4. Financial instruments

4.1 INTRODUCTION

There are a great number of financial instruments that are acceptable from a sharia point of view, others are not admissible and there is also a grey area with products that pass muster in the eyes of some but are haram in the eyes of others. As noted earlier, the pioneers of the idea of an Islamic economy had no idea how to shape such an economy; nor had the first practitioners of Islamic finance (Kahf 2004). The various financial instruments had to be developed in the practice of banking. There are by and large two sets of instruments, namely those based on profit-and-loss sharing, and the rest. Many instruments are the subject of ongoing discussions, as their legal form may be different from interest, but their economic function is not always far removed from conventional interest, or from gharar and maysir. The most widely used financial instrument, *murabaha* (see below), did not even exist in its present form when the first serious large-scale initiatives for Islamic banking were launched: the Islamic Development Bank and the Dubai Islamic Bank, both established in 1974. It was derived by Sami Hamoud, a visionary Jordanian economist,[1] from a publication by al-Shafii and only in 1976 recommended to these two banks (Kahf 2004, p. 33, n. 13).

The early writers on Islamic finance and the Islamic economy in general had to navigate in uncharted waters and came up with inchoate and sometimes incoherent proposals. On one page Qureshi plays with the idea that banks should neither pay nor charge interest and that the costs of banking should be borne by the state. Two pages further, he advocates partnerships between banks and their clients which would yield profits, apparently without any need for the state to step in (Qureshi 1991, pp. 131, 133). Mahmud Ahmad (1999, ch. 2) developed a scheme where banks provide free credit and debtors are required to furnish a counter loan, not unlike the practice of JAK Banken in Sweden (see Section 3.3.3). The counter loan would be for a smaller sum, but for a longer period, such that the total of the counter loan, measured as the amount of money times the period during which it is furnished, equalled the loan provided by the bank. Mr Qureshi's second idea won the day, but not decisively. Profit-and-loss sharing may be the ideal of Islamic finance, in practice it only plays a secondary role.

The system of Islamic finance that has emerged over the years is based on the idea that riba, gharar and maysir should be avoided. Islamic financial institutions have sprung up that provide financial instruments meeting this requirement. We shall first cover the instruments that are based on profit-and-loss sharing, and then the others. A separate section is devoted to instruments whose sharia compatibility is seen as debatable. It should be noted that Muslims need have no compunction making use of the services and products of conventional financial institutions, provided they make sure these services and products are not tainted by riba, gharar and maysir or by haram investments.

Freedom of contract is restricted in Islam. It is not enough that halal instruments and activities are avoided. Islamic contract law imposes additional restrictions. Many Muslim jurists further hold that the class of permissible contracts is restricted to those that are mentioned in the sharia, the so-called nominate contracts (El-Gamal 2006, p. 18; Sinke 2007, p. 17). This restriction hasn't proven fatal for the development of an Islamic financial sector, however, as bankers and fiqh scholars have been quite skilful in the art of dressing new financial instruments in the garb of the nominate contracts. A complete survey of these instruments is hardly possible, and would anyway soon be obsolete.[2] Nevertheless, some basic forms reappear in various guises and it is quite possible to give a reasonably comprehensive idea of current practices in the world of Islamic finance.

In this chapter we first review the financial instruments that are widely seen as halal and then in a separate section instruments that are accepted in some quarters but frowned upon by others. Another section is devoted to the requirements that Islamic contracts have to meet, which differ in several respects from conventional contracts.

4.2 HALAL INSTRUMENTS

4.2.1 Which Instruments are Considered *Halal*?

The ideal of Islamic finance is a situation where the capital provider shares the business risks of the borrowing entity, which means that it shares in its profits but also in its losses, in some cases even shouldering the losses fully. This is called profit-and-loss sharing, or PLS. The class of PLS instruments consists of two types:

- *mudaraba*, or trustee finance, also known as *qirad*, and a version developed for agriculture, *muzara*

- *musharaka*, that is, partnership financing, with its variants *musharaka mutanaqisah* or diminishing musharaka and *musaqat*, applied in orchard keeping

Alongside these PLS instruments a veritable smorgasbord of other financial instruments has sprung up. In all of them (except quard hasan in some cases), the financier receives a return in the form of a fee or a mark-up on the price of the goods that are bought with the help of the funds supplied. The underlying idea is that the Quran, 2:275, prohibits interest but applauds trade, and profit is not frowned upon. Sharia scholars generally accept these fees and mark-ups, provided the financier also bears some of the risks associated with owning the good. Not all sharia scholars find a return in the form of a mark-up acceptable, though. Still, the following instruments are generally regarded as halal:

- *murabaha*, or mark-up financing, with a variant called *musawama*
- *ijara*, leasing, with its variant *ijara wa iqtina*, which means lease to own, or lease purchase
- *bai'salam*, that is, prepaid purchase
- *quard hasan*, or beneficence loan
- *istisna*, a contract of manufacture with progressive financing
- *sukuk*, certificates or Islamic bonds
- Islamic credit cards.

These instruments will now be discussed successively.

4.2.2 *Mudaraba*

Mudaraba (stress on the second syllable) can be translated as trustee finance contract or trust financing. The Maliki and Shafii law schools also use the name *qirad*. The bank, or any other money provider, acts a *rabb al-mal* or financier, capital owner, and provides the entire capital needed for financing a project. The other party, the *mudarib* or agent, manages the venture and brings their labour and expertise in. The capital provider is similar to a sleeping partner. Parties agree beforehand on the proportion in which they share any profits. Losses are borne exclusively by the capital provider. The mudarib cannot share in any loss, because the sharia stipulates that one cannot lose what one does not contribute. Even poor management is no reason to hold the mudarib responsible, unless there is evidence of wilful or culpable negligence (Chapra 1998).

The mudaraba contract is a profit-sharing contract. Mudaraba is therefore reserved for business finance, it is not suitable for consumer finance. In farming there is a special variant of mudaraba, called *muzara*. The bank may provide funds or land, or the landowner provides land and seeds, and the harvest is divided between the farmer and the bank or the landowner. Mudaraba is used in trade finance and in investment projects with short gestation periods, but it is not very popular, apart from its use as a form of deposit taking by banks (see Section 5.2). The fact that losses are exclusively borne by the financier brings with it serious agency problems. There is little incentive for the mudarib to do his utmost to make a success of the project financed by a mudaraba contract. As we shall see in Section 5.3.3, the fact that any profits are shared between the mudarib and the financier does not help either. We shall also see that it may be difficult for the financier to find out how large profits are. Further, wilful or culpable negligence is often difficult to prove, and even if it is, the prospect of long drawn-out court cases with an uncertain outcome does little to enthuse financiers for this sort of contract. Collateral may be requested to help reduce these moral-hazard risks (more on moral hazard in Section 5.3.3). It may, for example, help to prevent the entrepreneur absconding, but this is hardly sufficient to neutralize the disadvantages.

The majority of the sharia scholars are of the opinion that the mudaraba contract is revocable, which implies that it could be cancelled by any of the two partners at any time (Sarker 1999). It may be noted that even if mudaraba is widely accepted as sharia-compliant, there are dissenters. Haque (1995, p. 51) argues that a mudaraba contract is not really about partnership, but only about profit sharing. This may have worked fine in ancient times as a method for financing long-distance trade, but in present-day economies the mudarib is wholly subject to the capitalist, and the farmer to the landowner. It has no basis in any clear text from the Quran or the Hadith and in the present time, in the words of Haque (1995, p. 162), it is only developed 'as a way to justify economic serfdom, political and social corruption, and effete morality'. This is, however, far from being the dominant view.

4.2.3 *Musharaka*

Musharaka (again, stress on the second syllable) is partnership financing. It can be seen as a kind of equity participation contract. Both profits and losses are shared according to a predetermined formula, usually in the same proportion as the partners' shares in the firm's equity capital, though profits can be shared in any equitable proportion. Losses must be shared in proportion to capital contributions. Partners may decide to share profits not only taking account of capital contributions, but also of the amounts of labour supplied. The Shafii school requires profits to be divided exclusively in proportion to capital contributions. This is because the contribution of labour, or skill and management, is difficult to measure and it is assumed that labour will be contributed equally. Profits, like losses, should also be in proportion to the risk shared. However, if two partners contribute to the capital and only one of them is actually working, then even according to the Shafii school the working partner's share in the profits should be higher than his share in the partnership's capital (Chapra 1998). There is a form of musharaka where some partners only contribute their skills and effort to the management of the business without contributing to the capital, but such partnerships are not recognized by the Maliki and Shafii schools. There are various other forms of musharaka (see Chapra 1998). In one of these, all partners have full authority to act on behalf of the others and are jointly and severally responsible for the liabilities of their partnership business, provided that such liabilities have been incurred in the ordinary course of business. In others, in particular where partners own unequal shares in the capital of the firm, their liability towards third parties is several but not joint. Like mudaraba, musharaka is exclusively meant for business finance.

Musharaka partnerships can be securitized. Musharaka certificates or notes representing ownership in the assets of the partnership can thus be traded on the secondary market, provided the assets of the partnerships are not mainly liquid assets. In that case, trade would only be sharia-compliant if the price of the certificates would reflect the nominal value of the assets, otherwise riba would be involved. Fiqh scholars seem to agree that a minimum of 50 per cent of the assets should be non-liquid (Sinke 2007, p. 32).

A special form of musharaka is *musharaka mutanaqisah* or dimishing partnership. This variant is used in home finance. Ownership of a dwelling is shared by the capital provider and the occupier. The share of the capital provider in the dwelling diminishes over time as the occupier makes regular payments to the capital provider. In orchard keeping there is another special musharaka-like contract called *musaqat*. The harvest is shared among the partners according to their respective contributions.

Unlike under a mudaraba contract, under a musharaka contract the entrepreneur, the user of the funds, also runs the risk of a financial loss. Musharaka financing is used for long-term projects, but also for projects that need flexible financing or for providing working capital. Musharaka financing requires the setting up of a joint venture that is an independent legal entity, according to some (Gafoor 1996, p. 43). The share of the capital provider may vary, but Saudi Hollandi Bank (SHB) in Saudi Arabia usually takes a 80–90 per cent share in a project. The bank can have representatives on the firm's board of directors and all parties involved have the right to participate in the management of the firm (see www.shb.com.sa).

Like mudaraba, musharaka finance runs up against agency problems. These are slightly less serious in this case, because not only profits but also losses are shared, and musharaka finance consequently is less impopular than mudaraba finance, but serious they still are, as the analysis in Section 5.3.3 will show. These difficulties are compounded by the fact that Islamic law does not allow any collateral in the case of musharaka finance, as that would undermine the idea of partnership. This ban, however, is not always strictly applied (see Section 5.3.3).

4.2.4 *Murabaha*

The most popular Islamic financial instrument is murabaha, that is, a cost-plus or mark-up contract (once again, stress is on the second syllable). The word murabaha derives from the Arabic word 'ribh', meaning profit. A murabaha contract is a trade contract, stipulating that one party buys a good for its own account and sells it to the other party at the original price plus a mark-up. The mark-up can be seen as a payment for the services provided by the intermediary, but also as a guaranteed profit margin. Payment may take place immediately, but also at a later date or in instalments. In the case of deferred payments we have in fact a combination of murabaha and a credit sale, *bai'muajjal* (Usmani n.d.). Bai'muajjal is a shortened form of *bai bithamin ajil* (Obaidullah 2005, p. 68). It has become common practice to denote a credit sale with a mark-up as murabaha, and sometimes the terms murabaha and bai'muajjal are used interchangeably.

The mark-up may openly use interest rates, such as the London Interbank Offered Rate (LIBOR), as a benchmark. The well-known sharia scholar Sheikh Muhammad Taqi Usmani explains why, with the help of an example of two brothers, A and B. A trades liquor, which is of course haram. B trades sharia-compliant soft drinks. He wants a similar return for his efforts as his brother and therefore applies the same rate of profit for his soft drinks as his brother does for the alcohol. There is no transgression on the part of B, his pricing is not haram (Deutsche Bank 2007). The use of interest rates as benchmarks for determining mark-ups, and more generally for pricing Islamic financial instruments, is widely accepted by fiqh scholars, be it with some lack of enthusiasm. Usmani states that murabaha is far from ideal from an Islamic point of view; it should only 'be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted only to those cases where mudarabah or musharakah are not practicable' (Usmani n.d.).

Under a murabaha contract, the seller and the buyer must agree on the mark-up. The seller thus is obliged to reveal to the buyer the cost of the good to himself (*State Bank of Pakistan* 2005). It is not always possible for the seller to ascertain the cost of the goods to be sold or establish the price paid for it, and in that case a variant of murabaha applies, called *musawama*. This is identical to murabaha, except that the seller is not under the obligation to reveal his cost or purchase price, so that there is no way for buyer and seller to haggle about the size of any mark-up.

The murabaha contract is by its nature first of all a means of trade finance. It is suitable for the financing of, among other things, machinery, consumer durables, trade supplies and means of transport. Pakistan International Airlines, for instance, concluded murabaha contracts with a number of banks in 2002 to finance the purchase of airliners. There are particular risks involved when murabaha is used in longer-term transactions, as explained below.

One aspect stressed by the proponents of Islamic finance is that purely financial deals are banned, murabaha loans should always be connected with goods transactions. It has, however, proven easy to circumvent this requirement and to use murabaha as a cumbersome method to obtain a purely financial loan. The financier in this case buys commodities and sells these to its client, who resells the goods but repays the murabaha loan later. In the Gulf countries a retail banking variant, *tawarruq*, has been developed exactly for this purpose (see Section 4.3.4). The use of the murabaha contract for such pure credit transactions has been condemned in the strongest terms by the Sharia Appellate Bench of the Supreme Court of Pakistan (Usmani 2000, § 190–191). It states that a murabaha transaction by a bank may only be undertaken to finance the purchase of a good by a bank, and should only be resorted to in cases where musharaka and mudaraba are not practicable. Note that Sheikh Usmani was on the bench.

For a murabaha contract to be sharia-compliant, the financier must bear the risks associated with owning goods, in particular the risks of loss and damage (the financier may take out an insurance), but also any liability for hidden defects, until they have been delivered to the client. A murabaha contract requires the financier to sign two separate contracts, one with the supplier of the goods, who sells the goods to the financier, and one with his client, who buys the goods from the financier against deferred payment (Chapra 1998). One serious risk for the financier is that the client may have second thoughts, in which case the financier gets stuck with the goods. The client usually promises to buy the good, but fuqaha differ on whether this promise is binding for the buyer (Elhiraika 2003, p. 14; see more on this subject in Section 4.4).

It will be difficult to increase the contract period after it has been agreed, unless the financier accepts a longer repayment period without increasing the mark-up. Such an increase of the mark-up is excluded, as it would make the mark-up a function of the loan period and thus indistinguishable from interest. Rollovers are excluded. This is because the same good cannot be the subject of a new transaction (Obaidullah 2005, p. 75). As for early repayment, before the contractual time limit, this is possible, but the client has no right to a reduction of the mark-up. That may pose problems for clients that have obtained finance for a period of several years and want to sell the financed object, such as a car or a house, well before the end of the loan period. Conventional loans can be amortized without having to pay interest after amortization. Under a murabaha contract, by contrast, an amount roughly equal to the capitalized value of future interest payments under conventional loans has been added to the purchase price in the guise of the mark-up and a discount in the case of early repayment cannot be included in the contract. It would, again, make the mark-up openly time-dependent. Still, financiers are free to offer a rebate, as a gesture of kindness, but they are not allowed to promise it beforehand.

In principle, the financier may not add a penalty to the mark-up in case of late payment by the client, unless the penalty avoids riba. That means that it must be independent of time and unrelated to the capital sum of the debt. See Section 4.4 for further discussion.

4.2.5 *Ijara* and *Ijara wa iqtina*

Ijara is a contract under which the financier purchases the required item and leases it to their client. Upon expiration of the lease, the title of the item may be sold to the lessee. Parties may agree to such a sale beforehand in a separate contract. Under *ijara wa iqtina*, lease to own, or lease purchase, periodic instalments include a portion that goes toward the final purchase and transfer of ownership of the product. This can be seen as a call option premium. It gives the lessee the right to buy the good at the end of the lease period at an agreed resale price. Islamic banks and Islamic windows of conventional banks routinely offer ijara financing for periods from, say, three to seven years. This form is, again, popular for financing means of transport, including airplanes and machinery. Longer periods apply for home finance. Lease can be seen as the transfer of the usufruct of an object, to which there are no objections in the sharia. As with murabaha, penalty clauses for late payments should avoid riba (El-Gamal 2000, p. 14).

The financier may finance his own activities by issuing leasing notes. Investors buying these notes receive from the financier part of the rental payments that the financier, the lessor, in his turn receives from the lessee. The lessor may of course buy the lease object from a third party, but he may also buy the object from the lessee and lease it back, with an understanding that the lessee buys it back at the end of the lease period at an agreed price.

A necessary condition for ijara to be permissible is that the lessor remains the owner of the leased object for the whole period of the lease and bears any liabilities, such as manufacturing defects, emerging from ownership, though not any liabilities pertaining to its use. This implies that permissible ijaras are operating leases. The dividing line between operating leases and financial leases is, however, hard to draw. Ijara wa iqtina and ijara coupled with a sales contract would hardly qualify as operating leases under the definition of the International Accounting Standards (IAS) Board.[3] The fact that ijara wa iqtina and some other ijara contracts are very similar to financial leases makes some fuqaha doubt their permissibility. Long-term lease contracts shift the entire price risk to the lessee, given the fact that ijara contracts cannot be cancelled. This is particularly so with ijara wa iqtina or ijara coupled with a sales contract, if the 'residual' value of the asset, or the resale price, is fixed in advance. The quality of the asset at the end of the lease period is unknown when the lease conditions are made up, and the market-related price is also unknown. Agreeing a resale price beforehand is therefore, in the eyes of those fuqaha, a case of gharar. Even under a simple ijara contract without a sales contract, the end result for the lessee may turn out to be worse than the outright purchase of the asset through an interest-bearing loan, which is deemed unfair. Suppose the lease contract is for five years. The lessee would have to continue making lease payments even if he does not need the asset, say, after two years. In the case of a purchase of a good through an interest-bearing loan, the purchaser can sell the asset on the market and repay the loan, thus reducing his loss. This he cannot do under the terms of an ijara contract. Under an ijara wa iqtina contract there is the additional injustice that, if the lessee is unable to make lease payments, he may lose his stake in the asset even through he has paid a part of the asset price beyond the rental charge he would normally pay in an operating lease (Chapra 1998, 2007). Contracts where any purchases at the end of the lease period are only optional and the price would be market-related and not fixed in advance, would go a long way to meet the objections of the critical fiqh scholars.

4.2.6 *Bai'salam*

Bai'salam is a sales contract where the buyer pays in advance for goods. It is a purchase with deferred delivery, or buyer's credit. The goods need not already exist at the time the bai'salam contract is entered into, but they must be ascertainable, that is, they should be described exactly as to both quality and quantity, and the exact date and place of delivery must be specified in the contract. Otherwise the contract would be tainted by gharar. It remains, of course, uncertain whether the goods will be actually available. If the seller is unable to deliver, parties may agree to postpone delivery to the next crop or the seller returns the advance paid to him, without any increase (M.F. Khan 1997, p. 37). If the seller fails to deliver while able to do so, this is a breach of contract and the buyer may take the matter to court.

Bai'salam is applied to agricultural products and also to fungible manufactured goods or for providing working capital to small traders. Farmers and other small entrepreneurs would suffer disproportionally if buyer's credit were not available. Bai'salam is a bit of an exception in the Islamic financial landscape, as forward contracts are not generally acceptable. You cannot sell what you do not own and possess. Its permissibility is based on the sunna (for instance, Bukhari, vol. 3, book 35, ahadith 441–449). Bai'salam may be a forward contract, but it differs in two important aspects from the usual forwards and futures. First, under a bai'salam contract the full price of the product must be paid in advance. Second, at maturity the buyer must take delivery of the good (Al-Suwailem 2006, p. 30). Muslim scholars argue that in this way speculative activities (maysir) are prevented, but the downside is that hedging also becomes more difficult.

The ultimate buyer may act as the financier, but banks may also fulfil this role. In the latter case, the goods will be resold after the financier takes delivery. The bank may reduce its price risk if a third party, for instance a prospective customer of the farmer or trader, promises to buy the good at a certain date for a certain price. The bank may alternatively enter into a parallel bai'salam to exclude price risk. A parallel bai'salam is also called for if the bank does not want to commit any liquid funds for this transaction. One application of bai'salam outside agriculture where banks can play a useful role is export finance (Obaidullah 2005, pp. 95–9). Remember, though, that bai'salam is only allowed for fungible goods.

The Maliki law school in Madinah allowed trading in salam contracts in secondary markets already around the year 800. The exceptions were essential food commodities, such as wheat, barley, dates and salt, as the Prophet Muhammad had instructed his followers that food can only be sold if possessed in advance. The other three Sunni law schools do not allow resale or transfer of ownership before delivery has been made (M.F. Khan 1997, p. 37). Salam contracts allow financiers to take security or guarantee, but not to impose a penalty for late delivery (Elhiraika 2003, p. 59).

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), has ruled against bai'salam for shares in a standard, Sharia Standard 21, that became effective in January 2007 (Gassner 2007b; Gibbon and Norman 2008). The reasoning appears to be that the shares cannot be described well enough for the future, as the underlying assets may change. This means that gharar is involved. But there are respected scholars who disagree and accept bai'salam for shares, on the grounds that shares are all identical and readily available on the market (Gassner 2007a).

4.2.7 *Quard hasan*

Quard hasan loans are beneficence loans, on which no interest is charged. The lender may, however, charge a commission. It is meant for those who are less well-heeled, such as farmers and other small businessmen and poor consumers. It can also be used for other ends. In Pakistan quard hasan loans, or *Qarz-e-Hasna* loans as they are called there, have been provided to science students doing advanced studies (Bokhari 1984). That means they have been used as an instrument of education policy.

A qard hasan loan is free of any rate of return, although the recipient may wish to reward the provider with a return in excess of the original amount borrowed. While banks cannot enforce the payment of additional amounts, some provide the facility to corporate borrowers in the expectation that these will return sums in excess of the original borrowing (Naughton and Naughton 2000, p. 149)

4.2.8 *Istisna*

Istisna is a contract of manufacture with progressive financing, or a contract of acquisition of goods by specification or order where the price is paid progressively in accordance with the progress of a job. Payments are made as the building or manufacturing of the object comes closer to completion.

An istisna contract concerns goods that do not yet exist, and would consequently imply gharar. However, an exception has been made by fuqaha on the basis of qiyas (analogy) and equity. The analogy is with bai'salam. A major reason for banning gharar is that one party should not take advantage of asymmetric information, that is, a lack of knowledge on the part of the other party. There is little danger of such a market imperfection under an istisna contract, where there is a party A who agrees to construct or manufacture a particular product, with predetermined specific features, and to deliver it to party B at a predetermined price (Obaidullah 2005, p. 35).

It was the Hanafi school of law that saw the need for the istisna contract. Hanafi scholars realized that some goods would never be produced if no one guaranteed their purchase. This is the case with goods produced at high cost and goods that have to be tailored to very specific tastes. Houses, ships, factory buildings and infrastructural projects come to mind. The Hanafi school furthermore allows payment to be deferred. According to some schools of law, the price has to be paid in full in advance, as under a bai'salam contract, but the Islamic Fiqh Academy of the Organization of the Islamic Conference decided in its seventh annual meeting in Jeddah in 1992 that payment in instalments or deferment of payment until completion of the object is permissible (M.F. Khan 1997, p. 38).

4.2.9 *Sukuk*

Sukuk are tradable, asset-backed, medium-term notes. The name sukuk is sometimes translated as certificates, or as Islamic bonds. Islamic bonds sounds a bit like a contradiction, and of course no predetermined interest rate is promised on these so-called bonds. Still, they may offer investors a steady stream of income. Sukuk are backed by real assets and often, but not always, they represent ownership of real assets. The first Islamic global bond issue was floated in 2002 by the Malaysian government. The lead manager of the issue was HSBC Bank Malaysia and the sukuk paid a spread over six-months LIBOR. Sukuk are mainly aimed at institutional investors, though there have been issues with a minimum value of each sukuk below the equivalent of €2000.

The Fiqh Academy of the Organization of the Islamic Conference legitimized the use of sukuk in February 1988, but it took some years before the market developed (Jobst 2007, p. 19). Sukuk are not only issued by or on behalf of governments and quasi-sovereign agencies, but also on behalf of corporations, such as the Saudi Arabian car hire firm Hanco Rent-a-car in 2004. Sukuk issues are regularly heavily oversubscribed and the volume issued shows a steep rise, from $7.2 billion in 2004 to nearly $39 billion in 2007, with more than $90 billion outstanding at the end of 2007 (Jobst et al. 2008). The restricting factor is supply, not demand. Estimates of the pool of Islamic money available for investment in sukuk exceeded $300 billion in 2006 (Soy 2006). Sukuk seem to be attractive not only to wealthy Middle Eastern investors, but to non-Muslim Western investors as well. They enter them in their books as their allocation of emerging market debt. Sukuk flotations are not restricted to Islamic issuers either. Borrowers in non-Islamic countries, from Germany to China, are also interested in tapping the Middle Eastern capital markets. The German state of Saxony-Anhalt issued a €100 million sukuk in 2004, with Citigroup as the lead manager, and the World Bank issued its first sukuk for 760 million Malaysian ringgit ($202 million) in 2005. In 2006 a US private firm, East Cameron Partners, issued a sukuk for $166 million to finance offshore gas drilling in Louisiana. In his 2007 budget, the then British Chancellor of the Exchequer, Gordon Brown, announced plans to develop London as an international centre for Islamic financial products, including a secondary market for sukuk. One measure concerned offsetting the coupon payments on the securities against the company's profits for corporation tax purposes, similar to interest on conventional bonds. The first sukuk was listed on the London Stock Exchange in July 2006.

In the cases just described, it was not the borrower itself, but a special purpose vehicle (SPV) that issued the sukuk. In Malaysia that was Malaysia Global Sukuk Inc., owned by the Ministry of Finance. The money collected was handed over to the government, in exchange for real estate which was purchased from the country's Federal Land Commissioner for a five-year duration and which was then leased to the government. The sukuk, in fact floating rate trust certificates, thus were backed by real assets. The lease rental payments from the government to the SPV match the payments payable on the trust certificates. On the expiration date, the real estate was to be sold back to the government at the face value of the sukuk, so that any rise or fall in the valuation of the underlying assets had no bearing on the sukuk issue (Horne 2002).

Sukuk come in different shapes:

1. *Ijara sukuk*. These in their turn have two forms:

   (a) the sale–leaseback construction just described;
   (b) the headlease–sublease ijarah model, in which the owner of the assets headleases them to the issuer and rents them back. This was the model used in the Saxony-Anhalt sukuk.

   Ijara sukuk can be traded on the secondary market at negotiated prices. They are not debt but evidence of ownership. But what to do when the lease period ends? One option is to issue sukuk with a fixed maturity date, as in the case of the Saxony-Anhalt sukuk. In the case of a sale–leaseback, it can further be stipulated that the issuer will buy back the real estate, as in the case of Malaysia mentioned above. If the sukuk have no fixed maturity date, the issuer might buy back the sukuk at the expiration date of the lease. The AAOIFI has issued a standard not allowing the issuer to promise to purchase ijara sukuk back at their nominal value, rather than their market value (Ali 2005, p. 31). This was repeated in a fatwa delivered in February 2008 (see below). Such a guarantee would make sukuk too much like conventional loans against interest. The terms of the original Malaysian government sukuk obviously would conflict with this standard.

2. *Mudaraba sukuk.* A company or its bank sets up a special purpose mudaraba and investors provide finance for a project in return for sukuk. The special purpose mudaraba owns the assets that are financed by the returns of the sukuk sale. The company or the bank may act as a mudarib for this special purpose mudaraba (Obaidullah 2005, p. 160). Profits should be distributed according to some pre-agreed ratio.
3. *Musharaka sukuk*. In this case, the borrower and the lender set up a joint venture of a musharaka nature, with the borrower putting in some percentage of the funds required in equity and investors supplying the rest through sukuk purchases. Profit is shared according to some formula agreed between parties, and losses and expenses are distributed according to the amount of finance contributed by each party. This is a form that is attractive, for instance, for financing toll roads, but can also be used for financing other infrastructure or real estate.
4. *Murabaha sukuk*. The SPV in this case buys a good that a company needs and resells it with a mark-up, against payment in instalments. Murabaha sukuk offer investors a steady stream of income. As murabaha sukuk are purely debt instruments, they can only be traded at their nominal value. However, in Malaysia fiqh scholars follow a more liberal interpretation of the sharia than their colleagues elsewhere, and allow trading in debt at negotiated prices (Obaidullah 2005, pp. 161–2). This means that sukuk can be traded before the date of maturity at a discount, which for all practical purposes means that interest is paid and received. In the Middle East and elsewhere this practice is anathema.
5. *Istisna sukuk*. Here the SPV representing investors becomes the seller and contractor-manufacturer of an asset to a buyer (say, the government) and uses back-to-back istisna for creation of the facility. In other words, the SPV takes upon itself the legal responsibility of getting the facilities constructed, and subcontracts the work to manufacturers or contractors. The sukuk sold to investors may have different maturities, to match the instalment plan that has been agreed upon by the two parties. Liquidity is low, as istisna sukuk are debt and can only be traded on secondary markets at their face value (Obaidullah 2005, p. 165).

This list of sukuk forms is not exhaustive, financiers are free to devise other varieties (see Obaidullah 2005 for a more detailed enumeration). One development is the convertible *sukuk*, which can be exchanged for equity. Dubai Ports, for example, issued a $3.5 billion pre-IPO convertible sukuk in January 2006.

The different forms of sukuk have different characteristics. Apart from the legal guise they adopt, sukuk can be fixed-rate or flexible-rate, in the latter case usually coupled to LIBOR or Euro Interbank Offered Rate (EURIBOR). They further differ as to liquidity. Murabaha and istisna sukuk score low on liquidity, musharaka, mudaraba and ijara sukuk are more attractive in this respect.

A sukuk flotation can be seen as a securitization of assets. Not all forms meet with universal approval of Islamic jurists. If, for instance, lease claims are securitized and sold to the public in the form of sukuk, the buyer receives a financial instrument that pays a fixed income and carries a low risk. Does this involve riba or is it a claim on a fraction of a very stable stream of profits? Opinions differ. In the same way, musharaka participations can be securitized by issuing negotiable certificates, or sukuk. This may make sense in the case of large investments, such as infrastructure projects or large industrial complexes (Khan 2002). Such securitization took off on a large scale in Malaysia after the Shafii school ruled it halal. Hanafis and most Hanbalis, by contrast, consider it haram, and Malikis deem it admissible only under very strict conditions (El-Gamal 2000, p. 6). The division goes so deep that Bahraini Islamic banks refuse to trade with Malaysian Islamic banks (*Euromoney* 2001). Other disagreements are bound to rise over the fatwa issued by the AAOIFI in February 2008 that sukuk that promise holders to be paid back the face value at maturity or in case of default are not admissible. Instead, a price based on the market value of the underlying assets is required. Otherwise, the whole construction would be very close to a conventional loan against interest, with the capital sum guaranteed.[4] AAOIFI recommendations do not have the force of law and it remains to be seen how the industry will react to it.

4.2.10 Islamic Credit Cards

Life without a credit card is hardly possible in modern economies, but credit card purchases may involve interest payments. Generally there is no problem from a Muslim point of view if card holders pay the credit card company within the grace period, so as to avoid paying interest, though not all fuqaha concur. Various sharia councils have made liberal rulings that enabled financial institutions to develop Islamic credit cards that provide credit for longer periods than the usual one-month grace period. With these cards, purchases are automatically financed over a fixed period, usually 12 months. Early payment results in a price reduction (El-Gamal 2000, p. 5).

Apparently, providers do not always see each other's product as truly Islamic. Bahrain's ABC Bank announced in June 2001 that it was to launch the first credit card conforming to strict sharia regulations.[5] Bank Islam

Malaysia Bhd in its turn claimed that its card, launched in July 2002, was the first credit card developed by the Islamic banking industry.[6] The card, both Mastercard and Visa are available, cannot be used for payments in bars, discos and night clubs, for the purchase of beers, escort and massage services or for gambling.

The characteristics of Islamic cards vary. The Bank Islam Card involves the sale of a piece of land by the bank to the customer, immediately followed by a purchase of the same piece of land by the bank at a lower price. The proceeds of the latter transaction are disbursed into an account against which the customer can redraw cash and purchase goods with the credit card. Presumably the purchase of the piece of land by the client will be paid in instalments, though the bank's website is silent on this point.[7] This construction is called *bai inah* (see Section 4.3.3). The bank's profits come not only from the difference between the purchase and sale prices of the piece of land that twice changes hand, but also from fees and profit charges, partly depending on the repayment period. One wonders whether the boundary between fee and interest has not become blurred by these 'profit' charges. The only difference with conventional cards seems to be that the 'profit' is not compounded (Obaidullah 2005, p.108). Given this minimal difference, one wonders whether the diatribes against the pernicious effects of interest that one finds in parts of the Islamic literature and on Islamic websites are not a bit overblown. Interestingly, sometimes the criticism of interest is specifically directed at compounded interest.

The Bank Islam Card is based on a disputed financing method, bai inah, and therefore fits awkwardly in this section, but that is not the case with other credit cards. The card announced by Kuwait Finance House in September 2003, to be used specifically to buy consumer durables from selected shops, was based on ijara. It was an instrument for hire purchase but was no longer available in 2007. Its *Al-Tayseer* (meaning 'ease the way') card, which can be used both as a Visa and as a Mastercard, is more like a conventional credit card in its range of applications. It requires monthly balance repayments amounting to one-third of the outstanding balance. Card holders pay an annual fee plus a fee for cash withdrawals and other transactions.

4.3 GREY AREAS

4.3.1 Introduction

Some financial instruments are clearly halal. There are no objections to buying shares in business firms, provided their activities comply with

Islamic norms (see Section 6.4). Participation in share capital in itself is not seen as speculation, but rather as co-owning physical assets, which is not unlike musharaka. But it must not be tainted by interest. Preferred stocks are not acceptable, as they provide a fixed return. This is seen as riba (Naughton and Naughton 2000, p. 150). Then we have the instruments which were reviewed in Section 4.2. They are generally, but not always universally, regarded as sharia-compliant. In this section we go further down the scale and comment upon a number of financial instruments that have been developed by the Islamic financial industry but are judged totally unacceptable by important sections of the fuqaha fraternity. First in line, however, are not the financial instruments per se, but the conditions under which they are traded, namely the trading of debt at negotiated prices. This is followed by a discussion of the most important disputed financial instruments, namely: *bai inah*, or *bai-al-einah*, repurchase by the seller; *tawarruq*, the purchase of a good on credit followed by a sale to a third party; and derivatives, in particular options, futures, bai'salam and *arbun* or *urbun*, a kind of call option.[8]

4.3.2 Trading of Debt at Negotiated Prices

The sale of debt other than at face value is generally seen as haram. Trading at other prices would boil down to paying and receiving interest. Jurists argue that gharar is involved as well, as the buyer may not know the true financial position of the debtor (Chapra 2007, p. 349). In other words, there is asymmetric information. In parentheses, if this latter argument is taken seriously, a large part of commercial activities could be branded haram and economic life might more or less come to a standstill.

In Section 4.2.9 we have seen that in Malaysia the trading of debt at negotiated prices is nevertheless allowed, provided there is an underlying real transaction. Support is provided by Chapra (2007). He finds the two arguments against the trading of debt other than at face value not convincing in the case of debts that are not created by borrowing and lending money, but as a by-product of real transactions. Selling a debt at a discount, for instance, in the case of a murabaha transaction, means that the buyer receives part of the profit margin agreed by the bank and the buyer of the good. Gharar is not involved either, as the debtor often is a well-known company with a high credit rating. Chapra would like the jurists to understand that the sale of such asset-based debt should not be considered haram. This would have at least two benefits: a secondary market would spring up and the debt could be securitized. A secondary market is important because it would give banks better opportunities for liquidity management and securitization would enable the banks to better perform their role in financial intermediation. Chapra may find a sympathetic ear in Malaysia, fiqh scholars in the Gulf States cannot but condemn his ideas.

4.3.3 *Bai inah*

A second transaction on which Malaysia and the Gulf States differ is repurchase by the seller, *bai inah*, also spelled *bai al-einah*. This may take the form of a purchase of a good on credit from a bank and selling it back to the bank at a lower price against immediate payment. Bank Islam Malaysia uses this method for its credit card. The 'real' transaction thus may involve a good that the client will never have in his possession and perhaps does not even see (Bank Islam Malaysia's piece of land). Any credit transaction can be based on this construction. One might say that this transaction formally does not involve interest, but that it is meant to provide the client with credit or a credit line and the bank with an income that economically does not differ from interest. The Shafii scholars from Malaysia and other South-East Asian countries tend to consider exclusively the formal aspects, whereas jurists from the Gulf States take intention into consideration and reject bai inah.

4.3.4 *Tawarruq*

Gulf scholars may reject bai inah, but they permit a somewhat similar transaction on the grounds of darura (necessity). This is tawarruq. Literally, tawarruq means 'monetization', that is, of the traded commodity. In a tawarruq construction someone buys a good on credit, often from a bank in the guise of a murabaha transaction, and sells it to a third party spot. The bank may charge itself with selling the good on behalf of its client. Banks may also resort to a tawarruq transaction with other banks if they need liquid funds themselves. For large transactions, platinum and aluminium, traded on the London Metal Exchange, and in Malaysia also palm oil, are used. Silver and gold cannot be used, because these are seen as equivalent to money. Consequently, a mark-up is not permissible, and banks are only interested in tawarruq transactions if they can make a profit through a mark-up.

Scholars allowing or even advocating tawarruq base themselves on Ibn Taymiyya, who ruled this transaction makruh, undesirable, but not forbidden (Gassner 2007a). The individual is free to decide for himself whether or not to engage in makruh activities. The necessity can be on the client's side, as when he needs money for a medical treatment or a marriage, or it may be on the bank's side, for instance, when regulatory constraints do not, or do not yet, allow the use of more straightforward cash management techniques. Obviously, it is hard to agree on criteria for what qualifies as 'necessity'. Like bai inah, tawarruq is seen as a case of *hiyal*, or legal stratagem. The formal requirements for an Islamic contract may be met, but the intention of the transaction is not to buy a good on credit, as in a normal murabaha transaction, but pure debt financing. No surprise then that the Fiqh Academy in Mecca rejected tawarruq, or at least organized tawarruq, in a ruling produced in 2003 (al-Suwailem 2006, pp. 103–4). The fact that many Islamic jurists reject this use, or misuse, of the murabaha contract does not seem to have had any impact on the practice, however (El-Gamal 2005a).[9] A minimum requirement for tawarruq to be acceptable for the fiqh scholars that do not reject it outright is that there is a time lag between the different transactions involved. This is to make sure that the parties are exposed to price risk and the gains from the transactions can be regarded as a reward for risk borne rather than riba (Obaidullah 2005, p. 110).

Banks do not necessarily have to organize the sale of the good underlying the tawarruq transaction. Bank clients may also buy a good on credit from a bank through a murabaha transaction and sell the good themselves. In Saudi Arabia, for instance, people are known to have bought cars on credit, only in order to resell these immediately and invest the money on the stock market (England 2007).

4.3.5 Derivatives

Derivatives have largely been anathema in Islamic finance, though the permitted bai'salam transaction is a kind of commodity future. Derivatives are seen as speculative, involving maysir and/or gharar, and often in conflict with the requirements that a contract should not cover more than one transaction and that financial instruments must be backed by real assets. Furthermore, there is a consensus that risk cannot be separated from real transactions, for that would make risk transfer a zero-sum game, which jurists see as running against the injunction in Quran 2:188, 'Do not misappropriate one another's property unjustly' (Al-Suwailem 2006, p. 83).

Derivatives come in many guises. One of these is options. Options on precious metals or foreign exchange would amount to trade in money and are categorically forbidden. Most sharia scholars, among those the jurists of the Islamic Fiqh Academy at Jeddah, see options as a promise to sell or purchase something at a specific price within a stipulated time and such a promise cannot be the subject matter of a sale or purchase, in their view. Fuqaha in Malaysia see things differently and deem any kind of benefit admissible. Since options involve a benefit for the purchaser, a right without an obligation, trading of such a benefit is judged to be permissible (Obaidullah 2005, p. 182). Others opine that only very specific kinds of options pass muster. Consider companies that provide their employees with options to buy shares of the company at a predetermined price. A rise in the share's price above the strike price is a gain to the employees and a cost to the company. However, this cost is utilized as an incentive for the employees, so the final result of the contract is a win–win outcome. The idea is that wealth created through the effort of the firm's employees compensates for the loss arising from the increase in the share's price. In the usual kind of call options, by contrast, any changes in the price of the underlying good means that one party gains and the other loses (Al-Suwailem 2006, p. 80).

There is much confusion in this area. Call options on financial instruments, for instance, would involve what fuqaha see as pure speculation, maysir, if neither the buyer nor the writer of a call holds the underlying stock, nor has any intention to hold it. This should lead to the verdict: not permissible. Stock options leave open the possibility to deliver shares at the exercise date, but this seldom happens. They are issued by an options exchange and buyers and writers use them for speculation or for hedging. Speculation is simply forbidden and hedging is considered not permissible because it is trading in risk. The case is, however, different with warrants, options to buy shares of a company at a certain price (Naughton and Naughton 2000). These options are not used for pure speculation or hedging, there is an intention to become a shareholder in a company.

An alternative to, or a variant of, call options is *urbun* (also spelled *arbun*), which is a premium paid by the buyer in order to obtain the right to decide at a later moment whether to buy or not.[10] Urbun is similar to a call option in the sense that the down payment is not returned in case the buyer decides not to buy the good or asset after all. The difference is that the premium on a call option is not returned in the case the option is exercised either, whereas the down payment on an urbun purchase is part payment for the good or asset if the sale is effectuated. This, incidentally, makes an arbun contract less attractive to the writer than a conventional call option. The Hanbali school is the most liberal in allowing arbun, other schools, in particular the Hanafi school, tend to be opposed to it (Gassner 2007b; Gibbon and Norman 2008). They argue that the retention of a down payment by the seller is akin to misappropriation of the property of others and hence is not permissible (Obaidullah 2005, pp. 182–3).

In case sharia boards ruled all call options haram, this would make not only speculation but also hedging difficult. It looks possible to devise alternative solutions. Al-Suwailem, for instance, developed the idea of hedging through not-for-profit arrangements, in particular mutual or cooperative foreign-exchange hedging funds. Mutual hedging would mean that participants credit any gains or losses on their currency operations to their account with the fund. The fund could demand initial capital from participants to provide for periods with net deficits (Al-Suwailem 2006, pp. xii, 118). Such arrangements do not yet seem to exist, however, and it might be difficult to persuade members to part with their gains. This might be circumvented by asking every participant to pay a gift into the fund commensurate with their foreign-exchange exposure.

Urbun and mutual funds are examples of (possibly) sharia-compliant forms that bankers and Muslim scholars have devised to circumvent or weaken the ban on derivatives. The need is particularly felt on the foreign-exchange market. The standard view on hedging in the foreign-exchange market is that it is haram because it involves gharar, riba and forward sales of currencies (Chapra 2007, p. 352). But, as Chapra notes, hedging reduces uncertainty and thus, if anything, reduces gharar. In favour of hedging, Chapra points to one of the important objectives of the sharia, the protection of wealth (*hifz al-mal*). Without hedging this is hardly possible under floating exchange rates. According to Chapra, we should look at the reason, *illah*, for the prohibition of forward transactions. If the prevention of speculation is the reason, hedging should be restricted to transactions related to sales and purchases of real goods and services. However, the counterparty should not be a speculator either. The question of interest could be solved if the bank that acts as counterparty invests the foreign exchange involved in a swap in a permissible way. This would mean that the funds are not invested in interest-bearing bonds, but in ijara certificates, sukuk or murabaha investments.

One way to weaken the objections of fuqaha when one wants to hedge risk on foreign-exchange markets is to use bai'salam contracts (Obaidullah 2005, p. 179). An exporter A who anticipates a cash inflow of $50 after one month and expects a depreciation of the dollar might make a bai'salam sale of $50 against rupees (with his obligation to pay $50 deferred by one month). The spot exchange rate is 1:22. Since the exporter is expecting a dollar depreciation, he may be willing to sell $50 at the rate of 1:21.5. There would be an immediate cash inflow of Rs 1075. But why would the counterparty pay rupees now for a promise to be repaid in dollars after one month? The answer is: in the expectation of making a profit. If the counterparty expects an appreciation of the dollar, say to 1:23 during the one-month period, it expects to receive Rs1150 for the Rs1075 it invested in the purchase of $50. This would of course involve speculation, but on a lesser scale than with conventional forwards. This is because the counterparty would be more restrained in trading as payment has to be made immediately, whereas under a conventional forward not only delivery but also payment is delayed. Still, a majority of fuqaha does not allow the use of bai'salam on the foreign-exchange market.

A sharia-compliant solution for hedging seems possible with the help of a swap (Obaidullah 2005, p. 198). Consider the following case. Exporter A from India has sold goods to US customers and anticipates a payment of \$50 after one month, which at the current exchange rate of 22:1 would amount to Rs1100. Exporter A expects a fall in the external value of the dollar. Exporter B from the USA anticipates to receive Rs1100 after one month, but fears a fall of the rupee. A and B now can hedge their risks through a foreign-exchange swap. Exporter A borrows \$50 from B and B borrows Rs1100 from A for a period of one month. After one month A repays the loan, using the \$50 received from his customer, and B does the same with the proceeds of his exports to India. Both A and B can invest the borrowed sums in sharia-compliant investments, such as murabaha loans or ijara participations. If the loans are interest free, they should not meet with any objections from the fiqh specialists. Such swaps are also used by Islamic banks (Obaidullah (2005, pp. 196–7). Say an Indian bank owning dollars and a US bank owning rupees may swap these currencies and invest the money on their domestic money markets until the capital sums have to be repaid. Their investment income during this period is in their domestic currencies, which partially reduces their currency risk.

A swap involves forward transactions. These can also be used for providing credit, as an alternative for common advances in conventional banking. If a business firm, for instance, wants to have its inventory financed, the bank cannot simply provide credit against interest, but it may buy the inventory and sell it back with a mark-up on a time schedule geared to the firm's needs. The bank does not sell what it does not own and the price and the characteristics of the good are perfectly known to both parties. There is thus no gharar involved, and the margin between the bank's buying and selling prices can be labelled as profit, as the bank has to bear the risks associated with ownership and thus acts as an entrepreneur (Wigglesworth 2006).

Instead of using forward transactions in a swap, one could also hedge price risks with the help of futures. These too are generally considered to be haram, as they not only involve the sale of assets that the seller usually does not yet possess at the time the transaction is concluded, but also are in most cases not meant to result in actual delivery of goods or assets. Futures are either used for speculative purposes or for hedging, which is condemned as trading in risk. In so far as the buyer of a future contract really wants to take delivery of a good, futures contracts should meet with less disapproval. Futures trade contracts are promises to deliver or to take delivery, and these are allowed. The Maliki school furthermore allows futures contracts to be traded, like they have always done for bai'salam contracts, but the Hanafi, Shafii and Hanbali schools do not. According to them, the trader will have to wait until the delivery is made before he can resell those goods. This would at first sight preclude the development of a secondary market for futures. However, parallel transactions would solve this problem. A buyer of a futures contract would be unable to sell this contract on the secondary market, but he could sell a new futures contract and thus free his money (M.F. Khan 1997, pp. 57–9, 65).

A Malaysian authority on Islamic law, Muhammad Hashim Kamali, has made short shrift of objections against futures transactions in general on the following grounds:

1. It should not be branded as gambling (maysir), as it serves an economic purpose: it reduces price risk.
2. Futures transactions involve selling assets that the seller does not own at the time of the agreement. Such short-selling is generally seen as haram. However, the ban on short-selling in the Hadith is restricted to unique goods or assets and does not include generic (fungible) goods or assets (cf. bai'salam).
3. Possession of goods or assets prior to sale is in principle required in order to avoid deception (gharar), but this argument against futures does not hold water as delivery is guaranteed by the futures clearing house.
4. The ban of jurists on delaying both delivery and payment in a sale and the offsetting of a futures position with another finds no convincing grounds in the Quran or the Hadith.

Kamali therefore concludes that futures transactions are Islamically permissible as long as they steer clear of non-permissible commodities and of interest elements, including of course interest rate futures (Ebrahim and Rahman 2005, pp. 275–6).

There are a few Muslim countries with futures markets: Indonesia (coffee and crude palm oil), Kazakhstan (wheat), Malaysia (crude palm oil, stock index and government debt) and Turkey (currency). In addition, there is some over-the-counter trading based on bai'salam in a number of Islamic countries, including Iran (Ebrahim and Rahman 2005, pp. 277–8).[11]

Things are certainly moving in the world of Islamic derivatives. The Bahrain-based International Islamic Financial Market (IIFM, see Section 5.4.4), seeks to play a leading role. In September 2006 the IIFM signed a Memorandum of Understanding with the International Swaps and Derivatives Association, with an eye to developing a master agreement for documenting privately negotiated sharia-compliant derivatives transactions. 2008 should see the results.[12] Still, forwards and futures for financial instruments will not easily be allowed. If the AAOIFI has declared bai'salam transactions for shares inadmissible (Section 4.2.6), transactions that do not require immediate payment or do not concern instruments that represent physical goods will be seen even more as conflicting with the sharia. The industry is active in devising ways around the bans, however (see the case of the foreign-exchange swap discussed aboven).

4.4 ISLAMIC CONTRACT LAW

Islamic financial transactions are of course subject to Islamic contract law. This means that contracts have to obey the bans on riba, gharar and maysir and haram activities, but there is more. We give a quick overview of the main principles.

- Uncertainty. The ban on gharar implies, among other things, that there should be no uncertainty about the characteristics of a good, the exact price and the date of delivery. These must all be known at the time of concluding a contract. Also, a seller and/or financier first must own the goods before they can sell or lease them, which implies that the goods must exist before they can be sold. There are exceptions to this rule: istisna and bai'salam.
- Complexity in contracts. Another aspect of gharar concerns complexity in contracts. The sunna does not permit interdependent contracts (Obaidullah 2005, p. 33). A contract should not cover more than one transaction. A sales transaction and a lease agreement, for instance, cannot be combined in one contract. Also, a murabaha transaction consists of two separate transactions that should be independent of each other. They should be separately documented and the goods bought and sold should be in the risk of the financier between the purchase by the financier and the sale to the client, the ultimate buyer (*State Bank of Pakistan* 2005).
- Legal status of promises. Unlike in Western law, in Islamic law a promise is not equal to a contract. A promise to buy or sell under a murabaha contract, therefore, is a moral obligation and not a legal obligation. If the promise is not enforceable in a court of law, that may make a murabaha contract risky for a bank. Especially if prices are volatile and the client feels he can make a better deal, the bank may have bought a good that the client eventually refuses to take delivery of. The reason appears to be that sharia law does

not recognize a contract that has as its object a future thing. Ijara, bai'salam and istisna are exceptions, and only allowed if an exact description is given of the goods to be delivered, the place and time of delivery and the price to be paid (which has to be paid immediately in the case of bai'salam). All this follows from the need to steer clear of riba and gharar. Exchanges that could result in riba al-nasia (riba by way of deferment) should therefore be concluded immediately, and countervalues must be, at least in their essence, in existence and known to the contracting parties. The Islamic Fiqh Academy at Jeddah, however, has ruled that the fulfilment of promises made in commercial transactions is obligatory in the legal sense if the promises are unilateral (a unilateral promise is called *wa'd*) and the promise has caused the promisee to incur some liabilities. If the promisor then has second thoughts, the court may force him either to sell or buy the good as promised or pay damages (Deutsche Bank 2007). In conclusion, there can hardly be any overriding objections for Muslims against following Western legal practices in this respect.

- Agreement among parties. Sharia law requires that offer and acceptance must be linked and must be made during the same meeting. If acceptance of an offer is made subject to any condition, it does not count as an acceptance but as a counter-offer. If the meeting ends without the parties reaching agreement, the offer is deemed to have expired (Sinke 2007, p. 21).
- Obligations of ownership. Under Islamic law, the owner of a property pays property taxes. In the case of leased property, it is therefore not the occupier who pays the tax. The same goes for insurance. If no Islamic forms of insurance are available and the law of the land requires property to be insured, darura or necessity may be invoked by Islamic scholars as a reason to allow conventional insurance (Thomas 2001).
- Penalty clauses. As riba is forbidden, penalty interest in case of late payment is also forbidden. But this does not amount to a flat rejection of any penalty clause. In some countries, such as Bangladesh and Pakistan, a penalty provision is introduced in mark-up based contracts for late payment (Sarker 1999). There is an enormous diversity of views on this subject among fiqh scholars. At one extreme are those that allow only imprisonment to serve as a deterrent, but prohibit any monetary penalty on the defaulter and do not allow compensation to the aggrieved party, for fear that this might become equivalent to interest. Imprisonment of course only serves as a deterrent to unjustified delay in payments;

it would not offer the aggrieved party any compensation. Jurists of a more liberal bent allow the imposition of a financial penalty on the debtor who delays payment without justification. Again this would serve as a deterrent. According to some, the aggrieved party should receive this penalty only in the case that the penalty is imposed by a court. If that happens, there are again two views. In one view the aggrieved party may receive compensation both for the damage caused by late payment and for the loss of income that it may suffer. The other view only allows compensation for the actual damage but not for the loss of income. If the penalty is not determined by a court, it cannot be used for compensating the aggrieved party. It must be used for charitable objectives (Chapra 1998, 2007). The prevalent position, however, seems to be that creditors may impose penalties for late payments, which have to be donated, either by the creditor or directly by the client, to a charity, but a flat fee to be paid to the creditor as a recompense for the costs of collection is also acceptable to many fuqaha. HSBC Amanah, for instance, charges what they call an administration fee for late or partial payment and if the fee exceeds their actual expenses incurred, the surplus is donated to a public charity. Sharia scholars have agreed that conventional banks that participate in Islamically structured transactions are not bound by this rule and may be paid penalty amounts in proportion to their participation in a transaction. This regards not only murabaha contracts but also musharaka and ijara contracts (Zubair 2008).

If penalty clauses for late payment must be restricted to a compensation for the costs made by the creditor, this may mean that there is little incentive for debtors to make sure they are current on their debt service, other than that their reputation may be at stake. The Malaysian authorities try to reduce this moral-hazard risk by bringing criminal charges against borrowers who default without being forced to do so by their business situation (Bokhari 2002). This, however, is expensive and court cases may last for a long time, with an uncertain outcome. A solution found by banks themselves in the case of murabaha finance is to include a charge for late payments in the mark-up and to offer a rebate for payment on time (Pal 1999, p. 70; Kuran 2006, p. 10).

- Guarantees. Asking for guarantees is somewhat problematic. A seller in a murabaha transaction, for instance, may ask the client to find a guarantor. However, the guarantor may not ask for payment for his services other than administrative costs, as such a payment would smack of riba. There are jurists, though, who would allow

> guarantors to ask a remuneration because they would otherwise be hard to find, in particular if international trade is concerned (Oahalou and Bouissaghouane 2003, p. 62).
>
> In PLS transactions (mudaraba and musharaka), guarantees would be out of place in principle, as the financier has to bear the risks associated with entrepreneurship. In other contracts, such as ijara and murabaha, financiers can accept securities. These may take the form of a personal guarantee, guarantees from other financiers, real estate, goods (provided these are not subject to a sale contract) and pledges of physical goods. Pledges of intangibles are not admissible, because of concern over valuation and repossession (Wilson 2002).

Underlying these principles are the basic ideas which sharia law is said to represent. The first basic idea is that dealings between people should be just and equitable. There is a strong emphasis on commutative justice (Hassan 2002). Contracts where one party is duped by another are considered void. We have seen in Section 3.4.2 that the bans on gharar and maysir rest on this notion of justice. The same goes for the ban on riba. The second basic idea is liberality (ibid.). When in distress, people should be treated generously. In particular, when people are unable to repay their debts in time, they should be granted easy terms. The Quran (2:280) says: 'If the debtor is in a difficulty, grant him time till it is easy for him to repay; but if you waive the sum by way of charity it will be better for you, if you understand it.' This may be a fine principle in relationships between private persons in close-knit communities with a fair amount of social control, but in the business of banking it easily gives rise to moral-hazard problems. Debtors can be expected to take undue advantage of such leniency. Hence the problems with penalty clauses.

A fundamental difficulty with Islamic jurisprudence is that there is no homogeneous interpretation. It is not bound by precedent and if one Islamic court rules some transaction or asset halal, another one may come to the opposite conclusion. There is no ultimate authority. For instance, Malaysia has been in the forefront of developing new instruments such as sukuk, whereas Saudi Arabia initially did not allow trading in sukuk. This impedes the development of Islamic financial markets, which is why the Islamic Financial Services Board (IFBS) was inaugurated in Malaysia in 2002, with the support not only of the Islamic Development Bank (IDB) and the AAOIFI, but also the International Monetary Fund (IMF). Its aim is to develop standards for regulatory and supervisory agencies and in that way contribute to a harmonization of practices in the Islamic financial industry.

The uncertainty surrounding Islamic jurisprudence may be one reason why Islamic financial contracts often choose English law as the applicable law.[13] Alternatively, Islamic law is chosen, with a provision for commercial arbitration. This may offer the best way to apply sharia law, as national courts will not intervene as long as there are no conflicts with national law.

4.5 CONCLUSIONS

Strict adherence to sharia law restricts the range of financial instruments that can be used. Financial institutions have been extremely resourceful in developing instruments that to a greater or lesser extent mimic conventional ones. Whether they stretch the meaning of the adjective 'Islamic' too far in the process is the subject of ongoing discussions. Many seem to find any solution acceptable as long as it obeys the letter of the law, even if it in other people's opinion goes against the spirit of the law. Interpretations of the letter of sharia law moreover differ widely, and consequently financial institutions face quite an amount of uncertainty over whether instruments that have been given the stamp of approval from their own sharia board will be found acceptable by other religious boards and councils. Standard-setting bodies could help to harmonize rules and increase the size of the market for any product, which in its turn might help reduce the price of Islamic financial instruments and make them more competitive.

NOTES

1. Malley (2004) provides an overview of Sami Hamoud's role in developing Islamic banking.
2. See Gainor (2000) for a practical approach to the development of new Islamic financial products.
3. The terms 'financial lease' or 'finance lease' and 'operating lease' are not well-defined. In general, in a financial lease the lessor finances an asset but does not operate it. This does not mean that in an operating lease the lessor operates the asset. 'Operating lease' is a catch-all term for all leases that are not financial leases. One might distinguish a class of 'pure' operating leases where the lessee does not commit himself to any permanent or long-term use. Ijara wa iqtina clearly does not belong to this class. The International Accounting Standards Board denotes a lease in IAS 17 as a finance lease in the following situations:

   - The lease transfers ownership of the asset to the lessee by the end of the lease term.
   - The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised.
   - The lease term is for the major part of the economic life of the asset, even if title is not transferred.

- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
- The lease assets are of a specialized nature such that only the lessee can use them without major modifications being made.
- If the lessee is entitled to cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
- Gains or losses from fluctuations in the fair value of the residual fall to the lessee (for example, by means of a rebate of lease payments).
- The lessee has the ability to continue to lease for a secondary period at a rent that is substantially lower than market rent.
(www.iasplus.com/standard/ias17.htm, July 2008)

It appears that ijara wa iqtina would generally qualify as a finance lease under IAS 17, given the second and fourth bullets. The first bullet only formally does not apply. This is also the case when an ijara contract is supplemented by a sales contract.

4. The fatwa is available on www.aaoifi.com/aaoifi_sb_sukuk_Feb2008_Eng.pdf. The AAOIFI sharia board is headed by Sheikh Muhammad Taqi Usmani, a name we have met earlier in this chapter and will come across again a few times.
5. www.islamic-banking.com/news/bahrain/archive/abc_card_0601.php.
6. www.islamonline.net/English/News/2002-07/25/article06.shtml.
7. See www.bankislam.com.my/Bank_Islam_Card.aspx.
8. *Bai inah* and *tawarruq* are instruments to obtain credit while nominally meeting the requirement that a financial transaction must be asset-backed. Another instrument was *'uhda*, an exchange of a cash payment for temporary custodianship and use of property, widespread in Hadramaut (Yemen) from the fourteenth through the twentieth century (Boxberger 1998). People in need of money could sell or grant custody of property, such as land or palm trees, with the right to buy it back at the same price. The buyer gained usufruct and could either use the property themself or rent it back to the seller. The 'uhda could be inherited or sold. Some authorities considered it a mortgage, others a sale.
9. See for the rejection of tawarruq, against the opposition not only of the banks but also of the government, by the Sharia Appellate Bench of the Supreme Court of Pakistan: Usmani (2000), para. 219 and 227.
10. The urbun contract is very old, it already existed at the time of the second caliph, Umar, c. 700 (Al-Suwailem 2006, p. 31).
11. The difference is that futures trading is standardized whereas forward or over-the-counter trade is not.
12. www.isda.org/press/press091206iifm.html; http://uk.reuters.com/article/electionsNews/idUKL0585255520080207.
13. See Bälz (2004) on the complexity of litigation involving Islamic contracts in non-Islamic jurisdictions.