

## Islamic Financial Products

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The main difference between conventional and Islamic financial systems is that the latter is based on keeping in view certain social objectives intended for the benefit of society. This is because Islam is an ethical system which guides man in all his activities including commerce and trade. Whereas a conventional banker need not be concerned with the moral implications of a business venture for which money is lent, the Islamic banker has a much greater responsibility in this respect. This leads one to a very fundamental concept in Islamic banking, namely the relation between investor and the bank. In the case of Islamic banks, this relationship is conceived as a partnership, whereas in conventional banking it is that of creditor-investor.

Islamic finance is based on equity, whereas the conventional banking system is debt based. Islam is not against the earning of money, but it prohibits the earning of money through unfair trading practices and other activities that are socially harmful in one way or another, which is why predetermined interest or *riba* is forbidden. This edict springs from the Islamic belief that wealth should not be hoarded but put to productive use so that others can share in its benefits. It is also considered wrong to charge for the use of money; essentially, the owners of capital must share in any losses as well as in the profits of any enterprise invested in. At the same time, Islam does not allow uncertainty or *gharar* in contracts. This counts out, for example, a contract in which someone undertakes

to insure or indemnify another or allow them the option to sell or buy an asset. Speculation or gambling (*maysir*) is also unacceptable, which weighs against insurance and dabbling in futures and options. Finally, Islamic banks will not finance projects involving products that are *haram*, or forbidden under Shari'ah, most obviously pork and alcohol.

Further, Islamic banks which have committees made up of senior officials and Islamic scholars to decide whether or not projects conform to Shari'ah, will not always respond entirely predictably on what is and what is not suitable for funding. This arises from the fact that the Shari'ah is not a codified body of law, but is open to interpretation and always developing with each new ruling. As we saw in chapter 2, Muslim scholars do not always see eye to eye on what is acceptable and what is not and this debate can, on occasions, touch on the very fundamentals of the system.<sup>50</sup>

Thus, in going forward, we will now see how Islamic banking and products have developed following the conventional financial market and how the challenges have also arisen.

#### 4.1 The Emergence of Islamic Banking

The Islamic financial services industry comprises an increasingly diverse range of institutions, including commercial and investment banks, mutual insurance and investment companies. Banks, however, remain the core of the financial services industry in many countries since they account for the bulk of financial transactions and their soundness is of key concern for systemic stability.

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<sup>50</sup>“What is Islamic banking”, *Cairo Times* ([www.cairotimes.com](http://www.cairotimes.com)), 3 April 1997.

The first Islamic bank<sup>51</sup> was established in Egypt in 1963 and was called the Mit Ghamr Local Savings Bank. The bank operated on the basis of Shari'ah law and prospered because it was able to meet the savings and credit needs of its customers. The success of the Mit Ghamr Local Savings Bank proved that a bank operating according to Islamic principles could flourish. It was followed, in 1967, by the Nasir Social Bank. This was the first social bank<sup>52</sup> to be constituted according to Shari'ah principles. Apart from managing various forms of financial transactions, the bank also granted interest-free loans to its customers.<sup>53</sup>

Following these initial successes, a number of Islamic banks were founded in various other Muslim countries in the Middle East from the mid-1970s onwards. They included:

- The Islamic Development Bank in Saudi Arabia (1975)
- The Dubai Islamic Bank (1975)
- The Faisal Islamic Bank in Egypt (1976)
- The Faisal Islamic Bank of the Sudan (1977)
- The Jordan Islamic Bank (1978)
- The Jordan Financial and Investment Bank (1978)
- The Islamic Investment Company Ltd in The United Arab Emirates (1978)
- Kuwait Finance House (1979)

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<sup>51</sup>The terms "Islamic banks" and "Islamic financial institutions" are used interchangeably to refer to financial institutions operating in countries where all financial transactions are conducted according to Islamic precepts, as well as specialised institutions and windows of conventional banks that offer Islamic products and instruments in countries where both conventional and Islamic banking coexist.

<sup>52</sup>The projects financed by a social bank are necessarily for the development of society. Such a bank must add some value to the society besides just earning profits.

<sup>53</sup>International Organisation of Islamic Banks 1402H/1982M 5:106.

In order to coordinate Shari'ah rulings between the various Islamic banks in different countries, an International Association of Islamic Banks was established in 1977, with its headquarters located in Saudi Arabia.

More Islamic banks followed in the 1980s, including the first Islamic bank to be established in a non-Muslim country. This was the International Islamic Bank of Investment and Development in Luxembourg, which was founded in 1980. Other Islamic banks established in the 1980s included:

- The Abu Dhabi Islamic Bank (1980)
- The Qatar Islamic Bank (1981)
- Islamic counters in Pakistan banks (1981)
- The Malaysia Islamic Bank Ltd (1983)
- The Mauritania Islamic Bank (1985)
- The Tanzibar Islamic Bank (1985)
- The Iraq Islamic Bank (1985)
- The Turkey Islamic Bank (1986)

With the new generation of wealth creation of the Asian Tigers through the mid-1970s to the mid-1990s, came greater awareness of Islamic finance as an alternative to trading and banking in South-east Asia. Malaysia has been particularly energetic in her efforts to popularise its Shari'ah-compliant products and services to position itself to become the centre of the international Islamic capital market in the region. Securities Commission (SC) market policy and development division director, Dr Nik Ramlah Nik Mahmood, has made it known that the country will continue its efforts to develop innovative and competitive instruments to heighten its profile internationally. The challenges include addressing the lack of awareness of products and services as well as Shari'ah requirements. Shari'ah scholars and jurists are to be

involved in the development process and the application of new technologies such as e-commerce. Among the significant progress made to date is the good take-up rate for Malaysia's sovereign US\$500 million (US\$1 = RM3.80) global Islamic debt securities launched in June 2002. The debt papers, which were twice oversubscribed, signal Malaysia's penetration into the West Asian market and the immense appetite the market has for Islamic-based financial instruments. It was a confirmation that the people there were exposed to the product and they were looking for Shari'ah-compliant investments.<sup>54</sup>

Whilst Malaysia promoted Islamic banks as a constructive outlet for religious fervour, Saudi Arabia would not allow Islamic banks in, lest they imply that the kingdom's existing banks were un-Islamic. (The Saudi royal family, not incidentally, subsists largely on income from conventional investments.) The government finally allowed one Islamic bank to open in 1987, though the word "Islam" was nowhere in its name.

Today, in banking centres like Kuwait, Dubai and especially Bahrain, which is known for its strict regulatory measures, Islamic banking is serious business. A respected group known by the acronym AAOIFI (Accounting and Auditing Organisation for Islamic Financial Institutions) has codified Shari'ah rulings into a set of industry standards. The early zealots have given way to more pragmatic professionals. Even the Shari'ah scholars — once recruited from the local mosque and barely fluent in English, much less financial statements — are now armed with advanced degrees in economics.

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<sup>54</sup>"Malaysia to popularize *Shari'ah* compliant products and services", [www.islamic-banking.com](http://www.islamic-banking.com), 23 August 2002.

Since 2000, eight countries consisting of Malaysia, Indonesia, Iran, Saudi Arabia, Pakistan, Sudan, Bahrain and Kuwait have been making efforts to establish a common and harmonious Islamic banking system. In a meeting in Kuala Lumpur on 3 November 2002, these countries inked an agreement to establish the Islamic Financial Services Board to promote Islamic banking.<sup>55</sup> “In the last five years, the industry has accomplished more than it did in its first 20,” says Shamil Bank’s Jaroudi, in 2002.<sup>56</sup>

## 4.2 Different Paths, Same Goal

However, there are many similarities between Islamic and conventional finance, since both deal with a common set of operating business realities. In most cases, Islamic and conventional finance, simply travel different paths towards the same goal. Consider these examples:

- Most businesses need long-term financing and in conventional finance this is accomplished through some combination of long-term debt and owners’ capital. Interest is the mechanism which makes the wheels turn here, but obviously, this is not an option under Shari’ah law, so one Islamic solution is to have passive partners contracted for a certain share of the profits, with another share going to the entrepreneurs who manage the business. This solution meets the concept of partnership as required by doctrine, yet at the same time it functions in a similar way to a conventional preferred-shareholder contract. And if the

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<sup>55</sup>“Govt encouraging Islamic banking in country”, *The Nation* (www.nation.com.pk) 8 November 2002.

<sup>56</sup>Cited in Useem, Jerry, 2002, op cit.

business does not want to dilute its ownership by bringing in partners, other options exist, such as leasing. A lease does not involve formal interest or a partnership stake, yet satisfies the business' need for long-term financing of plant and equipment and the investor's need to earn a fair return.

- Inventory financing is another requirement common to both Islamic and conventional commerce. An Islamic business in need of short-term inventory financing can purchase the inventory on credit, that credit being supplied either by the inventory supplier or a bank. The bank can purchase the inventory for the business based on the business's promise to buy the inventory later for cost plus a fair markup.
- Many businesses find it necessary to supply credit to their customers through accounts receivable. An Islamic business can do this but is not permitted — as in conventional finance — to refinance by pledging or selling those receivables because they are not real assets. Under Islamic law, financial assets cannot be sold or used as collateral, so an Islamic business either has to finance its credit extensions from internally generated funds or arrange for a third party to buy the goods on behalf of its customers and resell them to those customers with a markup — just as the Islamic business would finance its own purchases from suppliers.

These are some of the simpler Islamic alternatives to conventional finance. To the outsider, some of these arrangements may seem to be no more than elaborate subterfuges for conventional financial transactions. This conclusion, however, would ignore a number of important subtleties with respect to intentions, the detailed legal incidents of the various transactions, the religious and secular constraints on banking practices, and the limited number of financial contracts currently available to practitioners of Islamic finance.

### 4.3 What Investment Products are Permissible under Islamic Shari'ah Law

Turning our attention to the range of Shari'ah-compliant financial instruments that are available in global markets today, it is clear that interest-based securities (e.g. bonds, bank deposits, etc.) are not acceptable since these securities provide returns that are pre-determined and unrelated to the underlying performance of the asset that is generating the returns. On the other hand, by the same logic, equity securities (shares) are considered permissible by a consensus of contemporary Muslim scholars, including the Islamic Fiqh Academy,<sup>57</sup> because the profits an investor makes on equity securities are tied to the returns of the underlying company and hence are risk-related. However, in recognition of the sensitivity of the subject, it is recommended that Muslim investors place their money in Islamic mutual funds that are professionally managed and have the added guarantee of a qualified Shari'ah Supervisory Board.

Investment in a common stock of companies engaged in permissible activities is also allowed under Shari'ah law, though preferred stocks are prohibited in Islam since they guarantee to holders the amounts paid out as dividends to holders of preferred stock. Also permissible for investment are mutual funds whose holdings consist of shares in companies

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<sup>57</sup>The Islamic Fiqh Academy (IFA) is a subsidiary organ of the Organisation of the Islamic Conference (OIC), created by the Third Islamic Summit Conference held in Makkah al-Mukarramah (Saudi Arabia) in Rabiul Awwal 1401 H (January 1981). It is based in Jeddah (Saudi Arabia). Its members and experts are selected from among the best scholars and thinkers available in the Islamic world and Muslim minorities in non-Muslim countries, in every field of knowledge (Islamic Fiqh, science, medicine, economy and culture, etc.).

complying with Islamic screening criteria, both qualitative (permissible activities) and quantitative (financial ratios).

#### 4.4 Shari'ah Investment Principles

When it comes to deciding where to place one's investments, the first set of filters is quite straightforward: exclude all companies whose primary business involves forbidden products (e.g. alcohol, pork, tobacco, financial services, weapon production, and entertainment).<sup>58</sup> The second set of filters, which are based on financial ratios, is a lot more complicated, not to say anomalous. They relate to making certain compromises on three prohibitions, namely, carrying interest-bearing debt, receiving interest or some other form of impure income, and trading in debts at a price other than their face values.

The rules recently adopted by the Dow Jones Islamic Index (DJII) board are as follows:

- Exclude companies with a debt-to-total-asset ratio of 33 per cent or more.
- Exclude companies with "impure-plus-non-operating-interest income" to a revenue ratio of 5 per cent or more.
- Exclude companies with accounts receivable to a total assets ratio of 45 per cent or more.

The first compromise is based rather loosely on a famous *hadith* where Abu Bark asked the Prophet how much of his wealth to give in charity, and the Prophet said: "One third, and one third is plenty". This is clearly an out-of-context application of the *hadith*, and jurists do not claim that it is used as a legal proof, but rather as a comforting rule of thumb.

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<sup>58</sup>A typical screen given by the Dow Jones Islamic Index (DJII) Shari'ah board can be found on the web ([www.dowjones.com/corp/index\\_products.htm](http://www.dowjones.com/corp/index_products.htm)).

The second compromise assumes that 5 per cent is a negligible amount, though no sources have been found, so far, which mention the origin of this ruling.<sup>59</sup> The third compromise is based on the view that if the majority of the company's assets are illiquid, then the total assets may inherit the status of that majority.<sup>60</sup>

These Dow Jones rulings are virtually identical to those advocated in earlier years by the Shari'ah boards of fund management companies in Islamic countries. They are also much the same as the guidelines used by other equity indices, such as the FTSE Global Islamic Index Series (GIIS). Initially pioneered in January 1999 by The International Investor (TII) and calculated by FTSE, the FTSE GIIS was the first truly global Islamic index series. It was designed to track the performance of leading publicly traded companies whose activities are consistent with Islamic Shari'ah principles. In the same year, 1999, the GIIS was incorporated into the FTSE family of indices. Using the FTSE World Index as the universe, TII applies Shari'ah principles, following guidelines provided by its Fatwa and Shari'ah Supervisory Committee to rule out those companies whose business activities are incompatible with the Islamic law.<sup>61</sup>

#### **4.5 Equity-Financing and Debt-Financing in Pre-Islamic Arab Society**

Having laid out the basic principles for Shari'ah-compliant investment, one can now turn our attention to the actual financing of investment and debt through Islamic financial instruments. Effective risk-management in Islamic finance deserves

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<sup>59</sup>"Permissible investment vehicles", [www.wponline.org](http://www.wponline.org), 16 September 2002.

<sup>60</sup>Cf. Usmani M. Taqi, *An Introduction to Islamic Finance*, 1998, pp. 208 and 210.

<sup>61</sup>The International Investor ([www.tii.com/services.indices.html](http://www.tii.com/services.indices.html)).

priority attention, but it entails many complex issues, including income recognition, adequacy of collateral and disclosure standards, which need to be better understood if they are to be successfully addressed. In order to do so, one must go back to the very beginning of Islamic financial institutions, for Islamic banking can only be properly understood in terms of its historical origins.

In every society, Islamic or non-Islamic, traditional or modern, business ventures are financed either by the proprietor's own capital or else by borrowing money. Today's banking and financial system, and the facilities and services that it provides, have evolved largely to address the need for financing by others' capital.

There are two types of financing from others' capital, namely equity-financing and debt-financing. In the particular case of Islamic banking, the relevant question here is what is the stand of Shari'ah with regard to these two types of financing? Looking back to the pre-Islamic era, long before the advent of Islam, the Arabian Peninsula was already a thriving trading community where Arab traders already practised both equity-financing and debt-financing. Equity-financing was effected through two basic types of contract (*uqud al-ishtirak*), namely trustee profit-sharing (*al-mudharabah*) and joint-venture profit-sharing (*al-musharakah*). Debt-financing was similarly effected through two types of contract, in this instance, deferred contracts of exchange and *riba*-based lending. Since *riba* is synonymous with modern-day interest, one can refer to the latter category as interest-based lending.

The first type of Arab debt-financing in the pre-Islamic period — deferred contracts of exchange (*al-bai*, *al-tijarah* and *al-dayn*) — can be looked at in the following way. A contract of exchange takes place when a commodity or service is exchanged for another commodity or for money. In commercial dealings, contracts of exchange arise in sale-and-purchase

contracts and leasing contracts. The contractual relationship is therefore of the category of seller-buyer or lessor-lessee. Contracts of exchange may either be transacted through immediate cash payments or else deferred. When the settlement from one side of the contract — such as payment in money — is deferred or delayed, the contract becomes a deferred contract of exchange. A deferred contract of exchange is therefore akin to a credit sale-and-purchase. Moreover a deferred contract creates a debt and in this respect features as a debt-financing instrument.

In the pre-Islamic period, there were five basic types of deferred contract exchanges in the Arab financial world:

- (i) Deferred instalment sales (*al-bai bithaman ajil*)
- (ii) Deferred lump-sum sales (*bai al-murabaha*, also spelled as *murabahah*)
- (iii) Leasing (*al-ijara*)
- (iv) *Salam* sales (*bai al-salam*, also known as *bei salam*, meaning project or capital financing)
- (v) Manufacture sale (*bai al-istisna'*)<sup>62</sup>

The second category of debt-financing in the pre-Islamic period was based, not on a contract of exchange, but involved, instead, interest-based lending (*riba al-nasiah*) (in modern terms, money lending). The contractual relationship here was that of debtor-creditor. At the point of lending, the lender lends the money to the borrower. At the point of repayment, the borrower repays the lender the principal amount of money lent, plus an “additional” in the form of interest. Interest-based lending naturally creates a debt, and is therefore a debt-financing instrument.

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<sup>62</sup>Refers to an order made by a purchaser to a manufacturer to produce goods according to description given of an agreed price and on the basis of an agreed mode of payment.

#### 4.6 Islamic Equity-Financing and Debt-Financing

With the advent of Islam, Shari'ah law, guided by its primary sources of the Quran and the *Sunnah*, laid down various injunctions that would subsequently form the basis of Islamic banking and finance. With regard to equity-financing, a very notable feature of the Shari'ah is the fact that the Quran does not deal directly with this issue at all; it was left to the *Sunnah* to clarify matters. The *Sunnah* simply affirmed that the *uqud al-ishtirak* (profit-sharing contracts) of *al-mudharabah*, *al-musharakah* and other similar contracts, which had been practiced by the pre-Islamic Arab world, were all allowed, being designated *jaiz* or *mubah* ("indifferent") in relation to Islam.

While the Quran is silent on equity-financing, it comes out strongly on debt-financing, as does the *Sunnah*, which also deals extensively with the subject. In essence, although interest-based lending is forbidden (*haram*) by Islam, deferred contracts of exchange are permitted (*jaiz* or *mubah*). In other words, lending is allowed in Islam, but it has to be without interest. Under Shari'ah law, this type of lending is known as a "benevolent loan" (*al-qard al-hasan*) and it therefore has more relevance in relation to the social-welfare economy, or where there are social ramifications to a transaction as in the case of contracts involving the government, rather than in the private or commercial sectors.

Clearly, debt-financing is one area where there are major differences between Islamic finance and the conventional financial system. Whereas debt-financing in conventional finance is almost entirely built upon interest-based lending, this type of contract is expressly forbidden (*haram*) under Islamic law. Conversely, the Islamic debt-financing instruments of deferred contracts of exchange are not generally known in the conventional financial world. Nevertheless, there are still some similarities between the two systems, even when

it comes to debt-financing. The contract of *al-ijara* (leasing), for example, is also employed in conventional debt-financing; likewise, the contract of *bai' al-murabaha* (deferred lump-sum sale), which is practised in credit sale-and-purchase transactions in both Islamic and conventional marketplaces.

#### 4.7 Equity Securities: Profit-Sharing Contracts

As Islamic banking prohibits conventional loan-taking to finance business interests, there are two ways in which one can obtain project financing the *halah* way.

(i) *Al-Mudarabah* (trustee profit-sharing)

A bank may undertake to finance acceptable projects according to the principle of *al-mudarabah*. Here the bank acts as the “provider of capital” and will offer 100 per cent financing for the relevant project, whilst the initiator of the project is the “entrepreneur” who will manage the project. The bank cannot interfere in the management of the project, but has the right to undertake the follow-up and supervision task. In these circumstances, both parties will agree, through negotiation, on the ratio of the distribution of the profits generated from the project, if any; in the event of the project making a loss, then the bank bears all the losses.

*Mudarabah* is the closest classical analogy to the modern relationship between stockholders and bank management. However, the analogy is not perfect. For example, if management corresponds to the *mudarib*, or trustee, and stockholders to capital investors, then *mudarabah* rules would dictate that both be compensated with a share of profits. But if the manager is merely an employee of the bank, who then is the *mudarib* and who is entitled to a share in the profits? The problems arising from such

interpretations have been considered mere practical problems, not moral or religious ones, and are therefore easily surmounted. Scholars seem to conclude that the old rules of partnership should be consulted only in broad essentials.<sup>63</sup> In other words, as Vogel has indicated, the modern company is accepted as a new type of contractual relationship, which owes deference only to the basic principles of Islamic partnership law, not to its every detail.<sup>64</sup>

(ii) *Al-Musharakah* (joint-venture profit-sharing)

Alternatively, a bank may undertake to finance acceptable projects according to the principle of *al-musharakah*. In this instance, the bank, together with the initiator or initiators of the relevant project, will provide the equity-financing for the project in agreed proportions. All parties, including the bank, have the right to participate in the management of the project, but equally, all parties have the option to waive such right. All parties agree through negotiation on the ratio of distribution of the profits generated from the project, if any. This ratio need not coincide with the ratio of participation in the financing of the project. In the event of a loss in the project, all parties bear the loss in proportion to their share in the financing.

In all modern forms of *musharakah*, the partners have equal rights. In the case of limited companies and cooperative societies, the shareholders delegate their powers (rights in respect of administration, etc.) to some amongst them to be called directors or some other appropriate title. In a partnership concern, the partners, by a mutual agreement, distribute amongst themselves their

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<sup>63</sup>See 'Ali al-Khafif, *al-Sharikat fi al-fiqh al-islami* (Cairo: Arab League, 1962); 'Abd al-'Aziz al-Khayyat, *al-Sharikat* (Beirut: Risala, 1984); and Mustafa al-Zaraq, *Madkhal*, 3:256–287.

<sup>64</sup>See Vogel and Hayes, *op cit*, p. 133.

responsibilities, duties and jobs. These arrangements are valid being identified as *'urf*, that is to say, customary practices of the business community.

A distinguishing feature of modern *musharakah* partnerships (the partnership aside) is the limited liability of the shareholders. They cannot be held liable for more than the amount of capital they have invested. This requirement makes it necessary to regard the *musharakah* as an entity separate from the individuality of the shareholders. This common *'urf* has given way to safe and stable *musharakah*, resulting in big commercial organisations and flourishing business.<sup>65</sup>

In the real-world, project financing may involve a combination of *mudarabah* and *musharakah* partnerships, where all partners contribute to the capital but not necessarily to the entrepreneurship and management as well. In such instances, profits need not be shared in accordance with capital contributions. They may be shared in any proportion agreed to by the partners, depending on their contribution to the success and profitability of the business.

#### 4.8 Debt-Financing Contracts

As we have seen, conventional, interest-based banking methods of debt-financing are unacceptable in Islamic banking, but there are several other financial tools which enable debt-financing to be implemented. Vogel's analysis shows the following:

- (i) *Al-Bai Bithaman Ajil* (financing the acquisition of assets through deferred installment sales)

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<sup>65</sup>See Irfani, A.M., *Musharakah and its Modern Applications*, Islamabad, December 1984.

A bank may finance customers who wish to acquire a given asset but to defer payment for a specific period, or to pay by installments under the principle of *al-bai bithaman ajil*. In such cases, the bank will first determine the requirements of the customer in relation to his period and manner of repayment. The bank will then purchase the asset concerned. Subsequently, the bank sells the relevant asset to the customer at an agreed price, which comprises the actual cost of the asset to the bank, and the bank's margin or profit. The agreement will allow the customer to settle the payment by installments within the period and in the manner agreed.

- (ii) *Al-Ijara* (financing the use of services of an asset through leasing)

Alternatively, a bank may finance its customers to acquire the right to use the services of a given asset under the principle of *al-ijara*. In this instance, the bank first purchases the asset required by the customer. Subsequently, the bank leases the asset to the customer for a fixed period, the lease arrangements and other terms and conditions being agreed to by both parties.

As far as the actual lease agreement is concerned, Islamic laws of leasing pose three sets of problems for modern Islamic finance, all arising from *riba* and *gharar* principles. The first set of problems concerns restrictions on the right of parties to fix the nature of the right sold — the usufruct — under the terms of their agreement. Islamic law understands the usufruct largely as a creature of contract, since only by the *ijara* contract does the usufruct become fixed and known (for example, for how many years does the usufruct continue?). Even so, the law does not give the parties total freedom in this respect. It views some benefits and burdens of the property as belonging naturally and unchangeably to the lessee, and others as belonging to the lessor.

The second set of problems arises from the fact that the usufruct of property is not something extant and tangible, but a stream of use extending into the future, which therefore makes it inherently risky and unstable (*gharar*). What if future events reduce the value of the usufruct to the lessee? Cautious in this issue, Islamic law gives broad scope to the lessee to cancel the lease if events should cause the usufruct to be less valuable to him than expected.

A third set of problems concerns the various types of future sale and option terms that conventional financial leases use to dispose of the residual value of the leased goods at the end of the lease term. Under Islamic law, such terms are invalid as uncertainty, risk and speculation are all prohibited by the Quran.

In the event, Islamic financial practice seems to have sidestepped all three groups of problems. As regards problems of damage or destruction of the leased property, many Islamic leases simply adopt the conventional financial lease provision that the lessee remains liable even in the event of the property's total destruction. Other Islamic lease agreements — for example, those of the Islamic Development Bank — pay heed to Islamic law, acknowledging the lessee's right to cancel in such an event, but often impose on the lessee the obligation to buy casualty insurance naming the lessor as the beneficiary. As regards the second problematic area, namely a lessee's right to rescind due to diminished benefit from the usufruct, the present practice seems simply to ignore the problem, allowing lessees to avoid the lease only for conventional legal reasons such as *force majeure* or a breach of contract or warranty.<sup>66</sup> Finally, on the third issue, namely the

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<sup>66</sup>*Force majeure* is a legal term which means that some important and critical event has occurred, as a result, releasing the person directly affected from his or her legal obligations in a particular matter that would otherwise have applied.

unenforceability of terms in lease disposing of the future residual value by options or sales, the solution in practice seems to be to include such terms in the leases, even if unenforceable Islamically, in the expectation that incentives other than the Islamic law will cause the promisor to uphold them.<sup>67</sup>

(iii) *Al-Ujr* (fee-based syndication services)

It should briefly be mentioned here that the above facilities may be organised on a syndication basis, for a fee, if the financial requirements are beyond the capability of a single bank or if it is desirable to spread the risk. Similar syndication services also apply to trade finance facilities.

(iv) *Al-Murabaha* (letters of credit: deferred lump-sum sales or cost plus)

In this instance, the customer informs the bank of his letter of credit requirements and requests the bank to purchase or import the required goods, indicating thereby that he would be willing to purchase the goods from the bank on their arrival on the principal of *al-murabaha*. The bank establishes the letter of credit and pays the proceeds to the negotiating bank utilising its own funds. The bank then sells the goods to the customer at a sale price comprising its cost and a profit margin under the principal of *al-murabaha* for settlement on a deferred term.

(v) *Al-Murabaha* (financing working capital: deferred lump-sum sales or cost plus)

Here, the customer may approach the bank to provide financing for his working capital requirements in order to purchase stocks and inventories, spares and replacements, or semi-finished goods and raw materials. In this instance, the bank first purchases the desired items, or

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<sup>67</sup>See Vogel and Hayes, *op cit*, pp. 144–145.

else appoints the customer as its agent to purchase the required goods on its behalf, and then settles the purchase price from its own funds. The bank subsequently sells the goods to the customer at an agreed price comprising its purchase price and a profit margin, and allows the customer to settle this sale price on a deferred term of thirty, sixty, ninety days or any other period as the case may be. On the due date, the customer pays the bank the agreed sale price.<sup>68</sup>

This kind of transaction has many advantages. First, although in ordinary circumstances no bank engages in trading in goods, finding this enterprise too risky and distracting, this commissioned *murabaha* enables the bank to avoid the drawbacks normally associated with trading in that a purchase is never made unless the bank already has an assured buyer who, moreover, informs the bank how to obtain the goods desired. Secondly, while the bank's profit (the markup) conceivably derives in part from its services in securing the goods through the first sale, it is far more likely — especially in the present day — to derive from the extension of credit in the second sale. To the extent that the bank's services in carrying out the two sales and the costs and risks of its interim ownership can be minimised, the transaction becomes economically very similar to a conventional commercial loan.<sup>69</sup>

- (vi) *Salam* (financing the acquisition of assets in the future: forward purchase)

The contract of *salam* — the forward purchase of generically described goods for full advance payment — has important potential as an Islamic financing device,

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<sup>68</sup>Ismail, Abdul Halim HJ., *Overview of Islamic Banking*, 2001.

<sup>69</sup>Vogel and Hayes, *op cit*, pp. 140–141.

particularly in relation to agricultural produce, but it is not yet used extensively. However, three major problems reduce the *salam* contract's value as a financing vehicle. The first is the risk of default by the seller, made more severe by the fact of repayment. A partial solution is to obtain some form of security from the seller, whether it be a pledge or a guarantee.<sup>70</sup> The second problem is the bank's need to liquidate the goods after delivery, an inconvenience made more serious by the Islamic legal rule that a *salam* buyer cannot sell the expected goods before actually taking possession of them.<sup>71</sup> To address this problem, the idea has surfaced of a "parallel" or "back-to-back" *salam*. Here, after buying goods of a certain description from a seller and paying the full purchase price (*salam* sale 1), but before the seller is due to deliver on that contract, the bank, in a separate and formally unconnected *salam* contract (*salam* sale 2), sells goods of exactly the same description and with the same due date to a third party, receiving full advance payment from that buyer. The net result is that the bank has reserved its position, fixed the profits it will earn from the two trades, and has an assured purchaser for its goods. Reportedly, classical authors have mentioned this transaction without disapproval.

The third problem affecting the *salam* contract's utility as a financing vehicle is that according to most scholars, Islamic law requires that if at the time of delivery the seller can neither produce the goods nor obtain them elsewhere, the buyer has only two choices: either withdraw his offer, or wait for the goods to become available later, with no

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<sup>70</sup>This is allowed by most, but not all, scholars. See Ibn Qudama, 4:347–352.

<sup>71</sup>See decision 65/1/d7, *Fiqh Academy Journal* 1 (1992): 711, 716. Ibn Rushd, *Bi-dayat*, 2:205–207; Ibn Qudama, 4:343–344; Bahuti, 3:306–307. Under the Maliki school, the buyer may sell his expectation of the goods back to the original seller or to another, as long as the purchased goods are not food. See Ibn Rushd, *supra*.

compensation permitted for the delay. In either case, the buyer loses all or much of the profit from the use of his money.

#### 4.9 Debt Securities

Islamic debt securities are debt-based financial instruments. It is therefore pertinent to recall that Islam allows, *inter alia*, the following methods of debt-financing:

##### (i) Deferred Contracts of Exchange

- *Al-bai bithaman ajil* (deferred sales) — this is usually applied for medium and long-term financing with periodic installment payments.
- *Bai al-murabaha* (deferred sales) — this is usually applied for short-term (trade) financing with lump-sum payments.
- *Al-ijara* (leasing) — this is usually a financial-lease type of contract applied for leasing of assets with periodic lease rental payments and ending with sale of the assets at nominal price.

##### (ii) Loans

- *Al-qardh al-hasan* (benevolent loans) — these are loans which are returned at the end of an agreed period without any interest or share in the profit or loss of the business. Therefore, it is a kind of gratuitous loan given to the needy people for a fixed period without requiring the payment of interest or profit. The receiver of *qard al-hasan* is only required to repay the original amount of the loan.

##### (iii) Refinancing of Assets

- *Bai al-inah* — here the owner of the assets requiring financing first sells the assets to the financing party for cash. Subsequently, he buys back the assets under a deferred sale contract.

In essence, the creation and structuring of the Islamic debt securities is as follows: a debt-financing contract is concluded; the provider of financing, to whom the debt obligations are due, securitises the debt in accordance with the relevant regulations and guidelines; the debt instruments are sold down and traded in secondary markets. Trading of the debt instruments is undertaken in the secondary markets under the concept of *bai al-dayn* (debt trading). The price of the debt instruments struck by the buyer and seller in any particular transaction is left to be determined by the market forces of supply and demand for funds.

#### 4.10 Shari'ah Qualifications in Leasing

Not all lease contracts qualify as contracts of *ijara* as defined by Shari'ah and the differences between typical lease contracts and those constituting *ijara* must be taken into account. For example, in a typical equipment lease, the risk of loss or damage to the equipment is usually shifted from the lessor to the lessee and the lessee is required to take out insurance to cover this risk. In contracts of *ijara*, by contrast, Shari'ah boards and other regulatory institutions generally require that the lessor must retain the risk of loss or damage of the equipment. Similarly, whereas in most equipment leases the obligation to maintain the equipment is shifted to the lessee, in contracts of *ijara*, the maintenance obligation is generally retained by the lessor.

In structuring a lease programme, contract arrangements must be developed to bridge these disparities between Islamic and conventional types of leases. For example, it may be possible to arrange lease-servicing contracts whereby the lease servicer agrees to maintain the equipment, repair any damage and replace lost equipment. Here the lessor retains the ultimate liability, not the lessee, but the lease servicer (a party that should be capable of bearing these risks) gives support to the lessor.

It generally seems to be the case that *ijara* contracts, as an Islamic investment vehicle, are becoming an integral part of the rapid expansion of Islamic financial products and a major investment tool offered by Islamic financial institutions. Indeed, one cannot foresee a portfolio of an Islamic financial institution that will not include *ijara* — they will be sought by Islamic institutions as part of their diversification strategy, along side *murabaha*, which is similar to any fixed-interest financing such as a car loan, equity and real estate. Market demand is bound to cause the growth of *ijara* contracts.

#### 4.11 Other Risk-Taking Products

What other financial instruments can substitute for Islamically forbidden interest-bearing debt instruments? The most notable effort has been the so-called *muqarada* bond, which resembles a revenue bond. “*Muqarada* bonds” are bonds where the proceeds are to be used for income-yielding public utility projects such as the construction of bridges and roads. Investors who buy *muqarada* bonds take a share of the profits of the project being financed, but also share the risk of unexpectedly low profits, or even losses. They have no say in the management of the project, but act as non-voting shareholders. Then there is a financial arrangement known as *qirad* (which is sometimes also called *mudarabah*), whereby the financier gets a share in the output, as similar to the case of *muqarada* bonds.<sup>72</sup>

#### 4.12 Islamic Insurance

One of the most obvious situations where there is a conflict between Shari’ah law and conventional financial institutions is in the case of insurance policies; here the concept of *gharar* has led to the condemnation of some or all types of insurance

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<sup>72</sup>Ariff, Mohammed, “Islamic banking references”, [www.islamicity.com/finance/IslamicBanking\\_References.htm](http://www.islamicity.com/finance/IslamicBanking_References.htm).

by Muslim scholars, since insurance involves an unknown risk. This has led to the development of *takaful* (co-operative) insurance in some Muslim countries. *Takaful* is an Arabic word meaning mutual help and cooperation and dates back to the early days of Islam. Traditionally it referred to relationships between family groups, villages or mosques, but in a modern context it is used to refer to the kind of services offered by an insurance company. Used in this way, the term *takaful* refers to a pact or practice among a group of members, called participants, who agree to jointly guarantee themselves against any loss or damage that may fall upon any of them as defined in the pact. In the event of any member, or participant, suffering a loss due to the defined mishap or disaster, he or she would receive a certain sum of money or financial benefit from a fund as defined under the terms of the pact to help meet or mitigate that loss. In short, the basic objective of *takaful* is to pay for a defined loss out of a defined fund. The loss will not be transferred as a liability to any intermediary as the operation does not fall under the contract of buying and selling whereby the seller would normally agree to provide the guarantee.

Clearly, the way today's so-called *takaful* companies operate, with administrative buildings and officers especially appointed to carry out the job, etc., is a long way removed from the traditional workings of *takaful* and as the world progresses, *takaful* transactions have been increasingly modernised and brought up to date. Today's Shari'ah-compliant *takaful* insurance schemes are guided by the following rules:

- (i) *Riba* is to be avoided. Interest is neither taken nor given. Investments are not made in interest-bearing bonds or other non-*halal* investments.
- (ii) No business participation is made in any commodity or activity prohibited by Shari'ah.

- (iii) The *takaful* contract attempts to determine the terms of the contract as clearly and definitely as possible in order to minimise ignorance and uncertainty.
- (iv) Business is conducted on the basis of a *mudarabah* partnership (see above).
- (v) There is no forfeiture of premiums if the policy lapses or is surrendered.
- (vi) A nominee cannot retain the benefit of the policy for his own use but receives it as an agent on behalf of his heirs.
- (vii) A Shari'ah advisory council oversees the operation of the scheme and advises on Shari'ah law.
- (viii) The company pays *zakat* (obligatory payment to the poor and needy) on its profits.<sup>73</sup>

#### 4.13 *Takaful* Insurance in a Contemporary Context

The world has defined *takaful* insurance transactions as a competitive product. The first Islamic insurance company, known simply as the Islamic Insurance Co. Ltd, was established in Sudan in 1979. This company was able to distribute profits to its shareholders at the rate of 5 per cent in 1979, 8 per cent in 1980 and 10 per cent in 1981. Following the success of the Insurance Company in Sudan, other Islamic insurance (*takaful*) companies were established in Islamic and in non-Islamic countries. They included:

- Islamic Arab Insurance Co. Ltd, Jeddah (1979)
- Dar Al-Mal Al-Islami, Geneva (1979)
- Dar Al-Mal Al-Islami (DMI), Switzerland (1979)
- Islamic Takaful Co., Luxembourg (1983)
- Islamic Takaful, Bahrain (1983)
- Islamic Takaful and Re-Takaful, Bahamas (1983)

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<sup>73</sup>Hussain, Jamila, *Islamic Law and Society*, 1999, p. 191.

- Bait Al-Tamwil, Turkey (1986)
- USA Takaful, United States of America (1990)
- IBB Takaful, Brunei (1995)
- Islamic Takaful Company, (ITC) London

#### 4.14 *Takaful* Compared with Conventional Insurance

*Takaful* companies take those aspects of insurance that are not considered *halal* in Shari'ah law and adjust them so that they can fulfil the conventional role of insurance whilst at the same time being in accordance with Islamic law.<sup>74</sup> The common features shared by *takaful*-style insurance schemes and conventional insurance is that both feature specified maturity periods whereby the sum that is insured is paid to the policy holder, if he survives, or else benefits are paid to his beneficiaries in the event of his premature death. The calculation of premium is done by actuaries taking the same factors into account. In the case of *takaful*, the *tabarru'*<sup>75</sup> portion is calculated by actuaries who take the same principles into account as in conventional insurance.

The distinguishing features of family *takaful*<sup>76</sup> are that there is no element of forfeiture, no non-profit policies and the contribution/installment is the same since there is no policy which does not share profits. The profit-sharing ratio is clearly

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<sup>74</sup>Rashid, Syed Khalid, "Insurance and Muslims", paper presented at IIU Malaysia on 13 October 1992, quoting Siddiqi, *Insurance in an Islamic Economy*, 1985.

<sup>75</sup>This means "donation; gift; contribution". This one word apparently actually Islamises the insurance contract by removing most of the objectionable elements. This is actually the fundamental difference between insurance that is Shari'ah compliant (*takaful*) and conventional insurance.

<sup>76</sup>This aim of family *takaful* is similar to that of conventional life insurance, which is to provide for the surviving family members in the event of the death of the policyholder.

stated in *mudarabah* contract and the method of determining profit is clearly known to both parties. Profit is calculated and credited monthly at the annual rate of profit. The insured are regarded as participants and the company does not engage in practices or investments which are disallowed by Shari'ah. In the case of conventional insurance, however, forfeiture usually follows within three years if premiums cease; there are both profit and non-profit forms; premiums are high for part policies; policy holders may not know how profits are determined and what proportion they may receive; the interval of determining the bonus is not known; and the insured are clients, not regarded as participants.<sup>77</sup>

#### 4.15 Summary

It has been seen that the essential feature of Islamic banking is that it is interest-free. Although it is often claimed that there is more to Islamic banking, such as contributions towards a more equitable distribution of income and wealth and an increased equity participation in the economy,<sup>78</sup> Islamic banking as a financial institution nevertheless derives its specific rationale from the fact that there is no place for the concept of interest in the Islamic order.<sup>79</sup>

Whilst interest-bearing debt instruments are prohibited in Islam, there are some Islamic contracts which result in debt. They include *istisna'*, *murabaha*, and *ijara* financing. However,

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<sup>77</sup>Hussain, *op cit*, pp. 192–193.

<sup>78</sup>Chapra, M. Umer, "Money and banking in an Islamic economy". In M. Ariff (ed.), *Monetary Policy in an Interest-free Islamic Economy — Nature and Scope*. Monetary and Fiscal Economics of Islam, International Centre for Research in Islamic Economics, Jeddah, 1982.

<sup>79</sup>Ariff, Mohamed, "Islamic banking", *Asian-Pacific Economic Literature*, Vol. 2, No. 2, September 1988, pp. 46–62.

there are no effective derivatives of Islamic debt contracts which replicate conventional risk-hedging and leveraging contracts such as swaps, futures and options.

Similarly, in the equity security sector, there are no risk-hedging or leveraging contracts in Islamic finance that truly compare with available conventional derivatives. Only recently have favourable Shari'ah rulings made it acceptable to trade equity shares in the secondary market. Previously they had been classified as financial instruments in the primary market where the proceeds of the sale goes to the issuer and were therefore ineligible to be bought and sold. Now a number of Islamic scholars classify them as specific claims on real assets, thus making secondary market trading in them acceptable. This is at least a start towards the future formulation of equity derivatives that are acceptable in the Islamic world.

With respect to commodities and other goods, the *salam* contract is an imperfect Islamic substitute for a conventional forward contract. The related *istisna'* contract for goods being manufactured for a buyer provides another partial Islamic proxy for a forward contract. It is even possible to construct an Islamic contract that partially replicates a conventional futures contract, via back-to-back *salam* contracts.

Third-party guarantees do provide some risk protection in an Islamic context, and one of the characteristics of the *mudaraba* contract provides a *de facto* call option for *mudaribs* who are party to these substitute for a Western call option, but it has a number of qualifications that limit its use in many real-life situations. Conventional financial markets provide ample means — in terms of options — for managing risks such as deterioration in quality or another party's outright default, but in Islamic finance, where default remedies are limited by religious principles (e.g. no interest or penalty can be charged subsequently to a default), the only way to protect against credit risk is a third-party guarantee against such a default.

Currency markets in the West are among the most sophisticated of all financial markets, with a myriad of derivatives to handle all sorts of risk dimensions. Unfortunately, currency is not considered a real asset in Islam and hence there are no generally accepted proxy derivatives in this market to deal with foreign exchange risk.<sup>80</sup>

In Vogel's opinion, there is clearly a need for a modification of existing Islamic financial contracts which could meet at least some of the needs of both investors and capital users in the Islamic sector.<sup>81</sup> And even if useful Islamic financial instruments are devised, and their capacity to be traded assured, problems will remain concerning the shape and function of a market in which these instruments can be traded. Since Islamic institutions and investors are already trading on the conventional markets, why should they not either continue to use conventional markets or set up new ones modelled after them? The reason seems to be that use of these markets is just a measure forced on the industry while it awaits Islamically correct markets of adequate volume to emerge. Establishing such markets is made all the more daunting by the need for the government to cooperate by passing the extensive supportive legislation and regulation required to establish a securities market.<sup>82</sup>

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<sup>80</sup>However, there are transactions between two countries where the poorer country's central bank guarantees the value of its currency but does not assume any other liability in terms of the traded good. It is considered Islamically acceptable for an intermediary to buy the goods at a fixed price from one country in that country's currency and then sell it to another country for a fixed price in its own currency, thereby assuming the intermediate ownership of the traded good and shouldering the currency exposure as well.

<sup>81</sup>See Vogel and Hayes, *op cit*, pp. 231–232.

<sup>82</sup>Vogel and Hayes, *op cit*, p. 178.