The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration

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ABSTRACT

This paper demonstrates theoretical foundations of Islamic finance and their correlation with the Islamic finance industry. In this respect, the paper presents an over-all survey of the Islamic finance industry, Islamic-law injunctions pertaining to Islamic finance, quasi regulatory institutions, financial engineering, transaction structures and the evolving practices. The paper also highlights various areas of further research, a comprehensive treatment of which is critical to the continuing growth of Islamic finance in the international financial markets.
I. WHAT IS ISLAMIC FINANCE?

In common parlance, Muslims’ financial operations and interest free banking qualify for defining the expression ‘Islamic finance.’ Technically, however, the definition goes beyond the common understanding. It includes: the avoidance of interest or usury, which is generally referred to and known as riba or ‘unjustified increase;’ and the avoidance of ambiguity, which is generally referred to and known as gharar or ‘excessive uncertainty, risk and speculation.’ It also means to earn in a religiously permissible way, i.e., halal; “and more generally the quest for justice and other ethical and religious goals.”

Among others, two salient features provide a general defining guidance, namely, the philosophy of risk sharing and the promotion of social and economic welfare. The risk sharing philosophy considers the predetermined and fixed interest rate to be unilaterally exploitative on the borrower and, alternatively, suggest profit and loss sharing arrangement between the creditor and the debtor. The welfare philosophy takes objectives of an enterprise beyond profit maximization.

Although Islamic finance “fell into relative disuse during the colonial period” that started from the eighteenth century and lasted until the mid-twentieth century, the Muslims now seek to regain their identity by way of rebuilding their own institutions, including the financial institutions.

This paper introduces the Islamic financial services (“IFS”) industry, outlines the theoretical framework of Islamic finance and its correlation with Islamic law and discusses the processes of law-making in Islam, which bears significance in understanding the limitations and process of innovative growth in IFS industry. Part I of the paper begins with briefly tracing the modern history of Islamic finance to lead the discussion, in Part II and III, to the sources and functioning of Islamic law and its impact on contemporary Islamic finance. Part IV illustrates the significant prohibitions to be observed by Islamic finance, that is, injunctions to avoid interest-based and excessively speculative transactions. Part V seeks to demonstrate how the theoretical framework of Islamic finance exists today in the IFS industry. With a conclusion to follow, Part V includes a summary of various financial services that IFS industry offers and includes a brief description of contemporary Islamic finance transactions.

A. History of Islamic Finance: Issues of Muslims’ Political Identity

Pakistani scholars led the intellectual debate favoring feasibility of Islamic financial system in 1940s. Certain political and economic developments rolled the theory toward practice.

Politically, these developments include the rise of pan-Islamism slogans in the Muslim world starting after the decolonization of the various Muslim countries. Early on, Egypt
championed this vision in the Muslim countries. Saudi Arabia and other countries reinforced it later. The Arab-Israeli conflict fueled the momentum, which saw its climax in the form of the Organization of the Islamic Conference (“OIC”) that was established in 1970. From its inception, the OIC became involved in planning Islamic monetary and financial systems; and, at its fourth summit in 1974, held in Pakistan, the OIC resolved to create the Islamic Development Bank. In 1979, Pakistan became the first country to venture toward full Islamization of its banking sector. Furthermore, heightened political slogan in the Arab world gave birth to what we may consider as the partial economic justification for the existence of the IFS industry. Muslim organizations exerted political pressure on the governments in the Muslim countries, including those with known secular manifesto, to encourage Islamic-law-compatible financial products. Although Muslim organizations continued to mushroom throughout the Muslim world, the 1980s showed relatively moderate enthusiasm for Islamic banking. After the 1991 Gulf War, Kuwait was quick to announce the creation of Kuwait Finance House, the country’s sole Islamic bank.

Economic justifications for resurgence of Islamic finance primarily include what is termed as “petrodollar windfall” or “the most massive of transfer of wealth in modern times” referring to the quadrupling petrol price hike during the midst of 1970s. However, in the subsequent years, due to the increasing political tussle among the Arab states, most of the petrodollars flew toward the U.S. either by way of defense expenditure or in the form of deposits in the U.S. banks.

From 1990s onwards, the growth of Islamic banking and finance has leaped and, during 1996-1997, a 24-26 percent growth and its size exceeded US$ 200 billion. Most recently, the Islamic finance market is estimated to be exceeding US$ 400 billion and its present growth rate is 15%, which is considered the highest in the contemporary international financial markets.

It appears from the above that the political resurgence has been a consistent pressure on the demand for Islamic finance unlike the less consistent petrodollar windfall. Since over seventy percent of IFS industry is based on consumer financing, the prevailing demand appears to be from the Muslim middle class—and not from the petrodollars reserves. However, some scholars have argued that Islamic finance continues to grow more from the supply side and not from the demand side.

**B. Islamic Economics**

At the wake of nationalized economy in the post-colonized Muslim countries, Islamic finance emerged as a movement to Islamize the economy. The discipline therefore was earlier known as Islamic economics. However, although the discipline “was initially conceived as an independent Islamic social science, it quickly lost the emphasis on independence and …[,] once researchers started using conventional economics tools, their discipline was quickly subsumed by the larger field of economics.”
Under official patronage by various Muslim countries, the scholars of Islamic economics mainly emphasized on, *inter alia*, converting interest-based revenue generation to Islamic modes of financing. Islamic banking thus appeared as an offshoot of Islamic economics. At a small scale, however, Islamic banking started after the World War II, at the early days of post-colonization. It started on the basis of theoretical Islamic finance works that were authored in early nineteenth century in response to the modern (interest-based) financial intermediation that the significant Muslim majority refrained from participating.

C. **Islamic Finance Today**

The International Association of Islamic Banks requires every financial institution offering Islamic financial services to have a board of Islamic law scholars, which are directly elected by the shareholders. In theory, the Sharia (Islamic law) board can review any product proposal for its validation or otherwise. Upon refusal to validate by the board for its being noncompliant with the principles of Islamic finance, the financial institutions are left with no option but to scrap the proposal. However, some scholars have found many instances of the board rubberstamping the management’s proposals.

In order to standardize the regulation of IFS industry, the governments of various Muslim countries and the industry took many initiatives. Malaysia established National Syariah (i.e., Sharia) Board to harmonize the Islamic finance practices and advise the Malaysian Central Bank. Pakistan also established Sharia Board within the State Bank of Pakistan for the similar objectives, and the UAE, Bahrain and others followed suit. In general, the IFS industry in the Muslim countries is governed by a special regulatory regime as the conventional banking continues to be regulated under a different regime. The Muslim countries thus have a dual regulatory system catering respectively Islamic banks and conventional banks.

As for industry-oriented non-governmental initiatives, advisory bodies were established that include the Institute of Islamic Research at Al-Azhar University (established in Cairo in 1961), the Islamic Jurisprudence Council of the Muslim World League (established in Mekkah in 1979), the Fiqh Academy of the Organization of Islamic Conference (established in Jeddah in 1984). Although it does not play any formal role of regulating IFS industry, the practices of the Islamic Development Bank are also taken as industry standards. Industry sponsored bodies include the Accounting and Auditing Organization of Islamic Financial Institutions, the Islamic Financial Services Board and the International Islamic Financial Market, Liquidity Management Center, and the International Islamic Rating Agency. Despite the emergence of the above institutions, no single institution could be regarded as the central point of reference for guidance on the issues of compliance with Islamic law. Therefore, the central role of Sharia Board of each IFS institution continues to drive the bulk of industry innovation. However, opinions from Al-Azhar University, the Islamic Jurisprudence Council of the Muslim World League and the OIC Fiqh Academy have been decisive on various controversial transactional issues. If any IFS institution has launched a product relying on any opinion of its Sharia board or any of the above institutions, competitor IFS institutions
invariably adopt the same structure,\textsuperscript{36} infusing thereby continuation to the opinion and implicitly confirming its validity. This also signifies the cardinal role an Islamic law opinion plays in IFS industry today. The paper, therefore, discusses the role of Islamic legal opinion in some detail. In sum, the industry-oriented non-governmental institutions and the internal Sharia boards of the IFS institutions in effect collectively act as quasi-regulatory body.

\textbf{D. Product Designing and Efficiency}

The juristic trend for relying on the earlier juristic sources has led the IFS industry to borrow the classical contract forms that are approximated to the conventional financial transactions. The classical contract names are retained to portray the brand name of Islamic finance as well as with a desire to create an independent identity.\textsuperscript{37} These names are used for the equivalent conventional transactions, which include using “\textit{ijara}” for “lease,” “\textit{murabaha}” for “cost-plus sale,” “\textit{takaful}” for “insurance” etc. To start the product designing or reengineering process, the jurists are assisted by lawyers and bankers. The group collectively examines the short-listed conventional products and in the process removes the transactional steps that are violative of Islamic law and replaces them with those that are in compliance. The Sharia boards, therefore, play an important role in Islamic finance product developments. They also (indirectly) market the product by giving presentations at various conferences where professionals from the IFS industry are present. With a product offered by more than one institution, the competition reduces the profits and keeps a constant pressure for more innovation.\textsuperscript{38}

The number of Islamic finance scholars today is small and same jurists serve at the boards of various IFS institutions, provide expert testimonies before the quasi-regulatory bodies of IFS industry and assist in shaping policy opinions and quasi-regulatory framework for the IFS industry.\textsuperscript{39}

Scholars have argued that approximating conventional transactions with the help of transaction formats developed and used centuries ago by Muslim jurists may increase risks including mispricing and inefficiency. Bundling of risks was offered as an alternate, while highlighting the dangers of approximation strategy.\textsuperscript{40} In the long terms, the suggestion is to revive the substances (and not merely the form) of the classical jurisprudence and the economic or best benefit analyses that the classical jurists developed, i.e., the objective of enhancing economic efficiency.\textsuperscript{41} It has also been noted that the inefficiency caused by the use of classical contract forms is tolerable only if the spirit and substance of Islamic law is ensured.\textsuperscript{42}

Contrary to the aforementioned inefficiency observation on the contemporary Islamic finance, a scholar has argued that Islamic finance—which is derived from divine commands—is in fact efficiency enhancing, and its being paternalistic in nature does not affect its efficient character. In support, the scholar explains the standard two-prisoners’ dilemma and maintains that the divine command—“thou shalt not defect”—could yield mutual cooperation among the market participants, instead of causing inefficiency resulting from a mutual defection.\textsuperscript{43}
II. THE ORIGIN AND SOURCES OF ISLAMIC FINANCE

A. Theoretical Framework of Islamic Finance

Trade and commerce traditions were not new to Islam; Prophet Muhammad himself was known merchant and a trader. Consistent with the history of Muslims’ entrepreneurial business and financial transactions, Muslims today continue to explore commercial opportunities in accordance with the dictates of their belief. According to Muslim’s belief, their religious scriptures provide guidance as to their \textit{inter se} anthropomorphic relationship, dealings with the nature and the material aspect of the world. It is also part of the belief that everything belongs to God (\textit{Allah}), a monotheistic being, and the role of humankind is that of a caretaker; notwithstanding emphasis on property right in Islam. Property right, as we will discuss below, and freedom of trade by mutual consent are central to Islam. A strict accountability is attached to the acts of caretakers in return for benefiting from and exercising authority over the physical universe. The standards of accountability enjoin an approved behavior and refrain from the disapproved. The injunctions of doing “good” expand to cover all the activities of a believer. Seeking the permissible (\textit{halal}) and avoiding the forbidden (\textit{haram}) in all the pursuits of life is an overarching duty of a Muslim.

This leads to a jurisprudential examination of the religious scriptures primarily to understand and act according to the permissible (\textit{halal}) framework and to avoid what is forbidden (\textit{haram}). This jurisprudential study took the form of a discipline known as ‘Islamic jurisprudence’ or ‘Islamic law’ (\textit{Sharia}). In general, Islamic law extends to the understanding of a believer’s rights and obligations vis-à-vis God, the humankind and the universe at large.

Since Islamic law treats a person’s wealth and life at the equal footing, depriving someone (or enrichment at the expense of someone by employing any forbidden means) from his/her wealth is viewed with strong disapproval. Economic progress is generally linked to risk, which is considered essential for all innovations. Put differently, \textit{bona fide}, fair, equivocal and risk-sharing transactions are the hallmark of Islamic finance. Furthermore, in the business dealings, Islamic law enjoins to fulfill contractual obligations and honor commitments. Unfair dealings and advantages are ranked among the exploitative and unjust tactics; others of the kind include charging of interest on money loans, ambiguous contracts, monopolies and price fixing.

As discussed in Part VI below, it remains to be examined empirically whether the IFS industry is in compliance with the injunctions.
B. Formation of Legal Authority

Being revealed by God, through Prophet Muhammad, Quran thus is the principal guide, or the first primary source of Islamic law. Oral and practice-based Prophetic traditions became the second primary source of Islamic law.

In general, the sources in Islamic law may be categorized as revealed and non-revealed. The Quran is the first revealed source. Being a word of God in its letter and spirit, the Quran is communicated through the Prophet Muhammad. “All that is narrated from the Prophet, his acts, his sayings and whatever he has tacitly approved” (the “Prophetic traditions”) represent as a second revealed source; because the Quran declared the Prophet’s acts, sayings and tacit approvals to be divinely inspired. Both of the revealed sources are considered primary. On the other hand, the non-revealed sources were developed by the Islamic law scholars, and represent the methodology and procedure to ensure proper utilization of the revealed sources. Such sources include consensus of juristic opinion, analogical or juristic reasoning, previously revealed laws, legal opinions from companions of the Prophet (“companions”), equitable considerations, public interest, customs, presumptions of continuity and blocking the means to evil. All of the secondary sources derive their authority in the Quran and/or in the Prophetic traditions.

For the purposes of our discussion herein, the paper will focus on only some of the sources of Islamic law: The Quran, the Prophetic traditions, consensus of juristic opinion, and juristic or analogical reasoning.

1. The Quran (Al-Qur’an)

At the beginning, Prophet Muhammad preached “for humility, generosity and belief in God,” and the Quranic commandments were revealed subsequently, a period that is viewed as a beginning of “substantive legislation.”

The Quran was revealed in the course of twenty-three years from 610 through 632 C.E. Legal injunctions in the Quran are scattered in its various chapters and are not specific to any particular chapter and the verses containing the injunctions constitute a small portion of what is a compilation of 6,235 verses. The injunctions include matters related to family law, inheritance and criminal punishments. Specific injunctions on trade include the prohibition on charging of interest, which is discussed below.

In its narrative style, the Quran’s ratiocinative explanations to the injunctions provide guidance for understanding the injunctions in a broader spectrum. By addressing itself to the conscience of an individual, the Quran seeks to use its narrative style convincingly. While doing so, it expresses its “purpose, reason, objective, benefit, reward and advantage of its injunctions.” However, while some of the Quranic expressions are definitive in their application and leave no room for any further interpretation, some are open to more than one understanding. Islamic law has developed a comprehensive set of rules that identify such scope. The multiplicity of meanings is mainly due to the
Quran’s variation in grammatical use of language, which profoundly enlarges the scope of investigation on any given topic.\textsuperscript{70} Resolving ambiguity in injunctions from the primary sources requires assistance from other Quranic verses and, in case no help found in the Quran, from the Prophetic traditions.\textsuperscript{71} From the array of secondary sources, interpreting, deriving meanings, restricting and enlarging the scope of an injunction are various forms of juristic efforts that seek to understand the Quranic injunctions in light of the changing social conditions.

As for the Quranic text, it was recorded and confirmed during the lifetime of the Prophet. It is believed to have come down without sustaining any doubt as to the authenticity of its text.\textsuperscript{72}

2. The Prophetic Traditions (\textit{Sunnah})

The Quran declared the Prophetic traditions to be followed.\textsuperscript{73} The Prophet made a conscious effort to separate the word of God from his own by initially discouraging his companions from recording his life and practices so that there is no confusion about the text of Quran.\textsuperscript{74} The Prophetic traditions were compiled more comprehensively after his lifetime. Differences on the text and transmission of the Prophetic traditions ensued extensively only to lay foundation for a science for its study. Despite that the Quran remains the first primary source and overrides the Prophetic traditions, authenticity in text and transmission elevates injunctions arising out of the Prophetic traditions to the same level as that of the Quranic injunctions. However the number of such Prophetic traditions does not exceed ten.\textsuperscript{75} As for the status of Prophetic traditions vis-à-vis the Quranic text, they mainly consist of three categories. The Prophetic traditions either confirm and reiterate, or explain and clarify, or comprise independent rulings that cannot be traced back to the Quran—on which it is silent.\textsuperscript{76} Developing scientific study of the Prophetic traditions and for the acceptance of its text in legal reasoning, the Islamic law prescribes a number of categories, classifications and conditions to offer a systematic analysis.\textsuperscript{77} These stipulations help refine the juristic analysis toward finding any solution from this second primary source.

From the many, six collections of the Prophetic traditions are regarded more authentic of all—considering both in Sunni and Shiite schools, the total comes to twelve.\textsuperscript{78} Amongst all of the Sunni school collections, two are considered the most authentic due the strict and high standards the collectors employed during compilations. The total number of the Traditions in the two most authentic compilations of the Sunni school is about 10,000, which includes a significant number of Traditions that relate to trade, business and other financial transactions.

3. Consensus of Juristic Opinions (\textit{Ijma’})

In absence of any explicit guidance from the Quran and the Prophetic traditions, legal injunctions are derived through a unanimous consensus of juristic opinion (the “Consensus”). The Consensus is un-revealed and rationally arrived at source of Islamic law.\textsuperscript{79} In theory, the Consensus can only occurred after the Prophet’s lifetime,\textsuperscript{80} and it
presupposes existence of plurality of juristic opinions that are arrived at a universal consensus by tolerating differences of opinion in the process. Once established, the Consensus is a binding authority itself—as its reliance on the primary sources is no longer significant—and is not subject to repeal by another Consensus.

Its status as a source is established from the primary sources (i.e., the Quran and the Prophetic traditions). There is consensus on its being a source of Islamic law, but divergent views exist as to what may qualify as Consensus. According to a classical definition, nothing less than a universal consensus of the Muslim scholars (and not of jurists—which may be limited in number) would be binding. Some disagree for restricting Consensus to a consensus of Muslim scholars and emphasize on the consensus of the Muslims at large, including the laymen and the scholars. However, the majority of scholars have not agreed with such views over the centuries. Despite existence of some views supporting consensus of the majority of jurists to be binding (and not the genre of scholars), the popular view is in favor of the consensus of all jurists, however. Many prominent scholars of Islamic law have recognized the universal consensus to be totally unrealistic. Owing to the gap between the theory and practice of Consensus, very few instances are available when Consensus was achieved in its classical sense, and those instances are often restricted to the time of the companions of the Prophet and not thereafter.

Some recent scholars of Islamic law are of the view that Consensus did not receive scholarly attention as much as the science of Prophetic traditions, and consider lack of such attention to be responsible for the uncertainty as to what constitutes Consensus. By equating the classical position on the Consensus with utopia, scholars have suggested its institutionalization in the form of a legislative body.

4. **Juristic and Analogical Reasoning (Ijtihad)**

One of the essential features of Islamic law is to achieve a harmony between the revealed sources and the reason. Juristic and analogical reasoning (“Juristic Reasoning”) is the main instruments for achieving and maintaining this harmony. Juristic Reasoning is, therefore, one of the prime sources of Islamic law. The scope of Juristic Reasoning is to infer and extract meaning of an unclear text of the revealed sources. It could either be exercised in the form of analogical reasoning (qiyas) or in general.

As for analogical reasoning, it seeks to extend an injunction “from an original case...to new case, because the latter has the same effective cause as the former.” Put differently, it applies textual ruling that is available for a particular case (which is regulated by the text) to a new one, for there was no textual ruling regarding the new case and the effective cause between both the scenarios is the same. Therefore, discovering the common effective cause from the primary sources (i.e., the Quran and the Prophetic traditions) and applying it to a new set of circumstances that is not expressly regulated by the sources is one way of exercising Juristic Reasoning.
Encouraging Juristic Reasoning, a Prophetic tradition entitles a jurist of a rewarded (for his effort) even though his conclusion is incorrect; and for the correct conclusion a jurist is rewarded twice (both for the efforts and correct conclusion). Arriving at an answer is inherently subjective to a jurist, and may result into multiple opinions by the jurists. This generates plurality or divergence of opinions in Islamic law.\textsuperscript{99}

Exercising Juristic Reasoning remained popular until the ninth century.\textsuperscript{100} Thereafter, the number of jurists participating in the exercise fell down gradually. Owing to the decline in the participation in the Juristic Reasoning, some scholars declared extinction of the jurists and therefore disallowed any further exercise, a period in Islamic history that is known as the closure of the gate of Juristic Reasoning. Many, however, maintain that such closure never took place, nor could the gate of Juristic Reasoning could have validly been closed.\textsuperscript{101}

Qualifying conditions that a jurist is to possess include profound scholarship and sharp analytical skills.\textsuperscript{102} According to the classical position, once the conditions exist in someone he/she is capable of exercising Juristic Reasoning in all the fields where such is needed.\textsuperscript{103} A modern view, however, is to make Juristic Reasoning specific to “collective effort” that comprises experts of Islamic law and other disciplines.\textsuperscript{104} This view is based on the premise that it is not possible for a single person to possess knowledge of many disciplines with equal command and mastery as one may posses in one or a few.

5. Islamic Law Resembling Common Law

Defining the Islamic law making process, a notable scholar equated the Islamic jurists with the common law judges, and remarked:

Islamic finance thrives mainly in Islamic countries with officially adopted civil laws, but it is driven primarily by a canon-law-like interpretation of Islamic scriptures. However, one can readily see that the canon-like nature of Islamic jurisprudence is mostly rhetorical. The true nature of Islamic jurisprudence of financial transactions is very similar to Western-style common law. In particular, contemporary developments in Islamic finance owe more to juristic understanding of the canonical texts and previous juristic analyses than they owe to the canon itself.\textsuperscript{105}

C. Schools of Islamic Law (Madhahib): Juristic Reasoning versus Adoption of School

After the Prophet passed away and during the time of the companions (which lasted for about half a century, two main branches of Muslims emerged, namely, Sunni and Shiite primarily on political issues but latter each fraction developed its own jurisprudence. Since Islamic finance today is flourishing mainly in the countries with Sunni jurisprudence, Shiite Islamic finance practices are converging to Sunni transactional
structures. This paper will, therefore, only discuss the Islamic law and finance as viewed and interpreted by the Sunni schools.

In the early history of Islam, Islamic law and legal studies evolved through scholarly circles for discussion, led by various learned men, on various issues of Islamic law. By the early part of the eight century, such learned men had their own circles and students, but the legal doctrine was still not complete. Toward the end of the eight century, various jurists started developing legal assumption and methodology and, with the continued association with their respective circle, defending their respective views on Islamic law. The students would attend various circles in a city or in other cities without owing loyalty to any doctrine. However, the students joining a circle to teach would invariably teach what they learned from their own teacher in that circle. Toward the midst of ninth century, various scholars became field specialist and leaders, had personal followings, issued legal opinions and debated legal issues, and formed doctrinal schools that represented a collective entity—as opposed to a personal circle. Each school had its peculiar legal methodology and positive principles, and was named after its founder.

Fifty years after the Prophet (670 C.E.) until the early eighth century, two main schools emerged: One with traditional jurisprudential approach and others with rationalist. The golden age of Islamic law started from this point and lasted until the eleventh century and eight leading schools of Islamic law (including four of Shiite) emerged during this period. The next three centuries witnessed juristic elaborations within the established schools until the dark ages of Islamic law started with the fall of Baghdad to the Tatars in the thirteenth century. In 1876, the Ottomans’ codification of the Hanafi jurisprudence rekindled Islamic law, which was soon to be followed by various post-colonization juristic revival movements in the twentieth century.

Four Sunni schools comprising Hanafi, Maliki, Shafi‘i, and Hanbali flourished and survived over the centuries. The subsequent scholar in each school kept enriching the doctrine that they affiliated with. When the pace of exercising Juristic Reasoning dropped, Muslims (both laymen and scholars) followed the opinions of any of the established schools. Each school has substantial following in various geographic regions of the Muslim world, and the Muslim in such regions, until now, abide by the school-specific interpretations on issues pertaining to Islamic law. As for following a particular school, the general rule is that any person who is not capable of performing Juristic Reasoning must follow someone who is capable of doing so. So the choice of scholars (who are not jurists) and laymen is to refer to the opinions of a jurist. And, within the Sunni schools of Islamic law, the choice is limited to above-mentioned four schools.
III. OTHER FEATURES OF ISLAMIC FINANCE

A. Islamic and Legal Opinion (Fatwa)\textsuperscript{118}

Legal opinion played a central role in the emergence of the modern day IFS industry in 1976 when an Islamic legal opinion was introduced to extend the scope of cost-plus transactions. After that opinion, cost-plus financing became the standard and mainstream Islamic banking transaction, practiced now invariably by every Islamic bank. This legal opinion was based on an obscure opinion of a classical Maliki jurist. A standard practice of seeking a legal opinion ensued in the contemporary IFS industry.\textsuperscript{119}

Historically a rich tradition of providing legal opinions on issues of Islamic law started with the emergence of personal scholarly circles in the eighth century and continued thereafter.\textsuperscript{120} The recipients of the legal opinion were common people with questions pertaining to application of Islamic law, politically appointed judges and the political authorities including the caliph.\textsuperscript{121} The providers of legal opinion (“jurisconsult” or \textit{mufti}) were established scholars, and often leaders of their own schools.\textsuperscript{122} No distinction between a jurist and jurisconsult explicitly existed and jurisconsult was supposed to have the same skill-set, as required of a jurist.\textsuperscript{123} However, in latter periods of some Sunni schools, jurisconsult tended to be lesser qualified and would respond to questions only within the framework of his school of Islamic law, by relying upon opinions of the jurists of his school.\textsuperscript{124} This trend continues to date.

The required conduct of a jurisconsult include that he should be an exemplary moral figure, must not practice contrary to the opinion he issues and should not contradict the doctrines of his own school. Traditionally, the rules applicable to an Islamic judge were equally applicable to jurisconsult, which include display of dignified demeanor and avoiding emotional expressions and favoritism.\textsuperscript{125} Although jurisconsult is not generally required to set out his “methods of reasoning,”\textsuperscript{126} the scope of his work is defined and restricted by the question posed and the jurisconsult should respond accordingly. In other words, As [jurisconsults] must answer according to what is asked, their field of response is largely determined by the formulation of the question. Since the mufti is not an investigator of the facts, these are taken as given. In addition, while the issues involved ought to be ones that have actually arisen and should not be purely hypothetical or imaginary … questions are commonly posed in general terms, using the names of fictional individuals … or simply “a man” or “a woman.” Such usage of generic descriptions and fictional names distances the query from the particular evidential circumstances of the questioner. Yet in many settings, the [jurisconsult] is confronted personally by the questioner, whose name appears below the text of the question. In this distinctive juxtaposition of the abstract and the actual, questions delimit the [legal opinions] as a genre of legal response.\textsuperscript{127}
As for the current practice of providing Islamic law opinions by the jurisconsults to the IFS industry, scholars have noticed anomalies in such practice. It has been noted that IFS industry is only sought to be regulated by the opinions of the jurisconsults, which are remunerated by the respective IFS institutions either for their services as member of the Sharia supervisory board or as an independent consultant. A recent analysis of this practice criticizes the practice and finds it to be totally inconsistent with the established classical position of Islamic law that a jurisconsult cannot be paid by the person asking the question—other than payment of the administrative costs. Remuneration of jurisconsult used to be from the government. The work finds conflict of interest in providing opinions in matters where jurisconsults are remunerated, particularly on a pro rata basis, which is linked to the success of the product in respect of which the opinion is sought. The resultant economic pressure on jurisconsults has resulted in a widespread practice of circumventing tactics by relying upon obscurely minority views in order to push through the contemplated transactional structure. To avoid abuse of Islamic law opinions, the experts have suggested separating the jurisconsults’ role of a transaction consultant from its duties as an auditor that require him to ensure conformity with Islamic law. Another notable scholar has classified the trend of choosing permissive minority opinions from the classical jurisprudence as part of “shari’a arbitrage,” which is to find the closest approximation to the conventional financial practice (mainly by reengineering to accommodate an exceptional or minority permission) to be sold to an Islamic-finance-based captive market.

It appears that the financial and transactional teams do not share complete information with jurisconsults and the opinion is based upon limited information. Although questions have been raised on the integrity of the Islamic law opinion mechanism for the IFS industry, some other questions remain to be answered in this regard. These questions include: Whether and how the scope of the opinions is determined; What is the manner and procedure of opinion-seeking; How much information is provided to and shared with jurisconsult; Whether jurisconsults reiterate position of a particular school or actually engage in Juristic Reasoning with an intention of doing so; And, whether and how the opinions are reasoned.

The scholars have noted that public access to the processes of obtaining legal opinion is generally restrictive. However, once announced publicly, a legal opinion facilitates replication of the product design process within no time. And, unlike their classical counterparts, Islamic legal opinions today are no longer area-specific, and have become transnational with the increasing use of Information Technology.

B. **Rules on Property, Ownership and Contracts**

1. **Property and Ownership**

The classical Islamic law defines property to be an object that is capable of (i) physical possession and (ii) any beneficial use. According to this definition, many scholars
Consider commercial insurance to be invalid under Islamic law, for the object of sale in excessively uncertain or ambiguous.\textsuperscript{134} Classifications of property includes valued or unvalued property (or which is a public property or otherwise impermissible such as wine and pork), immovable or movable property and fungible or non-fungible properties. Each classification has detailed rules in all the schools of Islamic law, which also differ in details. Such differences of opinion include in respect of eligibility of usufruct for sale or lease, taking possession before reselling, deferred prices and prepaid forward sale etc.\textsuperscript{135}

Classical view of ownership recognized total or partial ownership (e.g., property plus usufruct or ownership of the either). Modern scholarship, however, treats ownership as a bundle of rights that is distributable to a number of entities.\textsuperscript{136} This distinction has lead to devising Islamic bonds (\textit{sukuk}) structure where title of the transaction property (with its usufruct) is transferred to a special purpose vehicle that deals with all the subleases issued in respect of the property.

Possession of property that gives rise to liability is generally either in the form of a trust or a guaranty arrangement. While in the possession of a trustee, any damage to the property that is caused only by way of trustee’s negligence or transgression makes the trustee liable for the loss. To the contrary, guarantor’s possession implies liability against all and any damages.\textsuperscript{137} Liability-risk issues that arise from these distinctions have informed the practice of Islamic banking in dealing with the deposits and cost plus financing issues, as discussed below.

2. Contract and its Conditions

According to an Islamic legal maxim, presumption of general permissibility governs until the contrary is established by an injunctive authority. This presumption is equally applicable to the Islamic law of contract that is and has always been central to Islamic finance in the Islamic history. However, in case of Islamic contracts, some scholars have regarded permissibility to be based on appropriate precedents,\textsuperscript{138} which in effect reverses the presumption.

In Islamic law of contract, scholars generally consider two kinds of contracts: One is compensatory, which is more in the category of mutual dealings, and is entered into by the parties for personal benefit; Second is charitable, which leans toward the worship category of injunctions, and parties entering into such contracts look for reward from God. For the mutual material benefits to be derived from compensatory contract, the parties are expected to agree on “value equivalence” of such benefits and, in this regard, should have access to all the relevant information. The Islamic law of contract, therefore, allows the parties to freely stipulate any conditions that they deem expedient as long as the express prohibitions are observed.\textsuperscript{139} Put differently, Islamic law of contract recognizes ‘party autonomy’ in contracts that do not fall into the exceptional category of the prohibited.
Mutual consent is the most cardinal point of Islamic law of contract. Supplementing the mutual consent, the classical jurisprudence enumerates some cornerstones of a valid contract, which:

“[P]ertain to parties of the contract, who must be eligible to conduct the contract, (2) contract language, and (3) object of the contract. A contract was not considered concluded if any of its cornerstones were violated. Conditions of contract conclusion may be grouped into conditions pertaining to (1) contracting parties (must be discerning, of legal age, etc.), (2) contract language (correspondence of offer and acceptance, elimination of unnecessary uncertainty), (3) unity of contract session, and (4) permissibility of object for specific contract. A concluded financial contract was deemed valid if it avoided six main factors: (1) ignorance about object, price, time period, and the like, (2) coercion, (3) conditions contrary to a contract’s nature (e.g., sale for a fixed period, or wherein the buyer’s use of his property is restricted), (4) unnecessary ambiguity in contract language, (5) encroachment on others’ property rights, and (6) unconventional conditions that benefit one parry at the other’s expense.  

IV. PROHIBITIVE INJUNCTIONS: RIBA (USURY OR INTEREST ON MONEY LOANS) AND EXCESSIVE UNCERTAINTY AND AMBIGUITY (GHARAR)

A. Introducing Injunctions on Riba

Broadly, there are two kinds of injunctions in Islamic law: One deals with the matters of worship and the other with the mutual dealings among the people. The general presumption for worship is that it is not allowed unless enjoined, whereas, in contrast, the default rule of mutual dealing is permissibility unless prohibited. While trade by mutual agreement is strongly recommended, taking undue advantage of anyone and depriving one from his/her property is prohibited in the strongest words in the Quran. Accordingly, in any given mutual dealing, rights of God, transacting parties and of third parties (e.g., society at large or any part of it in cases such as environmental pollution etc.) are involved and are required to be observed. Rights of God include avoiding transactions that comprise riba (interest or usury), excessive uncertainty (gharar), gambling (maysir) and other activities prohibited by God through His revelation. Rights of God, moreover, are latently present in every matter of mutual dealing, whereas such rights exist patently in matters of worship. In sum, the matters of mutual dealings entail more freedom than restrictions. This might assist in understanding that observing injunctions on mutual dealings by Muslims is also a part of worship attaching consequences in the hereafter.

Broadly, Islamic legal injunction for financial transactions could be examined in view of four types of activities, or on a net benefit analysis:
(1) beneficial ones that are apparently beneficial, (2) beneficial ones that are not clearly beneficial, (3) harmful ones that are apparently harmful, and (4) harmful ones that are not apparently harmful. No injunctions or prohibitions are needed for the first and third types of activities, whereas injunctions to perform the first type of acts, and prohibitions against the fourth, are necessary. In this regard, the [Quranic verses] clearly explained that drinking and gambling belong to the fourth category: Humans may be lured by the apparent benefits and thus lose sight of the greater harm.

In the case of wine and gambling, the Qur’anic solution was complete avoidance thereof, since those activities are not essential. In contrast, transfers of credit and risk are at the heart of finance, without which an economic system cannot function. The Islamic legal solution in this case was to impose restrictions on the means of transferring credit and risk, through prohibitions of riba [i.e., usury] and gharar [i.e., excessive uncertainty and ambiguity]...the forbidden riba is essentially “trading in credit,” and the forbidden gharar is “trading in risk,” as unbundled commodities.

In other words, Islamic jurisprudence uses those two prohibitions to allow only the appropriate measure of permissibility of transferring credit and risk to achieve economic ends. As many observers and practitioners in financial markets will testify, trading in credit and risk (perfected through derivative securities) is as dangerous as twirling a two-edged sword. Although those vehicles can be used judiciously to reduce risk and enhance welfare, they can easily entice otherwise cautious individuals to engage in ruinous gambling behavior. While financial regulators seek to limit the scope of credit and risk trading to protect systemic failures, Islamic jurisprudence introduces injunctions that aim also to protect individuals from their own greed and myopia.

1. The Prohibition of Riba: Equitable Considerations and Issue of Time Value

No one definition of Riba exists in Islamic law. The scholars extend its scope to increase in the exchange of two counter-values, but exclude the increased price of a credit sale—and therefore establishing the concept of time value for money. Put simply, while some scholars do not accept any increase to be valid, some treat a reasonable return to be justified. Most recently, a scholar has argued that equivalence of riba and interest is not appropriate, for there exists forbidden riba in the form of increase, as discussed below, which is not interest. Scholars who do not consider riba to be the equivalent of interest exclude the mark-up credit sales from the prohibition. In other words:

The concept of Riba is not confined to money lending only, but extends to exchange of goods as well. Shariah recognizes two forms of Riba – Riba al-Nasiah and Riba al-Fadl.

Riba al-Nasiah: Riba al-Nasiah deals with Riba in money-to-money exchange, provided the exchange is delayed or deferred and additional charge is associated

…
with such deferment. The term Nasi’ah … means to postpone, defer, or wait, and refers to the time that is allowed to the borrower to repay the loan in return for the “addition” or the “premium.” This kind of Riba is the basis of the prohibition of interest as practiced in today’s financial transactions. The prohibition of Riba al-Nasi’ah essentially implies that the fixing in advance of a positive return on a loan as a reward for waiting is not permitted by the Shariah. It makes no difference whether the return is a fixed or variable percentage of the principal, or 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.

Riba al-Fadl: Riba al-Fadl is more subtle and deals with hand-to-hand or barter exchange. Such prohibition is derived from the sayings of the Prophet (pbuh) who required that commodities are exchanged for cash instead of barter since there may be differences in the quantity to ensure that no exploitation takes place due to any mismatch in the quantity and the quality of the exchanges. Otherwise, it may give rise to an unjust increase, i.e., Riba. The concept of Riba al-Fadl is remarkably similar to the prohibition of increase in lending victuals in the Old Testament (Leviticus 25:37). Whereas the Old Testament prohibits quantitative increases, Riba al-Fadl Prohibits qualitative increases as well. Considering that in today’s markets, exchange takes place through the medium of money, the relevance of Riba al-Fadl has diminished, but the essence of the concept remains applicable to similar situations.

Riba was gradually prohibited. It first started discouraging it. Compound interest was first to be forbidden, which was prevalent in the pre-Islamic Arabia and the practice was to charge interest at a certain maturity date and the same was doubled and multiplied at future maturity dates. The final prohibition was more clear and categorical, which came through one of the last verses of the Quran and prohibited, as some scholars view, the compound interest. It is important to note that the Quran does not define the term riba. However, we may understand the basic concept of riba from the Prophetic traditions, as discussed below. One of the main grounds on which the Pakistan Supreme Court reversed its own judgment, which declared interest in all forms to be unconstitutional (on account of being un-Islamic), was the lack of certainty as to what constitutes riba in light of the Quran and the Prophetic traditions.

According to the Prophetic traditions, riba is generally categorized in two forms: (i) accruing over time through deferment of payments (“Riba of deferment”), and its worst form is the compound interest practiced in the pre-Islamic Arabia; and (ii) occurring in the form of an increase in exchange of different quantities of good/commodities of same genus or kind (“Riba of increase”). Both the forms are discussed in the Prophetic traditions. As for Riba of deferment, this comprises the increase that generally arises out of the money loans. As for Riba of increase, one authentic Prophetic tradition prohibited it and goes on to outline the general standard: “Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt, like for like, hand to hand, and any increase is riba.” To illustrate further:
Indeed, as some Hanafi jurists have noted, the six-commodities Prophetic tradition cited … stipulated two conditions: “hand to hand” and “in equal amounts.” Thus, if one traded an ounce of gold today for a deferred price of one ounce of gold next year, the transaction would still be deemed *riba*, despite the zero interest rate, because of violation of the “hand-to-hand” restriction. Those Hanafi jurists reasoned as follows: An ounce of gold today is clearly worth more than an ounce of gold in one year (recognizing the time value of money). Thus, one would never trade an ounce of gold today for an ounce of gold next year, unless one is getting something else in return (which is not disclosed in the sales contract). Whatever that extra benefit may be, they argued, it constitutes riba.\(^{155}\)

The above *Hanafi* view is further explained (by a *Maliki* jurist):

> It is thus apparent from the law that what is targeted by the prohibition of *riba* is the excessive inequity it entails. In this regard, equity in certain transactions is achieved through equality. Since the attainment of equality in exchange of items of different kinds is difficult. We use their values in monetary terms. Thus, equity may be ensured through proportionality of value for goods that are not measured by weight and volume. Thus, the ratio of exchanged quantities will be determined by the ratio of the values of the different types of goods traded. For example, if a person sells a horse in exchange for clothes ... if the value of the horse is fifty, the value of the clothes should be fifty. [If the value of each piece of clothing is five], then the horse should be exchanged for 10 pieces of clothing.

As for [fungible] goods measured by volume or weight, equity requires equality, since they are relatively homogenous, and thus have similar benefits. Since it is not necessary for a person owning one of those goods to exchange it for goods of the same type, justice in this case is achieved by equating volume or weight, since the benefits are very similar.\(^{156}\)

The concept of equity of and efficiency in exchange is supported by various Prophetic traditions such as when a man brought some high-quality dates for the Prophet from another city. The Prophet inquired if all the dates from that city were the same. The man replied that he exchanged/traded two or three volumes of the inferior-quality dates for one of higher-quality. Disapproving the practice, the Prophet told him not to do that again, and advised him to sell the lower-quality dates and buy the higher-quality dates with the sale proceeds. By way of an economic analysis of this tradition, selling the lower-quality dates at the best market price and buying the higher-quality ones at the most competitive price, this ensures overall market and exchange efficiency by precommitting those who observe ‘*Ribaa* of increase’ for acquiring market information and avoid any disadvantage.\(^{157}\)

As for time value of money, some recent scholars have observed that:

> It is a common misunderstanding and a myth that by prohibiting interest on loans, Islam denies the concept of the time value of money. Islamic scholars have always recognized the time value of money, but maintain that the compensation
for such value has its limitations. Recognition of an indirect economic value of

time does not necessarily mean acknowledging any right of equivalent material

compensation for this value in all cases. According to the Shariah, compensation

for the value of time in sales contracts is acknowledged, but in the case of

lending, increase (interest) is prohibited as a means of material compensation for
time.

The Islamic notion of opportunity cost of capital and time value of money can be

clearly understood by reviewing the distinction between investment and lending.

Time by itself does not give a yield, but can only contribute to the creation of
value when an economic activity is undertaken. Given a sum of money, it can be
invested in a business venture or it can be lent for a given period of time. In case
of investment, the investor will be compensated for any profit and loss earned
during that time and that time and Islam fully recognizes this return on the
investment as a result of an economic activity. On the other hand, if money is in
the form of a loan, it is an act of charity where surplus funds, are effectively being
utilized to promote economic development and social well-being.

In response to the contemporary understanding that interest on a loan is a reward
for the opportunity cost of the lender, Islamic scholars maintain that interest fixed
ex ante is certain, while profits or losses are not and to take a certain as a
compensation for the uncertain amounts to indulging in Riba and is therefore
unlawful. The element of uncertainty diminishes with time and the resultant return
on investment is realized, rather than the accruing of return due to passage of
time. In short, Islam’s stand on the time value of money is simple and clear.
Money is a medium of exchange; time facilitates completion of economic activity,
and the owner of capital is to be compensated for any return resulting from
economic activity. Lending should be a charitable act without any expectation of
monetary benefit.\textsuperscript{158}

2. Riba Today

Modern scholars have attempted to define \textit{riba}:

Focusing on \textit{Riba} in financial transaction, now we can construct a more formal
definition of the term. According to the \textit{Shariah}, \textit{Riba} 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 the duration of
loan. At least four characteristics define the prohibited interest rate: (1) it is
positive and fixed ex-ante; (2) it is tied to the time period and the amount of the
loan; (3) its payment is guaranteed regardless of the outcome or the purposes for
which the principal was borrowed; and (4) the state apparatus sanctions and
enforces its collection.

This definition of the term “\textit{Riba}” is generally accepted by all and is clear,
straight-forward, and unambiguous. One would not find any dispute in the literal
or the obvious meaning of the term \textit{Riba}, but it is the interpretation and scope of
the prohibition and its applicability to practical life which raise several questions
for Shariah scholars who have dealt with them over a period of time and each time a new situation arises.\textsuperscript{159}

Introducing a ‘benefit analysis’ for examining the classical jurisprudential texts, Professor Mahmoud El-Gamal argues that balancing economic freedom with risk of abuse always remained the guiding principle during the classical age of Islamic law. While balancing, the classical jurists would overrule the risk of usury and excessive uncertainty in favor of benefit consideration. For instance, Prof. El-Gamal expands his argument that, the prepaid forward sale was allowed for its overriding benefit to agriculture and other industries despite existence of excessive uncertainty for the subject matter. Buy-back or same-item sale repurchase was also allowed for its greater benefit that overrides the risk that such transactions might serve as a vehicle to charge interest.\textsuperscript{160}

The scholars noted that understanding *riba* today is more difficult, particularly if we try to do it purely with the help of financial economics. Despite that the works of classical juristic could be relatively inconclusive vis-à-vis the complexity of today’s financial markets, such works are still helpful in understanding various aspects of *riba*. The scholars went on to observe that it was partly true for understanding the prohibition of *riba* that it pertain to interest on money loans, because the permission for credit sales with a premium over cash is a recognition of time value or opportunity cost of money.\textsuperscript{161}

Deducing rules on *riba*, the classical jurists derived five rationales as being the underlying causes to understand the principles governing *riba*. Collectively, such causes represent: “Mathematical equivalence; Avoiding commercial exploitation; minimizing commerce in currency and foodstuff; Linking lawfulness of gain to risk-taking; [and] Using money and markets to allocate and moderate risks.”\textsuperscript{162} Another view about the prohibition of *riba* is to ensure that the money keep circuiting within society and does not remain limited to a fewer hands—or distributive justice.\textsuperscript{163} A more recent view is that religious prohibition saves the individuals from abusing the availability of credit self-detrimentally, helps avoid excessive indebtedness on account of individual’s irrational behavior and protects against “paying or receiving unfair compensation for receipt or extension of credit.”\textsuperscript{164} The more popular view, however, is that interest is exploitative, and therefore prohibited.\textsuperscript{165}

Unfair compensation could be eliminated by marking the interest rate to the market, and the contemporary Islamic finance owes its market interest rate determination (for any particular individual or entity) to conventional finance and its regulatory mechanism. In this regard, benchmarking Islamic finance credit sales interest rates to conventional interest rates has been regarded to be appropriate.\textsuperscript{166}

Since the objectives of commercial lending could be achieved by way of commutative contracts (i.e., sale lease etc.), Islamic law excludes lending from the mainstream financial transactions. Lending is generally considered a charitable act in Islamic law. By not claiming repayment as compensation, the lender seeks to give time value of his/her money in charity.\textsuperscript{167}
As noted, Islamic law aims at eliminating both the exploitation that is inherent in the loan interest and other dishonest and unjust gains in all exchanges transactions. By way of a summary of classical definition of *riba*, when the amount has been determined, no increase can be demanded if the payment is delayed. In this way, the definition of *riba* extends beyond compensation for the money lent. Therefore, the need for understanding *riba* in sales is equally important.

B. **Excessive Uncertainty or Ambiguity (Gharar)**

Excessive uncertainty or ambiguity (“uncertainty”) generally includes lack of complete information, deceit, risk and inherent uncertainty as to the subject matter of the contract. Uncertainty about future events qualities of goods may also be included whether any particular incompleteness is unilateral, bi/multilateral, intentional or otherwise. It is impossible to ensure absolute certainty in any given transaction. It is due to recognition of this intrinsic limitation that Islamic law tolerates uncertainty that in minor, but invalidates contract containing excessive uncertainty.

Like *riba*, scholars have argued that the prohibition of uncertainty protects an investor to excessive financial exposure “or payment of mispriced premia to eliminate existing risks.”

Examine conventional insurance and derivatives on the basis of uncertainty, the contemporary jurists prohibited such transactions including naked options. The jurists do not consider security, insurance and the option to exercise a right to be valid objects of sale; because the premia of insurance and the price of option are certain but the benefit to be derived from them are not, and thus the transaction comprises uncertainty. Analyzing the prohibition, it has been noted that jurists have prohibited only the unbundled sale of contingency or legal right—which are termed to be essentially trading in unbundled credit and unbundled risk—and not the bundled sale of insurance, credit and options.

V. **Financial Engineering in Contemporary Islamic Finance**

For the financial institutions to remain profitable, forces such as changes in demand or supply condition or regulatory structure drive financial innovation and financial engineering. Summarizing the Islamic finance contract conditions, scholars have outlined that a list of five a priori stipulations: (i) Compliance with Islamic law in general, (ii) conscious and willing agreement of the contact conditions, (iii) clarity and awareness that eliminates uncertainties, (iv) capability to fulfill all contract conditions at the time of its execution including possession or ownership of the goods or services sought to be transferred and (v) commitment of the parties not to subterfuge the spirit of Islamic law by applying any legal trick.
The scholars have provided some general guidelines for financial engineering in the today’s IFS industry. The guidelines include observing the principles of Islamic law that pertain to applying Juristic Reasoning, and other law making considerations such as taking a lenient view, safeguarding public interest, elimination of hardship and granting concessions in case of necessity.\textsuperscript{175}

A. Islamic Banking

Early development of Islamic banking was also facilitated by the governments of Muslim countries and the OIC. Unlike their conventional counterparts, the Islamic banks have distinguishing features that include offering risk-sharing credit services, putting more emphasis on productivity comparing conventional emphasis on creditworthiness, offering wider rage of products primarily by adding the risk-sharing in their portfolio, stable monetary return due to impossibility of creating debt without backing of goods and services—that reduces room for a sudden and mass flow of funds, a phenomenon that results from interest-based short-term funds and is generally responsible destabilizing speculation.\textsuperscript{176}

As of 2005, ninety-seven Islamic banks were operating throughout the world. Approximately fifty-eight percent of them are in the Arab world. Eighty-three percent of the total assets of the Islamic banks are concentrated in the Arab world.\textsuperscript{177}

B. International Banking Operations

While proposing macro-level reforms for Islamic economy, Islamic economists have proposed guidelines for international banking operations. In summation, such scholars have suggested that, in general, taking forward positions in foreign exchange would be permissible. As for international documentary credits, the scholars recommended establishment of an international fund, which is financed by the Islamic banks through monthly contributions, and using that fund for the settlements. In the meantime, the scholars advised the Islamic banks to continue with the existing settlement procedures.\textsuperscript{178}

C. Islamic Investment Funds and Islamic Investment Banking

The operational rules for domestic and international operations of Islamic banks are different from their conventional counterparts. For instance, the business of Islamic investment funds or banks has a different structure to work within. These funds are generally either ‘income funds’ or ‘growth funds,’ and are further classified as industry specific lease funds, commodities funds, equity funds and petroleum funds.\textsuperscript{179}

The pool of funds is managed by a fund promoter who is recognized as an agent in terms of Islamic agency law and is authorized to take all necessary actions for the purposes of agency. The agent or the fund promoter is entitled to a fixed-fee compensation for its
services. The fund promoter then appoints a fund manager on a fixed-fee basis or on profit-sharing. Here, the Islamic banks and the Islamic investment funds have a slightly different structure. The Islamic banks participate directly in profit-risk-sharing arrangement (also known as working-partner or mudarib—under a classical contract form known as mudarabah, which is discussed below) with the deposit holder, whereas the fundholders themselves bear all the risk of investment but the profits may be shared, as mutually agreed by the fund promoter and the fund manager. Furthermore, since the fund promoter works strictly in accordance with the terms of the agency granted by the fundholders, the agency agreement must specify the level of Islamic-law-compliance and the modes to ensure such compliance. Additionally, the fund manager should work in proximity with Islamic-law opinions or guidance from the Islamic-law board of the fund.\textsuperscript{180}

As for equity funds, which buy and sell shares of various companies, investment in them is generally considered consistent with the spirit of Islamic law as against investment in the debt funds. The scholars have, however, prescribed certain conditions for such investment to be permissible. First, the line of business test or that the fund must not deal with shares of a company whose primary business is not considered legitimate according to Islamic law, e.g., conventional banks, alcohol-based beverages industry, casinos, pork-based food industry. Second, the main-business test or that any interest earned by the fund must be separable from the fund’s total income. Also, since the sale of debt is only permissible at the face value, the receivable debt in the company’s portfolio must not exceed the ‘acceptable’ proportion. Any interest-based income in excess of ten-percent has been considered unacceptable. Third, debt-equity ratio test or that the debt-equity ratio of a company should not be in excess of one-third, the debt being one-third.\textsuperscript{181} As discussed below, debt-equity ratio criteria are constantly changing; this and other screening methodologies have been criticized for being inadequate to ensure Islamic-law-compliance.\textsuperscript{182} As for sale of debt prohibition in Islamic law and the shares of the companies that have accounts receivable in their portfolio, the scholars have ruled for permissibility if, after applying the dominant component test, the ratio of debt receivable is less than fifty-percent.\textsuperscript{183} These and similar standards and screening rules were initially evolved and developed by Al-Baraka Investment and Development Company and were latter “copied and popularized by Dow Jones Islamic Indexes (DJII) and Financial Times’ FTSE Islamic Indexes.”\textsuperscript{184}

At the early stages of Islamic mutual funds, various screening rules were developed. The most controversial of them were of the debt ratios, as discussed above. During 1990s, standardization process was hastened especially after Dow Jones Islamic Indexes changed the cutoff debt ratio from thirty-three percent of assets to the thirty-three percent market capitalization. Soon this screening method was no longer practical, one of the main reasons was that managers would sell the stock immediately after the ratios change and cross the tolerance threshold—and giving rise to tragic phenomenon known as “buy high, sell-low.” This was followed by the quickest race for developing the “Islamic hedge funds.”\textsuperscript{185} The debt-ratio criterion appears to be less strict in the Islamic hedge funds. For instance, Meyer’s Shari’a Fund (a pioneer Islamic hedge fund), has developed
D. **Hedging and Derivatives**

Recently, clarifying the previous position and a general rule that “Sell not what is not with you,” Professor Hashim Kamali has opined that future contracts in fungibles do not fall within the scope of the prohibition and are thus permissible under Islamic law.\(^{188}\) In an earlier work, Professor Kamali concluded that a blanket prohibition of futures is not supported by Islamic law. He, however, conditioned the permissibility of the futures to effective regulatory control that encourages trading in futures for genuine reasons and restricts speculative risk-taking.\(^{189}\)

Islamic law prohibits interest-bearing debt instruments. However, some Islamic-law-compliant transactions do involve debt such as manufacturing, cost-plus financing and leasing, as discussed below. But, Islamic finance generally faces scarcity of financial instruments that are used in the conventional finance to contain the market and credit risks involving debt, equity, commodity and currency transactions. However, certain Islamic finance transactions do provide somewhat resembling transactions structures that, though in a limited manner, contain the risk exposure—as partial proxies to conventional derivatives securities.\(^{190}\) As discussed with other classical contract forms and their modern adaptations, such “derivative-like”\(^{191}\) transactions include profit sharing partnership, forward contract, manufacturing contract, absolute option contract, third-party guarantee, and partial advance payment contract.

E. **Real Estate Investment Trusts**

After the bursting of the technology stock bubble, Islamic Real Estate Investment Trusts (Islamic REIT) emerged as an alternative investment strategy. Equity REITs is permissible according to Islamic law, and otherwise lucrative because of the fact that the REITs in the U.S. are required to give most of their net income in dividends. The optimal debt-equity ratio for REITs is considered to be forty percent to sixty percent. The REITs, therefore, have been under a disadvantage in terms of the Dow Jones Islamic Indexes according to which the permissible debt-equity ration should be less than thirty-three percent. However, Islamic REITs have not disclosed the methodology that allows them to invest in REITs with higher debt ratios; but there might either be a necessity argument or that REITs represent a different set of assets class—meriting a different screening benchmark.\(^{192}\)
F. Classical Contract Forms and Modern Transactions

1. Contract One: Profit-Sharing Dormant Partnership (*Mudarabah*)

Capital owners and investment managers enter into profit-risk sharing arrangements. Distribution of profit is in accordance with the pre-agreed proportion, losses are borne by the capital owner to extent of the capital invested. The investment manager loses the opportunity cost of his labor. Parties understand that the profit is not guaranteed. Although the investment manager is to follow the contract terms as how to conduct the business, capital owner cannot interfere in day-to-day business. The investment manager is a deemed fiduciary and expected to conduct the business with utmost honesty. Administrative expenses and those in the usual course of business are charged to the expense account. Profits cannot be distributed before settling liabilities and restoring the equity.  

Islamic banks undertake the above classical form from their asset and liability sides. As for asset side, the Islamic banks become the capital owner and use their deposit funds to be used as the capital. The Islamic banks are generally authorized by the deposit holders to pool their fund toward capital investment by the Islamic bank. As for the liability side, the Islamic banks become the investment manager, with depositors becoming capital owners. The depositors authorize the Islamic bank to mix their capital with its own funds—absence of this authorization will invalidate the polling of funds. Distribution of profit is proportionally pre-agreed, and each side providing capital bears loss. The pre-agreed profits are usually benchmarked to the market interest rate. Losses are rarely reported—or may only be suffered in theory. Many criticize the practical certainty of profit and equate it with interest that is prohibited.

This contract form is also used as an Islamic hedge fund and could either be for a specific or general purpose. The interest in the fund can only be traded if the fund mostly invests in tangible assets, and not in financial instruments. Similar to the conventional hedge funds, the fund managers of Islamic funds are compensated for their administrative expenses and receive a predetermined percentage in the profits and enjoy limited liability in case of any capital loss, unless they invested themselves in the pool of funds. This structure gives the fund manager a *de facto* call option on the profits of the fund.

2. Contract Two: Profit-Risk Sharing Partnership (*Musharakah*)

This contract form resembles Profit Sharing Dormant Partnership with some differences. In the present contract, both the parties provide capital, manage the enterprise, share pre-agreed proportional profit and share the loss proportionate to their capital investment.
Islamic banks use a modified version of this contract that is called Diminishing Partnership. The Islamic bank and its customer enter into a partnership to own an asset, with a condition that the bank will gradually sell its interest in the property to the customer at a pre-agreed schedule of payment. The Islamic bank provides the financing for early acquisition of the property. The pre-agreed payment scheduled, through which the Islamic bank sells its share in the asset to the customer, is benchmarked to the prevalent market interest rate. Although charging interest directly on asset-financing would be subject to the *riba* prohibition, the Islamic banks in effect receive interest for financing asset-purchase by following this transaction structure.

Another form of Diminishing Partnership is that the customer initially starts as an investment manager (as in Contract One above). After the customer starts buying the assets, it becomes proportional co-owner and thus partner, and the contract is transformed into a Profit-Risk Sharing Partnership (of Contract Two above). After buying 100% interest in the asset, the customer becomes a sole proprietor from a co-owner. Risk in the property shifts to customer with the transfer of property and, accordingly, the partnership diminishes.
3. **Contract Three: Cost-Plus Financing (Murabaha)**

Islamic law permits payment of a premium over cash price on a deferred price. For instance, A is selling a product at a cash price of $100. B offers to pay $105 but with deferred payment.

Islamic banks use this transaction model to provide finance to their customers with a cost plus marked-up profit. The customer executes an order in favor of Islamic bank to buy certain assets, and provides description of the seller and the cash price. In turn, the Islamic bank enters in two transactions: One with the seller of buying in cash; and, second, with the customer for selling the assets to the customer at a deferred price, which is scheduled (by way of installments or a lump-sum payment) and has a built-in marked-up profit component. The Islamic banks generally appoint the person placing the order (i.e., the customer or the ultimate purchaser) to act as an agent of the bank to buy on behalf of the bank. The marked-up profit is benchmarked to the prevalent market interest rate. Some Islamic banks do not get the asset transferred in their name (mainly to avoid transaction costs) and transfer the asset directly to the customer without actually owing it. Often, Islamic banks authorize the customer to act as the bank’s agent and transfer the asset in its own name. Such transfer transactions have been criticized as being contrary to Islamic law.

It is worth mentioning that, despite criticism on the extended use of this transaction, cost-plus financing transactions consist of the bulk of the Islamic banking business.

4. **Contract Four: Leasing (Ijarah)**

Islamic law permits leasing of properties and their use against payment of rent.

IFS institutions deal in two forms of leases: Operational and finance leases. In case of operational lease, the usufruct generated by an asset (generally, machinery, trains, ships, airplanes etc.) is sold to a lessee for fixed period and for a fixed price. The lessor retains the risk in property, but the lessee is responsible for usual maintenance. Being for a short period, the risk of the lessor is higher. In case of finance lease, the period of lease is spread over a longer period of time, wherefore the lessor is able to amortize the costs of the asset with profit and retain relatively higher financial security. At the end of the lease period, the lessee has the option to purchase the asset at the market value. The finance lease is generally not terminable at the option of the lessee, and requires mutual consent if the lessee would like to sell it during the lease period. Scholars have considered this aspect of the finance lease to be financially infeasible, because it makes the lessee to be worse-off than the customers of interest-based financing—where such stipulation does not exist. The non-cancelable nature has also been doubted for its permissibility under Islamic law. Like in contract three above, both of the leasing contracts are initiated at the request of the customer or the lessee to-be. At the conclusion of the contract, the asset is transferred to the lessee at a nominal price, or by way of a gift. Jurists have ruled that
such transfer can only be made with a separate contract after termination of the first contract, and on the basis of a promise to cause the transfer.\footnote{203}

5. **Contract Five: Manufacturing Contract** (Istisna)

Parties enter into a manufacturing contract of a specified product. The parties also agree on specifications, description, delivery date, and pricing and its modes. It is also permissible to defer the payment of price in such contracts.\footnote{204}

IFS institutions use this contract form for financing a manufacturing contract and enter into two manufacturing contracts. First agreement is with the party initiating a manufacturing request and includes the price payable in future (usually in installments) and IFS institutions agrees to deliver the product at the agreed date. Second agreement is in the form of a subcontract with a manufacturing contractor to manufacture and deliver the product according to agreed specification. The contractor usually receives advance payment or a staggered payment during the contract time. Usually the delivery dates are the same in both the contracts, and the original purchaser is authorized to take the delivery directly from the contractor.\footnote{205} The repayment schedule of the manufacturing contract is usually benchmarked at the prevalent market interest rate.

The buyer locks-in the price of customized commodities/products and any (whether demand-driven or otherwise) upward price movement of such commodities/products is not likely to have an adverse impact on the buyer. However, the manufacturer cannot sell the commodities/products to anyone else even at higher price.\footnote{206}

6. **Contract Six: Absolute Option** (Khiyar Al-Shart)

One party may confirm or cancel a contract in light of an absolute option contained therein. For instance, in the manufacturing contract (contract five above), the parties may agree for an absolute option to be exercised by the manufacturer, in case all of the buyers’ similar manufacturing orders sourced to the manufacturer.\footnote{207}

7. **Contract Seven: Forward Sale** (Salam)

Parties agree for future delivery for the price paid in advance. Forward sale is not available in every commodity; it is usually restricted to fungibles.\footnote{208}

IFS institutions undertake the forward sale in two ways. First, the IFS institution enters into two forward sale contracts, like contract five above, where the first contract is from the customer requesting future delivery and the future payment schedule and the second one with the supplier. Second, the IFS institution buys a commodity by paying in advance and, in an independent contract, sells the commodity to its customer on installments.\footnote{209}
The forward sale contracts installments have a built-in profit that is usually benchmarked at the prevalent market interest rate.

By entering into a forward contract and having been paid in full, the forward seller may either already have the commodity or may produce (or grow) it for future delivery. In the event that the seller has proprietary information for price volatility in future, the seller can hedge itself by securing a higher price against future delivery, when it expects adverse price movements in future.270

8. **Contract Eight: Islamic Insurance (Takaful)**

Risk-taking is part and parcel to the entrepreneurial spirit, and Islamic law recognizes the need for a protection. Islamic law also accepts seeking protection against loss from natural calamities. Covering risks that are games-oriented are not permissible within the valid Islamic insurance business. Islamic law provides a different structure for ensuring protection to entrepreneurial risk and loss from natural disasters. The development of the Islamic insurance industry has followed a non-conventional structure wherein the insurance company participates on a profit-loss sharing basis with a pool of participant (or policy holders) that mutually agree to cover each other in case of loss. In this structure the Islamic insurance company does not provide assurance/insurance to the policy holder, but acts on behalf of the policy holders to manage the business. The contributions or premia are pooled into a fund and invested into Islamic-law compliant investment opportunities. Profits are calculated after paying any claims, and surplus is shared between the company and the policy holders at a pre-agreed proportion.211 In this regard, the relationship of company vis-à-vis the policy holders is in the form of contract one above. It is worth mentioning that no reinsurance Islamic-law compliant alternatives are currently available. Therefore, the contemporary jurists have allowed Islamic insurance companies to deal with conventional reinsurance companies.212


This contract entitles the person appointed as an agent to receive a predetermined fee for performing a specified job or task, irrespective of the fact whether the assigned job/task was successfully accomplished. Penalties for breach of trust follow in case of dishonesty or violation of the terms of the contract.213

Islamic banks use this contract from for rendering fund management or investment management services to their customers. The contract is priced with a fixed amount for providing managerial services. After deduction of the managerial fee, the entire profit of loss is passed to the fund providers.214

10. **Contract Ten: Third-Party Guarantee (Damanah)**
Islamic law allows a third-party to stand as guarantor to the contracting parties. The guarantor, however, can only charge for its administrative expenses, and not cost of capital.\textsuperscript{215}

Owing to compensation restrictions, the guarantors in contemporary Islamic finance are only the sponsoring entities such as the government or the holding companies. The guarantor also holds lien on the contract assets.\textsuperscript{216} Some scholars have analyzed third-party guarantee models that could serve as a put option in view of the fact that various Islamic banks provide third party guarantees to cost-plus financing customer/purchaser (contract three above). That is to say, in the event that the purchaser concludes the cost-plus financing not to be as valuable as it thought, it may (theoretically) stop paying and let the assets go in the possession of the bank. This may be “a put option with a strike price equal to the value of the remaining installment payments.”\textsuperscript{217}

11. **Contact Eleven: Partial Advance Payment (Urbun)**

The parties agree to a future performance subject to one party furnishing partial advance payment. In the future, the party that has tendered the partial payment may choose to disregard the contract and, in such case, forfeit the money advanced to the other party.

Although it cannot be priced on the conventional options pricing model, the partial advance payment contract may offer a close substitute for the conventional financial options. For instance, an airline company intends to buy a fleet of aircrafts at a certain price, which may move upwards in the future and go beyond the company’s ability to pay. The company would also like to have the option to buy from the open market if doing so appear economical to the company. The company may enter into the partial advance payment contract with the manufacturer, and may allow its advance payment to be forfeited if the price turned out to be lower that the company has contracted.\textsuperscript{218}

12. **Contract Twelve: Islamic Bonds or Debt Securities (Sukuk)**

**History**

*Sukuk* is a plural form of *saak* that means title or investment certificate. *Sukuk*, in a contractual form, existed in the seventh century (during the first century of Islam). The soldiers and other public officials were paid in cash as well as in kind. The payment in kind was in the form of “commodity coupons” or “grain permits” (both named as *sukuk*) that were entitled for the promised quantity of the commodity (usually grains) upon maturity of the coupons or permits, as the case may be. Some would sell their coupons/permits for cash, although scholars at that time disputed permissibility of such sale.

Fourteen centuries later, the practice of *sukuk* was revived in 2001 when the Kingdom of Bahrain issued $250 million with five years of maturity.\textsuperscript{219} Thereafter, now *sukuk* are
mushrooming in the international financial markets and their structures are becoming increasingly complex, as newer transactional aspects are being added. Duplication of an existing model becomes more competitive, which gradually diminishes profit margins.\textsuperscript{220}

The Concept

As a general principle, direct lending and charging interest thereupon is not permissible under Islamic law. Therefore, the Islamic finance professionals, scholars and jurists came up with equity-disguised debt products, wherein, as discussed below, the bond-holder, say, in a leased-based \textit{sukuk} structure for instance, holds a beneficial interest in an underlying asset and receives rental income as its profit—which is usually benchmarked to the prevalent market interest rate or similar competitive pricing methodology. To achieve this, the transaction structure uses classical contract forms such as \textit{Mudarabah}, \textit{Musharakah}, \textit{Murabahah}, \textit{Ijarah}, \textit{Istisna’} and/or \textit{Salam}, which are describes above. \textit{Sukuk} based on any individual contract form or any combinations of them are common. \textit{Sukuk} based on combinations are known as hybrid \textit{sukuk}.

The \textit{sukuk} structures ultimately try and achieve approximating the conventional bond issue while staying Shariah-compliant. Duplication of an existing \textit{sukuk} structure becomes more competitive, which gradually diminishes the profit margins. However, the first entrants with an innovative structure continue to yield higher returns. \textit{Sukuk} issued at any international market have usually been on the conventional global bond format in accordance with U.S. Regulation S and Rule 144A.\textsuperscript{221}

The \textit{Sukuk} Standards

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has issued the \textit{Standard for Investment Sukuk} ("Standards"). The AAOIFI Standards are generally followed by the \textit{sukuk} issuers. The AAOIFI Standards do not treat \textit{sukuk} to be debts of the issuer but “fractional or proportional interests in underlying assets, usufructs, services, projects, or investment activities.”\textsuperscript{222} In general: “\textit{Sukuk} may not be issued on a pool of receivables. Further, the underlying business or activity, and the underlying transactional structures (such as the underlying leases), must be Shariah compliant (for example, the business or activity cannot engage in prohibited business activities).”\textsuperscript{223}

The AAOIFI has met recently (in September 2007) to discuss any possible revision in the \textit{sukuk} Standards. The outcome of the meeting is not public yet. Apparently, the convertible \textit{sukuk} were also one of the agenda items.

Convertible \textit{Sukuk}

Convertible \textit{sukuk} are a recent development. Unlike a latent equity feature in the regular \textit{sukuk}, they expressly offer conversion to equity.
The convertible *sukuk* have two parts: non-equity and equity. The non-equity part yields a coupon return that is paid from the underlying business activity (such as rent proceeds from the leased assets). The coupon return is redeemable at pre-agreed date(s) at the face value. The conversion-to-equity feature, on the other hand, allows *sukuk*’s conversion into a share of the designated entity, at a specified date and at a pre-agreed conversion formula.

There are no standard guidelines available specifically for convertible *sukuk* that are generally followed. AAOIFI’s standards guidelines are likely to be available soon to fill this gap.

In a recent transaction, a Dubai based port operator issued the largest-ever *sukuk* raising US$3.5 billion. Being convertible, using the *sukuk-al-musharaka* structure, the *sukuk* were aligned with a takeover bid. The structure allowed conversion of *sukuk* into equity upon an IPO, resembling a pre-IPO convertible bond. A detailed transaction structure is available at the transaction lawyers’ website.

### The *Sukuk* Transaction

The following describes a more prevalent model of the lease-based *sukuk* (*sukul al-ijara*). The model has been used in a number of *sukuk* issues. The regular lease-based *sukuk* are in fact lease-ending-with purchase (i.e., purchase of the underlying assets) and resemble the conventional asset securitization. The popular transaction structure is as follows:

1. The actual *sukuk* issuer sets up a special purpose company (“SPC”), which is bankruptcy-remote and distances the real issuer from the subscribers and SPC acts as the apparent issuer and the trustee for the issue;
2. A seller sells certain assets (usually real estate, plants and machinery, infrastructure project concession etc.) to SPC, say, for $750 million;
3. SPC leases the assets to a lessee for, say, a five year term. The lessee in most cases has been the seller itself. The lessee also provides an undertaking to buy the assets after the lease period, that is, after maturity of the *sukuk*;
4. SPC establishes a trust in respect of the assets and issues the lease-based *sukuk* to raise $750 million with a maturity of five years. Trading at the secondary markets, if any, starts taking place after this point onward until maturity;
5. The lessee, as per the term of the lease, starts paying six-monthly rentals during the term of the lease, and SPC distributes the rentals among the *sukuk*-holders;
6. After the five-year lease term, SPC sells the assets to the lessee/original seller pursuant to its undertaking, as mentioned in (iii) above, for $750 million;
7. To redeem the *sukuk* upon maturity after five years, SPC distributes $750 million among the *sukuk* holders;
8. SPC is dissolved after it has outlived its purpose, that is, after expiration of certain time following redemption of all the *sukuk*. 
VI. FUTURE RESEARCH DIRECTIONS

The scholarship on Islamic finance continues to be alarmingly insufficient. Academic critique has so far not partnered with the growing need for profound analysis. Although the accounting and financial analyses have been consistent but have not been able to greatly assist Islamic finance in innovation and financial engineering. As a result, a trend toward financial reverse-engineering has been growing, with lawyers being the main drivers. So far, it appears the legal practitioners have taken a lead in contributing to the Islamic finance literature.227

There are issues both at macro and micro levels that need to be immediately addressed. Future research should focus on a number of issues such as: regulatory analysis of the Muslim countries markets;228 comparative corporate governance and developing Islamic finance stock exchange;229 regulatory and quasi regulatory institutions; comparative tax structures, risk analyses including Shariah compliance risk;230 capital flight from Muslim countries;231 Islamic finance consumer advocacy; impact of incentives created by excess liquidity in Middle East; the role and scope of Islamic-law supervisory boards, and the corporate governance analysis of their working; the issuance of Islamic legal opinion vis-à-vis exercise of juristic reasoning; issues pertaining to harmonizing diversified opinions in Islamic law; and, the choice of law issues.

As discussed above, the growing use of U.S. Regulation S and Rule 144A formats in the debt-based IFS transactions of sukuk presents a pronounced effort by the IFS industry to comply with the modern corporate governance practices. However, for instance, the industry has done little to satisfy criticism its Sharia supervisory boards for indulging in conflict of interest transactions.232

As various authors have noted that IFS’ growth toward the equity market is yet to happen,233 complete integration of Islamic finance with the international securities markets seems partially dependent on development of Islamic equity products. Whether the equity-based transaction structures invite similar criticism, which its debt-based counterpart has received, can only be analyzed in future. However, structuring a new species of equity transactions that is compatible in the conventional financial markets would inevitably require, to say the least, adherence to the norms of corporate governance in its conventional and Islamic sense.

Empirical evidence is crucial in regards to actual practice of the IFS industry. The analysis should include examination of IFS contracts and their true adherence to Islamic law injunctions, the spirit of risk sharing, and the principles that seek to ensure fairness and curb the exploitative, unjust tactics.

In particular, the following questions may be examined. What policies and strategies may be analyzed to improve the regulation of the capital markets in the Muslim countries? Whether Muslim countries should adopt or import laws and regulation from the more developed markets? What such import is already taking place and, if so, what are the results of such convergence? Whether Muslim countries should first learn from
the experiences of East Asian markets? What tax structure is needed to help Islamic finance to integrate with conventional finance at home jurisdictions and abroad? How different is Islamic finance risk paradigm and what issues are involved in such examination? Whether Islamic finance has identifying itself as a mechanism for capital flight from the Muslim countries? Whether Islamic finance consumer advocacy groups are important for the further growth and promise of the Islamic finance, and what has been there role so far? Whether excess liquidity is in Middle East has created a negative incentive for long-term products, micro and entrepreneurial finance, and related financial activities that are known to be the essence of Islamic finance? How transparent is the process of product development? How efficient are the Islamic-law supervisory boards in offering a proxy for regulatory authority, as quasi-regulators? Whether Islamic-law supervisory boards and their working would pass the test of modern corporate governance practices? Whether the Islamic legal opinions for product development actually go beyond their scope and intrude into the sphere customarily reserved for the exercise of juristic reasoning under Islamic law, and, if so, what is the impact of such practice? How harmonization within the diversified realm of Islamic legal opinion and the working of various Islamic schools could be achieved? Whether a centralized Islamic-law supervisory board within each jurisdiction offers any solution to the diversification problem, such as in Malaysia, Pakistan etc? How to manage the diversification risk within a larger group of centralized supervisory boards? How various international jurisdictions will respond to a choice of law clause in Islamic finance transactions that seeks to enforce Islamic law as against a law of a particular jurisdiction? What is the extent of the contemporary Islamic finance in representing the promise of its adherence to Islamic law?

The above issues and the questions represent some of the most crucial areas. The IFS industry is apparently struggling with these questions. Future research and empirical examination of the above issues and questions will help the industry integrate better with the international financial markets. Analysis of such issues was not the focus of this paper, and would be dealt with separately in another work.

VII. CONCLUSION

This paper demonstrates theoretical foundations of Islamic finance and their correlation with the Islamic finance industry. In this respect, the paper presents an over-all survey of the Islamic finance industry, Islamic-law injunctions, quasi regulatory institutions, financial engineering, transaction structures and the evolving practices. The paper also highlights various areas of further research, a comprehensive treatment of which is critical to the continuing growth of Islamic finance in the international financial markets.

To link this paper with the aforementioned issues and questions, Islamic finance today appears competing aggressively with the conventional finance. On account of this competition, there is an unprecedented pressure for innovation. The innovation has often
resulted in a close approximation of the conventional financial transactions. The approximation strategy clearly suggests an intention to streamline the Islamic finance products with the conventional financial markets, and to offer a viable alternative. However, this strategy has exposed the Islamic finance industry to the risk of being labeled as an industry that is encouraging tactics to circumvent the Islamic law injunctions. This raises serious issues of corporate governance in the unique sense Islamic finance industry, which may not only thwart its growth within its “captive market” but may also result in reluctant reception in the international financial markets.

Furthermore, Islamic finance offers a great incentive for the Muslim countries to develop financial markets and bring them at a level where they are attractive for international participation. With the help of a macro strategy, Islamic finance could also be helpful in promoting small and medium enterprise, and micro and/or entrepreneurial finance that may lead to economic growth and development of the Muslim countries.

ENDNOTES

1 IBRAHIM WARDE, ISLAMIC FINANCE IN THE GLOBAL ECONOMY 1 (2000).
2 Id.
3 Id.
4 Id.
5 Id.
7 WARDE, supra note 1, at 74.
8 Id. See also SHAHRUKH RAFI KHAN, PROFITS AND LOSS SHARING: AN ISLAMIC EXPERIMENT IN FINANCE AND BANKING 7-14 (1987) (outlining the political and economic background of Islamic finance).
9 WARDE, supra note 1, at 75. See also PHILIP MOLYNEUX & MUNAWAR IQBAL, BANKING AND FINANCIAL SYSTEM IN THE ARAB WORLD 156 (2005) (noting that: “The Islamic Development Bank is a Multilateral Development Bank serving the Muslim countries. Its present membership stands at 55 countries. Its purpose is to foster economic development and social progress of member countries and Muslim communities, individually and collectively, in accordance with the principles of [Islamic law]. In order to meet the growing and diverse needs of its member countries, the Bank has established a number of institutions and funds with distinct administrative arrangements and operational rules. These entities and funds, affiliated with the Bank, enable the [Bank] to mobilize supplementary financial resources in line with [Islamic law] and to focus on those functions and activities, which cannot be covered under its normal financing arrangements. With these affiliated entities and funds, the Bank has evolved over time into a group called the IDB Group. During the span of about three decades of existence, the Bank has made significant strides. The Bank has not only successfully attained a respectable position among the multilateral development financing institutions, but also proved to be a model emulated by other Islamic banks.” Id.)
WARDE, supra note 1, at 77.

Id. at 96.

Id. at 103-106.

Id. at 105.

Id. at 93; KHAN, supra note 8, at 7-14 (outlining the political and economic background of Islamic finance).

WARDE, supra note 1, at 92-95 (describing the circumstances in which many Arab countries became dependant on U.S. protection for their defense and reason for flow of money to the U.S. including bank deposits).

See also MOLYNEUX & IQBAL, supra note 9, at 148-49 (noting that during the 1990s the growth rate remained relatively slower in comparison to fifteen percent of 1980s, but generally considering the 1990s period to be “most important” for the Islamic banking matured during this time into a viable alternative financial intermediation model).


Many international financial institutions are increasingly focusing on Islamic finance “to tap Islamic middle class.” See WARDE, supra note 1, at 86 (listing the main international financial institutions offering Islamic financial services).

MAHMOUD A. EL-GAMAL, ISLAMIC FINANCE: LAW ECONOMICS AND PRACTICE 190 (2006) (arguing that jurists involved in the process of legitimizing the otherwise doubtful transactions indirectly advertise—by speaking at various fora and conferences—and thus help to expand the consumer base).

Id. at 138 (noting also that soon after Islamic finance started mimicking the conventional finance, but the writing of Islamic jurisprudence and Islamic economics continue to assert that the conventional banking and finance is forbidden).


MOLYNEUX & IQBAL, supra note 9, at 147 (noting that credit and cooperative societies remained functional within the colonized Muslim world to offer inters-free financial solution at a limited scale, but proper Islamic banking institutions started emerging during 1960s. Id.).

WARDE, supra note 1, at 226-227 (quoting International Association of Islamic Banks to have required: “It is formed of a number of members chosen from among jurists and men of Islamic Jurisprudence and of comparative law who have conviction and firm belief in the idea of Islamic Banks. To ensure freedom of initiating their opinion the following are taken into account: (a) They must not be working as personnel in the bank. That means: They are not subject to the authority of the board of directors. (b) They are appointed by the general assembly as it is the case of the auditors of accounts. (c) The general assembly fixes their remunerations. (d) The Legitimate Control Body has the same means and jurisdictions as the auditors of accounts.” Id.)

Id. at 227.

Id. at 230.

MOLYNEUX & IQBAL, supra note 9, at 162-63.

EL-GAMAL, supra note 20, at 32.

See generally RODNEY WILSON, ISLAMIC FINANCE 61-63 (1997) (maintaining that: “In the long term the future of the [Islamic Development Bank] will depend on political developments as much as financial conditions. If the economies of the Muslim world move away from western secularism, the [Bank] may become even more important. Much will depend on the future in the Gulf region, especially in Saudi Arabia, but certainly during the last decade events seem to have been moving towards greater application of the Shariah law as Islamists win more political and economic influence.”) Id. 63; Mohamed Rafe Md. Haneef, Recent trends and innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities, in ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES 29-60 (S. Nazim Ali ed., 2005).
See generally EL-GAMAL, supra note 20, at 9, 15, 33, 34, 41 etc.

41 Id. at 26-27 (2006) (stating criteria for best benefit analyses, namely: “(1) allowing apparent benefit, (2) preventing apparent loss/harm, (3) preventing means of circumventing the law, and (4) consideration of specific circumstances in time and place.” Id. 29).

42 Id. at 54-55 (“This inefficiency would be tolerable only if we ensure that the spirit of the law that gave rise to adopted forms is protected. Otherwise, it would be shameful merely to copy or adapt inefficient historical forms and squander the substance of Islamic law. Ideally, contemporary jurists would develop a modern jurisprudence that embodies the substance of premodern law within the context of contemporary legal and regulatory frameworks. This ideal may be approachable in the long term but seems impossible in the short term. In this regard, earlier jurists had the luxury of seeking efficiency by adopting Roman or other legal forms. However, later jurists have to work under the heavy burden of sacred history, including unreasonable admiration of the presumed timeless wisdom of their predecessors. Thus, practical Islamic solutions for the short to medium term may abandon premodern forms only gradually.” Id.)

43 Id. at 10 (discussing Judge Richard A. Posner’s criticism of Adam Smith on supporting laws against interest based borrowing in which Judge Posner treated such support to be paternalistic and efficiency reducing, the author argues that: “Within the quasi-religious context of Islamic jurisprudence and finance, there is no doubt that religious injunctions are by definition paternalistic. Indeed, the charge of “paternalism” sounds compassionate when attributed to the Divine and therefore will not be contested. With regard to efficiency reduction, consider the following simple and well-known example, which suggests that paternalistic injunctions against dealings to which parties mutually consent can in fact be efficiency-enhancing.

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In the standard two-prisoners’ dilemma shown [above], each player has a choice to cooperate or defect, with the shown payoffs (the first payoff in each cell is for the row player, and the second is for the column player). For each of the two players, the dominant strategy, regardless of the opponent’s choice, is to defect (and get 5 instead of 4, or 1 instead of 0, depending on opponent’s action). Thus, the unique Nash equilibrium (wherein each player plays the best response to the other’s selected action) is defection for both players, whereby hereby each player I would receive 1.

In this well-known game, it is very dear that the equilibrium outcome of the prisoner’s dilemma, to which players will gravitate if left to their own devices, is inefficient. Mutual cooperation would yield 4 for each, instead of 1. In this case, a paternalistic divine command “thou shalt not defect” can in fact be efficiency enhancing. In a dynamic setting, Glaeser and Sheinkman (1998) explained ancient usury laws, which forbade all interest on loans, as a form a priori social insurance. In societies with pervasive poverty, the cooperative charitable lending rule provides transfers from fortunate individuals born with wealth to those less fortunate. Thus, the prohibition of mutually consensual interest-based can enhance ex ante efficiency by encouraging the cooperative outcome.” Id. 9-19).

DeLorenzo, supra note 6, at 9 (“Islamic business in history is an exotic and dynamic panorama that ranges from gem merchants in Ceylon, to caravan traders in Mali, to dealers of saffron in Muslim Spain, to sellers of aromatic oils in the deserts of Arabia, to colourful cotton markets in Turkey, to spice markets in India, to the hardwood merchants of Malaysia, to the plantations and industry of Indonesia, to carpetmakers in Kashmir, to the great merchant houses of the Levant, to the oil of the Arabian Peninsula, North Africa, and Brunei. The business practices and ethics in all of these places, and from the moment that Muslims arrived there, are derived from the same source. Modern Islamic finance and investing came from the same tradition….”” Id. at 13).

The Koran mandates that “partake of the good and work righteousness” See The Quran (23:51).

DeLorenzo, supra note 6, at 12-13.

Id. at 15.

Id. at 17 (quoting from a Prophetic tradition that “a persons wealth is as sacred as person’s blood”).

The Quran provides: “O you who have faith, fulfill all contracts.” (5:1). The Prophet have been reported to have said “ Muslims honor their covenants”. See id. at 13-14 (quoting from the Koran and the collection of Prophetic traditions).

DeLorenzo, supra note 6, at 11-12, 17.

Hallaq, supra note 47, at 33-34.

Id. at 49-50 (“[T]he process that ultimately led to the emergence of Prophetic Sunna as an exclusive substitute for sunan was a long one, and passed through a number of stages before its final culmination as the second formal source of the law after the Quran” id. 49).


Id. at 58.

The Quran 53:3. See also Kamali, supra note 59, at 484. For discussion on differences between manifest revelation (i.e., the Quran) and internal revelation (i.e., the Prphetic Tradition), see id. at18 and 63.


Kamali, supra note 59, at 1.

See generally id.

Hallaq, supra note 47, at 19-21.

Irshad Abdal-Haq, Islamic Law: An Overview and Its Origins and Elements, in Understanding Islamic Law 1, 11 (Hisham M. Ramadan ed., 2006); See also Kamali, supra note 59, at 17 (2003); and Muhammad Khalid Masud et al., Mufti, Fatwas, and Islamic Legal Interpretation in ISLAMIC LEGAL INTERPRETATION 3, 4 (Muhammad Khalid Masud et al. eds., 1996).

Kamali, supra note 59, at 17. The legal injunctions in the Quran comprise about 500 verses; however, some have argued that the number is 100.
KAMALI, supra note 59, at 27.

Id. at 27-55.

See generally Id.


KAMALI, supra note 59, at 58-59, 78.

Id. at 63-65.

Id. at 77-78.

Id. at 95 (footnote omitted).

Id. at 81-87.

Id. at 58-111 (outlining the main features of the jurisprudential standards for the acceptance of the Prophetic traditions).


KAMALI, supra note 59, at 228.

Id. at 231.

Id. at 231.

Id. at 232, 235.

Id. at 236-244.

Id. at 228-260 (outlining the jurisprudential differences on the scope and definition of consensus of juristic opinions (“Consensus”)).

Id. at 233.

Id.

Id. at 234.

Id. at 229.

Id. at 228-229, 259-260.

See generally Id. at 229.

Id. at 255-260 (suggested his own opinions in support of some earlier scholars suggesting institutionalization of the Consensus).

Many scholars of Islamic law generally discuss Juristic Reasoning and analogical reasoning separately as two independent sources. However, various scholars do not recognize a difference beyond the nomenclature. See generally KAMALI, supra note 59, at 298.

KAMALI, supra note 59, at 468.

This process resembles with the common law principle of stare decisis or of civil law ratio legis. In particular, a judge distinguishing ratio decidendi from an existing case and, upon finding that same ratio is involved in both cases, analogically applying decision of the earlier case to new facts. See generally id. at 299.

HALLAQ, supra note 47, at 130-132.

JOSEPH SCHACHT, AN INTRODUCTION TO ISLAMIC LAW 70-71 (1964) (reprint 1984).

See generally KAMALI, supra note 59, at 468-497 (setting out the history and jurisprudential development of the Juristic Reasoning). But see SCHACHT, supra note 100, at 70-71 (explaining the reason for lesser exercise of Juristic Reasoning to be an overall consensus among the scholars and jurists that:

“All essential questions had been thoroughly discussed and finally settled, and a consensus gradually established itself to the effect that from that time onwards no one might be deemed to have the necessary qualifications for independent reasoning in law, and that all future activity...
would have to be confined to the explanation, application and, at the most, interpretation of the
document as it had been laid down once and for all.” (id.)

But cf. Masud et al., supra note 66, at 34 (pointing out, in footnote 18, that exercise of Juristic Reasoning
never stopped and was possible all times in the Shiite school).

See Kamali, supra note 59, at 476-480 (outlining qualifications of a jurist to include the knowledge of
(i) Arabic, (ii) the Quran and the Prophetic traditions and their legal content, (iii) the Consensus and
analogical deduction and (iv) the objectives of Islamic law. See also Masud et al., supra note 66, at 16
(summarizing the requisite skill set for a jurist).

Kamali, supra note 59, at 476-482.

Id. at 496; see also El-Gamal, supra note 20, at 31-32 (stating that collaboration may provide
authoritativeness to groups of jurists on modern disciplines).

El-Gamal, supra note 20, at 17 (quoting from a contemporary jurist that: “It must be understood that
when we claim that Islam has a satisfactory solution for every problem emerging in any situation in all
times to come, we do not mean that the Holy Quran and [the Traditions] of the Holy Prophet or the rulings
of Islamic scholars provide a specific answer to each and every minute detail of our socioeconomic life.
What we mean is that the Holy Quran and the Holy [traditions] of the Prophet have laid down the broad
principles in the light of which the scholars of every time have deduced specific answers to the new
situations arising in their age. Therefore, in order to reach a definite answer about a new situation, the
scholars of [Islamic law] have to play a very important role. They have to analyze every question the in
light of the principles laid down by the Holy Quran and [the Prophetic traditions] as well as in the light of
the standards set by earlier jurists enumerated in the books of Islamic jurisprudence. This […] ongoing
process … keeps injecting new ideas, concepts and rulings into the heritage of Islamic jurisprudence.”

See generally id. 19-20 (2006) (noting, for instance, that Iran (country with majority Shiite following)
has imitated the bond (sukuk) structure predominantly practiced in regions of Sunni majority).

Hallaq, supra note 47, at 153.

Id.

Id.

Id. at 153-154.

Id. at 153-159.


Founded by Imam Abu Hanifa An-Nu’man Ibn Thabit at Kufa, Iraq (699-769 AC). See Khan, supra
note 78, at 60.

Founded by Imam Malik Ibn Anas at Madina, Saudi Arabia (713-795 AC). See Khan, supra note 78, at
78-80.

Founded by Imam Muhammad Ibn Adris Ash-Shafi’i at Baghdad, Iraq (767-820 AC). See Khan, supra
note 78, at 94-95.

Founded by Imam Abu Abdullah Ahmad Ibn Hanbal at Baghdad, Iraq (780-855 AC). See Khan, supra
note 78, at 60.

Hallaq, supra note 47, at 147.

“[E]licitation of juristic response to a question, modeled after Roman system of response….” See El-
Gamal, supra note 20, at 32.

Id. at 33.

Hallaq, supra note 47, at 153-155.

Masud et al., supra note 66, at 4 (discussing and tracing history of legal opinions in Islamic law).

Hallaq, supra note 47, at 153-155.

Wael B. Hallaq, Ifta’ and Ijtihad in Sunni Legal Theory: A Development Account in ISLAMIC LEGAL
INTERPRETATION 33, 33 (Muhammad Khalid Masud et al. eds., 1996). See also Hallaq, supra note 47, at
147.

Masud et al., supra note 66, at 17.

Id. at 22.

Id. at 25.

Id. at 22-23.

Hegazy, supra note 18, at 133-149.

Mahmoud A. El-Gamal, Limits and Dangers of Shari’a Arbitrage, in ISLAMIC FINANCE: CURRENT
148. *See generally Michael J. T. McMillen, Structuring a Securitized Shari’a-Compliant Real Estate Acquisition Financing: A South Korean Study, in ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES 79, 79 (S. Nazim Ali ed., 2005) (explaining confidentiality constraints for not disclosing or sharing complete transactional information with Islamic law scholars who provided guidance on the subject-matter transaction); See also EL-GAMAL, supra note 20, at 48 (noting in respect of the two interlinked contracts used for same-item sale-repurchase or sale-buy-back transaction that “in Islamic finance, jurists may be asked to validate each contract separately, without explaining the entire financial structure for which they will be used.” Id.).

149. Some contemporary jurisconsults have displayed the tendency of not following their own school, but refer directly to the Quran and the Prophetic traditions and in effect exercise Juristic Reasoning.

150. *See generally EL-GAMAL, supra note 20, at 129 (discussing the structure of Islamic hedge fund and noting lack of public information in this regard).


152. EL-GAMAL, supra note 20, at 36 (noting that if the object of insurance is to be ‘security’ than the payment of premia could be taken as its price, but some jurists argue that the certainty of premia is there but nonexistent for the object of sale).

153. Id. at 36-39.

154. Id. at 39.

155. Id. at 41.

156. Id. at 45 (noting views of Ibn Taymiyya, a leading jurist of the late classical age).


158. EL-GAMAL, supra note 20, at 43.

159. Iqbal & Khan, supra note 139, at 2-3.


161. EL-GAMAL, supra note 20, at 47-48.

162. See WARDE, supra note 1, at 93 (discussing a legal opinion issues by the Shaikh Al-Azhar (i.e., the President of the Al-Azhar University, Cairo, Egypt).

163. EL-GAMAL, supra note 20, at 51, 52 (tracing the history of riba in Islamic law and jurisprudence).

164. ZAMIR IQBAL & ABBAS MIRAKHOR, AN INTRODUCTION TO ISLAMIC FINANCE: THEORY AND PRACTICE 55-56 (2007).

165. The Quran, http://www.islamicity.com/QuranSearch/ (trans. Abdullah Yousaf Ali), 30:39 (“That which ye lay out for increase through the property of (other) people, will have no increase with Allah. but that which ye lay out for charity, seeking the Countenance of Allah, (will increase): it is these who will get a recompense multiplied.”).


167. EL-GAMAL, supra note 20, at 50.

168. The Quran, http://www.islamicity.com/QuranSearch/ (trans. Abdullah Yousaf Ali), 2:275-79 (“Those who devour usury will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: ’Trade is like usury,’ but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (The offence) are companions of the Fire: They will abide therein (for ever). Allah will deprive usury of all blessing, but will give increase for deeds of charity: For He loveth not creatures ungrateful and wicked. Those who believe, and do deeds of righteousness, and establish regular prayers and regular charity, will have their reward with their Lord: on them shall be no fear, nor shall they grieve. O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. If ye do it not, Take notice of war from Allah and His Messenger. But if ye turn back, ye shall have your capital sums: Deal not unjustly, and ye shall not be dealt with unjustly.”).

169. EL-GAMAL, supra note 20, at 50.

170. United Bank v. Messrs Farooq Brothers, PLD 2002 Supreme Court 800.

171. EL-GAMAL, supra note 20, at 49-51.
individuals from financial detriments. Behavior depend on how a “reference point” is presented to them; and a religious precommitment helps human idiosyncrasies such as people’s preference of risk-loving behavior over risk-and-loss averse behavior.

Whether adjustment for inflation or any indexation in any form falls within the definition of Riba, and finally whether prohibition of interest denies time value of money.”

Limited to consumer loans only, whether only excessive interest or compounding of interest is prohibited, the object of sale does not exist at contract inception, giving rise to excessive [uncertainty]. However, since deemed invalid based on that [uncertainty]. A canonical example is [prepaid forward sale], wherein the latter case the object of sale is the unborn calf, which may be still-born. Finally, if the commutative contract containing excessive [uncertainty] meets a need that cannot be met otherwise, the contract would not be deemed invalid based on that [uncertainty]. A canonical example is [prepaid forward sale], wherein the object of sale does not exist at contract inception, giving rise to excessive [uncertainty]. However, since that contract allows financing of agricultural and industrial activities that cannot be financed otherwise, it is allowed despite that [uncertainty]. Similarly, while contemporary jurists forbade commercial insurance based on excessive [uncertainty] and, availability of noncommutative [Islamic insurance] alternatives, they currently allow [Islamic insurance] companies to deal with conventional reinsurance companies, since [Islamic reinsurance] alternatives are not yet available.”

Id. at 50-51 (explaining that “Hanafi jurists extended the prohibition to all fungible goods measured by weight or volume, whereas Shafi’i and Maliki jurists restricted it to monetary commodities (gold and silver) and storable foodstuffs.” Id. 51).

Id. at 52 (2006).

Id. at 52-53 (footnote omitted) (adding in footnote, 17 of Chapter 3, that: “Of course, lacking the tools of calculus, which were only developed six centuries later, he could not speak of marginal utilities and hence spoke only of “benefits.” However, the economic idea is still the same: Equity dictates equality of amount when trading fungibles of the same genus, and equality of value when trading nonfungibles or goods of different genera.” Id. 202).

Id. at 53.

Iqbal & Mirakhor, supra note 146, at 61-62.

Id. at 56 (observing also that: “Four most commonly asked questions are whether the prohibition is limited to consumer loans only, whether only excessive interest or compounding of interest is prohibited, whether adjustment for inflation or any indexation in any form falls within the definition of Riba, and finally whether prohibition of interest denies time value of money.” Id.).

EL-GAMAL, supra note 20, at 48 (noting also that if the second sale is stipulated in the first agreement it would be clearly prohibited).


Id. at 78.


EL-GAMAL, supra note 20, at 54-55 (arguing from the modern psychological and behavioral economic research “that humans exhibit fundamental forms of irrationality in time preference, against which precommitment mechanisms (including those based on religion) can protect them.” Id. 55).

Iqbal & Khan, supra note 139, at 4.

EL-GAMAL, supra note 20, at 54-55.

Id. at 57 (extending also the same principle to lending of usufruct of a property).

Iqbal & Khan, supra note 139, at 5-7.

Vogel & Hayes, supra note 161, at 74.

EL-GAMAL, supra note 20, at 58-60 (outlining four conditions that invalidate a contract: “First, [uncertainty] must be excessive to invalidate a contract. Thus, minor uncertainty about an object of sale (e.g., if its weight is known up to the nearest ounce) does not affect the contract. Second, the potentially affected contract must be a commutative financial contract (e.g., sales). Thus, giving a gift that is randomly determined (e.g., the catch of a diver) is valid, whereas selling the same item would be deemed invalid based on [uncertainty]…. Third, for [uncertainty] to invalidate a contract, it must affect the principal components thereof (e.g., the price or object of sale). Thus, the sale of a pregnant cow was deemed valid, even though the status of the calf may not be known. Indeed, the price of a pregnant cow would be higher than the price of the same cow if it were not pregnant. However, the sale of its unborn calf by itself is not valid based on [uncertainty]. In the first case, the primary object of sale is the cow itself, whereas in the latter case the object of sale is the unborn calf, which may be still-born. Finally, if the commutative contract containing excessive [uncertainty] meets a need that cannot be met otherwise, the contract would not be deemed invalid based on that [uncertainty]. A canonical example is [prepaid forward sale], wherein the object of sale does not exist at contract inception, giving rise to excessive [uncertainty]. However, since that contract allows financing of agricultural and industrial activities that cannot be financed otherwise, it is allowed despite that [uncertainty]. Similarly, while contemporary jurists forbade commercial insurance based on excessive [uncertainty] and, availability of noncommutative [Islamic insurance] alternatives, they currently allow [Islamic insurance] companies to deal with conventional reinsurance companies, since [Islamic reinsurance] alternatives are not yet available.” Id. 58-59).

Id. at 60-61 (noting empirical finding of contemporary behavioral finance literature to emphasize that human idiosyncrasies such as people’s preference of risk-loving behavior over risk-and-loss averse behavior depend on how a “reference point” is presented to them; and a religious precommitment helps individuals from financial detriments.).

Id. at 62.

Iqbal & Khan, supra note 139, at 2.
which refers to removing difficulties faced by people in general due to change in circumstances. This rule makes things difficult for you’ (2: 185). The doctrine of necessity allows forty-five percent or more for accounts receivable of the total assets).

instance, “help the poor”).

incorporate what is not permissible under Islamic law and do not include the positive injunction such as, for safeguarding public interest. [Elimination of hardship (raf al-haraj)] is another basic principle of Islam which refers to removing difficulties faced by people in general due to change in circumstances. This rule is derived from the Quranic verse which translates as ‘God intends for you ease, and He does not want to make things difficult for you’ (2: 185). The doctrine of necessity darurah allows temporary suspension of normal law in case of dire need. Since this doctrine can often be misused, a word of caution is in order. The doctrine of necessity is meant to be used very sparingly. It is a rule to handle emergencies. Even in emergencies, it does not provide an automatic and unrestricted suspension of the law. First of all, it has to be determined that a situation has arisen where the doctrine can be invoked. While in individual cases it is the individual conscience which will determine this, in the case of public application a ruling must be given by [Islamic Law] scholars, in consultation with the experts in the relevant field. Second, the suspension of the normal law is not absolute. There are limits and conditions to be observed. The Quranic text (2:173) providing the basis for this doctrine itself lays down two basic conditions: the user must accept the sanctity of the original law implying a return to it as soon as possible) and, in the meanwhile, use the exception to the minimum possible extent.” Id.) (formatting changed).

MOLYNEUX & IQBAL, supra note 9, at 153.

Id. at 153 (stating that 18.56% were in South and South East Asia, nine percent Africa and 14.43% in the rest of the world; and 13.05% assets are in South and South East Asia and 3.63% in the rest of the world).

INTERNATIONAL INSTITUTE OF ISLAMIC ECONOMICS, supra note 22, at 104-109.

MOLYNEUX & IQBAL, supra note 9, at 157-161.

Id.

Id. (outlining also that investment in companies, with all other things being equal, airline, hotel, supermarket etc. may be considered permissible even though alcoholic beverages and port-based food is served and sold by them, because such business is a minor part of their whole operations). But see El-GAMAL, supra note 20, at 126-127 (discussing interest-based income that after initial stricter view the modern jurists allowed forty-five percent or more for account receivable of the total assets).

EL-GAMAL, supra note 20, at 125-133 (2006) (criticizing, among others, that these screens only incorporate what is not permissible under Islamic law and do not include the positive injunction such as, for instance, “help the poor”).

MOLYNEUX & IQBAL, supra note 9, at 159.

The world Al-Baraka literally means religious and divine blessings.

EL-GAMAL, supra note 20, at 12.

Id. at 12-13.

Id. at 129.

Mohammad Hashim Kamali, Fiqhi Issues in Commodity Futures, in FINANCIAL ENGINEERING AND ISLAMIC CONTRACTS 20, 42 (Munawar Iqbal & Tariqullah Khan eds., 2005).


VOGEL & HAYES, supra note 161, at 219.

EL-GAMAL, supra note 20, at 81-92 (investing the term “derivative-like” and discussion various issued in this regard).

Id. at 129-133.

See generally MOLYNEUX & IQBAL, supra note 9, at 168-169.

But see generally id. at 169.

VOGEL & HAYES, supra note 161, at 221-222.

Id. at 231.

See generally MOLYNEUX & IQBAL, supra note 9, at 169.
Islamic Profit and Loss Sharing Securities followed by $600 million by the Federation Malaysia, $700 million by the State of Qatar and, with more modifications, the Kingdom of Bahrain’s $250 million in 2004. Bank’s issue of $400 million in 2003, the State of Qatar’s $700 million in 2003, and the Kingdom of Bahrain, $400 million by the Islamic Development Bank). To date, the trend continues to grow, and so are the numbers. For instance, the Malaysia companies have issued Islamic debt of $24.97 billion as of 2006. See Hasan Jafri and Carolyn Lim, Deals & Deal Makers, Wall St. J., Sep. 26, 2006, at C4.

Haneef, supra note 219, at 31 (noting that Regulation S format sukuk include Islamic Development Bank’s issue of $400 million in 2003, the State of Qatar’s $700 million in 2003, and the Kingdom of Bahrain’s $250 million in 2004. Id.).


Mohamed Rafe Md. Haneef, Recent trends and innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities, in ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES 29-60 (S. Nazim Ali ed., 2005) (noting that the Kingdom of Bahrain issue of $250 million was soon followed by $600 million sukuk issue by the Federation Malaysia, $700 million by the State of Qatar and $400 million by the Islamic Development Bank). To date, the trend continues to grow, and so are the numbers. For instance, the Malaysia companies have issued Islamic debt of $24.97 billion as of 2006. See Hasan Jafri and Carolyn Lim, Deals & Deal Makers, Wall St. J., Sep. 26, 2006, at C4.

Haneef, supra note 219, at 31 (noting that Regulation S format sukuk include Islamic Development Bank’s issue of $400 million in 2003, the State of Qatar’s $700 million in 2003, and the Kingdom of Bahrain’s $250 million in 2004. Id.).


Id. at 428-429.

It is becoming customary for the practitioner, mostly lawyers and some financial experts, to write a descriptive overview of a transaction that they have recently handled. Sometimes, such works include analysis of regulatory and related challenges of Islamic finance. The lawyers’ works have started to focus more on the transactional structuring and regulatory issues.  See generally Michael J. T. McMillen, Islamic Shari’ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies, 24 FORDHAM INT’L L.J. 1184 (2001); Michael J. T. McMillen, Structuring a Securitized Shari’a-Compliant Real Estate Acquisition Financing: A South Korean Study, in ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES 29-60 (S. Nazim Ali ed., 2005) (noting that $250 million sukuk issue by the Kingdom of Bahrain, $600 million by the Federation Malaysia, $700 million by the State of Qatar and, with more modifications, $400 million by the Islamic Development Bank used the leased-based structure. Id. 32, 42). See id. at 31–42 (outlining a typical leased-based sukuk structure). See also El-GAMAL, supra note 20, at 107-108.


231 This issue is introduced recently. See Ibrahim, supra note 228.

232 See generally Hegazy, supra note 18, at 133-149.

233 See generally Haneef, supra note 219, at 60.

234 See generally Hegazy, supra note 18, at 133-149.