

I

Introduction

In his *Address to the Nobility of the German Nation* in 1520, Martin Luther wrote:

A cobbler, a smith, a peasant, every man, has the office and function of his calling, and yet all alike are consecrated priests and bishops, and every man should by his office or function be useful and beneficial to the rest, so that various kinds of work may all be united for the furtherance of body and soul, just as the members of the body all serve one another.¹

A cobbler was said to have asked Luther how he could serve God within his trade of shoe making. Luther's answer was not that the cobbler should sell a "Christian shoe," but rather that he should make a good shoe and sell it at a fair price.² Most interesting in Luther's quote is the similarity of his message to Sunni Islamic traditions, wherein – at least in theory – there are no distinct categories of clergy and laity, and wherein all righteous acts – including fair dealings in the marketplace – are considered important parts of religious life.³

The term "Islamic finance" brings to mind an analogy to the concept of a "Christian shoe," rather than to good products that are fairly priced. Indeed, we shall see that the primary emphasis in Islamic finance is not on efficiency and fair pricing. Rather, the emphasis is on contract mechanics and certification of Islamicity by "Shari'a Supervisory Boards." To the extent that "Islamic" financial products also cost more than the conventional products that they seek to replace – partly because of relative inefficiency, and partly to cover otherwise unnecessary jurist and lawyer fees – one may make partial analogies between those certifications and the European pre-Reformation practice of selling indulgence certificates. Thus, quoting Luther at the outset seems doubly appropriate, since he was simultaneously driven to oppose religious peddling through the sale of indulgences as well as usurious practices camouflaged by the mechanics of legitimate business and finance.⁴

In fact, the expression "Islamic finance" suggests two competing forces at work. The noun "finance" suggests that Islamic financial markets and institutions deal

with the allocation of financial credit and risk. Thus, Islamic finance must be essentially similar to other forms of finance. On the other hand, the adjective “Islamic” suggests some fundamental differences between Islamic finance and its conventional counterpart. Observers of the theory and practice of Islamic finance sense this tension between attempts to be essentially similar to conventional finance (emphasizing competitiveness and efficiency) and attempts to preserve a distinctive Islamic character (emphasizing Arabic contract names and certification by religious scholars). We shall see in future chapters that this “Islamic” distinction often can be preserved only at a cost, and minimization of that cost – driven by competitive pressures – may render it a distinction of form without substance.

Finance without Interest?

Most readers encounter Islamic finance first through grossly simplistic statements such as “Islam (or the Qur’an) forbids interest.” This has given rise to countless jokes about “how one can get an Islamic interest-free mortgage loan.” Even relatively sophisticated journalists follow this process of false reductionism, followed by tongue-in-cheek qualifications. For instance, in a recent article in *Fortune* magazine, Useem (2002) reported on typical Islamic financing through credit sales, known by the Arabic name *murabaha*, the details of which we shall examine in some detail in Chapter 4. Reflecting on the transaction, he exclaimed:

The result looked a lot like interest, and some argue that *murabaha* is simply a thinly veiled version of it; the markup [bank’s name] charges is very close to the prevailing interest rate. But bank officials argue that God is in the details.

This tongue-in-cheek quotation of the statement that “God is in the details” may otherwise be viewed as offensive and condescending. However, it is surprisingly tolerated, and sometimes nurtured, within Islamic finance circles. It reflects the prevailing form-above-substance approach of that industry. Islamic financial forms are derived, albeit loosely, from classical sources of Islamic jurisprudence, which process of derivation gives the industry its “Islamic” label.

In fact, there are numerous instances wherein reporters begin by stating that the distinguishing feature of Islamic finance is the prohibition of interest and then proceed to report the interest rate that Islamic instruments pay. For instance, Reuters’ August 13, 2002, coverage of Bahrain’s \$800 million *sukuk* (the Arabic term for “Islamic bonds”) followed their characterization of Islamic financial products as “interest-free” with a report that those *sukuk* will pay “4 percent annual profit.” Customary explanations that the transaction is asset-based, or that what appears similar to interest is in fact profit in a sale or rent in a lease, can often leave the uninitiated reader more perplexed about the “interest-free” charac-

terization. To provide concrete understanding of the mechanics and justifications of Islamic finance, we now proceed to consider two examples of popular Islamic structures at the retail and investment banking levels.

Example 1: Home Mortgage Transaction

For the first example, we begin with a conventional mortgage transaction as conducted in many states in the United States. The main components of my mortgage loan transaction in the state of Texas are illustrated in Figure 1.1.

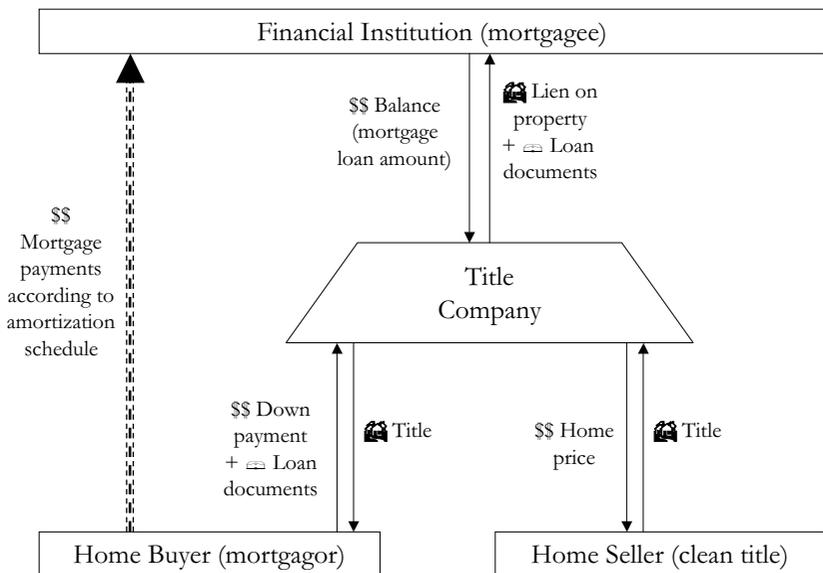


Fig. 1.1. Home Mortgage Transaction

The “closing” of this transaction took place at the title company offices. I brought a certified check for the amount of my down payment on the house (20 percent of the price plus closing costs), payable to the title company. The latter simultaneously collected the balance (80 percent) from my prospective mortgagee and subsequently issued a check to the seller for the sale price. I signed mortgage loan documents for the amount my mortgagee paid, promising to make mortgage payments according to the agreed-upon amortization schedule. I also had the option to prepay my balance, thus saving on financing charges, and obtaining clean title to the property at an earlier date, if I wished. In the meantime I received a title to the property, while my mortgagee obtained a lien thereon, thus restricting my ability to sell it without its permission.

The mechanics of this mortgage transaction are similar to numerous other forms of secured lending that evolved in modern times, made possible through searchable title databases that protect borrowers' and lenders' interests. Most Islamic jurists consider this transaction a form of forbidden *riba* (discussed in greater detail in Chapter 3), characterizing the various components of my mortgage as shown in Figure 1.2. According to this characterization, I borrowed a cer-

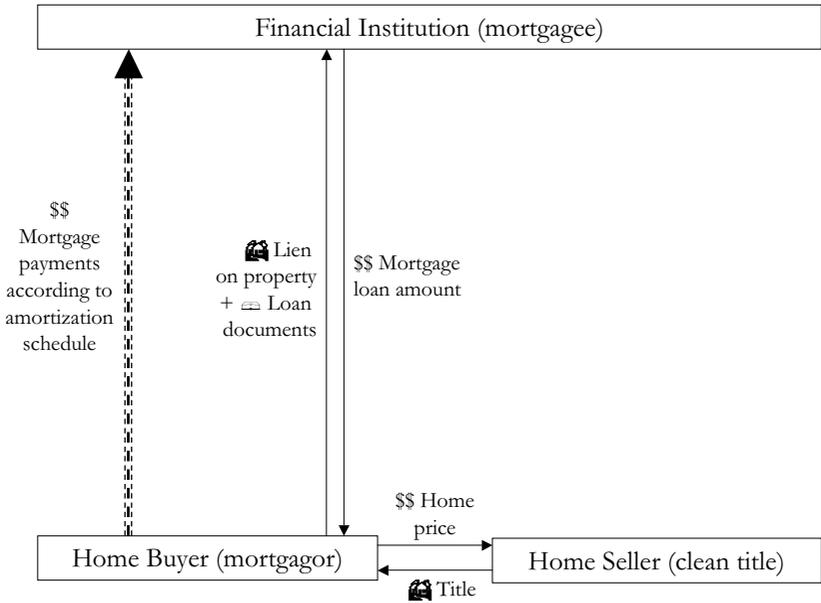


Fig. 1.2. Juristic Characterization of Mortgage Loan

tain amount of money from my mortgagee and promised to pay a larger amount of money in the future. This constitutes an interest-bearing loan of money, which the overwhelming majority of jurists (though not all) consider to be a form of the forbidden *riba*.⁵ Thus, by separating the loan from the sale contract for which it was intended, jurists equally condemn secured loans (such as mortgages) and unsecured loans (such as credit card balances).

One "Islamic" alternative that has been very popular in Islamic finance is the use of multiple sales in a *murabaha* transaction, as shown in Figure 1.3. In this transaction the eventual mortgagee must first purchase the property from the seller, obtaining title either directly or through a special-purpose vehicle (SPV). Then, the bank may turn around and sell the property on credit to the mortgagor, using amortization tables that are often calculated based on the same interest rate

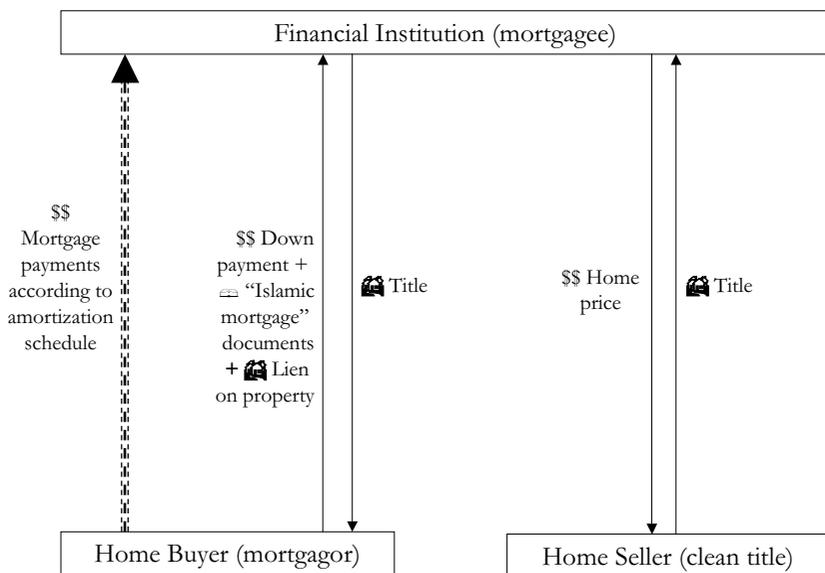


Fig. 1.3. *Murabaha* Alternative for Home Finance

used for conventional mortgages. One juristic difference, according to Islamic finance practitioners, is that the mortgagor in this case is involved in a credit sale contract, rather than a loan contract. In fact, because of requirements of some jurisdictions in the United States, and government-sponsored enterprises that assist with mortgage securitization, signed documents often contain terms such as "note," "loan," "borrower," and "interest." However, jurists have argued, the contract remains one of permissible trade rather than forbidden borrowing with interest. Depending on jurisdiction, the requirement of multiple sales, special-purpose vehicles, and documentations of title may add tax as well as legal costs. A second major difference to which jurists point is the peculiar structure that Islamic banks use for late payment penalties. We shall return to the basic secured lending transaction and its "Islamic alternative" in Chapter 4.

Example 2: Islamic Bond (Sukuk) Structure

For our second example, we consider a highly celebrated US\$100 million corporate Islamic bond (*sukuk*) issue by Tabreed Financing Corporation in March 2004. The corporate entity "Tabreed Financing Corporation" is a limited company SPV incorporated in the Cayman Islands for the purpose of issuing the

sukuk described here. The certificates issued by this SPV would act as an Islamic alternative to bond issues by the United Arab Emirates' National Central Cooling Company, nicknamed Tabreed (the Arabic word for "cooling"). The Shari'ah advisors characterized the bond structure that they approved as follows:⁶

i. Structure and Mechanism

We have reviewed the proposed structure and the transactions entered into in respect of the Sukuks, the principal features of which are as follows:

- 1.1 On a future date to be agreed between the parties, ... , the Issuer will declare that it will hold the Trust Assets (defined below) upon trust absolutely for the holders of the Sukuks. The Trust Assets (the "**Trust Assets**") comprise:
 - 1.1.1 Certain specified central cooling plants (the "**Initial Plant**") which the Issuer will purchase from Tabreed on a future date to be agreed between the parties;
 - 1.1.2 ...
 - 1.1.3 ...

and will be purchased by the Issuer using the net proceeds received from the issuance and sale of the Sukuks.
- 1.2 The Issuer will lease the Plant back to Tabreed, for which Tabreed will be obliged to make rental payments to the Issuer. The Issuer will pass these rental payments on to the holders of Sukuks.
- 1.3 ...
- 1.6 ...
- 1.7 Upon maturity of the Sukuks, or if earlier, upon the acceleration of the Sukuk following the occurrence of a Dissolution Event under the documentation, Tabreed will purchase the Plant from the Issuer.

The bond structure is thus as illustrated in Figure 1.4. We shall study other lease-based as well as sale-based Islamic bond or *sukuk* structures that have become popular in recent years in Chapter 6. The example shown here is typical in many respects: Principal plus interest is passed to *sukuk* holders in the form of rent of a property that is sold to the SPV and purchased back at maturity. Any event that could interrupt the payment of "rent" (e.g., destruction of the leased property) is characterized as a "dissolution event," prompting the continuation of payments in the form of repurchase price. As we shall see in Chapter 6, this reduces the risk structure essentially to that of conventional bonds, allowing *sukuk* issuers to obtain the same credit ratings they would obtain for conventional bonds, and to pay the same interest they would pay based on that credit rating. Needless to say, however, transactions costs are increased because of the creation of SPVs, as well as payment of various jurist and legal fees for structuring the bond issuance. Moreover, there may be hidden legal risks in *sukuk* structures that get uncovered

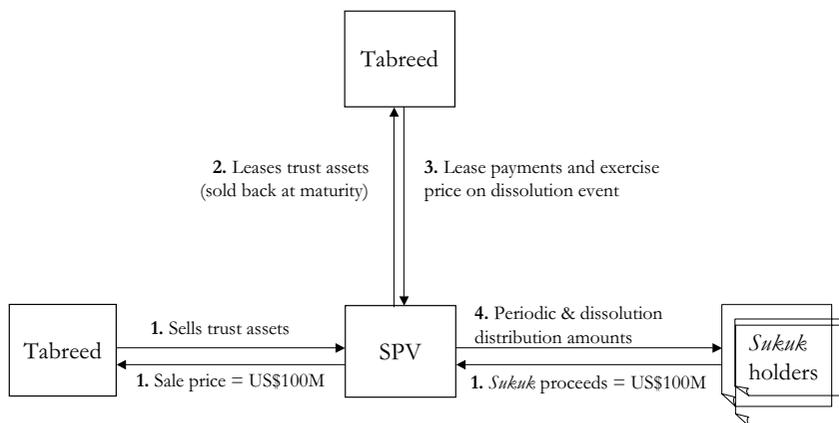


Fig. 1.4. Tabreed Sukuk Structure

only upon default. We shall discuss the potential advantages and disadvantages of various *sukuk* structures in Chapter 6.

1.1 Distinguishing Features of Islamic Finance

The most obvious distinguishing feature of Islamic finance (self-referentially) is the central importance of Islamicity certification (often called Shari‘a compliance) for various contracts. Indeed, the recent Kuwaiti Islamic banking law, enacted in 2003 as an amendment to the Kuwaiti Central Bank and bank regulation law,⁷ states explicitly that “Islamic banks are banks that perform banking operations – including all operations that the Trade Law lists, as well as those conventionally considered part of banking operations – according to the rules of Islamic Law (Shari‘a).”⁸ Most of the banking law amendment deals with licensing and capitalization issues (articles #87–92), relationship with the Central Bank (articles #94–5, 97–8), relationship to depositors and investment account holders (a unique feature of Islamic banks, article #96), and restrictions on ownership and trading in certain types of real assets (article #99).

Most of those legal provisions are similar for Islamic and conventional banks. In addition to the thorny issue of investment account holders (discussed in Chapter 8), the main distinguishing features of the Islamic banking section of the law are listed in articles #93 and #100:

93. An independent religious-law (Shar‘iyyah) supervision board must be established for each [Islamic] bank, consisting of at least three members, to be appointed by the bank’s general assembly. The incorporation documents and by-laws of the bank must dictate the

existence of this board, its composition, portfolio, and means of performing its tasks.

If disputes should arise between members of the Shari'a supervision board regarding religious legal characterization [of some transaction], the bank's board of directors may forward the question to the *fatwa* board [issuer of religious edicts] of the Ministry of Awqaf and Islamic Affairs, which is deemed the ultimate authority on the matter.

The [Shari'a supervisory] board must submit an annual report to the bank's general assembly, containing its assessment of the degree of adherence of the bank's operations to Islamic Shari'a, and any comments or reservations that it may have in this regard. This document must be included in the bank's annual report.

100. On all matters not explicitly addressed in this special section [on Islamic banking], Islamic banks are subject to the [general] rules of this [banking] law, provided that they do not contradict Islamic Shari'a.

The tone of this Islamic banking law clearly illustrates the central role of jurists in Islamic finance, as well as the general nature of the industry.⁹ In this regard, we may think of classical jurisprudence and modern finance as the two parents of contemporary Islamic finance. The Kuwaiti choice to add a section to the conventional banking law – highlighting deviations of Islamic banking practice wherever appropriate – makes it clear that the starting point in this formula is conventional financial practice, from which Islamic finance deviates only insofar as some conventional practices are deemed forbidden under Shari'a.

In other words, Islamic finance is not constructively built from classical jurisprudence. Rather, Islamic alternatives or modifications of conventional practice are sought whenever the latter is deemed forbidden. Thus, Islamic finance is a prohibition-driven industry. In this regard, the talented jurist Ibn Taymiyya (d. 728 A.H./1328 C.E.) famously stated that two prohibitions can explain all distinctions between contracts that are deemed valid or invalid: those of *riba* and *gharar*. We shall study those two prohibitions in great detail in Chapter 3. For now, we investigate the general economic advantages and disadvantages of a financial industry driven by religious prohibitions.

Prohibition-Driven Finance

Recent students of law and economics have maintained that the primary purpose of transaction law is often the enhancement of economic efficiency. For instance, Judge Richard Posner, perhaps the most significant figure in contemporary economic analysis of Anglo-American common law, wrote:

Often, the true grounds of legal decision are concealed rather than illuminated by the characteristic rhetoric of opinions. Indeed, legal education consists primarily of learning to

dig beneath the rhetorical surface to find those grounds, many of which may turn out to have an economic character.¹⁰

In this regard, the majority of legal scholars engaged in this type of analysis have found prohibitions – injunctions against certain types of financial transactions conducted by mutual consent, such as interest-bearing loans – to be puzzling. For instance, Posner denounced Adam Smith's support for laws against interest-based borrowing and lending as paternalistic and efficiency reducing.¹¹ Students of this field also find usury laws (against charging excessive interest) imposed in most states to be puzzling. Jolls, Sunstein, and Thaler (2000) expressed this puzzlement as follows:

Puzzle. A pervasive feature of law is that mutually desired trades are blocked. Perhaps most puzzling amid this landscape ... are bans on conventional "economic" transactions, such as usurious lending, price gouging, and ticket scalping. Usury, or charging an interest rate above a certain level, is prohibited by many states in consumer lending transactions. ... Not surprisingly, economists and economically oriented lawyers often view these laws as inefficient and anomalous.

Mutual consent also plays a crucial role in Islam. The Qur'an reads: "let there be among you trade by mutual consent."¹² The same emphasis is echoed in the Prophetic tradition: "I shall meet God before I give anyone the property of another without the latter's consent, for trade requires mutual consent."¹³ However, mutual consent in this context is considered a necessary but not-sufficient condition for validity of economic transactions. For instance, the majority of jurists strongly denounced the December 2002 *fatwa* issued by al-Azhar's Institute of Islamic Jurisprudence, which the public viewed as legitimizing the collection of interest on bank deposits. The *fatwa* (discussed in some detail in Chapter 8) characterized the depositor-bank relationship as that of an investor and his investment agent and legitimized collection of a fixed profit percentage (interest) as follows:

Those who deal with the International Arab Banking Corporation – or any other bank – thus forwarding their funds and savings to the bank to be their investment agent in the bank's permissible dealings, in exchange for a predetermined profit that they receive at pre-specified time-periods. ...

This transaction, taking this form, is permissible and beyond any suspicion, since there is no text in the Book of Allah and the Prophetic tradition that forbids such a transaction wherein the profit or return is prespecified, provided that both parties mutually consent to the transaction. ...¹⁴

Despite this appeal to mutual consent, most jurists, including all those involved in the area of Islamic finance, vehemently opposed the *fatwa*.

Recall that Posner rejected Adam Smith's attitude toward interest-bearing loans as paternalistic and efficiency-reducing. Within the quasi-religious context of Is-

lamic 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.

		Player 2	
		Cooperate	Defect
Player 1	Cooperate	4,4	0,5
	Defect	5,0	1,1

Fig. 1.5. Prisoners’ Dilemma

In the standard two-prisoners’ dilemma shown in Figure 1.5, 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 each player would receive 1.

In this well-known game, it is very clear 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 of 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 lending can enhance ex ante efficiency by encouraging the cooperative outcome.

In Chapter 3 we shall see that classical jurists envisioned the two major prohibitions in Islamic jurisprudence of financial transactions – those against *riba* and *gharar* – to be efficiency-enhancing. That is not to say that the manner in which injunctions against *riba* and *gharar* have been obeyed in Islamic financial practice necessarily achieved such increases in efficiency. On the contrary,

form-driven Shari'a arbitrage routinely reduces efficiency relative to conventional financial practices.¹⁵ In many instances, secular legal and regulatory constraints would have eliminated the dangers and inequities targeted by the two prohibitions. Thus, efficiency losses due to Shari'a arbitrage in such cases can be considered dead-weight losses. In other cases, where Islamic alternatives are required to avoid *riba* or *gharar*, the form-above-substance orientation of Shari'a arbitrage often adds to transactions costs without avoiding the harmful substantive effects of the forbidden factors.

Jurists, Shari'a Boards, and Innovation

We have already noted the prominent role of Shari'a boards in the development and marketing of Islamic financial products and services. The most public role played by those jurists is certification of Islamicity of various products, both in theory as well as in practice. Regulators have mandated formal inclusion of Shari'a board reports in annual financial statements and the like. Along with this official capacity, Shari'a boards also play an informal marketing function: by participating at various conferences and workshops and by publishing various writings that explain to the public why certain products are deemed Islamic, whereas others are not.

Eventually Islamicity criteria for well-established Islamic financial products become standardized, in part through efforts of industry-sponsored institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) or regulatory bodies such as the State Bank of Pakistan.¹⁶ Products that reach this level of maturity become the focus of various workshops for bankers and regulators, who generally understand the mechanics of those standardized products quite well.¹⁷ Once products reach this level of maturity, and become sufficiently widely accepted, the role of Shari'a boards is reduced substantially. Moreover, widespread understanding of those modes of finance reduces barriers to entry in Islamic finance, thus increasing competitive pressure and reducing profit margins. In turn, reduced profitability, coupled with a reduced need to educate the public about those well-established products, drives the industry toward constant innovation in search of new profit margins in new market segments.

This brings us to the other main functions that jurists on Shari'a boards play in various product development stages. Interactive discussions between bankers, lawyers, and jurists commonly start with an existing conventional product for which no Islamic alternative is available. The three groups then engage in a process of financial reengineering of the product, replacing its various conventional components that are deemed un-Islamic with others that can be presented to the public and defended as Islamic. In the later stages of product development and

marketing, the vehicle of choice has been modification and adoption of premodern nominate financial contract names. Coverage of the premodern contracts in classical jurisprudence texts thus makes the new products identifiable as Islamic. To maintain credibility, industry practitioners insist on using Arabic names of contracts, for instance, “*ijara*” instead of the equivalent “lease,” or “*murabaha*” instead of the equivalent “cost-plus sale.” In many cases, the contemporary practice marketed under some premodern Arabic name bears only very superficial similarity to the premodern financial practice discussed in classical jurisprudence.

The pursuit of profit margins through innovation is best exemplified in the development of “Shari‘a-compliant” mutual funds and, eventually, hedge funds, discussed in Chapters 7 and 10. The first stage of development in this area was pioneered by Al-Baraka’s Investment and Development Company and then copied and popularized by Dow Jones Islamic Indexes (DJII) and Financial Times’ FTSE Islamic Indexes (developed in cooperation with Kuwait-based The International Investor). The simple initial idea was to use standard fund management techniques, applied to a restricted universe of equities. Various screening rules were adopted to exclude stocks of companies in “sin industries” (e.g., breweries), as well as those of companies with significant forbidden practices (including the payment and collection of interest on loans).

In the early stages of introduction of “Islamic mutual funds,” various providers experimented with different screening rules, and many expressed skepticism regarding some of those screens (especially debt ratios). However, standardization eventually took hold. The standardized process was particularly hastened by the fact that screens selected in the late 1990s heavily favored booming technology stocks (especially after DJII changed its cutoff debt ratio from 33 percent of assets to 33 percent of market capitalization). The technology stock bubble of that period created a strong incentive to hasten the widest possible acceptability of this “Shari‘a-compliant” debt screen.¹⁸

In the early twenty-first century, the need for further innovation in this area became pressing. This need was caused not only by reduction in industry-wide rents as others learned to replicate standardized screens, but also by the bubble in technology stocks bursting. In fact, the debt screen that had become standard – exclude companies with debt-to-market capitalization above 33 percent – forced fund managers who bought stocks when the denominator of that ratio was at its peak to sell them as their prices fell, whether or not that was the best investment strategy.

Rather than recognize that any fixed debt-to-market-capitalization rule leads to such “buy-high, sell-low” tragedies, jurists turned to investigation of means to provide innovative Islamic investment alternatives that would perform well in “bear markets.” Some attention was paid to Real Estate Investment Trusts (REITs), re-

turns of which tend to be uncorrelated with market indices such as the Standard and Poor's 500. However, the biggest race quickly began for development of the first "Islamic hedge fund." In this regard, being first is very significant, since it allows fund managers who can successfully market some hedge fund strategy – say, basic long-short trading – to attract significant funds under management, in part through free indirect advertisement that would be otherwise illegal. In turn, once "Islamicity" of a shorting methodology is established, it can (and will) be soon replicated, thus increasing competition and reducing management fees.

I have chosen this example to illustrate a simple point: the mode of operation of our three parties in Islamic finance (financial providers, jurists, and lawyers) necessarily dictates chasing past returns and past trends in conventional finance. In the process, short-term profit margins are created for first-movers in the Islamic space, based on access to captive markets and free indirect publicity. However, as one should expect, medium- to long-term returns are severely limited for any industry that chases past returns.

Lawyers and Regulatory Arbitrage

While jurists assist in reengineering and marketing Islamic alternatives to conventional financial products, lawyers help Islamic financial providers take this product to market in two ways. First, they ensure that the reengineered product is compatible with legal and regulatory systems. This can be accomplished both by ensuring that the reengineered structure is as similar as possible to the conventional product with which regulators are familiar, and by helping to explain the new structure (and its minimal deviation from conventional practice) to those regulators. Second, lawyers strive to make reengineered products as efficient as possible, especially due to tax considerations and the need to incorporate special-purpose entities for various Islamic structures.

Discussions between lawyers and jurists thus center on a tradeoff between efficiency (proximity to conventional product being mimicked) and ease of marketing the product as Islamic (which requires noticeable, if superficial, differences). We shall turn to this tradeoff between efficiency and perceived legitimacy of the Islamic financial label in Section 1.2.

First, we conclude this section with a simple illustration of the functions that lawyers play in Islamic finance. Consider the case of an Islamic alternative to home-mortgage loans, as in Example 1. The two most common Islamic modes of home financing are *murabaha* (cost-plus credit sale) and *ijara* (lease) financing. We shall discuss how the premodern contracts carrying those names were transformed into modes of financing in Chapters 4 and 6. For the purposes of this section, suffice it to say that in both financing modes, as envisioned by con-

temporary jurists, the financier needs to own the property for some period of time (either directly or through an SPV). In the case of *murabaha* financing, the financier buys the property and then sells it to the customer on a credit basis (usually with a markup benchmarked to a conventional interest rate, such as the London Interbank Offer Rate [LIBOR]). Indeed, it is this financier ownership of the property, for any period of time, however short, that jurists use to differentiate between an interest-bearing mortgage loan, deemed forbidden, and a *murabaha* financing contract, deemed valid.

The mechanics of a *murabaha* financing transaction sometimes blur the boundaries between interest-bearing loans and credit-sale financing. In many *murabaha* transactions, the customer is appointed as the financier's agent. Thus, the customer may proceed as the financier's buying agent to purchase some property on its behalf, and then as the financier's selling agent to sell that property to himself. Technically, jurists argue, the financier in fact owns the property during that period of time between the two agency sales and bears the risk, for instance, of its destruction by lightning.¹⁹ In the case of lease financing, jurists insist that permissible *ijaras* are operating leases, rather than financial leases, thus forcing the financier to maintain substantial ownership of the property throughout the lease period. Thus, both *murabaha* and *ijara* financing models require financiers to engage in purchase and sale of properties. Indeed, Islamic finance jurists highlight this "asset-based" nature of Islamic finance as one of its distinguishing features that allow avoidance of the forbidden *riba*.

In sharp contrast, most regulatory frameworks for banks define them as financial intermediaries and forbid them from owning or trading real properties (including real estate, dubbed in the United States as OREO – an acronym for "Other Real Estate Owned"). Moreover, in the case of lease-to-purchase real estate financing, the customer pays a monthly contribution toward eventually owning the property. Later in the mortgage, the customer may in fact have paid off 90 percent or more of the property's price and yet be exposed to the risk of losing the property if the financier is sued, loses, and declares bankruptcy. Both considerations call for the construction of bankruptcy-remote SPVs that hold title to the property and serve as parties to various agreements regarding obligations for repairs and insurance as required by jurists.

Islamic finance lawyers utilize skills that they honed in the area of structured finance during the boom of the 1980–90s to ensure that Islamic finance structures are as efficient as possible in terms of legal fees, costs of incorporation, and taxation. Lawyers also play a pivotal role in comparing and contrasting the risk allocations to the financier and customer under conventional and Islamic arrangements. In the context of *murabaha* and *ijara* financing in the United States, their arguments have successfully convinced the Office of the Comptroller of the

Currency (OCC, which regulates nationally licensed banks) that both modes as practiced constitute examples of the normal business of secured lending as conducted by commercial banks. The primary mover at the time was United Bank of Kuwait's Al-Manzil program for home financing in New York. The two OCC letters of understanding dealing with *murabaha* and *ijara* are available on the Web site www.occ.treas.gov. Two excerpts follow:

OCC #867, 1999: Lending takes many forms. . . . Murabaha financing proposals are functionally equivalent to, or a logical outgrowth of secured real estate lending and inventory and equipment financing, activities that are part of the business of banking.

OCC #806, 1997: Today, banks structure leases so that they are equivalent to lending secured by private property . . . a lease that has the economic attributes of a loan is within the business of banking. . . . Here it is clear that United Bank of Kuwait's net lease is functionally equivalent to a financing transaction in which the Branch occupies the position of a secured lender.

Those conclusions beg the question: If the economic substance of Islamic home finance is deemed to be functionally equivalent to conventional banking forms of secured lending, why should we not say that secured lending is more akin to trade or leasing than to forbidden interest-based cash loans? In fact, as we shall see in Chapter 4, the argument for equating interest-based secured borrowing as practiced today to interest-bearing monetary loans of premodern times appears very weak according to the standards of premodern jurisprudence. Thus, applying the classical rules of *riba* in that jurisprudence to contemporary financial practices may be unwarranted, especially in the presence of anti-usury laws, truth-in-lending regulations, and elaborate bankruptcy law protections.

1.2 Islamic Transactions Law as Common Law

English and American lawyers have found financial engineering within the context of Islamic jurisprudence to be a natural exercise. Indeed, many Islamic finance lawyers have found Islamic and English common law sufficiently similar that they decided to make most Islamic financial structures subject to the latter. A student of Islamic law expressed his realization of similarities between the two legal systems as follows:

In the course of studying Islamic law in its everyday practice I have been increasingly struck with its similarities to the common law form in which I have also been trained in the United States.²⁰

This inherent familiarity with the modes of analysis in Islamic jurisprudence stems from its close relationship with Anglo-American common law. Although most historical studies trace the origins of common law during the reign of Henry II to

Roman and canon laws,²¹ some recent historical scholarship has traced the roots of some parts of the common law of financial transactions to Islamic origins. One of the earliest studies in this area traced the British system of trusts to the Islamic institution of *waqf*.²² More recently, John Makdisi traced the origins of many innovations in British contract law to Islamic origins.²³ Indeed, similarities extend to the very methodology of legal inference based on case studies of legal precedents and reasoning by analogy.

This explains the relative success of Islamic finance in the Anglo-American world and in Islamic countries that have had a history of British rule (e.g., Gulf Cooperation Council (GCC) countries or Malaysia). In the meantime, divergence between the common-law nature of Islamic jurisprudence, on the one hand, and the rhetoric of interpreting the Islamic canon, on the other, has led to fundamental failures of Islamic finance in countries that attempted to “Islamize” their entire financial systems (Iran, Pakistan, and Sudan). Rosen (2000, p. 64) correctly explained those failures of contemporary attempts at *de jure* implementation of Islamic Law as follows:

in Pakistan and Sudan the simple use of Islamic law as an arm of the state has slipped through the fingers of those at the center. The reason, I believe, is that these regimes have been trying to apply a common law variant as if it were a civil law system.

This confusion is even more acute in countries that have not been officially Islamized. Many of those countries’ official legal systems were derived from European civil codes: Swiss in the case of the Turkish republic (1926), French in the cases of Egypt (1949), Syria (1949), and Iraq (1953).²⁴ The architect of those codes, ‘Abdal-Razzaq Al-Sanhuri, argued successfully before the Egyptian parliament in 1948 that they contain all the aspects of Islamic jurisprudence that agreed with widely accepted principles of modern legal theory.²⁵ Yet, we continue to hear calls for “application of the Islamic Shari‘a” in Egypt, post-Baathist Iraq, and other countries.

The legal environment for Islamic finance is made more complicated by statements about the supremacy of Islamic law, even in countries that are relatively secular. For instance, Egyptian Constitution Article 2, amended in May 1980, stated that all subsequent laws and legislations must be derived from Islamic Law. This constitutional requirement was further strengthened through a later Egyptian Constitutional Court’s ruling:

It is therefore not permitted that a legislative text contradict those rules of Shari‘a whose origin and interpretation are definitive, since these rules are the only ones regarding which new interpretive effort (*ijtihad*) is impossible, as they represent, in Islamic Shari‘a, the supreme principles and fixed foundations that admit neither allegorical interpretation, nor modification. In addition, we should not contemplate that their meaning would change with changes in time and place, from which it follows that they are impermeable to any

amendment, and that it is not permitted to go beyond them or change their meaning. The authority of the High Constitutional Court in this regard is limited to safeguarding their implementation and overruling any other legal rule that contradicts them.²⁶

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 understandings of the canonical texts and previous juristic analyses than they owe to the canon itself. According to one of the most prominent jurists working in this field:

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 Sunna 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 Sunna 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 Shariah have to play a very important role. They have to analyze every question in light of the principles laid down by the Holy Quran and Sunna as well as in the light of the standards set by earlier jurists enumerated in the books of Islamic jurisprudence. This exercise is called *Istinbat* or *Ijtihad*. ... [T]he ongoing process of *Istinbat* keeps injecting new ideas, concepts and rulings into the heritage of Islamic jurisprudence.²⁷

In other words, by “injecting new ideas, concepts and rulings,” Islamic jurists make law in a manner very similar to common-law judges presiding over cases for which there are no common-law precedents.

Precedents, Analogies, and Nominate Contracts

It is worthwhile noting that the process of juristic inference (*ijtihad*) discussed above is restricted in Sunni schools to reasoning by analogy (juristic rather than logical). Early jurists used a variety of tools, including benefit analysis (*istislah*) and juristic approbation (*istihsan*). However, most surviving Sunni schools have chosen to follow the rules of Islamic legal theory as established by Al-Shafi‘i, who declared that “*ijtihad* is *qiyas*” (i.e., the only permissible form of juristic inference is through analogical reasoning).²⁸ It is also worth noting at this point that the operation of a hybrid common-civil-law system, which nonetheless focuses on reasoning by analogy from precedent, is not unique to Islamic finance.²⁹

As a consequence of this reliance on analogies to legal precedents in Islamic law, jurists looking for alternatives to conventional financial products frequently search

through classical books of jurisprudence for precedents that can be used – directly or in modified form – to accomplish their goal. For instance, the earliest writers on Islamic finance envisioned a two-tiered silent partnership system, modeled after the *mudaraba* contract of classical Islamic jurisprudence.³⁰ As we shall see in Chapter 8, this model continues to be utilized on the liabilities sides of Islamic banks, giving rise to many regulatory and corporate governance problems. It is also used appropriately in a variety of securitization schemes, such as mutual funds and mortgage-backed securities.

For Islamic bank assets, the most popular mode of financing has been a variation on the classical *murabaha* (cost-plus sale) contract, modified by the late Sami Humud as a means of extending credit without violating the Islamic prohibition of interest-based loans. Humud (1976) seems to be the first prominent instance of proposing the use of cost-plus *murabaha* in a credit sale setting (*bay' bithaman 'ajil*), with an added binding promise on the customer to purchase the property, thus replicating secured lending in a “Shari‘a-compliant” manner. Islamic banking began its steady growth shortly after this idea was popularized and adopted by jurists in the late 1970s. While the liabilities of Islamic banks continue to be structured in terms of “investment accounts” on a profit-and-loss-sharing basis, *murabaha* and other debt-financing forms have dominated the assets side of Islamic banks’ balance sheets.

Numerous books on Islamic finance define the subject in terms of “permissible” classical nominate contracts (*murabaha*, *mudaraba*, etc.) that are commonly used in modified forms today. This contrasts sharply with a general rule in Islamic jurisprudence stating that the default ruling in financial transactions is permissibility, exceptions being based on prohibitions of *riba* and *gharar*. Jurists active in the area of Islamic finance readily admit this reality. However, they have found constructive analogies to classical nominate contracts – known to be devoid of *riba* or excessive *gharar*, or allowed as exceptions to the general prohibitions – to be more fruitful. The alternative would have been to allow the default ruling to stand, abstaining from issuing opinions on any new financial contracts, unless and until a valid analogy is constructed to determine that any given transaction contains forbidden *riba* or substantial *gharar*.

There are many reasons for Islamic finance adopting the Arabic names of pre-modern contracts, not least of which is the desire to create an independent identity and brand name for Islamic finance. In this regard, the use of classical nominate contracts helps to connect the current financial practice to the revered classical Islamic age. On the other hand, this adherence to variations on ancient and medieval nominate contracts and the associated need to preserve as many of the conditions stipulated by classical jurists to keep those contracts devoid of *riba* and

excessive *gharar* are the primary reasons that Islamic finance has heretofore fallen significantly short of its potential.

Convergence of Sunni and Shi'i Approaches

The modes of Shari'a arbitration discussed in this book are predominantly practiced in Sunni-majority regions, such as GCC countries, Malaysia, Pakistan, and Sudan. However, extrapolation from the experiences of Islamic finance in those countries to Shi'a-dominated regions appears justified, despite some basic differences in jurisprudence.

In principle, Shi'i jurisprudence can reach very different conclusions from its Sunni counterpart. That is not only because of minor differences in recognized canonical traditions, which differences also exist between the various Sunni schools. The primary distinction is that most Shi'i schools do not restrict juristic inference on matters that were not addressed in canonical texts to the use of analogy. In Chapter 2 we shall see that some progressive Sunni jurists – such as the Azhari jurist 'Abdul-Wahhab Khallaf – also argued for allowing all forms of juristic inference in the domain of financial transactions. However, the majority of contemporary Sunni and Shi'i jurists alike have gravitated toward the comforts of analogical reasoning and use of classical nominate contracts, as discussed in this chapter.

Some flexibility is given to Muslims living in non-Muslim lands. The *fatawa* (religious edicts) issued by Ayatullah Sistani (Iraq's most prominent Shi'i cleric) seem to accommodate many forms of conventional finance for those Muslims. For instance, he allowed depositing funds with banks, and collecting interest thereof, on the basis of permissibility of charging interest to non-Muslims in those lands. Moreover, he allowed Muslims to take mortgage loans from non-Islamic banks – even with knowledge that they will pay principal plus interest – provided that they do so with an intention other than “borrowing” in the classical sense of “*iqtirad*.”³¹ Likewise, the prominent Sunni jurist Yusuf Al-Qaradawi issued a similar *fatwa* allowing Muslims in North America to finance their home purchases with conventional mortgages. He based this ruling on three considerations: (1) the opinion of Abu Hanifa that permitted dealing with *riba* in non-Muslim lands, (2) determination that the mortgagor is the primary beneficiary from mortgage home financing, and (3) invoking the rule of necessity.³²

The rules are much stricter for Muslims living in Islamic lands, within both the Sunni and Shi'i schools. Within that context, Sistani appears to revert to Shari'a-arbitrage alternatives that have been popular in Sunni-majority Islamic countries. For instance, in answers (543–6) on his Web site, he forbade borrowing from private or public banks with stipulated conditions of paying interest, which he thus characterized as forbidden *riba*. His proposed alternatives are trade- and lease-

based contracts, for which he uses the Arabic names *bayʿ* and *ijara*. Recognizing that those contracts are used to synthesize interest-based loans, he ruled merely that conditions that render the underlying loan transparent must be deemed invalid, much like Sunni jurists have permitted operating leases but forbade financial leases (as we shall see in Chapter 6). Based on the same analysis, he disallowed depositing funds with conventional banks.³³

Thus, whether – and if – Iraq imposes Islamic transactions law according to the juristic views of the Shiʿi majority, or according to the juristic views of the Sunni minority, the resulting system of Islamic finance would likely follow the same Shariʿa arbitrage path currently charted in places like GCC, Malaysia, and Pakistan. Evidence of convergence between the Shiʿi and Sunni Islamic financial modes of operation is clear in Iran’s recent efforts to issue *sukuk* that imitate the lease-based structures utilized in the Sunni-majority regions. Collaborative efforts to create liquid Islamic money and capital markets have led to convergence within Sunni Islamic financial jurisprudence, for example, to allow Malaysia to tap funds from more conservative GCC investors. Likewise, Islamic countries with Shiʿi majorities are likely to continue their own process of juristic convergence to gain access to those growing Islamic financial markets.³⁴

Tradeoff between Efficiency and Legitimacy

Throughout this book we study the current practice of Islamic finance, which has adopted a peculiar form of regulatory arbitrage that is best characterized as Shariʿa arbitrage. The practice of Shariʿa arbitrage proceeds in three steps:

1. Identification of a financial product that is generally deemed contrary to the perceptions of Islamic Law (Shariʿa).
2. Construction of an “Islamic analog” to that financial product. Examples include Islamic home (mortgage) or auto financing – commonly using the Arabic-nominate contracts *murabaha* or *ijara*, as well as Islamic bonds or certificates commonly marketed under Arabic names like *sukuk al-ijara* or *sukuk al-salam*. In fact, an important step in executing Shariʿa arbitrage is finding an appropriate Arabic name for the Islamic analog product, preferably one that was extensively used in classical Islamic legal texts.³⁵ Differences in contract forms and language thus justify and lend credibility to the “Islamic” brand name.
3. In the meantime, an Islamic financial structure marketed under an Arabic name must be sufficiently similar to the conventional structure that it aims to replace. Sufficient similarity would ensure that the Islamic structure

is consistent with secular legal and regulatory frameworks in target and origin countries.³⁶

Legitimacy of declarations that an Islamic analog product is Islamic, whereas the conventional financial product it aims to replace was not, increases with deviations of the analog's financial structure from its conventional counterpart (in both form and substance). This may require the creation of otherwise unnecessary SPVs or the addition of superfluous financial transactions. Those additional economic entities and activities necessarily increase transaction costs and reduce efficiency of the resulting Islamic financial products and services.

Consequently, professionals structuring an Islamic financial product have to examine the tradeoff between their product's efficiency, on the one hand, and its credibility in target Islamic financial markets, on the other. Depending on target markets for the various products (e.g., Malaysia vs. Sudan, as two historical extreme points), one may choose different structures (e.g., favoring efficiency in Malaysia and credibility in Sudan). For instance, Malaysian bankers had developed repurchase markets for Government Investment Certificates (GICs) since the mid-1980s, allowing Islamic banks to use interbank markets for liquidity management and Bank Negara to engage them in open market operations. More generally, Malaysian jurists continue to allow various forms of debt trading, which enhance liquidity and efficient pricing of various instruments. In contrast, the Sudanese have until very recently maintained that *musharaka* (partnership) certificates built on profit-and-loss sharing are the only ideal forms of Islamic bond alternatives. Sudanese Islamic banks have generally purchased those certificates and held them to maturity. Lack of liquidity in those Sudanese instruments has resulted in inefficient pricing and absence of effective monetary policy through open market operations, ultimately leading to demonetization and the general weakness of the Sudanese financial system.

1.3 Limits and Dangers of Shari'a Arbitrage

Consider the previously discussed Tabreed *sukuk* structure in Example 2, as a quintessential exercise in Shari'a arbitrage. Tabreed wished to issue bonds and pay bondholders an interest rate commensurate with market rates. This would be interest-bearing debt, which is deemed by most jurists as forbidden *riba*. The Shari'a-arbitrage approach in this case required structuring the transaction as a lease of one or more assets (cooling plants). The assets were sold to an SPV created for the purpose of this transaction. The SPV proceeded to lease the asset back to Tabreed, collecting interest in the form of rent, and distributing it to certificate holders. At lease end, the SPV sells its assets back to Tabreed.

We shall return to this and similar transactions involving sale and resale of the same property in Chapter 4. Premodern jurists discussed at length same-item sale-repurchase (most commonly called *bay' al-'ina*), which was a known ancient legal arbitrage method to circumvent the prohibition of interest-based lending. In this regard, the *sukuk* structure involves sale of property (including its usufruct), followed by temporary repurchase of usufruct (lease), and then full-fledged repurchase of the property and its remaining usufruct. In Chapters 4–6 we shall discuss at some length the juristic grounds for questioning various bond-alternative or *sukuk* structures, which differ from conventional bonds only in superficial form. For now, we focus on other legal problems that *sukuk* structures may cause.

Risk of Mispricing

To the extent that differences in form may also lead to substantive differences between *sukuk* and bonds, such potential differences may lead to legal problems:

1. If the company issuing lease-based *sukuk* had previously issued regular (conventional) bonds, how would its issuance of *sukuk al-ijara* affect earlier bond-holding creditors? In particular, would the debt owed to those earlier creditors be de facto subordinated to the new debt by virtue of implicit collateralization? If the company defaults on earlier debts, how are the respective rights of bond and *sukuk* holders to be determined, and under which legal system? How would a third party's entitlement (*istihqaq*) to the leased property affect the lease structure, under Islamic jurisprudence and under relevant secular law?
2. Can this procedure be abused as a means of shielding company assets from existing creditors?
3. To avoid credit downgrades if the sold and leased-back property ceases to produce usufruct (and thus to yield rent to *sukuk* holders), *sukuk* are made essentially callable by designating such circumstances as “dissolution events.” How can one price this embedded option? Unlike standard pricing based on credit-risk models, the callability in this case relates also to operational risk factors. In general, pricing Islamic finance instruments becomes increasingly difficult because of its characteristic bundling of multiple risk factors.

In fact, to avoid most of those problems, *sukuk* are structured legally to replicate the seniority and risk structures of conventional debt instruments. To the extent that lawyers have been successful in replicating conventional bond structures, *sukuk* as an asset class should eventually be recognized merely as expensive bonds. Moreover, credibility of those instruments may come into question. For

instance, the highly respected and learned Saudi scholar 'Abdullah ibn Mani' retracted his approval of Bahraini government-issued *ijara-sukuk* after he was convinced that ownership of the underlying properties was not fully transferred to the lessor, as required in *ijara* (leasing) contracts discussed in great detail in classical jurisprudence books.

In the meantime, errors may be made in replicating the risk structure of conventional bonds in *sukuk*, thus mispricing of embedded options may eventually cause divergence between the two asset classes, leading to collapse of *sukuk* markets. This possibility should not be dismissed. The GNMA CDR experience due to mispricing embedded options in interest-rate derivatives was not foreseen prior to that market's collapse, even by the most astute financial professionals; see Johnston and McConnell (1989). Interestingly, this mispricing in modern financial innovation occurred despite the focus of conventional finance on disentangling various risks to price them more efficiently. In this regard, the use of premodern contract forms in Islamic finance essentially reentangles the various risks, for example, by allowing an increase in price due to embedded options, while disallowing sale of those options separately. In certain instances, as argued in Chapter 3, this bundling of risks may enhance efficiency and reduce harmful speculation. However, the more likely result of approximating modern transactions with premodern ones is increased risk of mispricing and inefficiency.

Legal and Regulatory Risks

Another set of risks discussed in Chapter 10 relate to issues of money laundering and criminal finance. The structured finance technologies utilized in Islamic finance aim primarily to separate would-be borrowers or lenders from interest-bearing loans – the process we have labeled Shari'a arbitrage. The degrees of separation introduced for that purpose – in the forms of multiple trades, or special purpose vehicles, and the like – dangerously resemble the “layering” tools of money launderers and criminal financiers. In addition, the use of those tools of structured finance often require utilization of offshore financial centers to reduce tax burdens and minimize incorporation costs for various SPVs.

Of course, both of these sets of concerns are not unique to Islamic finance. Indeed, the means and venues of structured finance characteristic of Shari'a arbitrage were originally devised in the Anglo-American world as tools of regulatory arbitrage – mainly aiming to minimize tax burdens for corporations, trusts, and high-net-worth individuals.

However, there is considerable cause for concern regarding the use of those sophisticated tools of regulatory arbitrage in Islamic finance. Recent corporate scandals in the United States have shown that Western regulators lack the requi-

site sophistication to understand and track complicated financial structures. In this regard, one must recognize that financial regulators and law enforcement officials in the Islamic world lag significantly behind their Western counterparts in sophistication and understanding of structured finance.

This makes the chance for abuse by money launderers and criminal financiers higher in Islamic finance than elsewhere. To the extent that such criminal financiers always seek the weakest link in regulation and law enforcement, this makes Shari'a-arbitrage-oriented Islamic finance potentially vulnerable to such abuse. Moreover, the industry's "Islamic" brand name has been tarnished and abused in the past, for example, as part of the BCCI affair or Egyptian "fund mobilization companies" rumored to have run pyramid schemes in the 1980s.³⁷

Beyond Shari'a Arbitrage

Returning to the economic concerns of inefficiency and mispricing, we should recognize that nominate contracts in classical Islamic jurisprudence – valuable vehicles that they were for the time those texts were authored – can serve only a very limited number of financial functions. At the time those classical texts were authored, the number of financial markets was extremely limited. Hence, financial instruments that eventually became classical nominate contracts (credit sales, leases, etc.) had to serve multiple functions in terms of allocation of credit and risk. In contrast, modern financial markets and institutions (money markets, capital markets, options markets, etc.) were designed to disentangle various risks, in a manner that allows us to price them more efficiently.

In this regard, adherence to classical nominate contracts necessarily amplifies the aforementioned tension between efficiency and credibility objectives. This, in turn, must force the industry to choose one of two directions:

1. Classical conditions of nominate contracts may be systematically relaxed to enhance efficiency, in which case they would have served no purpose. We shall see examples of this in practice, especially in the area of *murabaha* financing. The risks of this approach are twofold:
 - (a) Practically, the target audience of Islamic finance may grow progressively more disenchanted by the lip service it pays to classical texts, without adhering to the conditions therein.
 - (b) Theoretically, any hope for recovering the substantive content of various Islamic legal and religious provisions may be lost forever. Indeed, some have argued that it was precisely this fear of losing religious substance that prompted some scholars in the thirteenth century C.E. to declare that the doors of *ijtihad* (juristic inference) must be closed.

2. Islamic finance may continue to be an inefficient replication of conventional finance, always one step behind developments in the imitated sector. Eventually, sophisticated clients of the industry may lose hope that it can ever provide a bona fide alternative to conventional finance – the primary reason they tolerate its form-above-substance approach. At that stage, Islamic finance would lose large portions of its constituency and become a mere footnote in financial history.

The alternative, to which this book is dedicated, is to try to understand and apply the substantive spirit of Islamic Law. This can be accomplished by understanding the economic functions served by classical legal provisions and the general principles that prompted classical jurists to pursue those functions within their economic and legal environment. This, in turn, can pave the road for developing financial products that may be marketed more effectively to Muslims and non-Muslims alike, without need for Arabic names of classical nominate contracts, and without hiding behind the “Islamic” brand name.