a competent and innovative management imbibed with high standards of integrity and Islamic banking professionalism; to develop a motivated workforce inculcated with appropriate work ethics fully committed to the Bank and to offer efficient and courteous service to customers; to constantly strive to protect its shareholders' interest; to be always conscious of its responsibilities and duties as an Islamic corporate citizen.	*Norges Bank, Norway*	The company's primary objective must be to maximize shareholders' long-term returns. There must be a clearly defined business strategy that is anchored in the board of directors. The company must present accurate, adequate and timely information concerning its financial position and other relevant information. The company's board of directors shall protect the interests of all shareholders and shall be accountable for the decisions made by the board. The board of directors shall supervise the day-to-day management and company activities, and shall ensure a proper organization of these activities, including adequate internal control systems.
Kuwait Finance House, Kuwait	In accordance with the Islamic principles, KFH ensures that while working with the public professionally, the company guarantees an honorable relationship with its client base and the Muslim community as a whole	*Coastal Federal Bank, USA*	Our basic corporate objective (is) maximizing the value of our shareholders' investment

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Faisal Islamic Bank of Egypt	The ultimate goal being to eventually institute an elaborate and comprehensive banking system based on the rules of Islamic Shari'ah which meets the needs of all those concerned... shareholders-clients-employees.	***Deutsche Bank, Germany***	Mission: We compete to be the leading global provider financial solutions for demanding clients creating exceptional value for our shareholders and people.
Bank Muamala t Berhad, Malaysia	To build the bank into a modern, dynamic and strong Islamic Bank that would play a role in providing a viable alternative to the conventional system, that will contribute to the development of Modern Malaysia.	*Commonwealth Bank, Australia*	The key financial objective of the Bank is to have Total Shareholder Return in the top quartile of our Australian listed peers over each rolling five year period.
Badr-Forte bank, Russia	To contribute to the globalization of Islamic Banking as the principal institution within the Russian Federation implementing Islamic financial and economic concepts, which offer a unique solution for social justice and harmony in our contemporary society	*BBVA Group, Spain*	The seven corporate principles are as follows: Focus on the customer as the centre of business; creation of shareholder value through business activity; teamwork as the engine in the creation of value; a management style that generates enthusiasm; ethical behavior and personal integrity as a way of understanding and conducting business; innovation as the engine of progress; and corporate social responsibility as an intrinsic part of development.
AlBaraka Islamic Bank, (Bahrain and Pakistan)	We strive to be a premier regional Islamic bank, dedicated to the economic and social development of our target markets, maximizing our clients and shareholders value, and focusing on the human resource development in an environment of creativity and innovation. Albaraka is committed to develop and promote an integrated Islamic Financial System. Compliance with the rules and principles of Islamic Shariah is the core of the banking and financial activities of the Bank. To this end, the Bank has successfully sought the advice and expertise of Islamic scholars acclaimed for their knowledge and piety from all over the Islamic world to guide is path and monitor its performance (website)	*BNP Paribas, France*	BNP Paribas founds its corporate project on three commitments: 1) toward its customers, BNP Paribas undertakes to give first priority to their satisfaction and to constantly improving the quality of their welcome and of the services offered, 2) toward its shareholders, BNP Paribas undertakes to put value creation at the very heart of its options, 3) toward its employees, BNP Paribas undertakes to ensure a dynamic and stimulating management of careers and remuneration by developing employee share-ownership and promoting social dialogue. The respect of these commitments is guaranteed by the team spirit of all the bank's employees and their adherence to a code of ethics founded on transparency, professionalism and quality

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Dubai Islamic Bank, UAE	(The) Objectives of the Bank (are): 1) Providing banking services of the highest standards according to Islamic *Shariah* without dealing in riba (interest on money) and by using thestate-of-the-art technology in computer, telecommunication and information system 2) Investing funds prudently to achieve optimum and not maximum profits, for the mutual benefit of customers and the bank. 3) Coordination, cooperation and integration with other financial bodies that apply Islamic *Shariah* in their dealings, in order to support creating a base and regulations for an Islamic financial system. 3) Development of the Islamic society in all fields of the economy by investing in industries, agriculture, commerce, and real estate in order provide job opportunities. 4) Promotion of social benevolence through its Islamic methods, particularly through Zakat. 5) Contributing to the welfare of society in line with the five main tenets of Islam, namely protection of life, purity of mind, property, honour and social justice. 6) Promoting the savings habit and encouraging people to invest wisely within the parameters of Islamic *Shariah* through investment and finance instruments to suit individual requirements. 7) Making available the necessary capital for entrepreneurs for the establishment of economic projects and creation of alternative instruments for finance according to Islamic *Shariah*.	*Jyske Bank A/S, Denmark*	(...) The Jyske Bank Group is managed and operated as a business. At the same time, we attach great importance to treating the three groups of stakeholders – shareholders, customers and employees – with equal respect. (...) Our objective is to provide our shareholders with a satisfactory long-term return on their investment. Thus, the aim is for Jyske Bank every year to be one of the top-performing Danish banks based on the level of our earnings. Jyske Bank is thus an excellent choice for shareholders who want to make a long-term investment and who do not attach great importance to decisions which generate only short-term price increases.
Islamic Bank of Thailand, Thailand	(The bank's goals are): to maintain the role of a bank that is not tied up with interest; to strengthen the business; to carry out social and organizational stability; to provide an excellent service; and to well direct and supervise the community development	*RHB Group, Malaysia*	Mission: To become the most admired Malaysian financial services company by providing excellent customer services, enhancing shareholder value, providing challenging career and learning opportunities for employees, demonstrating responsibility for society.

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ABC Islamic Bank (E.C.)	Our mission is to uphold our carefully formulated *Islamic principles* in the quest for *mutual prosperity for our clients and the Bank.* In pursuit of our mission, we commit the Bank to the purest forms of Islamic banking products and services from a Shari'a perspective. We remain demonstrably *independent from the conventional sector* and recognize the *importance of Islam's social objectives* in conducting business. We are committed to delivering a *level of service* that matches, or exceeds, the market practice internationally. To do so, we seek to employ the best available human resources and the technology to apply the *highest professional, moral and ethical standards.*	*HSBC Canada, Canada*	HSBC in Canada is committed to being Canada's leading international financial services organization, a leader in chosen markets, and recognized by its clients as proactive, responsive, competitive and secure. To achieve a superior long term return for our shareholder we will efficiently deliver a differentiated client experience which reflects our commitment to excellence in sales, service and products, and which is delivered by highly motivated and well qualified employees, working as a team. Through managing for value, HSBC in Canada is committed to making a world of difference to its clients, employees, communities and shareholders
Meezan Bank Limited, Pakistan	Establish Islamic banking as banking of first choice to facilitate the implementation of an equitable economic system, providing a strong foundation for establishing a fair and just society for mankind. To be a premier Islamic bank, offering a one-stop shop for innovative value added products and services to our customers within the bounds of *Shariah*, while optimizing the stakeholders' value through an organizational culture based on learning, fairness, respect for individual enterprise and performance.(website)	*Barclays Group, UK*	Barclays aims to be one of the most admired financial services organizations in the world; in the eyes of our shareholders, our customers, our colleagues and the communities in which we work. The best measure of our long term performance is the total return we give to our shareholders - the increase in the price of our shares, assuming that any dividends are used to buy more shares, known as 'Total shareholder Return'.

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Source: Extracts of corporate mission and goals obtained from websites or annual reports.

Annex III: Legal Basis and Nature of Regulations on Internal SSBs in Selected Countries

Country	Legal base for SSB	SSB competences as spelled out by existing laws	SSB composition	SSB decision making	SSB Appointment and dismissal rules	Fit and proper criteria for SSB members
Bahrain	*BMA Rulebook - Volume 2- Islamic Banks - The BMA (2005) and all AAOIFI standards*	General duty to verify *Shariah* compliance and issue an annual report. Binding advice The shareholders shall decide how SSB will discharge this duty	At least three members (according to AAOIFI)	Unspecified (to be decided by shareholders)	Appointed by Shareholders. Dismissal is proposed by Board and approved by shareholders (according to AAOIFI standards)	Conflict of interest and competence clauses (According to AAOIFI governance standards).
DIFC *	*Law regulating Islamic financial business, DIFC Law No. 13 of 2004 and the Islamic Financial Business Module of the DFSA Rulebook*	Oversees and advises on *Shariah* compliance. Specific duties to be established and documented by the BIFS.	No less than three members	Unspecified	Appointed and dismissed by the bank's governing body	They must be competent (based on previous experience and qualifications) and are not directors or controllers of the BIFS
Indonesia	*Act No. 7 of 1992 as amended by Act 10 of 1998, Regulation 4/1/PBI/2002.*	General obligation to verify *Shariah* compliance (duties as stipulated by National *Shariah* Board and established by in bank's articles of association).	Unspecified	Unspecified	Any appointment or replacement of SSB members must be reported to Bank Indonesia and approved by the National *Shariah* Board	Documentary evidence on SSB members' previous experience to be submitted to Bank Indonesia's Board of Governors.

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Jordan	*Art. 58 of Law 28 of 2000 as amended by temporary Law No.46 of 2003.*	Ex ante audit (*fatwas*), ex-post audit, opinions on *Shariah* matters referred to it.	No less than three members	By unanimous or majority vote. Its votes are valid only if a majority of members is present.	Appointed by the general assembly of shareholders Discharged only through a reasoned decision taken by 2/3 of the board of directors and endorsed by the general assembly. Changes have to be notified to the Central Bank.	Unspecified
Kuwait	*Art 93 of Law No. 32 of 1968.*	General obligation to verify *Shariah* compliance of banking operations.	No less than three members	By unanimity. In case of conflict the matter is referred to the Fatwa Board.	Unspecified	Unspecified
Lebanon	*Law No. 575 on "Establishing Islamic Banks in Lebanon".*	Certification of *Shariah* compliance and proposals for properly achieving bank's objectives pursuant to the *Shariah*.	Three members	Unspecified	Appointment for a renewable three- year period.	Unspecified (experts' background must be in Islamic law, doctrine and banking and financial operations).
Malaysia	*Islamic Banking Act of 1983 and Central Bank of Malaysia Act 1958 (Revised 1994) and Guidelines on the Governance of Shariah Committees (2004)*	Binding advice *Shariah* on compliance of banking operations for Islamic Banks. The Central *Shariah* Advisory Council is the ultimate arbiter.	Unspecified	Unspecified.	Unspecified.	There are several incompatibility clauses.
Pakistan	*IBD Circular No. 02 of 2004.*	General obligation to verify	Only one advisor required.	Unspecified.	Appointment must be approved by	They are compulsory and relate to

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		Shariah compliance of banking operations. The SSB must submit an annual report to shareholders.	A board may be set up at the bank's discretio n.		State Bank of Pakistan.	minimum qualification and experience, track record, solvency, financial integrity, honesty and reputation and conflicts of interests.
Phili ppin es	*Republic Act No. 6848 and Manual of Regulations for Banks-Implementing Rules and Regulations of Republic Act No. 6848*	It offers advice and undertakes reviews on matters relating to *Shariah* compliance.	At least three but no more than five members	Unspecif ied.	Unspecified.	SSB members must be Islamic scholars and jurists of comparative law.
Thai land	*Islamic Bank of Thailand Act B.E 2545.*	It has "the authority and duty to give advice and recommendati ons to the Board of Directors concerning Islamic principles related to the operation of the bank".	Not more than 4 members	At least half of the SSB members form a quorum and decisions are taken by majority vote.	SSB members have two year tenure and may be reappointed. They are appointed and removed by the board of directors.	Financial integrity, competence, honesty and conflicts of interests.
UAE	*Federal Law No. 6 of 1985*	General obligation to verify *Shariah* compliance of banking operations. Detailed competences to be established by the bank.	No less than Three	To be decided in the articles of associati on of the bank.	SSB members must be approved by the Higher *Shariah* Authority	Unspecified

* Dubai International Financial Centre

Source: Official country websites and central bank Annual Reports

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Annex IV: External *Shariah* CG institutions by country

Country	*Separate* Islamic Banking & *Takaful* Department at CB	Centralized SSB or High *Shariah* Authority or *Fatwa* Board	Islamic Rating Agency	*Separate* Islamic Capital Market Department within Securities regulator
Bahrain	Yes, Islamic Financial Institutions Supervision Directorate	No, but the International Islamic Financial Market is to promote the harmonization and convergence of *Shariah* interpretations in developing Islamic banking products and practices which are universally acceptable	No, but International Islamic Rating Agency operates in Bahrain.	No
Indonesia	Yes, the Directorate of *Shariah* Banking	Yes, the *National Shariah Board* is authorized to issue *fatw*as concerning products, services and operations of BIFS. It also recommends *Shariah* advisors to BIFS	No	
Jordan	No	No	No	No
Kuwait	No	The *Fatwa Board* in the Ministry of *Awqaf* and Islamic Affairs is the final authority on *Shariah* *d*isputes. Its advice is binding when it arbitrates on disputes between members of the same SSB	No	No
Malaysia	Yes, Regulation Department –Islamic Banking and *Takaful*	Yes. The *Shariah Council* advises central bank on *Shariah* matters and is the ultimate arbiter in *Shariah* interpretation disputes. The directives issued by BNM in consultation with the *Shariah* Council have binding authority over Banks with Islamic windows.	Yes, Malaysian Rating Corporation -Islamic Capital Market Department	Yes, Malaysian SEC- Islamic Capital Market Department. The SEC also has its own *Shariah* Advisory Board
Sudan	N/A, the whole financial regulatory system is Islamic	Yes, the *Shariah High Supervisory Board* is responsible for *fatwas,* contract specimen,	No	N/A, the whole financial regulatory system is Islamic

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		arbitrage, consultations relating to Islamic legal aspects, training, research, lectures, and seminars		
Pakistan	Yes, Islamic Banking Department	Yes, the *Shariah Board* of the State Bank is to advise the central banks on matters of *Shariah*. It also produces specimen of permissible Islamic Financial contract to ensure compliance with minimum *Shariah* standards	No	No, but several departments share Islamic finance portfolio
UAE	No	Yes, the *Higher Shariah Authority*, attached to the Ministry of Justice and Islamic Affairs, is the final arbiter on *Shariah* matters. It is also responsible of *Shariah* supervision.	No	No

Annex V: *Shariah* Governance disclosure Indexes in 13 IIFS*

IIFS	***SSB composition***	***Background of SSB***	***SSB Annual Report****	***Fatwas***	***Decision making***	***Duties & powers***
A	**1**	**1**	**1**	**0**	**0**	**0**
B	**1**	**0**	**1**	**0**	**0**	**0**
C	**1**	**0**	**1**	**0**	**0**	**0**
D	**1**	**0**	**1**	**1**	**0**	**0**
E	**1**	**0**	**0**	**0**	**0**	**0**
F	**1**	**0**	**0**	**0**	**1**	**0**
G	**1**	**0**	**1**	**0**	**0**	**0**
H	**1**	**1**	**1**	**1**	**0**	**0**
I	**1**	**1**	**0**	**0**	**0**	**1**
L	**1**	**1**	**1**	**0**	**0**	**0**
M	**1**	**1**	**1**	**0**	**0**	**0**
N	**1**	**1**	**1**	**0**	**0**	**0**
O	**1**	**0**	**0**	**0**	**0**	**0**
Effective Disclosure	**1.00**	**0.46**	**0.69**	**0.15**	**0.08**	**0.08**
Desirable disclosure	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**

*The 6 indexes are calculated by attributing a 1 to every item that is disclosed and a 0 to items that are not disclosed by the 13 IIFS specified in footnote 54, in information venues such as annual reports and websites. The average across IIFS for every item is then taken to calculate the effective disclosure index. The desirable disclosure index is 1 assuming that ideally every IIFS in the sample ought to disclose information on *Shariah* Governance processes and structures.

** Two IIFS had never issued a SSB report due to their recent establishment. Nevertheless, the items are counted as disclosed due to the IIFS overall high level of disclosure

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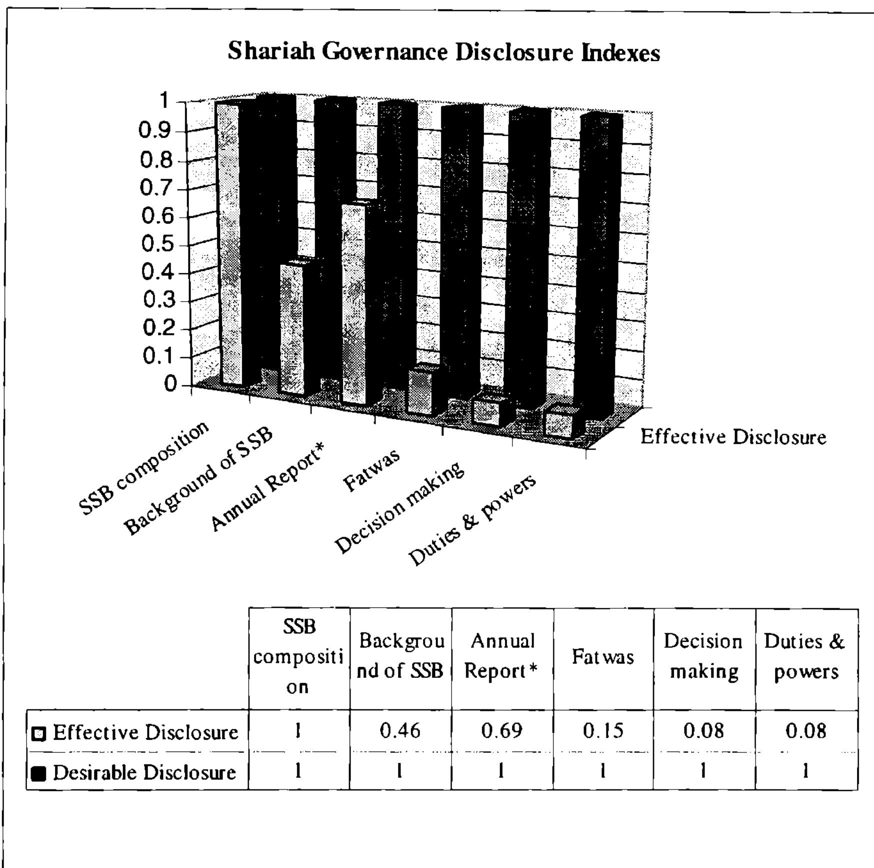

	SSB composition	Background of SSB	Annual Report*	Fatwas	Decision making	Duties & powers
□ Effective Disclosure	1	0.46	0.69	0.15	0.08	0.08
■ Desirable Disclosure	1	1	1	1	1	1

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Challenges Facing Islamic Financial Industry

Zamir Iqbal*

Abstract

This paper argues that at the present pace of growth and weak infrastructure, the industry will face challenges in achieving sustainable growth. On the contrary, if necessary policy measures are not taken, the industry may be adversely affected. The immediate need is to develop instruments that enhance liquidity; to develop secondary, money, and inter-bank markets; and to perform asset-liability and risk management. Its future growth and development will depend largely on the nature of innovations introduced in the market.

Islamic finance has recently received considerable attention in academics and policy making. Started over three decades ago in the form of commercial banking, the financia[1] activities conforming to Islamic Law (*Shariah*) have spread to investment banking, project finance, capital markets, insurance, wealth management, and micro-finance. Although, Islamic finance has survived well despite the obstacles and skepticism of the critics, it continues to face many challenges. This paper argues that at the present pace of growth and weak infrastructure, the industry will face challenges in achieving sustainable growth. On the contrary, if necessary policy measures are not taken, the industry may be adversely affected. The immediate need is to develop instruments that enhance liquidity; to develop secondary, money, and inter-bank markets; and to perform asset-liability and risk management. Its future growth and development will depend largely on the nature of innovations introduced in the market.

Section I of the paper identifies some areas of improvement in the banking and capital market sector and Section II makes some recommendations.

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1. For further discussion of issues see Iqbal and Mirakhor (1999); Iqbal (2005); Iqbal and Mirakhor (2007), and van Greuning and Iqbal (2007).

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Section I: Areas for Improvement

Although, there are several areas where there is room for improvement, given the significant of the banking and capital market sectors in the development of the financial system, the following areas need immediate attention.

1. Small Assets and Capital Size :

Although Islamic banks have grown in numbers, the average size of their assets is still small compared to that of conventional banks. As of 2001, no Islamic bank was among the top 100 banks in the world. More than 60 percent of Islamic banks were below the $500 million in assets considered to be the minimum for an efficient conventional bank, and aggregate assets of all Islamic banks were less than those of any single bank among the top 60 banks in the world. Table I lists assets and capital of the top 10 Islamic commercial banks which shows considerable margin between top tier and the bottom tier banks. Finally, the size of assets of the largest Islamic bank amounted to a meager 1 percent of the assets of the largest bank in the world.[2] Large institutions have significant potential for efficiency gains due to economies of scale and scope, organizational efficiency, and lower cost of funding. Due to their small size, Islamic banks are unable to reap these benefits.

Table I. Islamic Banks Assets and Capital as of 2006 (US$ million)

	Commercial Islamic Banks	Total Assets	Total Equity and Reserves
1	Al Rajhi Bank (Saudi Arabia)	28,057	3,636
2	ABC Islamic Bank (Bahrain)	22,441	2,072
3	Kuwait Finance House (Kuwait)	21,953	1,479
4	Dubai Islamic Bank (UAE)	17,548	1,845
5	AlBaraka Banking Group (Bahrain)	7,639	708
6	Bank Al Jazira (Saudi Arabia)	4,094	538
7	Bank Islam Malaysia (Malaysia)	3,969	554
8	Bank Muamalat Malaysia (Malaysia)	3,813	202
9	Qatar Islamic Bank (Qatar)	3,035	500
10	Sharjah Islamic Bank (UAE)	2,081	515

Source: Islamic Banks and Financial Institutions Information System (IBIS)

2. Iqbal (2001).

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2. Illiquidity:

Islamic banks are operating with a limited set of short-term traditional instruments, and there is a shortage of products for medium- to long-term maturities. One reason for these shortcomings is the lack of markets in which to sell, trade, and negotiate financial assets of the bank. There are no venues for securitizing dormant assets and taking them off the balance sheet. In other words, the secondary markets lack depth and breadth. An effective portfolio management strategy cannot be implemented in the absence of liquid markets, as opportunities for diversification become limited. Since the needs of the market regarding liquidity, risk, and portfolio management are not being met, the system is not functioning at its full potential. There is growing realization that the long-term, sustainable growth of Islamic financial markets will depend largely on the development of well-functioning secondary markets and the introduction of liquidity-enhancing and risk-sharing products.

3. Limited Scope:

In the absence of debt markets, underdevelopment of equities markets, and lack of derivatives markets, financial intermediaries play a critical role in the provision of Islamic financial services. Financial intermediaries not only are the main source of capital and risk mitigation but also are expected to undertake activities with wider scope. The changing global financial landscape will require Islamic banks to go beyond their traditional role as commercial banks and develop areas such as securities, risk management, and insurance that are either lacking or functioning on a limited scale.

The distinction between traditional commercial banking and investment banking is getting blurred, and there is a global trend to mix financial services with non-banking services. Although this trend is prevalent in major industrial economies, it has not been embraced by many of the emerging markets where Islamic finance is practiced. For example, a recent study that ranks several countries in the Middle East according to their level of financial development finds that countries throughout the region have a weak institutional environment and a poorly developed non-bank financial sector (Creane and others 2003).

4. Concentrated Banking:

Islamic banks tend to have a concentrated base of deposits or assets. They often concentrate on a few select sectors and avoid direct competition. For example, one Islamic bank may specialize in financing the agricultural sector, while

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another might do the same in the construction sector, and neither attempts to diversify to other sectors. This practice makes Islamic banks vulnerable to cyclical shocks in a particular sector. Dependence on a small number of sectors—lack of diversification—increases their exposure to new entrants, especially foreign conventional banks that are better equipped to meet these challenges.

This concentration in the base of deposits or assets reflects a lack of diversification, which increases their exposure to risk. Islamic banks' assets are concentrated in a handful of products. In terms of sector allocation, average financing activities of Islamic banks have been oriented primarily to trade (32 percent), followed by industry (17 percent), real estate (16 percent), services (12 percent), agriculture (6 percent), and others (17 percent; see Kahf 1999). Islamic banks are not fully exploiting the benefits that come from both geographic and product diversification. At present, they rely heavily on maintaining good relationships with depositors. However, these relationships can be tested during times of distress or changing market conditions, when depositors tend to change loyalties and shift to large financial institutions they perceive to be safer.

This risk of losing depositors raises a more serious exposure known as "displacement risk." Displacement risk refers to a situation where, in order to remain competitive, an Islamic bank pays its investment depositors a rate of return higher than what should be payable under the "actual" terms of the investment contract; it does this by forgoing part or all of its equity holders' profits, which may adversely affect its own capital. Islamic banks engage in such practices to induce investment account holders not to withdraw their funds. By diversifying their base of depositors, Islamic banks could reduce their exposure to displacement or withdrawal risks. With the changing face of banking and the introduction of Internet-based banking, achieving a high degree of geographic diversity on the liabilities side is conceivable and should be encouraged.

5. Weak Risk Management and Governance Framework:[3]

Several studies have identified weaknesses and vulnerabilities among Islamic banks in the areas of risk management and governance. Operational risk, which arises due to the failure of systems, processes, and procedures, is one area of concern. Weak internal control processes may present operational risks and

3. For further discussion, see Grais and Iqbal (2006) and Van Greuning and Iqbal (2007)

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expose an Islamic bank to potential losses. Governance issues are equally important for Islamic banks, investors, regulators, and other stakeholders. The role of Shariah boards brings unique challenges to the governance of Islamic financial institutions. Similarly, human resource issues, such as the quality of management, technical expertise, and professionalism, are also subject to debate.

6. Disparity in Theory and Practice:

By design Islamic banks are supposed to be "pass-through" financial intermediaries where the profit or loss on the assets side is passed to the investors (depositors). In addition, Islamic financial system encourages risk-sharing financial contracts which implicitly favor equity- and partnership-based financial instruments. However, the practice is very different from the theory in both aspects but especially in case of risk-sharing instruments. Table II shows assets composition of select Islamic banks and it clearly shows a bias towards trade-based, short-term and fixed-income like instruments. For example, the share of equity and other partnership based instruments like *Musharakah* and *Mudarabah* is less than 10 percent which is very different from the structure of the assets envisioned by the theoreticians.

Table II: Asset Composition of Select Islamic Banks

	1999	2000	2001	2002
Murabahah & Deferred Sales	80.1%	83.0%	86.7%	84.3%
Istisna	10.8%	8.7%	7.5%	7.0%
Ijarah (Leasing & Hire Purchase)	2.5%	2.4%	1.9%	2.9%
Mudarabah (partnership)	1.6%	1.6%	1.2%	3.1%
Musharakah (equity participation)	0.9%	0.8%	1.3%	1.2%
Qard Hasan	0.2%	0.3%	0.4%	0.5%
Other	0.2%	0.2%	0.5%	3.0%

Source: Islamic Banks and Financial Institutions Information System (IBIS)

Section II: Steps Forward— Some Recommendationss

Improvement can be made in several areas to promote and enhance the functioning of Islamic banks and other institutions providing Islamic financial services. However, certain areas deserve immediate attention, and these are discussed further in this section.

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1. Financial Engineering:

Financial engineering and financial innovations are driving the global financial system toward greater economic efficiency by expanding the opportunities for sharing risk, lowering transaction costs, and reducing asymmetric information and agency costs. Financial engineering involves the design, development, and implementation of innovative financial instruments and processes as well as the formulation of creative solutions. Financial engineering may lead to a new consumer-type financial instrument, or a new security, or a new process or creative solution to corporate finance problems, such as the need to lower funding costs, manage risk better, or increase the return on investments.

For Islamic financial institutions, a financial engineering challenge is to introduce new Shariah-compatible products that enhance liquidity, risk management, and portfolio diversification. Generally, attempts to apply financial engineering techniques to Islamic banking will require committing a great deal of resources to understanding the risk-return characteristics of each building block of the system and offering new products with different risk-return profiles that meet the demand of investors, financial intermediaries, and entrepreneurs for liquidity and safety. Securitization is a prime candidate for financial engineering. New financial innovations are also needed to satisfy the demand for instruments at both ends of the maturity structure: extremely short-term deposits and long-term investments. Money markets that are Shariah compatible do not exist at present, and there is no equivalent of an Islamic interbank market where banks could place, say, overnight funds or could borrow to satisfy a need for temporary liquidity. Although securitization of a pool of lease portfolios could help to develop the interbank market, the volume of transactions offered by securitization may not be sufficient to meet the demand (Iqbal 1999).

With increased globalization, integration and linkages have become critical to the success of any capital market. Such integration becomes seamless and transparent when financial markets offer a wide array of instruments with varying structures of maturity and opportunities for portfolio diversification and risk management. Financial engineering in Islamic finance will have to focus on the development of products that foster market integration and attract investors and entrepreneurs to the risk-return characteristics of the product rather than to the fact of the product being Islamic or non-Islamic.

As impressive as the record of growth of individual Islamic banks may be, so far they have served mostly as intermediaries between Muslim financial

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resources and major commercial banks in the West. It has been a one-way relationship. No major Islamic bank has been able to develop ways and means of intermediating between the supply of Western financial resources and the demand for them in Muslim countries. There is an urgent need to develop marketable Shariah-based instruments by which asset portfolios generated in Muslim countries can be marketed in the West.

Related to the challenge of financial engineering is another operational challenge for Islamic banks: the need to standardize the process for introducing new products in the market. Currently, each Islamic bank has its own religious board that examines and evaluates each new product without coordinating the effort with other banks. Each religious board adheres to a particular school of thought. This process should be streamlined and standardized to minimize time, effort, and confusion.[4]

Development of new products and financial engineering are resource-intensive activities. All major conventional banks have dedicated departments that conduct background market research, product development, and analytical modeling. These activities demand financial and human resources, which are costly. Conventional financial institutions can justify these costs, because they are able to recover them, in most cases, from the volume of business generated as a result of the innovative product. Costs associated with the development of new products are rising due to the increasing complexity of the business environment as a result of regulatory or accounting and reporting standards.

Islamic financial institutions are, in general, of small size and cannot afford to invest substantial funds in research and development. They are unable to reap the benefits of economies of scale. Considering the importance of financial engineering, Islamic financial institutions should seriously consider making joint efforts to develop the basic infrastructure for introducing new products. Conducting basic research and development collectively may save some of the costs required to build this infrastructure individually. A good example of such collective effort would be to sponsor research in the development of analytical models, computer systems, and tools to analyze the risk and return on different instruments.

Financial engineering is an area where Islamic financial institutions could benefit from more experienced Western institutions, which are more sophisticated in engineering and marketing the right product to the right client.

4. Informal discussions with practitioners revealed that religious boards sometimes are extremely rigid on minor technical matters and make the process of introducing a new product difficult and lengthy, resulting in missed business opportunities.

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Conventional investment banks, which have invested heavily in the infrastructure for developing new products, can work for or with Islamic financial institutions to develop Shariah-compliant products. Once a financial engineering shop is set up, it can develop different products with different risk and return profiles. In this respect, Islamic financial institutions would do well to develop synergies and collaborate with conventional institutions. Islamic financial institutions could outsource the development part to conventional institutions and keep the marketing part to themselves, a division of labor that could benefit both institutions.

2. Risk Management and Diversification:

Financial markets are becoming more integrated and interdependent, thus increasing the probability of expeditious contagion effects and leaving little room for swift measures against unexpected risk. Insufficient understanding of the new environment can create a sense of greater risk even if the objective level of risk in the system remains unchanged or is even lower. The current wave of capital market liberalization and globalization is prompting the need for enhanced risk management measures, especially for the developing economies and emerging markets. Whereas risk management is practiced widely in conventional financial markets, it is underdeveloped in Islamic financial markets.

Due to limited resources, Islamic banks are often unable to afford high-cost management information systems or the technology to assess and monitor risk in a timely fashion. With weak management and lack of proper risk-monitoring systems, the risk exposure of Islamic banks is high.

Providing a more diverse mix of financial services or spreading risks over a larger geographic area imply at least the potential for improved diversification, so the same protection against financial distress can be attained with fewer resources. For Islamic financial institutions, geographic expansion of the depositor base could achieve diversification on the liabilities side. Diversification on the assets side could reduce the variance of the returns that accrue to claimholders of the financial intermediary. Also, geographic and sectoral diversification on the assets side could break up the financial institutions' concentration in a region or a sector and thus reduce its exposure by creating less perfectly correlated risks. Geographic spread of products can further help the financial intermediary to improve its credit risk by selecting borrowers with the best credit and avoiding those with the weakest. With diversification, Islamic banks would be able to extend the maturity frontier.

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Islamic financial intermediaries need to adopt appropriate risk management not only for their own portfolio but also for that of their clients. Diversification and risk management are closely associated with the degree of market incompleteness. In highly incomplete markets, financial intermediaries are in a better position to provide diversification and risk management for the client because the responsibility for risk diversification shifts from the investors to the financial intermediary, which is considered to be better at providing intertemporal risk management. Islamic financial institutions need to take immediate steps to devise an infrastructure for implementing proper measures, controls, and management of risk and to create innovative instruments to share, transfer, and mitigate financial risk so that entrepreneurs can concentrate on what they do best: managing exposure to business risk in which they have a comparative advantage.

Exposure can also be reduced by working closely with clients to reduce their exposure, which will ultimately reduce the intermediary's exposure. In other words, if the debtor of the bank has lower financial risk, this will result in better quality credit for the bank. Furthermore, monitoring becomes vital in cases where Islamic banks invest in equity-based instruments because an institution with limited resources may not be equipped to conduct thorough monitoring. An institution with adequate resources may develop processes, systems, and training to undertake effective monitoring. There is clearly a need for Islamic financial institutions that can offer guarantees, enhance liquidity, underwrite insurance against risks, and develop hedging tools for a fee.

Finally, Islamic financial institutions need to realize the importance not only of financial risk and its management but also of operational risk, which is risk due to the failure of controls and processes. Currently, there is a serious lack of a risk culture and of enterprise-level sponsorship of active risk management. Formulating a strategy for risk management in Islamic financial markets will require (a) holding comprehensive and detailed discussion of the scope and role of derivatives within the framework of the Shariah; (b) expanding the role of financial intermediaries with special emphasis on facilitating risk sharing; (c) applying *takaful* (Shariah- compliant mutual insurance) to insure financial risk; and, finally, (d) applying financial engineering to develop synthetic derivatives and off-balance-sheet instruments.

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3. Non-Bank Financial Services:

For further growth, the role of intermediation should be extended beyond its traditional setup. In particular, there is a need to broaden the scope and range of financial services offered, similar to the concept of a "financial products supermarket." Such a supermarket would act like an "all-in-bank" covering all sorts of financial services. In this role, the Islamic bank would serve as a one-stop shop catering to different types of customers, ranging from private individuals, institutions, high-net-worth individuals, and corporations and offering products that serve their investment, borrowing, risk management, and wealth management needs. For example, such an institution would serve retail customers, manage investment portfolios, and provide various services for corporate customers. At the same time, like a broker, the financial products supermarket would be a retail firm that manages assets and offers payment and settlement services.

As financial systems become more sophisticated, institutional investors have grown significantly in size and importance. For instance, contractual savings with defined benefits, like insurance and pension funds, are managing a large volume of assets. In a financial system where securities markets are underdeveloped, which is the case of Islamic financial markets, financial intermediaries will have to provide a broader set of services, including non-bank financial services. Most Islamic banks are not adequately equipped to provide typical investment banking services, such as underwriting, guarantees, market research, and fee-based advisory services. The refinement and development of fee-based services would enhance the functionality of Islamic financial services. Fee-based contracts like *joalah*, *wakalah*, and *kifalah* require further development if they are to be recognized and operationalized to exploit the full capabilities of Islamic banks.

4. Development of Capital Markets:

Responding to the current wave of oil revenues and growing demand for Shariah-compliant products, Islamic capital markets are expanding at a quickening pace, and stakeholders are starting to realize their potential. Development of institutional infrastructure, such as accounting standards and regulatory bodies, is a step in the right direction.[5] However, the market needs host governments to undertake strong leadership and constructive policy actions.

5. These institutions include the IFSB, AAOIFI, Liquidity Management Center, International Islamic Financial Markets, and International Islamic Rating Agency.

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Well-developed Islamic capital markets will not only benefit borrowers and institutional investors, they also can enhance the stability of Islamic banks, providing them with improved portfolio, liquidity, and risk management tools. Ultimately, these developments will help to integrate Islamic financial markets, as well as the institutions that form them, into the broader conventional international financial system.

On the supply side, the volume of Islamic investments, with a preference for Shariah-compliant instruments, has grown to form a critical mass that can support a well-functioning and efficient capital market. It is evolving into a truly international market. Not only highly rated borrowers, such as the multilateral development banks (for example, the World Bank), but also developing-country borrowers with lower credit ratings, such as Pakistan, have successfully raised a considerable volume of funds in this market.

On the demand side, countries in the developing world, especially the middle-income countries, will require a significant volume of investments in infrastructure over the next decade. For Indonesia alone, additional infrastructure investments of $5 billion (2 percent of GDP) are required annually, to reach a 6 percent medium-term growth target (World Bank 2004). Because the domestic capital markets of these borrowers are often too shallow to satisfy their large investment needs, they will have to access external sources of financing.

Furthermore, Muslim stakeholders in middle-income countries are increasingly expressing their preference for Shariah-compliant financing. In turn, financial intermediaries, including private sector commercial and investment banks, as well as development finance institutions, will have to start paying more attention to the "non-financial" needs of their clients.

For the multilateral development banks, the development of Islamic capital markets is a highly relevant topic. First, multilateral development banks are deeply involved in infrastructure finance and are naturally interested in the Islamic capital market as a new and alternative source of financing. Second, by channeling the funds available in Islamic financial markets, which are mostly based in the countries with high savings such as the Gulf Cooperation Council countries and Malaysia, to finance investments in developing countries, multilateral development banks can create a new model for international cooperation while responding to the stakeholders' voices on both sides. Third, multilateral development banks can promote financial stability by encouraging

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the development of Islamic capital markets and providing the momentum to integrate the Islamic financial markets into the international financial system.

In the near future, structures such as *ijarah* (a lease) and *murabahah* (a cost-plus sales contract used to purchase commodities) that provide investors with a predetermined return as well as full recourse to the obligor probably will have more market potential than other structures. This will be driven primarily by investor preferences, but a large proportion of potential borrowers will prefer to lock in their borrowing costs rather than engage in pure profit-sharing schemes.

While the future appears promising, certain obstacles lie ahead, and market participants and regulators need to take concrete steps to support market takeoff. First and most important, market development requires strong sponsorship and leadership on the part of the host-country government, especially regarding legal and regulatory issues. For example, for an *ijarah* transaction, the owner of operating assets enters into a leasing transaction. While the owner of operating assets is often the government itself or related public sector bodies, the relevant laws and regulations in the host country may not allow these bodies to pledge or lease assets needed to structure an *ijarah* transaction. This is a fundamental point; the host country's policy actions are a key prerequisite for further market development.

In addition, borrowers, investors, and intermediaries need to nurture the market patiently. Islamic transactions are often less cost-efficient than conventional bond issues. Each new issue incurs higher legal and documentary expenses as well as distribution costs because it involves examining structural robustness in addition to evaluating the credit quality of the obligor. Since the terms available in Islamic capital markets are derived mostly from pricing levels in the more liquid conventional bond markets, there is no inherent cost advantage for borrowers tapping Islamic markets. Borrowers, therefore, need to formulate a comprehensive, long-term, and strategic view on how to reduce the overall cost of tapping Islamic markets, rather than focus on a single transaction. Investors can support market development by expressing their preference for *Shariah*-compliant instruments, namely, in their bid prices. Intermediaries can lead the process, perhaps through further standardization of transaction schemes and instruments.

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Commodity Murabahah Programme (CMP): An Innovative Approach to Liquidity Management

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Abstract

Liquidity is an important characteristic of banks. By their very nature, banks transform the term of their liabilities to have different maturities on the asset side of the balance sheet. At the same time, banks must be able to meet their commitments such as deposits at the point at which they become due. Thus, liquidity management lies at the heart of confidence in the banking operation. Customers place their deposits with a bank, confident they can withdraw the deposit when they wish. If the ability of the bank to pay out on demand is questioned, all its business may be lost overnight. The importance of liquidity transcends the individual institution, since a liquidity shortfall at a single institution may invoke systemic repercussion causing harm to the whole financial stability of a country. Therefore it is important for banks to have adequate liquidity potential when it can obtain sufficient funds promptly and at a reasonable cost. For Islamic banks, liquidity risk is a significant risk owing to the limited availability of Shariah-compatible money market instruments and lender-of-last-resort (LOLR) facilities. Hence, the recent introduction of commodity murabahah instrument based on tawarruq concept by Central Bank of Malaysia is deemed as an innovative approach to liquidity management. It certainly adds to the list of instruments for Islamic banks to manage their liquidity more effectively and efficiently. This paper reviews the structure and mechanism of commodity murabahah particularly for liquidity management purpose. As will be evident in this paper, this instrument has its own advantage which appeals to certain practitioners who were previously uncomfortable with `inah-based instruments.

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Introduction

Liquidity management lies at the heart of confidence in the banking operation. Customers place their deposits with a bank, confident they can withdraw the deposit when they wish. If the ability of the bank to pay out on demand is questioned, all its business may be lost overnight. In general terms, liquidity refers broadly to the ability to trade instruments quickly at prices that are reasonable in light of the underlying demand/supply conditions through the depth, breadth and resilience of the market at the lowest possible execution cost. A perfectly liquid asset is defined as one whose full present value can be realized, i.e. turned into purchasing power over goods and services, immediately. Cash is perfectly liquid, and so for practical purposes are demand deposits, and other deposits transferable to third parties by cheque or wire, and investments in short term liquid government securities. The importance of liquidity transcends the individual institution, since a liquidity shortfall at a single institution may invoke systemic repercussion causing harm to the whole financial stability of a country. Therefore it is important for banks to have adequate liquidity potential when it can obtain sufficient funds promptly and at a reasonable cost.

The concern over liquidity management is also relevant to Islamic bank that holds illiquid assets while its liabilities are liquid, and holds assets unpredictable in value while guaranteeing the value of its liabilities. Thus, since Islamic banks follow the same structure and characteristics of a commercial banks' balance sheet, they are not immune from liquidity risk. The potential mismatch between deposits and investment financing exposes Islamic banks to liquidity problems. On the other hand, if the banks maintain too much liquidity to avoid getting into the liquidity problems may in turn hurt its profitability. Therefore creating a right balance between the two objectives of safety and profitability is the crux of the liquidity management issue.

In Malaysia, the establishment of the first Islamic Inter-bank Money Market (IIMM) on January 3, 1994 was designed to provide the Islamic banks with the facility for funding and adjusting portfolios over the short-term and hence maintaining the funding and liquidity mechanism necessary to promote stability in the system. More importantly IIMM provide avenue for Islamic banks to manage liquidity more effectively and efficiently without undermining the principles of Shari`ah.

The development of a vibrant, efficient and effective Islamic Inter-bank Money Market requires the creation of a broad spectrum of innovative Islamic financial instruments and the infrastructure to promote active trading so as to enhance the breadth and depth of the market. Consequently, as part of Bank

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Negara Malaysia's initiative to support Islamic banking and finance development in Malaysia, Commodity Murabahah Programme (CMP) was introduced to facilitate liquidity management and investment purposes. CMP is a cash deposit product which is based on principle of *tawarruq*. It is designed to be the first ever commodity-based transaction that utilises the Crude Palm Oil (CPO) based contracts as the underlying assets. CMP transaction with Bank Negara Malaysia was first auctioned competitively in the IIMM on 14 March 2007 and marked an extensive effort by the country to become a significant player in Islamic financial market globally.

This paper provides insights into the structure and mechanism of Commodity Murabahah Programme as an instrument to serve the liquidity need and investment opportunity of Islamic financial institutions. In doing so, the paper also reviews some Shari`ah issues pertaining to the nominate contract used in CMP, namely the *tawarruq* principle. As will be evident in this paper, this instrument has its own advantages and value added which would make it the instrument of choice in meeting specific investment interests and needs.

The structure of the paper is as follows. Section 2 establishes the concept of liquidity management in Islamic financial institution. This is followed in Section 3 by a more detailed discussion on concept and modus operandi of Islamic liquidity management. Section 4 discusses the concept, structure and mechanism of Commodity Murabahah Programme. Section 5 reviews the various opinion of Muslim School of Fiqh on the validity of *tawarruq*-based products as practised in IIIMM. The final section contains the concluding remarks.

Concept of Lioudity Management

Banks in a business of offering debt contracts for liquid deposits that finance the acquisition of illiquid assets of uncertain value. Banks which hold illiquid assets and issue demand liabilities are one market response to the desires of individuals to improve terms on which they urgent demands to withdraw funds can be met. This transformation of liquid liabilities into illiquid assets necessitates banks to manage their liquidity position effectively and efficiently. Banks must structure their portfolios so that the pattern of asset returns can support the short-term obligations that they issue. Hence, liquidity is parallel to the term 'solvency' which means the ability to meet debts as and when they are due and this is achieved when the current assets of the bank exceed current liabilities. Consequently, liquidity risk emerges as one of the most important risks that banks need to address to avoid loss if it is not properly managed. Liquidity risk can be broadly defined as the potential loss to banks arising from

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their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.

Therefore liquidity risk management lies at the heart of confidence in the banking system. Failure to address liquidity problems not only can cause an insolvent bank to runs but may also have contagious effects. The systemic danger is that the failure of an insolvent bank can cause depositors of other banks to withdraw deposits. This can cause a solvent institution to become insolvent because two main reasons: first, a large proportion of bank assets are not easily marketable; and second because a panic may drive down the current value of those assets which are marketable. In the event of a run, a bank is forced to dispose of assets which, because of asymmetric information problems, cannot be sold at par as potential buyers impose a high risk premium in the purchase price.

In a normal situation banks and other financial intermediaries facing temporary shortages of reserves and secondary reserves of liquid assets can borrow them from other institutions. In developed country like the United States, a well-organised market for 'federal funds' allows banks short of reserves to borrow them overnight from other banks. Furthermore, the availability money market and inter-bank market i.e. market for short-term loans, is designed to meet short-term cash requirements of banks and other financial intermediaries. Maturities of loan normally range from overnight to one year.

Liquidity risk also applies to Islamic banks, since they are also constrained by illiquid assets to meet their liquid liabilities and financial obligations. According to theory, Islamic banks are less exposed to liquidity risk and therefore to instability than their conventional counterparts. An ideal Islamic banking model is reflected through its balance sheet structure that is dominated by profit-loss-sharing (PLS) on both the assets and liabilities sides. In such arrangements, it is believed that the depositors who share the risk with the bank on the liabilities side will naturally absorb any adverse outcomes on the assets side of the bank's balance sheet. In other words, any negative shock to an Islamic bank's asset returns is absorbed by both shareholders and investments account depositors. The value of the depositors' funds represents the real assets value of the banks. Thus, Islamic banking theoretically is deemed to be a good alternative to the conventional system due to its robustness and the potential stability that the system may provide.

However, the practices of Islamic banks are found to diverge in important ways from the ideal structures envisioned by the pioneers of Islamic economics.

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Rather than strictly sharing profits and losses with depositors, the practice of distributions of profits even if there are no or low profits creates distortions and put strains on the equity shareholders. In addition, most retail deposits scheme (current and savings) are based on contracts like *Wadi`ah Yad Dhamanah* (guaranteed safekeeping) or *Al-Qard* (loan), which are guaranteed principal contracts irrespective of the bank's profitability on its assets side. The prevailing practice of giving *hibah* (gift) at the rate equivalent to the rate of return on deposits offered by conventional banks further distort the ideal structure of Islamic banking. Consequently, Islamic banks resort to the second line fixed return techniques including *murâbahah* (cost-plus sale), *bai' bithaman 'ajil* (deferred payment sale), *bai' al-salam* (purchase with deferred delivery), *bai' al- istisna'* (commissioned manufacturing), and *ijârah* (leasing), etc[1] aimed at fixed and secured profits.

Islamic banks are also criticised for not giving priority to long-term development projects over short-term projects aimed at quick profits. This attitude is similar to that of the conventional banks that prefer short-term investments since banks work on the basis of small reserves and hence, must be able to liquidate their assets fairly quickly, if the need arises. The short-term structure of the Islamic banks' assets is even more pronounced with the predominance of debt-based contracts or fixed return modes like *murabahah* and leasing on the asset side of Islamic banks' balance sheet. The structure of deposits on the liabilities side which is not sufficiently long term further accentuates the reluctance of Islamic banks to get involved in long-term projects. Thus, from a substantive standpoint, Islamic banks do not operate very differently from their conventional counterparts.

In sum, the nature of Islamic bank's balance sheet is similar to conventional banks. On the asset side, Islamic banks offer products which are illiquid and relatively long-term in nature, whereas on the liabilities side Islamic banks accept deposits which are liquid

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1. Observers point out that the use of PLS instruments, namely mudarabah and musharakah financing have declined to almost negligible proportion. In many Islamic banks' asset potfolios, short-term financing, notably murabahah and other debt-based contracts account for the great bulk of their investments. Yousef (2004) refers to the strong and consistent tendency of Islamic banks to utilise debt-like instruments in the provision of external finance as *'murabahah syndrome'*. Also refer to (Iqbal & Molyneux, 2005; Kuran, 2004; Lewis & Algaud, 2001; Yousef, 2004).

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Islamic Approach to Liquidity Amanagement

One of the most important approaches to liquidity management is the ability of a bank to get access to secondary market such as capital market and inter-bank money market. The latter is generally referring to borrowing and lending activities for periods of a year or less. This money market has become a place for financial institutions and governments to manage their short-term liquidity needs. Thus banks normally expect to derive liquidity from both sides of their balance sheet and maintain an active presence in inter-bank money markets. They look to these markets as a source for discretionary acquisition of short-term funds on the basis of interest-rate competition, a process that can help them meeting their liquidity needs.

Conceptually, the availability of asset and liability options should result in a lower cost of liquidity maintenance. The costs of available discretionary liabilities can be compared to the opportunity cost of selling various assets, since banks also hold a range of short-term assets that can be sold if necessary. These assets also serve as reassurance to the potential suppliers of funds about the credibility and reputation of the bank, thus enhancing the bank's ability to borrow.

There are various short-term liquidity instruments in the conventional money market, offering different returns and different. These instruments include treasury bills, certificates of deposits, repurchase agreements, banker's acceptance, commercial papers and inter-bank money deposits. All these instruments have different characteristics pertaining to maturity periods ranging from over night to one year. In a nutshell, inter-bank money market allows surplus banks to channel funds to deficit banks using various instruments, thereby maintaining the funding and liquidity mechanism necessary to promote stability in the system. However, most of these instruments used in inter-bank money market are essentially interest-based instruments. Therefore, the establishment of a viable Islamic money market with Shariah-compliant instruments is not only needed for the smooth growth of the industry nowadays but it has already become a necessity.

Initial efforts to overcome the problem of liquidity management have been focusing on creating short-term and long-term debt instruments that are in line with Shariah principles. This was evident, in some jurisdictions, through the issuance of diverse Islamic financial instruments ranging from short-term papers to long-term bonds to meet the liquidity and investment needs of Islamic banking institutions. Perhaps, Malaysia seems to be the pioneer country in such

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initiatives with the establishment of the first Islamic Inter-bank Money Market (IIMM) in the world.

The IIMM was introduced on January 3, 1994 as a short-term intermediary to provide a ready source of short-term investment outlets and avenue for banks to manage their potential asset and liability mismatch based on Shariah principle. Through the IIMM, the Islamic banks and banks participating in the Islamic Banking Scheme (IBS) would be able to match the funding requirements effectively and efficiently. Since its first inception, there are number of instruments have been developed and introduced to the market, which suit diverse investors' requirements and needs. These instruments include Mudarabah Interbank Investment (MII), Wadiah Acceptance, Government Investment Issue (GII), Bank Negara Monetary Notes-i (BNMN-i), Sell and Buy Back Agreement (SBBA), When Issue (WI), Islamic Accepted Bills (IAB), Islamic Negotiable Instruments (INI), Islamic Private Debt Securities, Ar Rahnu Agreement-I (RA-i), Sukuk BNM Ijarah (SBNMI).[2]

Even though some of these instruments are Shariah compatible, others seem to be controversial. The controversies surrounding these instruments are mainly due to the overemphasising on the use of *bay` al-`inah* contract in devising most IIMM instruments. For example, Government Investment Issue (GII) which was initially issued by the Government of Malaysia based on *qard al-hasan* (benevolent loan) principle, now replaced by *bay` al-`inah*, allowing it to be traded in the secondary market via the concept *bay` al-dayn* (debt trading).

Bay` al-`inah is normally described as an arrangement whereby a person sells an asset to another for deferred payment. Subsequently, the seller buys back the asset from the buyer before the full payment of the deferred price and for cash payment which is of a lesser amount than the deferred price. In the case bay` al-`inah-based GII transaction, the Shariah-compliant asset (for example GII) will be sold by a financier (for example central bank) to the recipient bank at X price on deferred terms. Then, the recipient bank will sell back the asset (GII) to the financier on cash basis at Y price. The deferred price of X is higher than the cash price of Y, hence the difference is regarded as profit to the financier. Both sale contracts are executed separately.

Another example is the Negotiable Islamic Certificate of Deposit (NICD), which has also applied bay` al-`inah to produce the Islamic version of NCD. The sale and buy back mechanism (bay` al-`inah) is explained as follows: A high

2. For detailed descriptions of these instruments, refer to http://iimm.bnm.gov.my.

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net-worth individual client who wishes to deposit RM1 million in NICD with an Islamic bank would normally expect a fixed return from the bank. The bank sells its asset (i.e. its shares certificate) worth RM1 million to the client and get paid on cash basis. The bank now secures RM1 million deposits. Subsequently, the client sells back the share certificates to the bank at a deferred price, which is based on a profit rate; say 7.5 percent for duration of six months (7.5% x 6/12 x 1,000,000 = 37,500). The bank now issues the client NICD worth 1,037,500 as the nominal value. The issuance of the NICD is undertaken as evidence of the RM1,037,500 debt that the bank owes the client. At maturity, the NICDs are redeemable at par value where the client gets back the RM1 million deposit plus RM37,500 profit. More importantly this NICD is tradable in the secondary market for liquidity purposes.

In recent times, most of the contemporary Muslim jurists are clearly inclined towards the majority's view in disallowing and nullifying *bay` al-`inah* mainly disputing that it is a legal device (*hilah*) to circumvent riba-based financing, which in fact opens a 'back door' to riba. Those who against *bay` al-`inah* basically subscribes to the opinion of classical scholars such as Hanifis, Malikis, Hanbalis and some Shafiis schools who reject *bay` al-`inah* and opine that this kind of sale transaction is forbidden. This somehow explains the global rejection of the Malaysian practice of bay` al-`inah in Islamic financial market.

Nonetheless, Malaysian scholars who mainly subscribe to the opinion of Shafiis, Abu Yusuff, Abu Daud and Abu Thur, including a report from Ibn Umar are of the view that the *bay` al-`inah* contract is not contrary to Shariah principles, thus it is allowed. Among their arguments are summarised below:

1. The companion's report relied by those who reject *bay` al-`inah* is considered weak both in terms of its transmission (sanad) and wordings *(matan)*.[3] The proponents of *bay` al-`inah* argue that one of the narrators of the hadith named al-`Aliah binti Anfa` is unknown *(majhulah)*. Al-Dar Qutni regards her as an unknown figure, thus chain of transmission is doubtful and hence the hadith cannot be a proof. The companion's report is

3. The companion's report is a narration from Saidatina Aisyah: A mother once asked Saidatina Aisyah, she said: "O Mother of the Believers! I have sold a slave belongs to Zaid bin Arqam to `Ata' for 800 dirham. Since `Ata' needed some money, I have bought back the slave before it is due for me to receive 600 dirham". Saidatina Aisyah replied, "How could you execute such a bad sale. You should inform Zaid bin Arqam that his conduct has extinguished all his rewards for participating in jihad with the Prophet p.b.u.h. if he does not repent. The mother said: "What is your opinion if I forgo the profit and take the principal sum only?" Aisyah then recited a verse from which means: "Whoever receives an admonition from hid Lord and stops eating riba shall not be punished for the past, his case is for Allah (to judge)" (Al-Baqarah: 2:275).

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also weak in terms of its wordings *(matan)*. They claim that Saidatina Aisyah is not in capacity to determine the status and invalidate the rewards for jihad that Zaid had involved together with the Prophet p.b.u.h. in the battle fields since Zaid had conducted an *ijtihad* (rational reasoning) and was of the view that such a sale is permissible (Ahmad, 2007).

2. On the issue of hilah, the Malaysian scholars argue that not all *hilah* is rejected. In fact Hanafis and Shafiis school generally approve the use of *hiyal* (a plural for hilah) as long as it does not deny the rights of people or involve falsehood (batil) or even demeaning the religion. Al-Sarakhsi (as quoted in Ali, 2007) strongly argued that "*Hiyal* as they are produced by the Imam is permissible according to majority (jumhur) of the scholars, and those who detest that (the use of hiyal) did so due to their ignorance and lack of observation *(taammul)* of the Quran and Sunnah". Based on this premise, the Shariah Advisory Council of Malaysia argued that *hilah* as evident in the practice of Islamic instruments in IIMM is regarded as a mode to solve problems *(makhraj)* that is much needed by the people, provided that necessary conditions are duly followed in order to avoid any abuse of such contract which may lead to dispute or injustice (Central Bank of Malaysia, 2007).

Notwithstanding all the arguments to support *bay` al-`inah* concept, the fear that the practice of bay` al-`inah will be used as a camouflage for interest-based transactions cannot be totally neglected. In this regard, Malaysian scholars have warned the market players to strengthen and enhance the operational processes and documentation to comply with the features of bay` al-`inah as permitted. Moreover, since *bay` al-`inah* is still regarded as a matter if juristic disagreement among the Shariah scholars, it is advised that Islamic financial institutions to limit its use in products which really face difficulty in structuring them based on other consensually accepted contracts (Central Bank of Malaysia, 2007).

Of late, there have been attempts by Malaysian authorities like Central Bank of Malaysia to provide other alternative mechanisms to meet the need for cash and liquidity, without having to resort to riba-based mechanism or the contentious product based on *bay` al-`inah*. The instrument is known as commodity murabahah programme (CMP) which adopts the concept of *tawarruq*. The mechanism and structure of CMP will be discussed in the following section.

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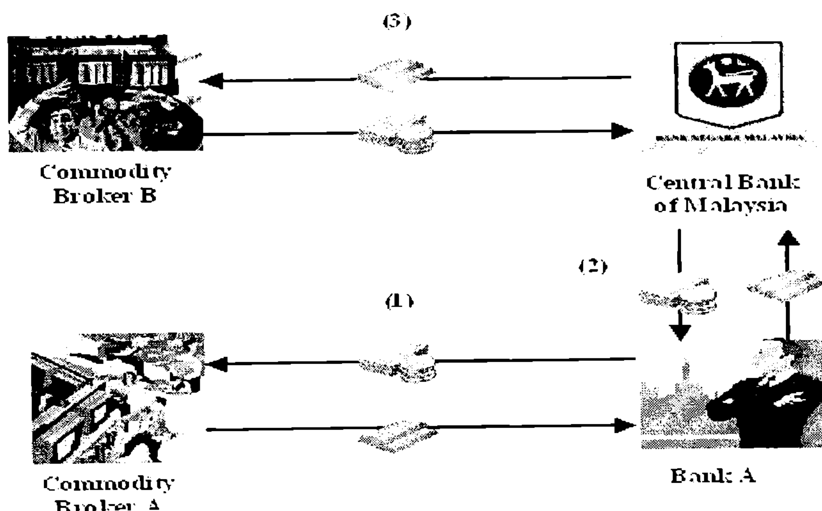
Commodity Murabahah Progamme (CMP)

Commodity murabahah is one of the most popular techniques used to manage short-term liquidity in the Gulf region (especially Saudi Arabia and United Arab Emirates) (El-Gamal, 2006). It is based on commodities traded on the London Metal Exchange (LME) on a spot basis with 100 per cent payment of the purchase price, then selling the purchased commodities to a third party on a Murabahah (cost-plus sale) basis for a deferred payment with a maturity from one week to six months, and with spot delivery of the sold commodities.

In Malaysia, commodity murabahah programme (CMP) was designed to be the first ever commodity-based transaction that utilises the Crude Palm Oil (CPO) based contracts as the underlying assets. Even though the concept which is based on tawarruq contract has long been discussed by the Shariah scholars worldwide, only recently such concept was being practically implemented. It was officially endorsed as a permissible instrument to be used in financial market and IIMM by the Shariah Advisory Council of Central Bank of Malaysia on 28th July 2005. The main purpose is to offer Islamic financial institutions a new instrument in managing liquidity in the IIMM. CMP provides certainty of returns as it is undertaken based on pre-agreed 'margin' or 'mark-up' from the sale and purchase of the underlying asset (Bank Negara Malaysia, 2007).

The structure of CMP for liquidity management (both to absorb and inject liquidity) comprising several activities are depicted in Figure 1 and Figure 2, respectively.

Figure 1: Commodity Murabahah Progragme for Liquidity Absorption



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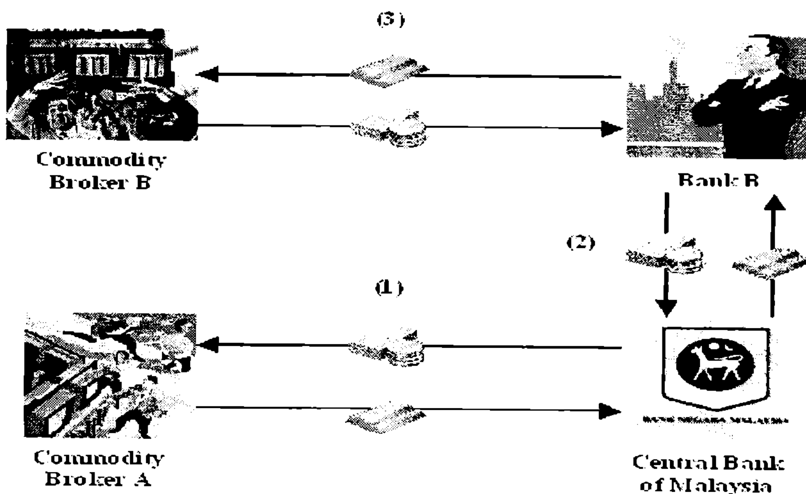
Several mechanism of CMP for absorbing liquidity as depicted in Figure 1 can be further illustrated as follows:

1. Bank A that faces excess liquidity can manage their liquidity by purchasing commodities from Broker A on cash basis. For example, RM 1 million.
2. Thereafter, the bank sells the commodities to Central Bank of Malaysia on deferred price (cost price plus profit margin). For example, RM 1 million (cost) plus 7.5 profit margin for a duration of six months (7.5% x 6/12 x RM1 million = RM 1,037,500).
3. Central Bank of Malaysia sells the commodity to Broker B in on spot at the original price to net off the commodity position that it holds when it purchased from Bank A. The Central Bank of Malaysia may appoint the bank as his agent to sell the commodities in the commodity market.

On maturity date, Bank A will be receiving the amount equivalent to the principal plus the net yield as agreed beforehand. In the final analysis, CMP provides avenue for Islamic banks that face excess liquidity to manage their funds productively, while the Central Bank of Malaysia can obtain funds immediately enabling an efficient and effective cash liquidity management.

On the other hand, if any bank faces temporary liquidity problems due to mismatch between assets and liabilities, they can also benefit from this CMP instrument. Several activities of CMP in injecting liquidity to problematic banks are depicted in Figure 2.

Figure 2: Commodity Murabahah Programme for Liquidity Injection



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As depicted in Figure 2 above, a bank that faces temporary liquidity problems can use CMP based on the following steps:

1. Central Bank of Malaysia purchases the commodities from Broker A on cash basis. For example, RM 1 million. Alternatively, the Central Bank of Malaysia can appoint Bank B (that faces temporary liquidity problem) as its agent to buy the commodities from commodity market. Bank B will receive the funds for the purchase of commodities on spot basis. The ownership of the commodities is then transferred to the Central Bank of Malaysia.
2. Thereafter, the Central Bank of Malaysia sells the commodities to Bank B on deferred price (cost price plus profit margin). Hence, the ownership of the commodities is now transferred to Bank B.
3. Bank B sells the commodities to Broker B in on spot at the original cost price to net off the commodity position that it holds when it purchased from Central Bank.

On maturity date, Bank B will have to pay Central Bank for the funds equivalent to the principal plus profits. In the final analysis, Bank B obtains funds on spot which is required to manage its liquidity effectively and efficiently.

The Polemics of Tawarruq-Based Transations

After highlighting the structure and mechanism of commodity *murabahah*, we now turn our discussion to the various Shari`ah issues pertaining to the transaction. Obviously, commodity murabahah involves contract of *tawarruq*. *Tawarruq* is actually a sale contract whereby a buyer buys an asset from a seller with deferred payment and subsequently sells the asset to the third party on cash with a price lesser than the deferred price, for the purpose of obtaining cash[4]. This transaction is called *tawarruq* mainly because when the buyer purchases the asset on deferred terms, it is not the buyer's interest to utilize or benefit the purchased asset, rather to facilitate him to attain liquidity (*waraqah maliah*). (Ahmad, 2007)

4. This definition is accepted by the OIC Fiqh Academy in their deliberation on the issue on 1st November 1998 (11 Rejab 1419H). See also (Wizarat al-Awqaf wa al-Shu'un al-Islamiyah, 2005).

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Hence, *tawarruq* and *bay` al-`inah* are similar as far as the substance is concerned. Both *tawarruq-* and *bay` al-`inah*-based instruments are serving exactly the same contractors' purposes, and share exactly the same economic substance and consequences, albeit their form may be different. The differences are mainly in two aspects. First, while the latter does not involve third party, the third party intermediary is present in the case of *tawarruq*. Second the sale of object in *bay` al-`inah* is returned to the original owner, whereas in *tawarruq*, there is no such condition. (Central Bank of Malaysia, 2007).

Interestingly, past jurists from Malikis and Hanbalis schools who categorically disallowed and nullified *bay` al-`nah* transaction, do not actually reject *tawarruq* outright. Instead, they were inclined to allow it mainly arguing that the presumption that the parties intended to circumvent the prohibition of riba was quite remote in tawarruq due to its tri-partite nature. However, two prominent Hanbali jurists, namely Ibn Taimiyyah and his disciple Ibn Qayyim Al-Jawziyyah departed from the majority Hanbali school's approval of *tawarruq*. They disallowed tawarruq and dismissed it as a legal trick (*hilah*) similar with *bay` al-`inah*. (Al-Zuhayli, 1989).

The issue of *tawarruq* is also tackled by contemporary jurists. A prominent OIC Islamic Fiqh Academy issued two rulings on the matter. The first opinion was issued in the 15th session of the academy in September 1998 (Rajab 1419H), whereby they permitted the contract subject to the condition that the customer does not sell the commodity to its original seller, to avoid direct evidence of *`inah* as a legal trick to circumvent the prohibition of riba. However, in its 17th session, held in December 2003, the Academy clarified its stand on *tawarruq* by distinguishing and classifying it between *tawarruq haqiqi* (real *tawarruq*) and *tawarruq munazzam* or *tawarruq masrafi* (organized *tawarruq*). While the former is allowed, the latter form which is widely practiced by Islamic banks today is deemed to be synthetic and fictitious as *bay` al-`inah* and hence disallowed.

The main justification for disallowing 'organised *tawarruq*' is that its mechanism resembles *bay` al-`inah*; whereby the Islamic financial institution who is acting as an agent to the customer (*mustawriq*) who need cash sells the asset which was initially purchased from the same institution to the third party. In many cases, this type of transaction would result in non-satisfaction of receipt conditions (*qabad*) that are required for the validity of the dealing. The reality of this transaction is extension of monetary financing to the party characterized as a *tawarruq* customer, and the buying and selling operations of the bank are most often just mean for appearances, but in reality aim to provide

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the bank an increase in compensation for the financing it provided. Therefore, this practice bears resemblance to the practice of *bay` al-`inah*, which is frowned upon by some as a form of legal trick (*hilah*) and does not represent the true *tawarruq* (*tawarruq haqiqi*) which has been approved by the classical jurists[5].

Consequently, many banks in Saudi Arabia have begun to emphasise that all commodities used for *tawarruq* are bought and sold in domestic markets, with real merchants delivering the goods and reassigning their ownership as dictated by trade. This is specifically done to address the concerns of the Academy on the issue of bona fide sales and purchases with corresponding ownership (*qabd*) and transfer of commodity risks. However, the attempt is again seemed to be more emphasizing on forms and legal technicalities rather than the economic substance, implying the predominant juristic approach of form-over-substance used in devising instruments in Islamic finance today.

Despite the criticisms towards *tawarruq*, the product has been generally perceived and received more favourable and positive than *bay` al-`inah* transaction, at least by a majority of past and present scholars. Unlike *bay` al-`inah* which is widely used in Malaysia and Brunei, *tawarruq*-based transaction has been spreading quite rapidly in GCC region especially Saudi Arabia, Bahrain and UAE. This development shows the concerns and recognition by some of the jurists globally of the need to find alternatives for solving the inherent problem of liquidity risk faced by Islamic financial institutions due to their balance sheet structure and nature.

As reviewed in the earlier part of this paper, liquidity risk is a very important issue need to be addressed by financial institutions. Failure to manage the liquidity risk prudently and effectively, inevitably leads to severe impairment of the viability and sustainability of the banks. More importantly, it has been proven both theoretically and empirically that a result of one bank's failure may have systemic effect leading to entire financial system at menace. Therefore, the controversy which surrounds the Shariah compatibility of the new product for liquidity management as in the case of commodity murabahah programme, should be surmounted by taking the systemic stability issue into right perspectives.

5. Despite the objection by many quarters towards tawarruq munazzam (organised tawarruq), such practice has been approved by a few contemporary scholars such as the leading Saudi jurist, Syeikh Abdullah Sulaiman al-Mani', Dr. Musa Adam Isa, Dr. Usamah Bahr and Dr Sulaiman Nasir al-Ulwan (Central Bank of Malaysia, 2007).).

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There is a maxim of Islamic jurisprudence which can be used in dealing with this matter, that is: "*Neither harm nor reciprocating harm*" (*La Darara Wa La Dirara*). This principle is based on an authentic hadith narrated by Ibnu Majah and ad-Daaruquti and others on the authority of Saad bin Malik Al-Khudari, who mentioned that the Messenger of Allah (p.b.u.h), said: "*There should be neither harming nor reciprocating harm*". Imam As-Suyuuti based on his famous book 'al-Ashbaah wan Nazhooir' asserts that this hadith is very significant as it embodies the fundamental principles and maxims of Islamic jurisprudence. Based on this principle, there is a need (*hajiyat*) to adopt some controversial contracts like *bay` al-`inah* and *tawarruq* as tools for liquidity risk management, without having to resort to conventional riba-based borrowing. This is supported by another maxim of Islamic jurisprudence: "*Severe harm is avoided by a lighter harm*" (*al-darara al-ashaddu yuzalu bi darari al-al-akhaffu*) or "*choosing between the lesser of two evils*" (*akhhaf al-dararyn*).

Within the context of our discussion, the choice is actually between having to resort to liquidity management instruments which imbued with clear-cut riba elements, or the alternative practice of contentious *tawarruq*-based instruments. Hence, based on the maxim, it is thought that to choose what is still disputed or doubtful (*shubhah*) is of lesser evil than to opt for transaction that is clearly prohibited (*haram*). Following the same, both the Shariah Advisory Council (SAC) of the Securities Commission of Malaysia and the Shariah Advisory Council of the Central Bank of Malaysia had officially endorsed both *bay` al-`inah* and *tawarruq* to be used for liquidity management purposes. One of the arguments raised to justify the support their adoption of Shafi`i's view in legalising *bay` al-`inah* and *tawarruq* is public interest consideration (*maslahah*)[6], which is to overcome the problem of liquidity shortage in the country, without resorting to conventional riba-based liquidity instruments and transactions.

6. Maslahah is one of the juristic devices that have always been used in Islamic legal theory to promote public benefit and prevent social evils or corruption. The plural of the Arabic word maslahah is 'masalih' which means welfare, interest or benefit. Literally, maslahah is defined as seeking the benefit and repelling harm. The words maslahah and manfa`ah are treated as synonyms. Manfa`ah (benefit or utility), however, is not technical meaning of maslahah. What Muslim jurists mean by maslahah is the seeking of benefit and the repelling of harm as directed by the Lawgiver or Shari`ah. Amongst the major school of Islamic jurisprudence, Imam Malik is known to be the leading proponent of upholding maslahah as one of the sources of Shari'ah. He uses the term "al-masalih al-mursalah" to connote interests which have not been covered by other sources of Shari`ah. On the other hand, the majority of other jurists reject it as a source of Shari`ah though, they practiced it without theoretically admitting its authority as an independent source of the Shari'ah. However, Al-Ghazali (who is from the Shafi`i school), uses the term istislah (seeking the better rule for public interest) but never claim it as the fifth source of Shari`ah. He also restricts its application to situation which is deemed to be of necessary to serve the interest of the public. For detailed discussussin, refer to (Al-Khoyat, 2000; Nyazee, 2000).

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Conclusion

Overall, this paper constitutes a preliminary attempt at gaining a holistic and integrated understanding of structure and mechanism of commodity murabahah programme (CMP) as an innovative liquidity management tool applied in Malaysian Islamic Inter-bank Money Market. As delineated in the beginning of the paper, Islamic banks are presented with a liquidity management problem since they must structure their portfolios so that the pattern of asset returns can support the short-term obligations that they issue on the liability side of their balance sheet. Therefore, efficient and effective liquidity management in Islamic finance is paramount to ensure smooth-running and safety of the whole financial system.

The effectiveness and efficiency of liquidity management mechanism partly depends upon banks' ability to resort to high quality coupled with Islamically accepted financial instruments that are tradable and marketable in the inter-bank money markets. Thus, the introduction of commodity murabahah instrument based on *tawarruq* concept by Central Bank of Malaysia is deemed as an innovative approach to liquidity management. It certainly adds to the list of Shariah-compliant instruments for Islamic banks to manage their liquidity more effectively and efficiently. Under this CMP mechanism, if Islamic banks face liquidity risk in the form of short-term funding difficulties, they can always raise funds on the money market based on Shariah principles. More importantly, since it is based on the internationally accepted structure, CMP has the potential to be marketed abroad which further supports cross-border transactions of Islamic financial institutions in a globalised world and to ensure market liquidity.

In the light of some controversies highlighted in the paper pertaining to the contentious mechanism of CMP which is structured based on *tawarruq* contract, this paper suggests that Islamic financial institutions should not feel contented with the existing condition. Instead, efforts should be magnified to continuously devise more desirable Shariah acceptable and workable alternative structures that can hedge themselves against mismatches and liquidity problems. Nevertheless, until and unless other alternative structures can be innovated, Islamic banks are encouraged to use the CMP which is less controversial. At least they are structured based on tawarruq contract which is not as precariously contentious as *bay` al-`inah.*

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In a nutshell, Islamic banks should do away all the controversial contracts that may impede the growth and progress of Islamic banking and finance industry. Indeed Islamic banking system has the potential to become one the promising sector to realize the noble objectives of Shariah, as it resides within a financial trajectory underpinned by the forces of Shariah injunctions. These Shariah injunctions interweave Islamic financial transactions with genuine concern for just, fair and transparent society at the same time as prohibiting involvement in illegal activities which are detrimental to social and environmental well-being.

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