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Products and Processes in Practice

NATALIE SCHOON

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Modern Islamic Banking

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When I first started to research Islamic finance, the thing I missed most was a book that would give me some indication of how this new type of finance fitted in with other parts of the financial industry. With that not being available, I started to compile a large selection of notes, which eventually made their way into this book. It has been discussed and debated with many people around the world, and it has been proofread and commented on by some of my best friends. I have listened to feedback from students, scholars and practitioners and hope I have not omitted any valuable information.

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Introduction

With an estimated size of around $1.5 trillion at the end of 2014, Islamic financial services still form a relatively small part of the overall financial industry. The balance sheets of large conventional banks such as HSBC and Citi, for example, easily exceed double that size. Regardless, the Islamic financial services industry has shown remarkable growth in recent decades, with reported growth rates of 15–20% per annum. This level of growth is expected to continue for the coming years and by far exceeds the anticipated rate of growth in conventional finance. The increase in wealth resulting from the rise in oil prices and the subsequent requirements for investments in oil-producing countries are a large contributor to the expansion of the Islamic finance industry. As a side effect of the current financial crisis, the ethical principles underpinning Islamic financial services have attracted more attention from both Muslims and non-Muslims.

Globally, we see a growth in both number and size of fully *Sharia'a* compliant financial institutions, as well as the offering of *Sharia'a* compliant financial products by conventional banks using different distribution channels. Although the term "conventional" is often associated with conservative and low-risk banking, in the context of this book the term "conventional" is used to identify the financial institutions that have long formed the majority of the financial infrastructure and are not specifically based on Islamic principles. As we have seen in the recent period since the end of 2007, these can by no means be labelled "conservative".

The principles that form the basis of Islamic finance are long-standing and can be traced back through time to the profit- and loss-sharing principles outlined in the Code of Hammurabi in the eighteenth century BC. Philosophers and theologians alike have debated the issues surrounding the justness of exchange and the charging of interest.

The modern-day history of Islamic finance began in the early 1960s with a small mutual savings project in Egypt, and has grown into a multibillion-dollar industry. Although it is too early to say whether Islamic finance will become mainstream, it certainly provides a viable alternative to other banking services.

This book has a number of distinct sections, and starts with the history of finance before looking into more detail at the ethical principles underpinning Islamic financial services and the Islamic law of contract. This is followed by the generally accepted prohibitions in *Sharia'a* as they relate to finance, and a generic explanation of the best-known Islamic financial products. The transaction types are divided into four main categories: partnership contracts; instruments with predictable returns; other instruments; and bond-like instruments (*sukuk*).

The theoretical background of the different transaction types is followed by an overview of how these are implemented in practice in retail finance, treasury, corporate finance, private equity and asset management. In addition, less well-known areas of the financial industry such as micro-finance, agriculture finance and cooperative finance will be considered. There is some overlap between the theoretical definitions of the products in Chapter 3 and their application in Chapters 5–8 and 10 to aid the reader. The role of the London Metal Exchange (LME) and the metal warrants is significant, due to their use in commodity *murabaha* transactions, and is detailed in Chapter 9.

There is, however, more to Islamic banks than just the products and services they provide. Similarly to conventional banks, they inherently run risks as part of their operations. How these risks compare and differ is explored further in Chapter 11. Unlike conventional banks, Islamic banks have an additional body of governance, the *Sharia'a* supervisory board, whose role it is to ensure, among other things, ex-ante and ex-post compliance with *Sharia'a*, as described in Chapter 12. Additional regulatory issues are addressed in Chapter 13, followed by capital adequacy and a brief overview of bank valuation in Chapters 14 and 15, respectively. The final chapter sheds some light on what the future may have in store.

Dates in this book refer to the Gregorian (commonly termed "Christian") calendar, which is based on the rotation of the earth around the sun and consists of 365 days (366 in a leap year). The Islamic (or *Hijri*) calendar is based on the orbit of the moon around the earth, which adds up to 354.36 days per year. The year count in the *Hijri* calendar starts at the migration of the Prophet Mohammed and his followers to Medina (*Hijra*) in the year AD 622. The year AD 2015, for example, equates to 1436 *Hijri* or 1436 H, which started on 24 October 2014.

CHAPTER 1

Historical Developments

The evolution of Islamic finance in modern history is only a small part of overall banking history, and in its current form only spans a period of around 60 years. This does not imply that Islamic finance did not exist prior to the mid-1960s. Comparable to other modes of financing, it has gone through periods of increased as well as diminished popularity, and ceased to exist for long periods of time. This chapter will look at the general history of banking as well as the way Islamic finance has evolved.

1.1 THE HISTORY OF FINANCE

Financial services have historically always played an important role in the economy of every society. Banks mobilise funds from investors and apply them to investments in trade and business. Although the actual origin of banking is difficult to determine, the history of banking is long and varied, and the financial system as we know it now is generally ascribed to the Florentine bankers of the fourteenth to seventeenth centuries AD.[1] The word "bank", for example, is derived from the Italian word *banco* (for the merchant's bench). Interestingly enough, the word "bank" also assists in tracing the origins of "bankruptcy", which relates to the breaking of a merchant's bench in medieval Italy as a signal of failure. Whether it be safe keeping, money changing, investing funds on behalf of others or making other capital goods such as land available at a charge, financial services have been around in some form for a long time. Even pre-dating the invention of money, safekeeping of valuables was long a task ascribed to religious temples. Deposits would initially have consisted of grain, but also other valuable goods such as cattle and agricultural implements, followed by precious metals such as gold. The latter would typically have been stored in a form that was easy to transport such as plates or bars. There were good reasons to store valuables in temples: the continuous stream of visitors would make it difficult for any thief to go about his business unnoticed, in addition

[1] Green, E. (1989) *Banking: An Illustrated History*. New York: Rizzoli.

to which they tended to be well built, making them secure. Perhaps even more importantly, temples were sacred places that were deemed to provide additional protection against potential thieves.

Evidence exists of priests in Babylon lending money to merchants as early as the eighteenth century BC, and the *Code of Hammurabi*,[2] believed to have been written around 1760 BC, includes laws governing banking operations in ancient Mesopotamia. Although not the first known law, it is the best-preserved one. Table 1.1 provides some examples of the laws in the code that are related to financial services.

In addition, any compensation for loss of articles in safekeeping and the amount of rent to be paid for having the usufruct[3] of land and different species of livestock was clearly defined.

TABLE 1.1 Selected entries from the Code of Hammurabi

Law	Description
48	If any one owe a debt for a loan, and a storm prostrates the grain, or the harvest fail, or the grain does not grow for lack of water; in that year he need not give his creditor any grain, he washes his debt-tablet in water and pays no rent for this year.
49	If any one take money from a merchant, and give the merchant a field tillable for corn or sesame and order him to plant corn or sesame in the field, and to harvest the crop; if the cultivator plant corn or sesame in the field, at the harvest the corn or sesame that is in the field shall belong to the owner of the field and he shall pay corn as rent, for the money he received from the merchant, and the livelihood of the cultivator shall he give to the merchant.
50	If he give a cultivated corn-field or a cultivated sesame-field, the corn or sesame in the field shall belong to the owner of the field, and he shall return the money to the merchant as rent.
51	If he have no money to repay, then he shall pay in corn or sesame in place of the money as rent for what he received from the merchant, according to the royal tariff.
52	If the cultivator do not plant corn or sesame in the field, the debtor's contract is not weakened.
119	If any one fail to meet a claim for debt, and he sell the maid servant who has borne him children, for money, the money which the merchant has paid shall be repaid to him by the owner of the slave and she shall be freed.
121	If any one store corn in another man's house he shall pay him storage at the rate of one gur for every five ka of corn per year.

[2]The Code of Hammurabi was a comprehensive set of laws, considered by many scholars to be the oldest laws established. Although the Code of Hammurabi was essentially humanitarian in its intent and orientation, it included the "eye for an eye" theory of punishment, which is a barbarian application of the concept of making the punishment fit the crime. The Code of Hammurabi recognised such modern concepts as that of corporate responsibility. See also King, L.W. (2004) *The Code of Hammurabi*, Montana: Kessinger Publishing.

[3]Usufruct is the legal right to use and derive profit or benefit from property that belongs to another person. It originates from civil law, where it is a real right of limited duration on the property of another. A lease contract, in which one party allows another to use but not own a good, is a form of transfer of the usufruct.

In the Roman Empire, money lenders would conduct their transactions from benches in the middle of enclosed courtyards rather than setting up shops. The ancient Roman money lenders merely converted any currency into the currency of Rome, which was the only legal tender in the city, and are not known to have provided any further financial services.

At the time of the ancient Greeks, bankers not only converted currency but also invested in projects and other businesses. Banking was no longer restricted to temples, and other entities such as money changers also conducted financial transactions including loans, deposits, exchange of currency and validation of coins. Trade finance, in the form of letters of credit, flourished. Money lenders in one city would, against a fee, write a credit note that could be cashed elsewhere in the country, which meant that no coins needed to be carried around on their journey, nor did guards have to be hired to protect it. Interestingly enough, most of the early bankers in Greece were foreign residents, and there is little known about the individual bankers themselves, although records have been found relating to Pasion (*c*.430–370 BC), originally a Phoenician slave, who rose to be one of the wealthiest citizens in Athens and owned one of the most successful private banks in Athens.[4]

Credit-based banking spread in the Mediterranean world from the fourth century BC. In Egypt grain has long been one of the most used forms of money, in addition to precious metals. State granaries functioned as banks, and when Egypt briefly fell under Greek rule, the government granaries were transformed into a network of grain banks with a centralised head office function in Alexandria. Payments could be effected by transfers between accounts without any physical money changing hands.

The Romans then perfected the administrative aspect of banking and introduced enhanced regulations of financial institutions, in the wider sense of the word. The practice of charging and paying interest developed further and became more competitive. However, as a direct result of the Romans' preference for cash, the development of the banking system itself was limited. Additional restrictions were introduced on the banking system by theologians and philosophers, mainly due to the fact that the charging and paying of interest was deemed to be immoral. With the fall of the Roman Empire, banking declined significantly in western Europe and did not feature again until the time of the Crusades from the late eleventh century AD.

The Crusades, in combination with the expansion of European trade and commerce, led to an increase in the demand for financial services. As a result of people travelling to a variety of different countries, there was a significant demand for money-changing services. Any service that would make it possible to transfer large sums of money without the complications of having to carry chests full of gold around and requirements for elaborate precautions against theft was particularly in demand. Crusades were expensive and the participants often had to borrow money, which was regularly done by mortgaging land and buildings. The terms were, however, far more favourable to the lender than to the borrower, as a result of which the demand for mortgages deteriorated over time.

The development of international trade led directly to the requirement for a foreign exchange type contract, the first of which was recorded in 1156 in Genoa.[5] The use of these types of contracts expanded significantly, not only because of the requirements following the

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[4]Shipton, K.M.W. (2012) Pasion, Athenian banker. In R.S. Bagnall (ed.), *The Encyclopedia of Ancient History*. Hoboken, NJ: John Wiley & Sons.

[5]Two merchant brothers borrowed 115 Genoese pounds to reimburse the bank's agents in Constantinople by paying them 460 bezants one month after their arrival in Constantinople.

development of international trade, but also since profits from time differences in a foreign exchange contract were not covered by canon laws against usury.

Financial contracts of this time were largely governed by Christian beliefs, which prohibited interest on the basis that it would be a sin to pay back more or less than what was borrowed. In addition, justness of price and fairness were important underlying guiding principles that applied to society as a whole and included financial services. The evolution from an interest-free to an interest-based banking system did, of course, not happen overnight, but was based on a number of factors such as the change from agrarian to commercial economies, the move towards pricing on the basis of supply and demand, decentralisation of the Church, and the recognition of money as a factor of production.[6]

During the Middle Ages, until the thirteenth century, the Church was the largest single entity possessing significant wealth and was an important lender. However, the impact of the Church declined, and as commerce flourished and generated more wealth than could be reinvested in commerce alone, it was the merchants who lent the money to finance individual and government consumption.[7] Initially only lending their own money, some of the merchants became merchant bankers lending both their own capital as well as capital deposited with them by others.

While in most of Europe the Christian prohibition of usury was still in place, charging interest was, however, legalised in Valencia in 1217 and Florence in 1403. The legalisation of interest in Florence was more significant for the development of the banking industry as we know it now since the Florentine bankers, who already had a presence in a number of European countries, started to offer loans and deposits on an interest basis.

In the UK, London was the main centre of trade and hence the majority of financial transactions were executed there, mainly from the many coffee houses in the City. In 1565, the Royal Exchange was established in London to act as a centre of commerce, and some of the banking business moved there too. However, during the seventeenth century stockbrokers were expelled due to their rather rowdy behaviour, and the buying and selling of stocks was again confined to the coffee houses.

In the early part of the seventeenth century Amsterdam started to grow into a major trade hub, which in turn resulted in it becoming the financial centre of the world. It managed to maintain this position until the Industrial Revolution in the late eighteenth and early nineteenth centuries, and was home to the first ever recorded economic bubble, due to tulip mania. The tulip was first brought to Holland in 1593 from the Ottoman Empire, and became so popular that in 1623 a single tulip bulb could fetch as much as 1,000 florins, which was equivalent to 6.7 times the average annual income. By 1636 the price had risen to unsustainable heights, and the bubble burst in 1637 as a result of an absence of buyers and abundance of sellers. Tulip mania[8] was only the first economic bubble of its kind. Inflated asset prices have since given rise to a multitude of busts and booms, the most recent ones being the dot.com boom and the subprime mortgage crisis.

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[6] DiVanna, J. (2008) A cloud is a promise, fulfilment is rain, *New Horizon*, 167, 20–22.

[7] Supple, B. (1977) The nature of enterprise. In E.E. Rich and C.H. Wilson (eds), *The Economic Organization of Early Modern Europe*. Cambridge: Cambridge University Press: “Commercial enterprise was more a source than a use of capital” (p. 423).

[8] Dash, M. (1999) *Tulipomania*. London: Victor Gollancz.

The Industrial Revolution put America and the UK firmly on the map of international finance. With this shift of emphasis, the banks in these countries gradually gained importance over time. London and New York became the major financial hubs, later on joined by Hong Kong, Tokyo and Singapore. The main financial centre in the Middle East has long been Lebanon, until the war broke out in 1972 and the banks started to move to Bahrain and later Dubai. Increasing internationalisation in trade, commerce and manufacturing applies to banks as well and was often achieved by a combination of the establishment of new branches and acquisitions. In addition, banks started to offer financial services across the whole spectrum, from retail to wholesale, with the side effect that the once numerous small banks have now mainly merged into a few large conglomerates offering increasingly complex financial solutions. Few relatively small banks remain.

The events of 2007 and 2008, beginning with the subprime crisis, which was largely considered to be an American problem, led to unprecedented liquidity problems and resulted in the bankruptcy of Lehman Brothers[9] and the forced sale of others such as Bear Sterns in March 2008 and Merrill Lynch in September 2008.

1.2 THE HISTORY OF ISLAMIC FINANCE

During medieval times, Middle Eastern tradesmen would engage in financial transactions on the basis of *Sharia'a*, which incidentally was guided by the same principles of justness in exchange and prohibition of usury that were also applied by their European counterparts at the time. They established systems without interest that worked on a profit- and loss-sharing basis. These instruments catered for the financing of trade and other enterprises and worked very effectively during and after the era known as the Islamic civilisation, which lasted from the late sixth to the early eleventh century AD. Over time, Western countries started to play a more and more important role in the world economy and as a result Western or conventional financial institutions became more dominant.

As the Middle Eastern and Asian regions became important trading partners for European companies such as the Dutch East India Company, European banks started to establish branches in these countries. The finance system they introduced was typically interest-based. On a small scale, credit union and co-operative societies continued to exist but the scale of their activities was very much focused locally on small geographical areas.

Although it was not until the mid-1980s that Islamic finance started to grow exponentially, the first financial company in recent history based on *Sharia'a* principles was the Mit Ghamr savings project in 1963. This financing project worked on a co-operative basis, and depositors had the right to take out small loans for productive purposes. In addition, the project attracted funds to invest in projects on a profit-sharing basis. The Mit Ghamr savings project was set up to allow the local population to have access to banking services and, where possible, to obtain a return on their money. In 1971 the project was incorporated in Nasser Social Bank. Around the same time as the Mit Ghamr savings project, financial services based on *Sharia'a* were set up in Malaysia, again to cater for the generally under-banked Muslim population. The earliest financial services offered in Malaysia were savings plans for the pilgrimage (*hajj*) to Mecca.

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[9]Lehman Brothers was officially deemed a defaulting counterparty on 15 September 2008.

In 1975, the Islamic Development Bank was established in Jeddah as a multilateral development bank assisting in mobilising funds for investment for projects in the member states. In the same year, the Dubai Islamic Bank was founded in the United Arab Emirates as the first privately established Islamic bank.

The years since 1975 have seen the establishment of many more banks and the development of the industry into a multibillion-dollar market. It is no longer just small banks offering Islamic finance. These banks themselves are growing, and large conventional banks are offering Islamic finance through their "Islamic windows". Fully *Sharia'a* compliant banks and conventional banks are actively working together to offer Islamic finance, utilising some of the structuring and distribution capabilities of the larger banks. As a result, we are seeing increasingly large transactions being structured. As of 2015, in excess of 25 organisations in the UK are offering Islamic financial services, and the Prudential Regulation Authority (PRA) has regulated seven fully *Sharia'a* compliant financial institutions.[10] The UK is well on the way to achieving its goal to become the largest Islamic financial centre outside the Muslim world. France and the Netherlands have both also announced their intention to become the largest centres for Islamic finance, but the required changes to their tax and regulatory systems have not yet started.

The USA, originally hesitant and only permitting Islamic financial services to be offered offshore, has amended its perception and now also allows Islamic financial services on its territory.

[10]The fully Islamic institutions authorised and regulated by the PRA are made up of one retail bank (Al Rayan Bank plc), four wholesale banks (European Islamic Investment Bank, Bank of London and The Middle East plc, Qatar Islamic Bank (UK), and Gatehouse Bank), one investment manager (Tejara Capital (UK)) and one insurance company (Cobalt Underwriting).

CHAPTER 2

Economic Principles

With the development of early civilisations in Mesopotamia around 3500 BC came the development of cities, empires and monumental buildings. A form of writing based on pictograms was developed and initially mainly used to exchange information about different crops such as the quality and quantity delivered to a temple for safe keeping and any deductions thereof. Taxes were introduced and early economic thought started to develop.

2.1 EARLY ECONOMIC THOUGHT

In ancient times commercial activities were generally not public enterprises but were actively run by the rulers and other parts of the elite such as the officials of the temples and palaces. The profits did not belong to the public but were typically kept by the elite to enhance their own financial position.

The officials of temples and palaces were in any case best placed to be the main entrepreneurs of the era. They not only were closely associated with the royals of the time, but also had good access to information on economic opportunities in local and distant markets, which they obtained from their extensive networks. Most importantly, however, they had access to the capital required to invest in trade and enterprise.

This is not to say that all entrepreneurs of the time were rulers or temple or palace officials. There is evidence of the existence of independent merchants who would act either on their own behalf or as agents for king or temple. The latter gave rise to a very early form of one of the main theories of economics, the principal–agent problem, also known as the problem of devising compensation rules that induce an agent to act in the best interest of the principal. Given the relatively low numbers of independent merchants acting as agents, however, this problem was not too prominent at the time.

As time went on and trade routes expanded, forms of trade finance developed and, as early as the thirteenth century BC, the concept of trade insurance was introduced in Hittite Anatolia and Syria. Anyone killing a travelling merchant was obliged not only to pay compensation, but also to replace the goods the merchant had with him. Partnerships were set

up between neighbouring countries, trade flourished, economies developed and concepts of demand and supply and a just price became important factors.

It was during this time that four interlinked themes started to surface: private property, justice in economic exchange and usury, with money or the value thereof linking all of these together. These have since been researched by Greek philosophers, theologians and Islamic scholars alike at different times over the past millennia. At the time, economics was not recognised as a science, but deemed to be a branch of ethics, which is in turn a branch of theology. It took until the Reformation and the subsequent division of religion and state for economics to become a science in its own right.

Money and Usury

Money and usury have always been subject to debate. As detailed in Section 2.2, the prohibition on interest is not new or unique to any particular religion. During the fourth century BC, Aristotle was of the opinion that money was a medium of exchange, but did not have an intrinsic value of its own since it was merely a human social invention with no utility in itself. Following on from that, it was fairly easy to argue that "a lender of money loses nothing of worth when lending it out". There is no unambiguous basis for the ban on usury in Christianity, but theologians in the early centuries AD argued that the ban on usury was absolute and without exception.

The debate on the value of money and usury has preoccupied philosophers and theologians over the ages. In practice, however, the lending of money did occur, often by applying transaction types that were structured in a way that interest was circumvented, although the lender would always receive some form of compensation.

The change of society away from being largely agricultural, the growth in international trade and the increasing segregation between the state and religion resulted in the ban on usury being revisited, and by the middle of the seventeenth century it was generally abolished throughout western Europe. The onset of the Industrial Revolution led Adam Smith to argue that capital should be seen as a factor of production just like land, labour and buildings and therefore has a cost or rent associated with it. He did, however, argue that the return should not be based on usury but should only reflect the risk and any opportunity cost.

Private Property

Private property and religion has long been a contentious issue. Within the Abrahamic faiths, property is typically deemed to be owned by God with man having "stewardship", and any property should be made available for public use. Although the same view is to date held by Islamic scholars, the Church turned against this in the early fifth century AD and began to accumulate significant amounts of property.

In the thirteenth century AD many theologians started to turn against the riches of the Church and to insist on vows of poverty. On the other hand, a large number of theologians believed that private property did not have any moral implications but, rather, had positive effects in stimulating economic activity and hence general welfare. This did not, however, mean that all private enterprise was endorsed, and purely seeking profit for the sake of it was still considered to be a serious sin. Like capital, private property in modern economic thought is seen as one of the factors of production, and the notion of stewardship has long

disappeared. In Islamic economics, the notion of stewardship still exists and property should be applied to enhance economic activity.

Justice in Economic Exchange

Is it appropriate to make a profit purely from a difference in price? How large can this difference be before it becomes unreasonable? These are the issues that are associated with the principles of justice in economic exchange. The general perception has always been that profits are acceptable as long as the entrepreneur is not motivated by pure gain and the profit (only just) covers the cost of his labour.

It is not all that simple. At the time of the ancient Greeks, Aristotle advocated that "a just exchange ratio of goods would be where the ratio (or price) would be in proportion to the intrinsic worth of each of the goods in the transaction". This leads to the conclusion that demand and supply are not taken into consideration at all. The Romans, on the other hand, considered demand and supply to be factors in the determination of price. Their view of a just price was any price agreed between contracting parties, without any consideration for intrinsic value.

During the twelfth and thirteenth centuries, Christian theologians amended their view on intrinsic worth and came to the conclusion that intrinsic value is determined by the "usefulness" of a good to one of the contracting parties. And although usefulness is difficult, if not impossible, to determine, the result was that goods were allowed to exchange at different prices in different places and times. An additional definition stating that "one should not charge for a good more than what he would be willing to pay for it himself" was added, perhaps inadvertently leading to the demand and supply mechanisms that govern modern market economies. Although this was the general view, the opposition was of the opinion that price should purely be related to the cost of production, and any prices over and above the cost were deemed to be artificially inflated. However, these price levels did exist at the time and the leap to thinking about the need for competition and immorality of monopolies was easily made.

Over time these arguments started to converge, and the just price was accepted as the natural, exchange-established price. Eventually the view that in a competitive market buyers and sellers will not transact at a price that is not acceptable to either one of the parties became generally accepted.

2.2 THE PROHIBITION OF INTEREST

The most powerful force in the universe is compound interest.

(Albert Einstein)

Although evidence exists of the existence of prohibitions on interest in other religions, such as Buddhism, the focus of this chapter is on the prohibition of interest in the three religions that are generally referred to as the Abrahamic or monotheistic faiths (Judaism, Christianity and Islam), the way in which the prohibitions entered into law and the impact of the availability of financial transactions over time that were executed in spite of the restriction. The ultimate aim is to provide an insight into the way in which opinions regarding the permissibility of

interest have changed over time and to provide a view on whether or not the prohibition on interest in Islam is likely to stay or whether it might be expected to change over time. This section contains a review of the prohibition of interest in the different religions; an overview of selective legal implementations; and an examination of how the challenges posed by the interest prohibition have historically been evaded. In addition, this section provides some controversial views on the prohibition of interest in Islam that have emerged more recently.

As mentioned earlier, during the fourth century BC, Aristotle was of the opinion that money was a medium of exchange, but did not have an intrinsic value of its own since it was merely a human social invention with no utility in itself.[1] The charging of interest was deemed to be inherently wrong since, in addition to not having an intrinsic value, money does not have self-replicating properties. Aristotle's view was reinforced by, for example, St Thomas Aquinas who was of the opinion that money cannot reproduce itself and St Bonaventure who clearly stated that "In itself and by itself money does not bear fruit but the fruit comes from elsewhere".[2] Aristotle identified two purposes of money making. The primary purpose was to provide for the household, which was deemed to be necessary and honourable. The second purpose was retail trade. Defined as the mode by which men gain from one another, it was deemed to be unnatural. He subsequently argued that although money was intended to be used in exchange, it was not to increase at interest, since it was meant to be consumed. He specifically defined usury as "the birth of money from money", which he rejected as the most unnatural way of making money since the offspring is identical to the parent.

Through the ages, interest has been a controversial subject, extensively debated by philosophers. Although it was common practice to charge a fee for money or goods lent, various civilisations introduced rules to ban interest altogether or, at a minimum, to limit the amount of interest that could be charged. At the same time, investment in trade and partnerships in which the investor took some form of risk were generally permitted and even promoted. In the early centuries AD the debates about usury and its permissibility were mainly led by religious scholars such as St Thomas Aquinas, Ibn Rushd and John Calvin. In later centuries, with the separation of Church and State in Europe, the debate shifted to parliaments and the leading economists of the time such as Adam Smith. The remainder of this section reviews the development of, and current views on, the prohibition of usury and interest in three main religions: Judaism, Christianity and Islam.

The Prohibition of Interest in Judaism

In the Torah and the Talmud, Judaism prohibits all charging of interest on loans, without any distinction between a charitable personal loan and a commercial loan. Two Hebrew words are used to identify interest. *Neshekh*, which literally means "a bite", from its painfulness to the debtor, is generally seen as illegal, exorbitant charges on a loan or usury. *Ribbit*, which literally translates as "to increase", is derived from the Hebrew *marbit* or *tarbit* and denotes the gain on the creditor's side.[3]

[1] Aristotle, *The Politics*. In A.E. Monroe (1948), *Early Economic Thought: Selections from Economic Literature prior to Adam Smith*. Cambridge, MA: Harvard University Press, pp. 1–30.

[2] Le Goff, J. (1990) *Your Money or Your Life – Economy and Religion in the Middle Ages*. New York: Zone Books.

[3] http://www.jewishencyclopedia.com/view.jsp?artid=58&letter=U&search=usury, accessed 29 December 2010. The English spelling of *neshekh* (or *neshek*) differs between sources.

In summary, a number of generally accepted principles can be identified that formed the basis of the Jewish prohibition on usury in medieval times. The first principle is that a loan is supposed to be given to be expended; in other words, the money is meant to be used. The general interpretation of this point is that, similarly to when he would have purchased an asset, the borrower needs to pay the principal amount of the funds. That is to say, only the cost of the loan, which equals the amount provided, needs to be repaid to the lender. The focus of the risk in this case is on the borrower, not the lender. In addition, it is the duty of the borrower to repay the debt as it is his responsibility to either reinstate the property of the lender or to compensate him for it. Secondly, money is considered to be a store of value and not an asset. It can therefore not be the subject of a sale transaction. In addition, the primary purpose of money is to effect exchanges, and hence it is to be consumed. Similarly to the views expressed by St Thomas Aquinas, Judaism recognises that a charge can be made for an asset that is not consumable, but not for an asset that is meant to be consumed since the asset cannot be returned to the previous owner in its original state. At this point in time, the idea that the ownership and the use of money could be divided was explicitly rejected by the scholars. Finally, being compensated for waiting was not permitted. On this basis usury, which was defined as the sale of time or time value for money, was deemed to represent a payment for waiting and was thus prohibited. The monetary value of time, however, which can be defined as the value associated with the ability to have the use of the money, was deemed to be natural.[4]

The essence of the Jewish laws that prohibit interest are rooted in religion,[5] and the Torah specifically identifies the prohibition on interest in Deuteronomy 23: 20–21,[6] Exodus 22: 24[7] and Leviticus 25: 36–37.[8] Although there are many similarities between the Torah and the Old Testament, there are also some subtle differences. The Torah, for example, interprets "brother" in Deuteronomy 23: 21 as any fellow Jew. This is contrary to Christianity, in which the charging of interest to a stranger is permitted, but charging interest to a brother is not. Christians tended to interpret "brother" as any human, and hence the prohibition in Christianity was absolute. In the fourth century BC Aristotle[9] had already concluded that although the Jews would not be allowed to lend at interest to a fellow Jew, they could freely do so to any non-Jew, which was the generally accepted view among Jewish religious scholars.

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[4] Kirschenbaum, A. (1985) Jewish and Christian theories of usury in the Middle Ages, *Jewish Quarterly Review* (New Series), 75(3), 270–289.

[5] Kirschenbaum (1985).

[6] Deuteronomy 23: 20–21 (Complete Jewish Bible, http://www.chabad.org/library/bible_cdo/aid/9987, accessed 21 January 2011):

20: You shall not give interest to your brother, [whether it be] interest on money, interest on food or interest on any [other] item for which interest is [normally] taken.

21: You may, [however,] give interest to a gentile, but to your brother you shall not give interest, in order that the Lord, your God, shall bless you in every one of your endeavors on the land to which you are coming to possess.

[7] Exodus: 22: 24 (Complete Jewish Bible):

When you lend money to My people, to the poor person [who is] with you, you shall not behave toward him as a lender; you shall not impose interest upon him.

[8] Leviticus 25: 36–37 (Complete Jewish Bible):

36: You shall not take from him interest or increase, and you shall fear your God, and let your brother live with you.

37: You shall not give him your money with interest, nor shall you give your food with increase.

[9] Aristotle, *The Politics*.

Raba, a fourth-century AD rabbi, formulated the essential element of risk taking, which makes the charging of interest justified. He argued that usury could not be derived from the prohibitions on overreaching or stealing. In the case of overreaching, the injured party is not aware that he is subject to deceit or the extent of the deceit, whereas with the paying of interest, the paying party is fully aware that he is deprived of his money as well as the amount he is deprived of. Raba does not equate interest to stealing since, contrary to the charging of usury, in robbery the victim loses his money against his wishes. He thus argues that interest is not prohibited in the rules of law as it is the result of an obligation undertaken by the borrower with his full knowledge and consent, which will need to be met regardless of a potential lack of perfect correlation between the money paid and the value received.[10]

In the fifteenth century AD, Conrad Summerhart argued that a charge for the use of money is allowed since the creditor runs the risk of losing his money following bankruptcy of the borrower. The Rabbinic scholars, however, never really considered the potential risk of loss to the lender in their analysis of usury.[11]

Anecdotal evidence exists that Jewish bankers would, until well into the twentieth century, obtain written confirmation from their clients stating that they were not Jewish and had no objection to being charged or paid interest.[12]

One of the currently more influential orthodox rabbis, Rabbi Shraga Simmons, upholds that until this day borrowing and lending at interest between Jews is not permitted.[13]

The Prohibition of Interest in Christianity

Within the framework of Christianity, the early definitions of usury were based on a number of different teachings by, among others, St Ambrose and St Jerome, who advocated that usury was considered to be anything given in return for a loan in excess of what was lent. Usury was not just restricted to loans of money, but generally applied to loans of any asset. In addition, statements regarding the prohibition of usury were incorporated in the Capitulary of Nijmegen (AD 806), which mentions "There is usury wherever one demands more than one gives"; and Gratian's *Decretum,* which says "Everything that is demanded beyond the capital, is usury" .[14] Many biblical references, such as Deuteronomy 23: 19–20[15], Exodus 22: 25[16] and

[10] Kirschenbaum (1985).

[11] Kirschenbaum (1985).

[12] From a personal conversation with a retired London-based banker who used to work for the London branch of an Israeli bank.

[13] http://judaism.about.com/library/3_askrabbi_o/bl_simmons_interestloans.htm, accessed 25 January 2011.

[14] Le Goff (1990).

[15] Deuteronomy 23: 19–20 (King James Version, http://www.kingjamesbibleonline.org):

19: Thou shalt not lend upon usury to thy brother; usury of money, usury of victuals, usury of any thing that is lent upon usury.

20: Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury: that the LORD thy God may bless thee in all that thou settest thine hand to in the land whither thou goest to possess it.

[16] Exodus 22: 25 (King James Version):

If thou lend money to any of my people that is poor by thee, thou shalt not be to him as an usurer, neither shalt thou lay upon him usury.

Leviticus 25: 35–37,[17] strongly oppose the idea of making money with money, which forms the basis for the definition of usury. Leviticus 25: 35, in addition, clearly defines the prohibition on usury as a form of social insurance particularly aimed at the protection of the poor and the needy. Interestingly enough, the same provision does not explicitly exist in the Torah.

The Code of Canon Law from around 1187 clearly states that, as far as the Church is concerned, the basic definition of usury is that it is everything that is asked in return for a loan, beyond the value of the loan itself. In itself, the earning of money through usury is deemed to be a sin forbidden by both the Old and the New Testament, as is just hoping to receive additional property beyond the property itself. Requesting a higher price for a sale on credit is also seen as an act of usury, albeit an implicit one. The Code further states that all gain acquired through usury must be reimbursed in full to the true owner.[18]

Around the same time, Innocent III argued that no interest could be charged to Crusaders, but for all others moderate interest was acceptable and Christians should only be protected against immoderate or excessive usury. Innocent III's decree specifically refers to the Jewish money lenders, implying that the charging and paying of interest between Christians was still not permissible.[19]

In his *Summa Theologica*, which was written between 1225 and 1274, St Thomas Aquinas poses, in question LXXVIII, four sub-questions to be considered in relation to the sin of usury. He asks himself whether it is sinful to receive usury for money lent; whether it is lawful to ask any other consideration for money lent; whether a man is bound to restore anything he may have made out of usurious gains; and whether it is lawful to borrow money upon usury. Aquinas argues that to receive usury for money is unjust for a number of reasons. Not only does it involve a sale of something that does not exist, it also causes inequality between people, which, he argues, is in itself contrary to justice. Aquinas' definition of usury is that it is a price charged for the use of any asset, and it is therefore not just restricted to money. In addition, he is strongly of the opinion that money cannot have any self-replicating properties since it is an inane object, unlike humans, animals and vegetation. He recognises, however, that where the asset can be used and subsequently returned to its owner, such as the renting out of a property, a charge is permissible. Referring back to the primary purpose of money as defined by Aristotle – to effect exchanges, and hence its principle purpose is consumption or alienation – he considers charging money for something that has been consumed to be unlawful.[20] In this respect, Aquinas also refers back to the civil law of the time which states that:

> *things which are consumed in use do not receive a usufruct, either according to natural reason or civil law, and that the senate did not create a usufruct in their case (for it could not), but a quasi usufruct.*

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[17] Leviticus 25: 35–37 (King James Version):

35: And if thy brother be waxen poor, and fallen in decay with thee; then thou shalt relieve him: yea, though he be a stranger, or a sojourner; that he may live with thee.

36: Take thou no usury of him, or increase: but fear thy God; that thy brother may live with thee.

37: Thou shalt not give him thy money upon usury, nor lend him thy victuals for increase.

[18] Le Goff (1990).

[19] Stow, K.R. (1981) Papal and royal attitudes toward Jewish lending in the thirteenth century, *AJS Review*, 6, 161–184.

[20] St Thomas Aquinas, *Summa Theologica*. In Monroe (1948), pp. 51–78.

The theologians of the time did not reject the idea that capital could be put to productive use and that anyone providing capital should be rewarded for making it available. They purely rejected the providing of a loan at interest without any economic purpose, or without the lender taking at least some form of risk.[21]

Five exceptions were identified to the prohibition on usury: penalties for unexpectedly delayed payments; if the investor could have earned a greater legitimate profit in the event he had invested in an alternative type of investment; when the usury could be considered a remuneration for labour; when the usurer ran the risk of not being reimbursed; and when there was a level of uncertainty in the investment.[22] Striking similarities can be found in the application of usury prohibitions in Judaism.

By the twelfth century AD, significant economic growth and further development of societies and economies from agrarian to more urban resulted in an increase in the number of Christian usurers. With the emergence of an early form of capitalism in the thirteenth century AD, Christian values started to diverge and, although still generally condemned by the Church, the general view on interest and usury started to shift towards defining usury no longer as all interest, but only as excessive interest.[23] The commercial growth of the sixteenth century AD and the increasing demand for capital resulted in the development of a financial system that could provide finance for the growth in trade, both nationally as well as internationally. In the early sixteenth century, John Eck argued that a 5% interest rate was harmless and could be applied as long as the loan was provided to fund an actual business opportunity. Money and stock markets were developed throughout western Europe and capitalism was introduced into society. The demand for loans against interest increased even further, even though the Church still condemned interest. It was at this time that Calvin rejected the notion that interest was illegitimate from either a moral or a theological viewpoint, and instead advocated that the productivity of labour benefits from the injection of capital and that this capital could not be without cost. He argued that the biblical prohibitions as defined in Deuteronomy, Exodus and Leviticus concerned loans to the poor, and did not apply to commercial and industrial lending that was associated with investments for the purpose of financing businesses.[24]

In his treatise on contracts and usury, written around the same time, Carolus Molinaeus makes the distinction between usury (*usura*) and *interesse*, which literally translates as “to be or lie between”. He bases this distinction on one of the exceptions of interest outlined earlier, in particular those related to penalties for unexpected delays and where the investor could have otherwise earned a greater legitimate profit. He opines that *interesse* is related to losses that are sustained or gains that are prevented due to the delay in the repayment of the principal amount, and that in this case the payment of interest is permissible since it reflects compensation for a loss. In addition, he sees no problem with the charging of usury instead of a proportion of the expected profit, as long as the money was borrowed to make a profit from a legitimate business, and goes on to argue that “usury is not condemned unless it defrauds or oppresses one’s

[21] Le Goff (1990).

[22] Le Goff (1990).

[23] Le Goff (1990).

[24] Graafland, J.J. (2010) Calvin’s restrictions on interest: Guidelines for the credit crisis, *Journal of Business Ethics*, 96(2), 233–248.

neighbour". He argues that principally the prohibition on usury is to be read as excessive and unreasonable, and does not apply to any payment that is moderate and acceptable.[25]

From this time onward, other theologians and philosophers such as Ferdinando Galiani, David Hume and Anne Robert Jacques Turgot also start to consider that receiving usury for a pure loan of money is unlawful, but that being rewarded for sharing the risk in an investment is permissible, as long as it is moderate and restrained. Penalties for late payment and to cover losses sustained because someone else was using a person's money became acceptable.[26] Similar to Molinaeus, Galiani argues that although a loan should not attract any usury, the lender should be reimbursed for any risk he takes in making the funds available.[27]

Adam Smith, in *The Wealth of Nations* (1776), argues along similar lines and states that "as something can every-where be made by the use of money, something ought every-where to be paid for the use of it". In Smith's view the lowest rate of interest charged should be just above the level to compensate for occasional losses to which lending is generally exposed, thus recognising the credit risk the lender is exposed to. He further believes that an anti-usury law is counterproductive since it increases the "evil of usury" due to the fact that the debtor not only has to pay for the use of the money but also needs to indemnify the creditor for the risk he runs in the event he is found guilty of usury and incurs a penalty. He does, however, strongly believe that a maximum rate of interest should be fixed in such a way that it would be slightly in excess of the market rate on a good security, but not too much above since that would result in speculation.[28]

Jeremy Bentham, in a series of letters in the defence of usury, opines that there is no requirement for a legal maximum interest rate since, as he states in his first letter in the series:

> *no man of ripe years and of sound mind, acting freely, and with his eyes open, ought to be hindered, with a view to his advantage, from making such bargain, in the way of obtaining money, as he thinks fit: nor, (what is a necessary consequence) any body hindered from supplying him, upon any terms he thinks proper to accede to.*

Bentham finds the fixing of a rate of interest an unnatural situation since what is deemed a reasonable rate of interest is based on an individual's perception as well as his requirements. He concedes that interest should instead be based on free choice, negotiation between the parties, and demand and supply. The agreed rate of interest should, in his view, depend on the price someone is willing to pay for the use of money similarly to the way the price for any other asset is determined.[29]

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[25] Carolus Molinaeus, *Tractatus Contractuum et Usurarum Rediuumque Pecunia Constitutorum*. In Monroe (1948), pp. 103–120.

[26] Jones, N. (2008) Usury. In R. Whaples (ed.), *EH.net Encyclopedia*. https://eh.net/encyclopedia/usury/, accessed 19 October 2015.

[27] Fenando Galiani, *Della Moneta*. In Monroe (1948), pp. 279–308.

[28] Smith, A. (2000) *An Inquiry into the Nature and Causes of the Wealth of Nations*, complete and unabridged version. New York: The Modern Library.

[29] Bentham, J. (1787) *Defence of Usury; Shewing the Impolity of the Present Legal Restraints on the Terms of Pecuniary Bargains In a Series of Letters to a Friend To Which is Added A Letter to Adam Smith, Esq; LL.D. On the Discouragements opposed by the above Restraints to the Progress of Inventive Industry.* London: T. Payne & Son.

The change from agrarian to commercial economies, the move towards pricing on the basis of supply and demand, the segregation of Church and State, and the recognition of money as a factor of production[30] eventually led to a situation in which the charging and paying of interest was more and more acceptable.

The ban on interest was eventually repealed by the French bishops during the French Revolution in 1789. The Vatican followed suit and repealed the ban on interest in 1838.[31]

The Prohibition of Interest in Islam

Of the three religions under review, Islam is the most recent. Around the year AD 610, Arabs became aware of the fact that both Judaism and Christianity, which were practised in the Byzantine and Persian empires, were more sophisticated than their own pagan traditions. Spiritual restlessness ensued in Mecca and the Peninsula, and although it was generally accepted that the High God they worshiped, Allah (literally "God"), was the same as the deity worshipped by the Jews and the Christians, they felt left behind since they had not been sent a prophet or scripture in their own language. The Arabs considered themselves to be a lost race, exiled from the civilised world and ignored by God himself. This changed when, starting in the holy month of Ramadan in AD 610, and continuing until his death, the *Quran* (literally "the recitation") was revealed to the Prophet Mohammed, and he started preaching Islam in AD 612. The Arabs now had their own scripture and their own prophet. In AD 622 the Prophet Mohammed moved from Mecca to Medina, and this year became the start of the Muslim calendar. In 786–809, a cultural renaissance took place in Baghdad and other cities of the empire, and the caliph encouraged the study of *fiqh* and the compilation of the *hadith*, which enabled the formation of a coherent body of Islamic law (*Sharia'a*) consisting of two parts.[32] The main text and first recourse to law is the Quran, which contains the word of Allah as revealed to the Prophet Mohammed. The second major source of law is the *Sunnah*, or the biography of the Prophet, which consists of a compilation of specific narratives associated with sayings, acts and tacit approvals of the Prophet, the *hadith* (news or reports).[33]

Contrary to Christianity, in which religion takes priority, the emphasis in Islam is more on ethics and collective morality, and less on religion by itself.[34] The main body of Islamic law provided with the Quran and the *Sunnah* did not, however, always provide clear answers to how the different principles would apply in day-to-day life, and, similar to Judaism and Christianity, religious philosophers applied different techniques such as *ijma'* (consensus of independent jurists from the *ummah* of the Prophet), *qiyas* (analogy or case law) and *ijtihad* (interpretation) to provide further clarity on a variety of matters. Similar to Christianity and Judaism, there are a number of references in *Sharia'a* to the prohibitions of usury, which are

[30] DiVanna, J. (2008) A cloud is a promise, fulfilment is rain, *New Horizon*, 167, 20–22.

[31] Visser, H. (2009) *Islamic Finance Principles and Practice.* Cheltenham: Edward Elgar.

[32] Armstrong, K. (2000) *Islam: A Short History.* London: Weidenfeld & Nicolson.

[33] Hallaq, W.B. (2009) *An Introduction to Islamic Law.* Cambridge: Cambridge University Press.

[34] Wolters, W.G. (2009) *Islamitisch Financieren – Tussen Principes en Realiteit.* Arnhem: Sonsbeeks Publishers.

mainly contained in *Surah* 2 (*Al-Baqarah* – The Cow),[35] 3 (*Al Imran* – Family of Imran)[36] and 30 (*Ar Rum* – The Romans).[37] Generally, the ban on interest is interpreted as being absolute and without qualification.

The Arabic word *riba* is generally translated as "increase" or "excess" and is, in the strictest interpretation, an amount or rate that is due in excess of the principal of a loan.[38] Whether this is the most accurate interpretation has, however, been subject to a long history of controversy, since there is room for interpretation of the associated verses. Hadhrat-i-Omar (first century of the Islamic period), for example, has been quoted as saying that "the last to be revealed was the verse of usury and the Prophet expired without explaining it to us. Therefore, give up usury or anything resembling it".[39] The implication of this statement is that he was unclear on whether *riba* implies usury (excess) or whether the wider interpretation of increase should be applied. In the latter case, any inequality in a trade, such as the exchange of unequal quantities or quality of assets, would classify as usury. Although some scholars apply *riba* solely to money and the money-like assets, Omar urges erring on the side of caution by adding "give up usury or anything resembling it".

In the twelfth century AD, one of the most renowned scholars of the time, Ibn Rushd, known in Europe as Averroes and a contemporary of St Thomas Aquinas, argued that the rationale for the prohibition of *riba* is related to the possibility of cheating. This exists particularly in *riba fadl*, which occurs in the exchange of assets that are unequal in value.[40] Like Aquinas, Ibn Rushd's thinking was strongly influenced by the philosophies of Aristotle. In the late twelfth century AD, Imam Razi started to make the distinction between two kinds of *riba*: *riba nasia*, which is typically translated as predetermined interest on a loan of money; and *riba*

[35] From *The Holy Qur'an* (2000) translated by Abdullah Yusuf Ali. London: Wordsworth Editions.
Surah 2:

275: Those who devour usury will not stand except as stands one whom Satan by his touch hath driven to madness. That is because they say: "Trade is like usury" but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are Companions of the Fire: they will abide therein (for ever).

276 : Allah will deprive usury of all blessing, but will give increase for deeds of charity: for He loveth not creatures ungrateful and wicked.

278: O ye who believe! Fear Allah, and give up what remains of your demand for usury, if you are indeed believers.

279: If ye do it not, take notice of war from Allah and His Messenger: but if ye turn back, ye shall have your capital sums: deal not unjustly, and ye shall not be dealt with unjustly.

[36] *Surah* 3:

130: O ye who believe! Devour not usury, doubled and multiplied; but fear Allah; that ye may (really) prosper.

[37] *Surah* 30:

39: That which ye lay out for increase through the property of (other) people, will have no increase with Allah: but that which ye lay out for charity, seeking the Countenance of Allah, (will increase): it is these who will get a recompense multiplied.

[38] Noorzoy, M.S. (1982) Islamic laws and riba (interest) and their economic implications, *International Journal of Middle East Studies*, 14(1), 3–17.

[39] Noorzoy (1982).

[40] Ibn Rushd (2000) *The Distinguished Jurist's Primer*. Reading: Garnet Publishing.

fadl, which applies to *riba* in barter transactions.[41] *Riba fadl* is generally defined as any excess compensation to one of the parties resulting from an exchange or sale of goods. It occurs where the value of the asset offered by one party is not the same as the value of the asset offered by the other. The *hadith* narrated by Ubida ibn al-Samit in the Book of Transactions provides some further insight on this:

> *The Messenger of Allah (PBUH) said, "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, in equal weights, from hand to hand. If these species differ, then sell as you like, as long as it is from hand to hand."*

This is often read in combination with a *hadith* narrated by Abu Said al-Khidari, which states:

> *Sell not gold for gold in equal quantity, nor sell anything for the same thing in lesser quantity … nor sell anything present for that which is absent.*[42]

The combination of these two *hadith* has resulted in the generally accepted interpretation by Muslim scholars that bartering of the same commodity in different qualities or quantities is not permitted since an exchange of unequal values is deemed to be similar to interest on a loan, thus extending the ban on usury to goods as well as money. Instead, in the event unequal quantities or qualities are involved it is desirable to fully monetise a transaction via the execution of two trades: a sale of the asset against money; and the purchase of the other asset, which also takes place against payment. As a result, any uncertainty regarding the potential presence of *riba* would be avoided.

At the time of Ibn Khaldun, in the fourteenth century AD, economic activity was subject to the constraints embedded in the Quran and the *Sunnah.* Many commercial transactions were forbidden and *riba* was deemed to be an illicit gain that was not just restricted to loans. The prohibition on *riba* at the time applied to brokers who dealt in money as well as traders. There are a number of known references by Ibn Khaldun to usury.[43] He recognised that the practice of money changing did occur in the Empire, but specifically stated that "the money-changer must not grant credit and receive increment". In addition, he made reference to the illegitimacy of money changing: "to earn a livelihood by money-changing involves great risk to those who engage in it" and "any loan bringing benefit [to the lender] is unlawful".

The prohibition on *riba* did not, however, mean that making a profit was not permitted. To the contrary, the generation of wealth was, and still is, deemed to be of high importance since it will benefit not just the individual, but society as a whole. Equally, the interdependence between supply, demand and price was recognised, due to which it would be permissible to sell at a price that would be set by the working of market forces. Merchants were allowed to sell at a profit over and above the cost of the good, which would include wages, customs, duties and taxes, but they were only allowed to do so if the demand was high enough. In addition, the storage of goods until such time as prices improved was permissible. There was, however, a clear distinction made between profit, which was defined as the income achieved

[41] Qureshi, A.I. (1974) *Islam and the Theory of Interest*. Lahore: Sh. Muhammad Ashraf Publications.

[42] Qureshi (1974).

[43] Spengler, J.J. (1964) Economic thought of Islam: Ibn Khaldun, *Comparative Studies in Society and History*, 6(3), 268–306.

through effort and strength, and capital accumulation, which was represented by profits in excess of the merchant's needs.

Although it is generally accepted that interest on loans and inequality of exchange in barter transactions are not permitted, differences of opinion exist between the different schools of thought in Islam on some of the more minor points associated with the exact interpretation of what constitutes *riba*. There is, for example, evidence that interest has been deemed acceptable in the case of cash *waqf*, which is an interest-bearing charitable trust fund. This is in accordance with Hanafi *fiqh*, although the other schools of thought did not agree with this view and maintained that interest would not be permissible for these types of instruments either. The practice of setting up cash *waqf* was established in fifteenth-century Ottoman Turkey under the rulings of Hanafi *fiqh* and was generally accepted in the legal and economic systems by the seventeenth century.[44]

The prohibition on interest caused important limitations from an economic standpoint since it restricted the freedom of mercantile speculation. The ban on interest was not the only prohibition unpopular with the merchants. Particularly in the early days of Islam, the prohibitions on wine and games of chance were equally unpopular, and they tended to be at least partially evaded.[45]

It is generally accepted that all forms of contracts and transactions must be free from *riba* on the basis that there should be no reward for time preference alone. Reward, returns or benefits must always be accompanied by some form of liability or risk.[46]

Although to this day the majority of scholars are still of the view that the ban on interest is absolute and unqualified, there have more recently been a few scholars who believe the prohibition itself is open to interpretation and should probably be seen in light of the commercial and social realities of the time. Yusuf Ali, a renowned translator of the Quran, for example, translates *riba* as usury and states that "my definition [of usury] would include profiteering of all kinds, but excludes economic credit, the creature of modern banking and finance",[47] thus implying that a reasonable interest rate would be permissible. Others argue that the above-mentioned verses, when considered in their context, are related to the protection of the poor, and are not applicable to economic credit. Instead, they argue that a reasonable rate of interest is permitted as long as it is not excessive. They interpret *Al Imran* 130 to mean that interest is permissible as long as the lender does not charge as much as or more than the principal.[48] This is often combined with a verse from *An-Nisa* (The Women), which specifically states that trade needs to be mutually beneficial.[49]

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[44] Noorzoy (1982).

[45] Muir, W. (1883) *The Rise and Decline of Islam*. Bristol: Bristol Selected Pamphlets.

[46] Obaidullah, M. (2005) *Islamic Financial Services*. Jeddah: Islamic Economics Research Center, King Abdulaziz University.

[47] Noorzoy (1982).

[48] *Surah* 3:

130: O ye who believe! Devour not usury, doubled and multiplied; but fear Allah; that ye may (really) prosper.

[49] *Surah* 4:

29: O ye who believe! Eat not up your property among yourselves in vanities: But let there be amongst you Traffic and trade by mutual good-will: Nor kill (or destroy) yourselves: for verily Allah hath been to you Most Merciful!

The Prohibition of Interest and the Law

The prohibition on interest has over time been subject to debate by a range of philosophers and theologians, and was for long periods mainly, but not completely, confined to these areas. The prohibition is not restricted to a single religion or a single jurisdiction but appears to have been universally applied at one time or another across the world. Maximum interest rates as well as complete bans on interest have found their way into different laws such as the *Lex Unicaria* and the Magna Carta, but equally in UK and US civil laws. This section reviews the development of laws over time in two Christian jurisdictions, the US and the UK, as well as the Middle East (*Sharia'a*) and Israel (Judaism).

Early Legal Systems

There is evidence that the priests in Babylon acted as money lenders to the merchants as early as the eighteenth century BC. The Code of Hammurabi, believed to have been written around 1760 BC, includes laws governing banking operations in ancient Mesopotamia. The Code of Hammurabi was a comprehensive set of laws, and is considered to be the first codified law. Although the Code of Hammurabi was essentially humanitarian in its intent and orientation, it contained the "eye for an eye" theory of punishment, which is a barbarian application of the concept of making the punishment fit the crime. Modern concepts associated with behaviour such as corporate responsibility can be found back in the articles of the law.[50] Besides the humanitarian aspects, the Code also contains rules regarding repayment of debt, as well as the permissible levels of payments for storage and the use of land and equipment. In addition, any compensation for loss of articles in safekeeping and the amount of rent to be paid for obtaining the usufruct of land and different species of livestock were clearly defined. Usufruct is the legal right to use and derive profit or benefit from property that belongs to another person. It originates from civil law, where it is a real right of limited duration on the property of another. Article 93 of the same Code has been said to imply that compound interest is not permissible,[51] and although likely, this cannot be substantiated since most sources refer to article 93 as being illegible. The ancient Greeks and ancient Romans used to freely charge interest and, in addition, secured the debt as well as the interest on the borrower, which resulted in the situation that in the event the borrower could not repay his debt he would automatically become the slave of the creditor. During the Egyptian Twenty-fourth Dynasty (730–715 BC) King Bocchoriss forbade the taking of interest in excess of the principal.[52]

The Romans recognised the right to lend and borrow against a specified return, but did not permit excess returns on loans of money, oil or other fungible goods known as the *mutuum*. The *mutuum* was only permitted as long as the same kind and quality was returned to the lender, since fungible goods could not be separated from the substance and their main purpose was to be consumed.[53] Fungible goods were defined as those that could be weighed, measured or numbered.[54] In addition, interest was prohibited unless it was contractually agreed between the parties upfront. The one contract in which interest was permitted was the

[50] King, L.W. (2004) *The Code of Hammurabi*. Montana: Kessinger Publishing.

[51] Saleh, N.A. (1986) *Unlawful Gain and Legitimate Profit in Islamic Law*. Cambridge: Cambridge University Press.

[52] Saleh (1986).

[53] Jones (2008).

[54] De Roover, R. (1967) The Scholastics, usury, and foreign exchange, *Business History Review*, 41(3), 257–271.

foenus nauticum, a contract to lend money for large projects. Roman law embodied in the *Lex Unicaria* of 88 BC recognised an interest rate of up to 12%, which became the legal maximum in 50 BC by decree of the Senate. This decree remained in place until Justinian introduced a tiered structure in AD 533 in which 12% was the legal maximum to be charged for *foenus nauticum;* 8% for business loans; 6% for those not in business; and 4% for distinguished persons and farmers.[55] Although it is unclear how the different rates were determined, it is likely that consideration had been given to the perceived risk associated with the transaction as well as the economic necessity of the loan.

Christian theologians did not subscribe to the same view and the prohibition on interest was built into canon law – the body of laws and regulations adopted by the Church – although the same prohibitions were not necessarily included in the secular laws of the time. Secular law and commercial practices around the second half of the sixteenth century increasingly started to legitimise loans with interest, under the proviso that the loans were made with good intentions and not to be excessively usurious. Lending was by then permitted in most European countries, which was either incorporated in the civil laws that were based on the original Roman laws, or on the basis that whether or not usury was a sin was up to the conscience of the individual, as was the case in the Netherlands and England. In the latter two jurisdictions, the state tended not to interfere in issues of usury unless it was considered to be antisocial.[56] Islamic law, which is based on the religious teachings of *Sharia'a*, maintains to this day a prohibition on interest.

Anti-Usury Laws in the UK and the USA

The Roman laws were codified in the *Lex Unicaria*, which included the stipulations on interest outlined in the previous section. With the demise of the Roman Empire from the late fourth century AD onwards and the subsequent development of the European nation states, the individual countries over time developed their own laws. In the initial stages, the canon laws of the Church would generally be the leading body of law, but as time went on they developed into a separate body of law. In the UK this process took place by means of a series of royal decrees and later on Acts of Parliament.

The "Laws of Edward the Confessor", a compilation of 39 laws, dealt with Jewish as well as Christian usury, and evidence exists that Henry II actively prohibited Christian usury as early as 1136.[57] In 1215, King John signed the first version of the Magna Carta, which included two clauses dealing with any loans at interest that might be outstanding on the borrower's death. Neither clause, however, made it into any of the subsequent versions.[58]

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[55] Jones (2008).

[56] Jones (2008).

[57] Seabourne, G. (2003) *Royal Regulation of Loans and Sales in Medieval England – Monkish Superstition and Civil Tyranny*. Woodbridge: Boydell Press.

[58] If anyone who has borrowed a sum of money from Jews dies before the debt has been repaid, his heir shall pay no interest on the debt for so long as he remains under age, irrespective of [from] whom he holds his lands. If such a debt falls into the hands of the Crown, it will take nothing except the principal sum specified in the bond.
If a man dies owing money to Jews, his wife may have her dower and pay nothing towards the debt from it. If he leaves children that are under age, their needs may also be provided for on a scale appropriate to the size of his holding of lands. The debt is to be paid out of the residue, reserving the service due to his feudal lords. Debts owed to persons other than Jews are to be dealt with similarly.
See http://www.bl.uk/treasures/magnacarta/translation/mc_trans.html, accessed 10 May 2011.

At the same time, the Fourth Lateran Council, which was conducted by Pope Innocent III, prohibited Jews from taking oppressive and excessive interest from Christians, but allowed them to lend money at interest as long as the rates were deemed to be reasonable. The ban on Jewish interest was, therefore, not absolute. In the years 1274, 1275, and 1290 Edward I issued proclamations and statutes against usury, strongly condemning any form of it. In 1290 he expelled all Jews from England on the pretext that they were money lenders and thus committing a criminal offence. Although the charging of interest was banned and there is evidence that some royal action was taken against usury, the ban on usury, which carried a penalty of excommunication under canon law, was hardly enforced under any of the royal decrees. It was not until 1363 that the first usurers were finally put on trial.[59]

One of the main challenges has long been the fact that the term usury in itself was rather loosely defined as the excess return on something that was lent. It was therefore unclear whether late payment penalties or selling at inflated prices for payment at a later date would fall under the prohibition or not. In addition, different rules appear to have been applied to Jews and Christians regarding the permissibility of applying an additional charge when selling on credit. Jews would be allowed to charge an additional amount over and above the sale price, but Christians were not. Until 1290 Jewish usury was, within limits, generally accepted, and Jews were allowed to make a profit on loans. Besides the ban on charging usury to minor heirs that is defined in clauses 10 and 11 of the 1215 version of the Magna Carta and reiterated in the clause 5 of the Statute of Merton in 1235–1236, Jews could freely charge usury and were not hindered by the government. This is, for example, evidenced by a charter of Henry III to the University of Oxford, which allows the Jews of Oxford to take up to 2 pence (2d.) per pound per week from the scholars of the University as long as the interest would not be compounded.[60] There were other limitations in place specifying the percentages that could be charged. The draft Statute of the Jewry (1284–1286), for example, limited the interest the Jewish money lenders could charge to "no more than half a mark for a loan of 20 shillings (20s.) or 8 shillings 8 pence (8s. 8d.) per year, and for 40s., one mark, or 17s. 4d., 'and for more, more, and for less, less'". In addition, the period of the loan was limited to a maximum of 3–4 years.[61] For Christians, however, all profit over and above the principal was banned, a ban that extended to profits on credit sales. In 1363 rules were put in place to be able to act against circumvention of the usury laws. These rules applied in London, but did not get introduced in the laws until 1487. The rules ware particularly aimed at the practice known as *chevisance*, which consisted of entering into a combination of artificial sales transactions, one at a higher price for future payment and the resale of the same asset at a lower price for immediate payment, thus facilitating a loan against interest.[62]

During the period leading up to the introduction of the 1571 Bill against Usury, occasionally money lenders were taken to court but generally the actions taken to reduce the practice of usury were fairly inconsistent. During the first part of Edward I's reign (1272–1307) any instance of usury was actively investigated and punished accordingly, and he went as far as to evict all Jews when they continued to charge usury after the Statute of Jewry in 1275. Subsequent royal decrees tended to refer to canon rules, thus making the charging of usury more

[59] Seabourne (2003).

[60] Seabourne (2003).

[61] Seabourne (2003).

[62] Seabourne (2003).

like a moral sin than a criminal offence. A special usury tribunal was instated by the court in 1363, but only very few cases were pursued. The cases that were tried in the tribunal did not tend to result in severe punishments, a situation that remained as long as the prohibition was in place. It cannot be ignored that the royal actions were, at least in part, driven by financial motivations. The court of Edward I, for example, benefited financially when actions were taken against the Jews and the Italian merchant usurers, and when Edward III included an anti-usury article in 1341–1343 this was at least in part driven by the fact that he needed funds to meet the cost of his war with France. Tempting as it might be to assume that anti-usury action was largely governed by a desire to enhance the financial position of the Crown, this is unlikely to have been the case. Only a few cases were taken to court and there is no evidence of widespread confiscation of funds by the Crown. It is therefore reasonable to believe that, to a significant extent, any action taken to combat usury was related to the desire to eradicate wrongful conduct and to avoid any adverse economic consequences for the country. Moreover, the laws were mainly aimed at the Christian usurers and only marginally dealt with the Jews and the Italian merchants, which would lead to the conclusion that the bans were mainly motivated by religious principles.[63]

In 1468, Henry VII introduced a law defining usury as something that occurred when anyone lent:

> *money to and for a tyme, taking for the same lone any thing more besides or above the money lente by wey of contracte of covenaunte at the tyme of the same lone, Savyng laufull penaltees for nounpament of the same money lent.*

Although this definition prohibited the general charging of interest, it did allow lenders to charge penalties on default.[64] In 1546, Henry VIII repealed this law and replaced it with an Act on Usury in which it was declared that all interest in excess of 10% was usurious and thus unlawful. This Act was subsequently repealed by Edward VI, who again prohibited all charging of interest. The act appears not to have had the desired effect of eradicating lending at interest. To the contrary, there is reason to believe that instead it increased the amount of lending and resulted in higher percentages being charged.[65] The latter is likely related to the fact that the money lender would need to be compensated for the higher risk he was taking as a result of the prohibition.

In 1571, a Bill against Usury was presented in the House of Commons, which after having been subject to some debate in the months before was eventually passed in May.[66] Law started to play a larger role in society, and the concepts of usury as defined by Aquinas, who viewed it mainly as a factual and contractual matter, were redefined to make it a crime of intent.[67] As long as the money lender could prove that the interest charge was not intended to be usurious, the loan and the interest charge would be permissible. The comments made in

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[63] Seaborne (2003), pp. 66–69.

[64] Jones (1998).

[65] Smith (2000).

[66] Journal of the House of Commons: May 1571. *The Journals of All the Parliaments during the Reign of Queen Elizabeth* (1682), pp. 180–90. http://www.british-history.ac.uk/report.aspx?compid=43685&strquery=wilson 1571 usury, accessed 12 February 2011.

[67] Jones, N. (1989) *God and The Money Lenders: Usury and the Law in Early Modern England*. Oxford: Basil Blackwell Ltd.

Parliament clearly identify that the law itself did not prohibit usury, since the Act of Edward VI was repealed by Elizabeth on the grounds that it

> *hath not done so much good as was hoped it should but rather the said vice of usury and especially by way of sale of wares and shifts of interest hath much more exceedingly abounded to the utter undoing of many gentlemen, merchants, occupiers and others.*

Elizabeth not only revived the statute of Henry VIII, but also the maximum legal interest rate of 10%, which remained in place until 1624 when it was reduced to 8%.[68] The maximum interest rate was subsequently reduced to 6% soon after the Restoration with the introduction of an Act of Parliament called "An Act for Restraining the Takeing of Excessive Usury" simultaneously introducing a penalty of £20 and imprisonment.[69] In 1714 the legal maximum was reduced to 5%, where it remained until 1854.[70]

The legally maximum interest rate was not, however, intended to set the market rate of interest but, to the contrary, appears to have been determined based on the rate a borrower of good credit quality could obtain in the market. The main justification for the introduction and subsequent maintenance of a maximum level of interest was that it was in the interests of advancing trade relations and agriculture.[71] Eventually, the usury law was repealed, although this did not happen at once but in a number of steps including the removal of Bills of Exchange up to 3 months from the scope of the law by the Bank Charter Act of 1833. All usury laws in the UK were finally abolished in 1854.[72]

The Statute of Usury of 1714, which limited the interest rate that could be charged in the UK to 5%, is generally accepted to be the basis for all anti-usury legislation in the USA. Contrary to European countries, where usury laws were repealed between 1854 and 1867, US usury laws largely remained in place. There were, however, differences in individual states in the implementation of the laws. In 1850, New York amended the law so that the maximum rate of usury only applied to individuals and excluded corporations from using the Act on Usury to reduce the interest they were charged, an example that was followed by many other states. In 1867, Massachusetts fully repealed its usury law on the basis that a market rate of interest could not be fixed without due consideration of the duration of the loan, the amount or any collateral provided.[73] Massachusetts has since reinstated its usury law and a legal maximum rate of 20% is now in place.[74] On 31 March 1980, President Carter signed the Depository

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[68] Smith (2000).

[69] Charles II, 1660: An Act for restraining the takeing of Excessive Usury. *Statutes of the Realm: volume 5: 1628–80* (1819), pp. 236–237. See http://www.british-history.ac.uk/report.aspx?compid=47261, accessed 11 May 2011.

[70] Horack, B.S. (1941) A survey of the general usury laws, *Journal of Law & Contemporary Problems,* 8(1), 36–53.

[71] Smith (2000).

[72] Horack (1941).

[73] Horack (1941).

[74] Massachusetts Legislature, General Laws, Part IV – Crimes, Punishments and Proceedings in Criminal Cases, Title I – Crimes and Punishments, Chapter 271 – Crimes Against Public Policy, Section 49 – Criminal Usury. http://www.malegislature.gov/Laws/GeneralLaws/PartIV/TitleI/Chapter271/Section49, accessed 20 May 2011.

Institutions Deregulation and Monetary Control Act into law. The purpose of Title II of this law, the Depository Institutions Deregulation Act, was to “provide for an orderly phase-out and ultimate elimination of interest rate ceilings”, effectively repealing the anti-usury laws at federal level.[75] To date, however, most individual states enforce a maximum interest rate, although there are significant changes between them. The determination of the exact maximum interest rate is, however, not straightforward. The District of Columbia, for example, limits the interest to 24%, except for loans in excess of $1,000 that are not a mortgage, where the borrower is a not-for-profit corporation, the loan is made for business purposes or for the acquisition of property as an investment. For any other loan no maximum applies.[76] Nevada, on the other hand, does not apply any limits to the interest rate that can be charged provided that it is contractually agreed between the parties.[77] Virginia has set the legal maximum rate of interest at 12% and allows for certain exemptions, such as payday loans for which no legal maximum is defined and pawnbrokers who are subject to a maximum rate of 10% per month on amounts up to $25, 7% per month for loans between $25 and $100, and 5% for amounts in excess of $100 provided the loans are secured by tangible personal property.[78] The state of Washington has set the maximum legal rate of interest to the higher level of 12% and 4% above the average Treasury Bill rate over the previous 26 months. The rule applies to consumers only, and has a large number of exceptions such as lease and hire-purchase transactions, retail instalment transactions, credit card debt, and deferred payment sales contracts.[79] The legal maximum rates vary significantly between states and, as of May 2011, range between 5% over the federal discount rate, which currently equates to a total of 5.75%,[80] and 36%.[81]

Interestingly, the Interest Rate Reduction Act that was introduced to Congress on 19 January 2011 is designed to amend Section 107 of the Truth in Lending Act to introduce a maximum interest rate of 15%.[82] In the current version of the Act no such restriction is in place.[83]

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[75] Federal Reserve Bank of Boston (1980) Depository Institutions Deregulation and Monetary Control Act of 1980 – summary booklet. http://www.bos.frb.org/about/pubs/deposito.pdf, accessed 22 May 2011.

[76] D.C. Code §28-3301 - §28-3314. Title 28 Commercial Instruments and Transactions, Subtitle II Other Commercial Transactions, Chapter 33 Interest and Usury. http://dc.gov/DC/Government/Publication%20Files/Consumer/LawsDecember21/InterestandUsury.doc - 2010-12-30, accessed 20 May 2011.

[77] Nevada Revised Statues – Title 8, Commercial Instruments and Transactions. Chapter 99, Money of Account and Interest. http://www.leg.state.nv.us/nrs/, accessed 20 May 2011.

[78] Code of Virginia 6.2.300 http://leg1.state.va.us/cgi-bin/legp504.exe?000+cod+6.2-300, accessed 20 May 2011.

[79] Revised Code of Washington (RCW), Chapter 19.52 RCW Interest – Usury. http://apps.leg.wa.gov/RCW/default.aspx?cite=19.52, accessed 20 May 2011.

[80] The Federal Discount Rate is the rate at which an eligible financial institution can borrow from the Federal Reserve Bank. On 18 May 2011, the rate was 0.75%. http://www.bankrate.com/rates/interest-rates/federal-discount-rate.aspx, accessed 20 May 2011.

[81] http://www.loanback.com/category/usury-laws-by-state/, accessed 22 May 2011.

[82] Congressional Bills 112th Congress, 1st Session. H.R. 336 Introduced in House. http://www.gpo.gov/fdsys/pkg/BILLS-112hr336ih/html/BILLS-112hr336ih.htm, accessed 20 May 2011.

[83] FDIC Law, Regulation and Related Acts, 15 U.S.C. 1606. http://www.fdic.gov/regulations/laws/rules/6500-200.html#fdic6500107, accessed 20 May 2011.

Anti-Usury Laws in Israel

The Talmud, written before the sixth century AD, is still considered to be one of the most important Jewish legal source books. Although at the time society was largely agrarian, there are significant parallels between its treatment of interest charges and the laws of the state of New York, on the same subject, thus showing that legal and moral attitudes toward usury, particularly where it concerns the needy and the impoverished, have not changed much over time.[84] In medieval times promissory notes written between Jews living in the Ottoman Empire were often notarised by a Muslim court, which would ensure they would be recognised and accepted by anyone, thus further enhancing their transferability.[85]

The Israeli judicial system was formalised in 1984, with legal codes and procedures derived from a variety of sources. Although British law, mainly as a result of the British Mandate period, forms the basis of the law, it is equally influenced by Ottoman legal codes and, where civil rights are concerned, American legal practice.[86] In addition, a second legal system is in place in the form of religious courts, the Rabbinical Court, which typically deals with family law including matters such as marriage and divorce. There are no anti-usury laws in place, and the Bank of Israel sets the interest rates, but no legal maximum is applied.[87]

In Jewish legal theory the taking of interest is theoretically justified, even though it is religiously forbidden. The obligation to pay the interest is a civil obligation that exists if it is undertaken consciously and in good faith. A distinction is made between loans to the needy and impoverished, and business loans.[88]

Anti-Usury Laws in the Middle East

Sharia'a law includes all elements associated with legal frameworks such as statutes, customs, legal deeds and court decisions. Once the basic legal body (*masa'il*) was established, the Muslim jurists started to formulate the legal maxims (*al-Qwai'd al-Kulliyyah al-Fiqhiyyah*), which evolved from the spirit of the law in combination with the established rulings. The legal maxims are short theoretical statements that express the goals and objectives of *Sharia'a*.[89] One of the more important legal maxims specifically defines the incorporation of market practices and customs in a contract, as long as they do not violate any of the other sources of the law: "customs is a source of judicial decisions: custom whether general or private is to be taken as a judicial decision to establish a rule of law".[90]

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[84] Meislin, B.J. (1966) Parallels between Talmudic and New York usury laws, *Comparative Studies in Society and History*, 9(1), 84–100.

[85] Ray, N.D. (1997) The medieval Islamic system of credit and banking: Legal and historical considerations, *Arab Law Quarterly*, 12(1), 43–90.

[86] US Library of Congress. http://countrystudies.us/israel/84.htm, accessed 20 May 2011.

[87] Bank of Israel Laws 2010.
http://www.bankisrael.gov.il/deptdata/pikuah/bank_hakika/eng/new_law_2010_eng.pdf, accessed 20 May 2011.

[88] Kirschenbaum (1985).

[89] Kamali, H. (2006) *An Introduction to Sharia'ah*. Selangor: Ilmiah Publishers, p. 134.

[90] Hasanuzzaman S. M. (2007), *The Economic Relevance of Sharia'ah Maxims*. Jeddah: King Abdul Aziz University, p. 50.

Islamic law is similar in nature to any other legal system, but there are some significant differences between Western legal systems and Islamic law.

1. **Religious basis**. All currently active law systems, including English law, have been developed with religious norms and values as a starting point, and there are significant overlaps between the different legal systems. *Sharia'a* is generally considered to be more all-encompassing as it includes not only family and property law, but also public and private behaviour, which is the result of its stronger religious basis.[91] Within *Sharia'a*, however, the laws are interpreted based on *usul al-fiqh*, and not on statutory interpretations as is the case in common law.
2. **Lack of uniformity**. The interpretation of *Sharia'a* differs depending on the branch of Islam and the school of thought within them. As a result, there is a possibility that a rule in force in one area is not applicable in another. Although this is in theory similar to differences in law between different countries, this situation is further complicated by the fact that boundaries between different schools of thought are not geographically determined.
3. **Non-jurisdictional**. *Sharia'a* is not country-specific, but applies to all Muslims, disregarding their geographical location. This becomes particularly clear in the *Beximco Pharmaceuticals Ltd* v. *Shamil Bank of Bahrain EC* case[92] in which the (English) court specifically noted that Islamic law could not be considered by the court as jurisdictional law for the purpose of private international law since there is no country actually employing Islamic law.

Islamic jurisprudence (*fiqh*) is the body of rules and principles that are developed by each and every Muslim jurist's reasoning aiming to approach the highest ideals of Islamic doctrinal aspiration, thus forming the accepted interpretation of *Sharia'a* laws.[93] Whilst *Sharia'a* law was the main law of the Ottoman Empire, the paying and receiving of interest was prohibited. In the 1850s, however, when the Ottoman Empire started codifying its laws, it started with the Commercial Code, which was largely based on the 1807 French code. The associated courts were the first to operate outside the remit of *Sharia'a*.[94] The adoption of the French code, in combination with the establishment of the Bank of Egypt and Ottoman Bank, directly resulted in the explicit legalisation of interest in the Empire.[95]

In the late nineteenth century, Britain granted extra territorial jurisdiction and protection agreements to Bahrain, Qatar and the United Arab Emirates. Rather than substituting the existing legal systems, however, they introduced their own legal infrastructure in parallel, which governed non-Muslim foreigners who resided in the region, while Muslims remained subject to the local laws. Although all Middle Eastern countries have since gained independence and

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[91] Schacht, J. (1964) *Introduction to Islamic Law*. Oxford: Oxford University Press.

[92] English Appellate Division (2004) 101(8) L.S.G. 29.

[93] Zahraa, M. (2000) Characteristic features of Islamic law: Perceptions and misconceptions. *Arab Law Quarterly*, 15(2), 168–196.

[94] Zubaida, S. (2003) *Law and Power in the Islamic World*. London: I.B. Tauris.

[95] Kuran, T. (2011) *The Long Divergence – How Islamic Law Held Back the Middle East*. Princeton, NJ: Princeton University Press.

codified their own laws, commercial law is typically still based on English law; family law is generally based on *Sharia'a*.[96] Although many countries throughout the Middle East are introducing Islamic financial institutions, which are not permitted to charge interest, the legal systems still recognise interest and do not set a legal maximum.

Solutions Designed to Evade the Challenges Posed

The prohibitions on the charging and receiving of interest have been in place for many centuries, albeit in different guises. There have been times when the prohibition on interest was absolute while at others maximum legal rates of interest were established. The underlying reasoning for the ban on interest or the introduction of a maximum rate was typically associated with a form of social insurance. The prohibitions were introduced to guarantee protection of the poor and needy and to ensure they could have access to funds at what was deemed a reasonable rate of interest.[97] Even now, the maximum interest rates that apply in the USA are solely concerned with consumers, and do not tend to apply to corporations. Although the prohibition was often included in civil laws, it was not necessarily deemed to be a criminal offence but was instead considered a moral sin to charge interest.

Notwithstanding the legal prohibitions, lenders and borrowers have throughout history explored and implemented ways to avoid the ban on interest. Jewish money lenders, for example, were subject to the prohibition on interest when directly lending to or borrowing from other Jews, even though they could freely lend at interest to non-Jews. Thus, the introduction of a non-Jewish intermediary would circumvent the prohibition and allowed Jews to indirectly obtain loans at interest from other Jews. Following on from a ruling by Rashi, a Jewish creditor who held a pawn of a non-Jewish debtor was allowed to transfer the debt to another Jew as long as he transfered the underlying security at the same time. The receiving party would then be allowed to directly collect the interest on the loan. A further ruling by Rabbenu Tam stated that as long as there was a non-Jewish intermediary involved the lending party was allowed to collect the interest directly from the ultimate borrower without any requirement for further involvement of the intermediary. This basically resulted in a possibility for Jews to lend to other Jews at interest for which the non-Jewish intermediary would likely have charged a fee. The charging of a penalty for late payment provided yet another way to circumvent the prohibition on interest. Penalty clauses for late payment have been allowed since at least as early as AD 54, and are permitted on the basis that the creditor needs to be compensated for the profit he might have earned if the loan had been repaid on time. In order for the lender to be compensated, however, he would need to have some form of certainty that the debtor would indeed default since the penalty could only be charged after an event of default had taken place. The practice involving penalty clauses and lending at interest by means of a non-Jewish intermediary appears to have been widespread, but varied by country and did meet with resistance from the rabbis.[98] In addition, personal finance

[96] Al-Suwaidi, A. (1993) Developments of the legal systems of the Gulf Arab states. *Arab Law Quarterly*, 8(4), 289–301.

[97] Glaeser, E.L. and Scheinkman, J. (1998) Neither a borrower nor a lender be: An economic analysis of interest restrictions and usury laws, *Journal of Law and Economics*, 41, 1–36.

[98] Fuss, A.M. (1975) Inter-Jewish loans in pre-expulsion England, *Jewish Quarterly Review* (New Series), 65(4), 229–245.

was in some cases undertaken via lending circles. A group of people would each deposit a pre-agreed amount of money every month and take it in turns to withdraw the whole amount as a loan. This is still practised in Middle Eastern and Asian countries. For businesses, loan agreements between borrowers and lenders were permitted as long as both parties shared in both the profits and any losses.[99] The *'isqa*, which is described in the Talmud as having the characteristics of both a loan and a trust, became one of the important financial instruments to finance trade and business. The *'isqa* is a type of joint venture in which an investor provides funds or merchandise to a borrower. The borrower applies the funds to investments or trade as he sees fit, and the profits are shared between the parties based on the proportionate liability of the partners.[100] Under the condition that the borrower stated that he was appropriately awarded for his labour, he was not restricted in the way in which he would employ the capital. Generally both the investment and a minimum return would be guaranteed, effectively resulting in the creation of a debt consisting of the principal plus interest, which was to be repaid on a predetermined date.[101] Sales of goods at inflated prices to allow for payment at a later date were generally not accepted. Finance lease structures, in which the lender acquires the asset and provides it to the borrower to use against a fee, were generally permitted.[102] In this type of transaction, the fee consists of two components: the purchase of a share in the asset; and a rental fee for the part of the asset the borrower does not yet own. Over time, with the change in proportionate ownership, the rental component reduces and the repurchase component increases. At the end of the agreed lease period, the borrower has fully paid off the loan and becomes the owner of the asset.

The fact that the Jewish money lenders could pay and charge interest to non-Jews resulted in the situation that lending and borrowing against interest by Christians would often be executed using a Jewish money lender as a middle man or agent, a practice that was hampered by the expulsion of the Jews from England in 1290, but continued to flourish in other parts of the world as evidenced by, for example, the number of banks that have originated from Jewish families such as Rothschild, Julius Baer, Sal Oppenheim and Goldman Sachs. In England, the charters issued during the reigns of both King Richard I (1189–1199) and King John (1199–1216) specifically provided protection to the Jewish money lenders.[103] Unsurprisingly, unless a money lender had reasonable certainty of, at a minimum, getting their funds back they would be hesitant to lend money, and therefore required contracts to be structured in such a way that it gave them recourse to the borrower or his assets in the event of default. At the same time they needed to ensure they would not get in a position where the borrower could move to void the contract on the basis of it being usurious, which, depending on the laws in place at the time, would either apply to all interest or only to the proportion over the legal maximum interest rate. The latter could generally be provided as long as it could be proved that the interest rate was contractually agreed. In any case, the lender would typically go free if he could prove that he did not have malicious intent.[104]

[99] Meislin (1966).

[100] Udovitch, A.L. (1962) At the origins of the Western *commenda*: Islam, Israel, Byzantium?, *Speculum*, 37(2), 198–207.

[101] Kirschenbaum (1985).

[102] Meislin (1966).

[103] Fuss (1975).

[104] Jones (1989).

Besides using the Jewish money lenders, other practices to avoid falling foul of the prohibition on interest were applied, such as the incorporation of the lender in the corporation by defining the loan as an equity-type partnership investment, an instrument similar to the Jewish *'isqa* and, to some extent, the Byzantine *chreokoinonia,* which are both partnership type transactions in which all partners are liable for potential losses.[105] Although not suitable for consumer loans, they satisfied the religious principle that taking a share in the profit is permissible as long as the lender takes some risk.[106] In addition, similarly to Judaism, the charging of penalties for late payment was permitted, thus providing another way to circumvent the ban on interest.[107] Another common practice was the *chevisance*, which consisted of two artificial purchase and sale transactions. The first one would be the sale of an asset at an inflated price for future payment, with the second transaction – the resale of the same asset at a lower price against immediate payment – being contingent on the first, thus facilitating a loan against interest.[108]

The ban on usury did not result in a reduction of the requirements for both consumer and corporate lending. The Crusades, in combination with the expansion of European trade and commerce, led to an increase in the demand for financial services, not only to finance the Crusades or trade, but also to ensure that funds would be available at different locations along the route without the necessity of travelling with large amounts of physical money. Equity finance, which was, however, not always preferable or practical, and a combination of equity and debt finance was often applied. Unlike equity investments, debt has no additional upside to the lender beyond the agreed interest payment, but the lender runs the risk that the loan is not repaid as promised.

As a result, lenders would require borrowers to provide collateral to reduce any potential loss. Long-term debt would typically be secured with land, which was possible under Roman law in the form of a *pignus.* The *pignus* was a pawn contract in which the ownership of the property that was the collateral for the loan would be passed on to the lender for the duration of the loan. At the end of the period and upon full repayment of the debt, the ownership would be transferred back to the borrower. A different form of debt secured on land was the *hypothec,* a contract in which the property remained in the ownership of the borrower but could be seized by the lender in the case of default similarly to modern-day mortgage finance. From a lender's perspective, the *pignus* was preferable since no further action would be required in order to obtain ownership of the property in the event of default. Any income from the property would fall to the lender for the duration of the loan and, depending on the type of contract, the income might be used to reduce the outstanding principal of the loan. In a *mortgage* or dead-pledge contract, the income would fall to the lender, but would only serve as compensation for the lender, and could not be used towards repayment of the principal. Not unlike the recently revised global criteria for best-practice lending, the loan would typically be less than the value of the property pledged, making it a fairly riskless enterprise from the point of view of the lender. Either he would get his money back, or he would acquire a piece of real estate at a very favourable price. Although the lender would typically need to pay an

[105] Udovitch (1962).

[106] Glaeser and Scheinkman (1998); Schoon, N. (2008) *Islamic Banking and Finance*. London: Spiramus Press.

[107] Jones (1989).

[108] Seabourne (2003).

additional amount to obtain the property after default had occurred, the payment was usually not significant and would certainly not bring the total amount as high as the actual value of the property. As popular as these transactions were with lenders, they were less so with borrowers and were considered to be a last resort. The fact that lenders could easily abuse their position made it even less attractive. The lender could, for example, force default by making himself unavailable on the day of repayment. Due to the fact that no repayment had taken place, the borrower was technically in default, whether or not he had turned up with the funds at the right place and the right time.[109] Due to a combination of the different characteristics of the mortgage contract, in particular the associated change of ownership to the lender, and the fact that income from the property would fall to the lender, the contract was not deemed to be usurious and was therefore permitted. The weak legal protection for both parties significantly reduced the use of the mortgage contract and it was replaced with a sale of rents as the instrument of choice. In this case, the loan was secured on the sale of an annuity out of the income of the property. The annuity itself was considered to be payment for a permanent, irrevocable transfer of capital. This was contrary to the definition of interest, which was deemed to be a reward for a temporary, revocable transfer of capital. The sale of an annuity therefore fell outside the prohibition on usury. In addition, the instrument provided a strengthening of the lender's position due to the fact that it was the income stream itself that was sold. The instrument became even more prominent when in the late Middle Ages the right of redemption was introduced for the seller.

A securitisation-type contract was developed in Italy in the twelfth century AD. The transaction was based on a syndicate (*compera*) that was specifically designed to provide the capital to a business venture. In 1432, a *compera securitas* was established by the government of Genoa for the financing of a war fleet. The financing was secured on the right to the tax income from maritime insurance contracts, which was sold by the government to the *compera*, and which provided sufficient cash inflows to pay the agreed 7% fixed interest rate.

Although large landowners and governments had mortgages at their disposal or could obtain finance based on rental income, these transactions were generally not available for smaller businesses. Instead they had to rely on equity and venture partnerships (*commenda*). The *commenda* was a service contract in which the merchant provided the service and the investors provided the funds, which later developed in a form of limited liability partnership.[110] The *commenda* was long one of the main legal instruments and was particularly popular for overseas commercial ventures, the pooling of capital, and to bring together investors and business managers. It was not, however, a purely new invention and is likely based on the Islamic *qirad*, which is a similar type contract for a reward-sharing partnership in which the investors, who are solely responsible for any risk, are repaid the capital and a pre-agreed share of the profit at the end of the agreement. Any losses are borne by the investors.[111] Equally permitted in Continental Europe was the type of contract in which the lender would provide the borrower with goods against an inflated price to be paid at a future date, which the borrower would subsequently sell in the open market to obtain the required funds.[112]

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[109] Kohn, M. (1999) *The Origins of Western Economic Success: Commerce, Finance, and Government in Preindustrial Europe.* http://www.dartmouth.edu/~mkohn/orgins.html, accessed 20 December 2010.

[110] Kohn (1999).

[111] Udovitch (1962).

[112] Jones (1998).

Similar to the Jewish view, the charging of penalties on default was permissible and widely used to circumvent the usury prohibition. Other methods to ensure that a transaction would not be deemed usurious existed, including the issuing of a bill of exchange, which would consist of a mandate to pay in combination with an exchange of currency. The exchange contract itself would be directly tied to the different currencies, and any charge that was applied was not usurious, thus providing a suitable instrument for advance payments for foreign trade.[113] Traders who owed each other money, but could not afford to pay until the conclusion of a transaction, would draw a bill of exchange on the debtor that he could subsequently use as a means of payment or present to a bank to obtain cash at a discount. Unsurprisingly, the fact that these transactions did not attract any usury, in combination with a surge in the development of international trade, led to significant expansion in their use. A similar type of contract was the advance purchase contract, a combination of a loan with a forward transaction in which the merchant would pay the producer in advance for future delivery. Due to the sale nature of the transaction, it would be exempt from usury.[114] People providing deposits to a bank would not be paid any interest, but they were given a share in the annual profits of the bank in compensation for their risk.[115] Financial contracts of this time were largely governed by Christian beliefs, which prohibited interest on the basis that it would be a sin to pay back more or less than was borrowed, although this did not mean the banks were not allowed to reward depositors with a “free gift”. Despite the appearance that the medieval banks largely ignored the prohibitions on usury, this is not necessarily the case. They made strong efforts to comply with the usury doctrine, as becomes clear from the surviving books and records in which “interest income” is not mentioned, although “profit and loss on exchange” takes place of prominence.[116] The distinction between legitimate and illegitimate was, however, often a grey area.

The fact that the term *capitalism* in itself is not found in Islam does not mean that the concept does not exist. On the contrary, the characteristics of capitalism are prominent in the much greater emphasis on trade and investment Islam exhibits compared to Europe, where society was largely agrarian and trade had a subordinate role.[117] In order to finance the active trade in an environment in which there was an absolute prohibition on interest, other forms of financing were applied, and as long as the contract followed the spirit of the law in the interest of practical necessity or profit, and the letter of the law was not directly infringed, it would be permitted.[118] With the recent ascent of the Islamic financial industry many of the types of financing applied in the early centuries of Islam, such as the double sale of personal property, the double sale of land and the partnership transaction, are reintroduced and developed further in order to cater for the ongoing requirements of *Sharia’a* compliant finance.

The Islamic world and its predecessors have long traded on the basis of the principle that profit is for those who bear risk, which is still applied in the modern form of Islamic finance. The transaction type historically known as *qirad,* which is currently better known as *mudaraba,* provides a good example of this. In this type of partnership transaction, two distinct parties are identified, the investor of funds and the business manager. Any profits are shared

[113] Roover (1967).

[114] Kohn (1999).

[115] Fergusson (2008).

[116] Roover (1967).

[117] Labib, S.Y. (1969) Capitalism in medieval Islam, *Journal of Economic History*, 29(1), 79–96.

[118] Schacht (1964).

as agreed in the contract and any proportional distribution of profits is acceptable, as long as it is mutually agreed. However, with the exception of the situation in which the business manager has proven to be negligent, there is no liability on the business manager for any losses. The transaction is perfectly aligned with Islamic commercial ethics, although its popularity is likely to be more associated with the desire to avoid the charging of interest.[119] Investors are not necessarily comfortable with the fact that the business manager does not have a stake in the business and prefer to apply a *musharaka*-type transaction in which all parties provide funds as well as skill and expertise, even though the investors can, in some cases, be sleeping partners. The main difference with respect to the *mudaraba* transaction is, however, that losses are distributed between all partners proportionally to the amount of capital they have provided. Profits are shared in line with the mutually agreed ratios in the contract.[120]

The basis for many transactions currently executed in Islamic finance can be found in medieval times. The *salam* transaction, for example, is one in which immediate payment takes place for delivery of an asset in the future. Still in use for the financing of agricultural produce, in its current form it is occasionally also used to evade the prohibition on short selling. *Bittakhir*, a deferred payment sale in which goods are sold now for future payment, is in its current form known as *murabaha* or *tawarruq.* Both these transaction types are employed for interbank liquidity, but also to provide funds against a payment including a fixed mark-up at a predetermined date in the future. It is important to note that in this case the financier will always have to have ownership of the asset at some point during the transaction cycle, no matter how short this period might be. In addition, the mark-up is expressed as a single number and is not a percentage of the amount of goods sold, to ensure that any similarity with an interest percentage is avoided. The *qard*, or benevolent loan, allows for the lending of an asset or money free of charge. At the end of the period, the borrower either hands back the asset to its rightful owner, or repays the principal amount. The *qard* is still used to offer current account services, and although it cannot attract any interest, like in medieval Europe, the bank may reward the depositor with a "free gift". In addition, they were often combined with other constructions to evade the prohibition on interest such as a commission for an agent or an agreement to buy and resell an asset to the original owner. Other instruments available in medieval Islam, such as *hawala* (transfer or assignment of debt), *suftaja* (letter of credit), *ruq'a* (note), and *sakk* (cheque), are still largely applicable in the current incarnation of Islamic finance, albeit not in the exact same form.

In the recent history of Islamic finance, the *hawala* transaction is a transfer of funds from one party to another for which a fee can be charged by the intermediary. The underlying principle of the letter of credit is largely unchanged since medieval times and is a loan for the purpose of avoiding the risks of transport between different places that needs to be repaid to the bank or his associate in a different location. It typically applies to import and export finance. The bank or intermediary charges a fee for the transaction. The *sakk* has, however, significantly evolved from the cheque in medieval times to a bond-like instrument (*sukuk*) in modern-day Islamic finance, used to mobilise large amounts of financing. A transaction type similar to the medieval *chevisance* in Europe, a combination of two sales contracts for the same asset at different prices to facilitate a loan with interest, is the *bay al inah*, which is generally not permissible in the Middle East and the Levant, but is common practice throughout Asia.[121]

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[119] Udovitch (1962).

[120] Schoon (2008).

[121] See Ray (1997) for the medieval transactions, Schoon (2008) for the current practical application of the same instruments.

When reviewing the application and permissible transactions in Islamic law, it needs to be considered that there are different views on their acceptability depending on the school of thought as well as the individual interpretation of the *Sharia'a* scholars. The conditions under which a transaction type is deemed to be permissible may vary widely. In medieval times, but equally in modern times, there were differences in the permissibility of different types of contracts by the different schools of thought in Islam, and here too the notion of intent seems to be carrying significant weight in some of the schools, notably Hanifa and Safi, with others such as Malaki following the letter of the law much more closely.[122]

Conclusion

History does not repeat itself, but it does rhyme

(Mark Twain)

Although currently mainly associated with Islam, the prohibition of interest is not unique to the Islamic religion, but has been debated over centuries by the prominent philosophers of their time. It occurs, for example, in the Hammurabi Code and Roman law, Judaism and Christianity, and has been debated by Aristotle, St Thomas Aquinas and Ibn Rushd, to name but a few. Both Christianity and Judaism banned interest for a significant amount of time, although the differences in interpretation of the associated verses, in particular Deuteronomy, resulted in different ways of applying the prohibition between the two religions. Christians would generally interpret the word "brother" in Deuteronomy as any human, whereas Jews would consider only fellow Jews as their brothers. The result was that Jews could not lend at interest to other Jews, but could freely do so to non-Jews.

The main recurring themes among philosophers were that money was a medium of exchange, did not have any self-replicating properties and did not have an intrinsic value of its own since it was merely a human social invention with no utility in itself. It was further argued that money was intended to be used in exchange, and that something that was meant to be consumed would no longer exist and could thus not generate a return. Judaism, for example, bans all charging of interest on loans without making the distinction between charitable personal loans and commercial loans, but only where loans between Jews are concerned. The basis of the prohibition is similar in all three religions reviewed here and is based on a number of underlying principles. Money is a store of value, not an asset in itself, and, since it is meant to be used it is meant to be consumed and hence cannot attract a return. In addition, being compensated for waiting is generally prohibited, although the monetary value of time, which is the value associated with the ability to have the use of the money, is recognised as natural. While philosophers and religious scholars were debating the prohibition of interest, it was common practice across the different civilisations to charge for money or goods lent to satisfy the need for financing. Over time, views on interest in Christianity and Judaism changed as societies gradually changed from agrarian to urban and financing requirements became different. Initially prohibiting all interest payments, it was later considered that only excessive interest should be prohibited, which was aimed to protect the impoverished and the needy. The laws in

[122] Khan, M.S.A. (1929) The Mohammedan laws against usury and how they are evaded, *Journal of Comparative Legislation and International Law* (Third Series), 11(4), 233–244.

force in Europe and the USA reflect this changing view. In the UK, an anti-usury law which set the maximum legal rate was in place until it was finally abolished in 1854. In the USA, the federal usury law was abolished in 1980, although most individual states still have a maximum legal rate, in particular for consumer loans. Again, the principle that the poor and the needy require protection surfaces strongly. An interesting example, however, can be found in the state of Virginia where payday loans are specifically exempted and are not subject to a maximum legal rate of interest. Given that these loans are typically a last resort for the borrower, those who have no other choice than to use such loans are precisely the same people who would require most protection. In January 2011, as a direct result of the credit crisis of 2008, a Bill was presented in the US Senate to reintroduce a maximum legal rate of 15%. In Islam the prohibition on interest is generally deemed to be absolute and without qualification; the legal systems that are in place in Muslim countries do not, however, reflect this. Commercial laws are largely based on English law and the prohibition on interest is generally viewed as a moral sin, not a criminal offence.

Throughout history people have devised ways to evade the prohibition on interest by applying, for example, partnership contracts, which were allowed as long as the lender assumed some risk in return for which he would be entitled to a share of the profit. Contracts for the sale of goods on a deferred payment were equally permitted due to the fact that they were based on a trade, and the practice of adding a mark-up to the original sale price became a common way to evade falling foul of usury laws. Many of these structures applied in medieval times were similar across the different jurisdictions, and many of the techniques currently applied in Islamic finance find their roots in the exact same type of instruments such as the partnership, providing an asset against a rental fee and trade transactions at a price higher than the original purchase price payable at a later date.

With the Western civilisations becoming more urban and the developments during the Industrial Revolution, which resulted in the establishment of larger, more complex firms as well as the introduction of the concept of limited liability, the requirements for finance changed and it could no longer be provided via partnerships. The concept that capital is a factor of production and has a cost associated with it became more and more accepted, and interest became the benchmark reflecting the cost of capital, the risk of the transaction and the general growth rate of the economy.

Similarly to Judaism and Christianity, there is a prohibition on usury (*riba*) in the Quran and the *hadith*. Although its actual application is broader and includes excesses resulting from an exchange or sale of goods, *riba* is generally translated as interest on loans of money and is generally prohibited. A small minority of scholars such as Ebusuud Effendi and, more recently, Sheikh-al-Azhar Muhammad Sayyid Tantawi have voiced the opinion that *riba,* in particular when associated with financial transactions, should only be applied to usury, or excessive interest, and not to all forms of interest payment on a loan.[123] Although specific references to the prohibition of interest can be found in the body of Islamic law, which is formed by the Quran and the *Sunnah*, the majority of countries where Islamic law applies have implemented commercial law systems based on English law. Similar to medieval Europe where the legal system may have provided a maximum legal interest rate, but the charging of interest was not necessarily a criminal offence, *riba* is often considered a

[123] El-Gamal, M.A. (2003) Interest and the paradox of contemporary Islamic law and finance, *Fordham International Law Journal*, 27(1), 108–149.

moral sin. In addition, Islamic financial institutions typically calculate their mark-up, rate of return and cost of capital based on a benchmark interest rate such as the London Interbank Offer Rate (LIBOR).[124]

2.3 MODERN ECONOMICS AND BANKING

All men, even the most stupid and unthinking, abhor fraud, perfidy, and injustice, and delight to see them punished. But few men have reflected upon the necessity of justice to the existence of society, how obvious soever that necessity may appear to be.

(Adam Smith, The Theory of Moral Sentiments, 1759)

Economics as a Science

Modern economic theory starts in 1776 with Adam Smith and his epic tome *An Inquiry into the Nature and Causes of the Wealth of Nations*, in which he builds further on early economic thought. Smith identifies several factors of production beyond pure labour such as land and capital. This is more or less a direct result of the Industrial Revolution, which led to a shift from largely agricultural societies to societies focused on trading and production. Capital became an important factor of production, and Smith recognises that there is a cost associated with its use. At the same time, state and religion started to become more and more segregated, due to which the influence of the Church on the economy significantly reduced. His earlier work, *The Theory of Moral Sentiments*, which emphasised ethics and fairness, has generally not been given much attention. The two works combined provide a balanced view on the start of modern economics.

Smith strongly believed in the invisible hand that guides the free market, and demonstrates how self-interest encourages the most efficient use of resources in a nation's economy, with public welfare being a by-product. His free market concept and demand and supply theories laid the basis for current economic thinking, which, in addition, focuses on principal–agent problems, utility functions and market efficiency governing the balances in micro- and macro-economics. All economics questions arise because people, companies and governments want more than they can get. Within economics, this inability to satisfy all wants is called *scarcity*. As a result, every entity in an economy is continuously faced with the question of utility, or on what we spend our (limited) resources.

In modern economics, demand and supply govern the price of a good, while increasing globalisation heavily impacts the price at which some goods become available and profitability guides the majority of enterprises. "Justice in economic exchange" is still a basic principle underpinning demand and supply theories. Outsourcing of services and the production of goods to low-cost overseas locations are a good example of this.

Within the overall economy, banks have a specific function, which is associated with the provision of financial services. For conventional banks, this translates into the provision of a financial intermediary function and extending investment expertise to clients. Islamic banks have a similar economic function, but the implementation of the concept differs. One of the main differences

[124] El-Gamal (2003).

is that conventional banks make their money from maturity transformation or the difference between the short-term interest rates they pay and the long-term interest rates they receive. In Islamic finance the charging or paying of interest is not allowed, and this results in different modes of financing. This and other prohibitions in Islamic finance are reviewed in more details in the next subsection. Every transaction, including financial transactions, is subject to the law of contract, which is usually embedded in common law and is an important concept within *Sharia'a.*

Islamic Economics

The Islamic economy operates within the rules set-out in the Quran and the Sunnah and considers the market as the best and most efficient system to allocate resources. The market must, however, be subject to rules to protect all market participants. Similar to conventional economics described in Section 2.2, Islamic economics is based on the interconnecting principles of money and usury, private property, and justice. Private property rights are fully protected as long as the property is acquired legitimately. However, land and other natural resources need to be developed in ways that benefit all humans of all generations equitably. Justice applies both to the individual and the collective. All individuals are considered equal before the law and all rules need to be strictly obeyed by individuals as well as those in authority. The fact that someone holds a position of authority does not mean they do not have to abide by the rules.

Early Islamic economics has had a significant impact on economic thought and has made contributions in a variety of areas including, but not restricted to, taxation, market regulation, division of labour, ethical prescriptions regarding observance of the mean, and price determination.[125]

There are a number of key issues in Islamic economics that can be summarised as follows:[126]

- **Agent–trustee relationship**. Humankind is put on earth and entrusted to take care of resources on behalf of Allah.
- **Rule compliance**. All members of the collective need to abide by the rules in order to achieve an ideal society and economy.
- **Impact of scarcity**. Scarcity has three different aspects, including the recognition that at the micro level scarcity stems from misdistribution of resources, greed and gluttony.
- **Rationality and freedom of choice**. Humans have the ability to make their own decisions and choices in all aspects, which extends to economics.
- **Individual obligations, rights and self-interest**. Individuals have the right to fulfil their own economic interests. However, in the event that individuals are not able to pursue their own economic interests their rights are still preserved. Able persons who are not performing their obligations lose their rights.
- **Justice**. The concept of justice is central to economics in Islam and is multifaceted. Justice in Islam is the aggregation of moral and social values denoting fairness, balance and temperance.

The overall goal of Islam is the promotion of the welfare of humankind.

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[125] Chapra, M.U. (2010) *Muslim Civilisation: The Causes of Decline and the Need for Reform*. Leicester: Islamic Foundation.

[126] Askari, H., Iqbal, Z. and Mirakhor, A. (2015) *Introduction to Islamic Economics*. Singapore: John Wiley & Sons.

2.4 ISLAMIC ETHICS

The term "ethics" is typically associated with deciding whether specific behaviour is right or wrong and is guided by the ethical belief system of an individual. Ethics is closely related to morality, which can be defined as:[127]

1. The principles concerning the distinction between right and wrong or good and bad behaviour; or
2. A particular system of values and principles of conduct or the extent to which an action is right or wrong.

Whether a particular action is deemed to be right or wrong depends on the generally accepted standards in a community, and decisions are driven by the ethical and moral judgements of an individual. Business ethics is closely related to the ethics of individuals and the society as a whole and refers to a set of principles guiding the actions of a business, its owner and its employees. It is strongly driven by the principles of the founder and the society the business is incorporated in, and could be founded in society or religion. Islam comprises a very strong body of ethics incorporated in Islamic commercial law (*fiqh al muamalat*). *Fiqh al muamalat* contains rules of business conduct, permissible forms of business and desirable and undesirable modes of transacting. Any business claiming to be *Sharia'a* compliant, including Islamic financial institutions, needs to conform to *Sharia'a Islami'ah* (Islamic teachings) in all aspects of its operations, including management, governance, operations, marketing, accounting and auditing. It is important to understand, however, that *Sharia'a* works on the basis of what is known as the "principle of permissibility", which means everything is permitted unless it is specifically prohibited.

These principles have significant overlap with socially responsible investing and sustainable investing. Each of these explicitly acknowledges the importance of environmental, social and governance factors, as well as the long-term stability of the market as a whole. One of the main common denominators is the recognition that long-term sustainable returns are dependent on stable, well-functioning and well-governed social, environmental and economic systems. Contrary to socially responsible and sustainable investing, however, Islamic financial services have a strong foundation in religion and include a number of additional principles such as the prohibitions on interest (*riba*) and unnecessary uncertainty (*gharar*).

Basis of *Sharia'a*

Sharia'a translates as "the way" or "the path to the water source" and is based on two primary sources:

- *Quran* – the word of *Allah*; and
- *Sunnah* – sayings, approvals and actions of the Prophet during his lifetime.

In addition, there are three generally accepted secondary sources:

- *ijma*' – the consensus of Muslim scholars from the *ummah* (society) of the Prophet;
- *qiyas* – analogical deductions applied to the other sources to resolve a contemporary issue with similar characteristics; and
- *ijtihad* – interpretation by individual scholars.

[127] *Oxford English Dictionary*.

The main objective of *Sharia'a* is to educate individuals, establish justice, and realise benefits to people.[128] It governs every aspect of a Muslim's life, and can be broken down as outlined in Figure 2.1.

Although each of these dimensions has a different focus, they are closely interrelated. Islam governs every aspect of a Muslim's life, and includes politics, economics and social interaction, with the central premise of promoting justice and welfare. This also means that ethical principles are not restricted to *akhlaq*, but are also found in *aqidah* and *Sharia'a Islami'ah*. Similarly, the principles of *fardh* are also covered in *muamalat*. *Fardh* (duty of care) specifically states that people will need to make sacrifices to assist others, although this does not come at the expense of causing hardship to oneself. *Muamalat* covers commercial, criminal and civil acts associated with interaction among people, including commercial transactions, and includes elements associated with duty of care towards others. It is important to note that there is significant scope within *muamalat* to develop and amend the laws to cater for changing circumstances. This is contrary to *ibadat* (worship), which is deemed to be final and unchangeable.[129]

It is important to understand that the guidance contained within the different dimensions is not intended to be followed blindly. Islam emphasises intellect (*aql*), or the ability of people to apply their mind, in combination with the ability to make an informed decision (*ikhtiyar*), including the ability to choose between what is right and what is wrong. In other words, people have the responsibility to apply common sense and judgement when making choices in conflicting situations.

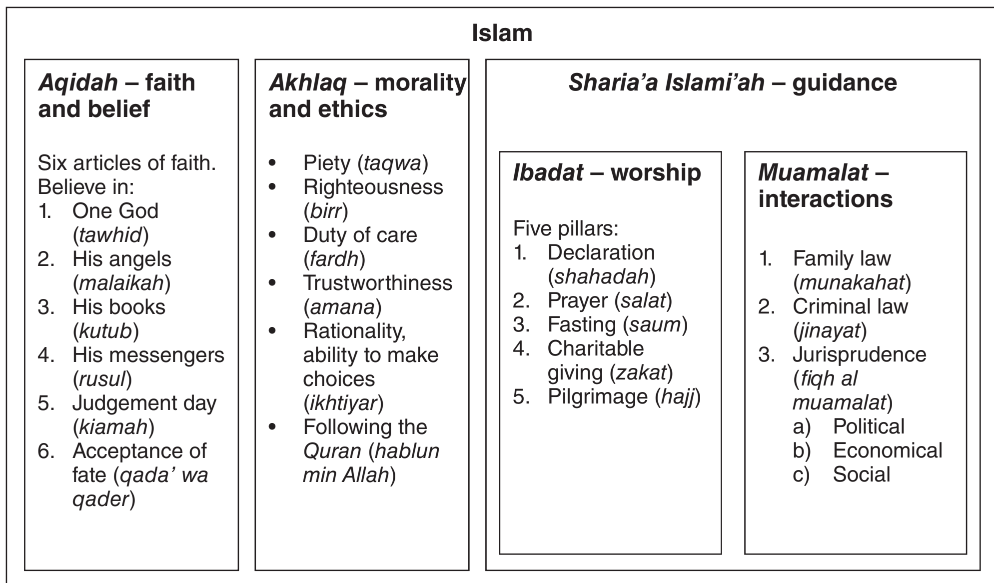

FIGURE 2.1 Dimensions of Islam

[128] Kamali, M.H. (1989) Source, nature and objectives of Sharia'a, *Islamic Quarterly*, 33(4), 215–235.

[129] Esposito, J.L. (2004) *The Oxford Dictionary of Islam*. New York: Oxford University Press.

Business Conduct

Ethical conduct in relation to business and commerce is included in *muamalat* and equally applies to all parties in a transaction. The rules encourage fairness in commercial and economic dealings, and moderation in the consumption of resources in order to create a just society.[130] Legitimate (*halal*) and illegitimate (*haram*) activities and actions are clearly defined, as well as anything that is undesirable (*makrooh*) and thus should, where possible, be avoided. Commercial and business ethics encompass the following broad guidelines:

- All parties to a transaction should:
  - be trustworthy;
  - be truthful;
  - promptly honour and fulfil their business obligations; and
  - be treated fair and just.
- Parties may not issue (potentially) misleading information or engage in price manipulation.
- All contracts (*aqd*) need to be specific, particularly in relation to the following elements:
  - quality, quantity, price and payment terms;
  - offer and acceptance regarding the product or service, price and payment terms;
  - delivery mechanism and delivery date; and
  - rights and obligations of the parties.
- Contracts need to be undertaken by mutual consent, without coercion, financial exploitation or to the disadvantage of one of the parties.
- Transactions need to be:
  - subject to full disclosure; and
  - free from deceit, misrepresentation and greed.
- Property may not be taken wrongfully.
- Employees need to be treated fairly.
- Work needs to be conducted in the best possible way.
- Others always need to be treated with dignity and respect.

These guidelines apply to all commercial dealings and are not restricted to trade or specific industries.

2.5 CONTRACTS AND PROHIBITIONS

The rules laid down in *Sharia'a* govern every aspect of a Muslim's life, including the way they conduct their business, the criteria for valid contracts and the prohibitions. The laws of contract and prohibitions are as firmly rooted in similar principles as the old philosophies regarding money, usury, private property and justice in economic exchange.

Law of Contract

Within the framework of *Sharia'a*, a contract only exists once both trading parties have agreed on all terms, including the asset, price and delivery. This is similar to (English) common law,

[130] Haniffa, R. and Hudaib, M. (2002). A theoretical framework for the development of the Islamic perspective of accounting, *Accounting, Commerce and Finance: The Islamic Perspective Journal*, 6(1–2), 1–71.

EXAMPLE: CONTRACT

My friend Juli is offering to sell me her 2007 BMW Convertible for £12,500. Although not an unreasonable price, the car is close to its next service and the tyres need to be replaced within the next 6 months. Taking these additional costs into consideration, I offer her £10,000 instead.

Given that I have made a counteroffer, we do not (yet) have a contract. Were she to accept my offer unconditionally we would enter into a contract.

which defines a contract as a legally binding agreement or a set of promises between two or more parties, which could be either in writing or oral (e.g. the purchase of this book from a bookshop). All parties have voluntarily assumed liabilities with regard to each other and, although the process can be as straightforward as buying a book for the price at which it is offered in the shop, it can also involve further negotiations and counteroffer(s). Nevertheless, as soon as there is unconditional acceptance by all parties involved, an enforceable contract exists.

The original offer is an expression of the willingness of the buyer or seller to contract on certain terms and allows the other party to accept the offer. An offer is not open indefinitely and as long as acceptance has not occurred, both parties can change their minds. An offer can be subject to a pre-agreed time limit, but even then the offer is not binding unless accompanied by a separate binding contract to keep the offer open as is. Under *Sharia'a*, it was originally stated that acceptance must be conferred during the same meeting. However, increasing globalisation means that contracting parties may not be able to meet face-to-face and modern means of communication are, similar to common law, allowed.

Under common law, a contract is valid if the following elements are met:

- **Intention**. Both parties need to have the intention to enter into a contractual agreement.
- **Consideration**. The concept of consideration is the basis on which courts decide whether an agreement that has resulted from the exchange of offer and acceptance should be legally enforceable. Consideration implies that there is an element of mutuality about the exchange, with something being given by each side. In the example in the box, the considerations are the car and the money. In English law, consideration is described as follows:

> *A valuable consideration, in the sense of the law, may consist either in some right, interest, profit or benefit accruing to the one party, or some forbearance, detriment, loss of responsibility given, suffered or undertaken by the other.*[131]

The consideration has to be sufficient, but whether or not it is adequate is typically out of scope of the courts.

- **Certainty of terms**. The terms of the contract must be clear and unambiguous. If one of the terms is not settled, the agreement is not a contract.
- **Capacity**. Parties must have the capacity to enter into a contract, which means they have to be mature and sane. Sanity can either be temporary or permanent. Temporary insanity

[131] *Curie* v. *Misa* (1875) LR 10 Ex 153, 162.

also applies when someone is under the influence of drugs or alcohol. The notion of maturity and sanity of counterparties implicitly applies under common law as well. However, unlike common law in the Western economies where counterparties are generally considered mature once they have reached the age of 18, under *Sharia'a* the legal age differs by school of thought and hence by country. On top of that, the legal age in Islamic countries often still differs between boys and girls.
- **Informed consent**. Parties need to have entered into the agreement voluntarily and should not have been forced into the agreement.
- **Legality**. The purpose of the contract should not be illegal.

Under *Sharia'a*, the elements of a contract are largely the same as those mentioned already. However, there are a few additional conditions with regard to the asset:

- **Permissibility**. The asset needs to be permissible in the eyes of *Sharia'a*. This means that it should not be *haram*, that is, no conventional banking and insurance, alcohol, pork, gambling, adult entertainment, tobacco and weapons. Illicit drugs are implicitly excluded since a contract involving an illicit drug would by nature be illegal.
- **Ownership**. Parties need to have ownership of the asset that is involved in the transaction, which implies that short selling is prohibited.
- **Ability to deliver**. Parties need to be able to deliver. Among the different schools of thought, the majority of the classical schools are of the opinion that the owner needs to have physical ownership prior to being able to sell any good or property. However, a number of classical scholars and the majority of modern scholars are of the opinion that the ability to deliver can either be absolute or non-absolute. The latter is, for instance, allowed for immovable goods, which will be supplied directly to the end buyer, goods in transit or in the event that the seller provides direct access to the goods.

Contract Validity

Whether it is a conventional or a *Sharia'a* compliant contract, the rules regarding validity are the same. Although a *Sharia'a* compliant contract has more elements that need to be satisfied, the general rule remains unchanged. A contract for which any of the appropriate elements is not met is void, voidable or unenforceable.

- **Void**. A contract that is void has technically never existed. Any goods or money exchanged between the parties need to be returned, even if they have been sold on to other parties.
- **Voidable**. If a contract is voidable, it operates in every respect as a valid contract unless one of the parties moves to declare the contract void. Once the contract is declared void, anything obtained under the contract must, where possible, be returned. In the event that goods have been resold before this point in time, the original owner will not be in a position to reclaim them. In the event that goods have been resold, the other party will have to compensate the original owner.
- **Unenforceable**. If a contract is unenforceable, it cannot be enforced in the courts of law if one of the parties refuses to honour their part of the transaction. Any item dispatched under the contract cannot be reclaimed by the original owner.

A special case exists for contracts that are unenforceable until authorised. This situation occurs when an agent, dealing on behalf of a counterparty, has exceeded his authorisation

and will require the ultimate counterparty to authorise the transaction. Examples of this are where a buyer offers a discounted price and the seller's agent agrees under the condition he will have to obtain authorisation from the seller, or a trader exceeding his own or the counterparty's limit.

Principles of Contract Applied to Financial Instruments

The elements of the law of contract mentioned in this section apply first and foremost to contracts of exchange, or trade transactions where one party purchases goods from another against payment. Financial instruments do not typically take the format of a contract of exchange, with the exception of foreign exchange contracts where the consideration does not involve any goods changing hands, but solely involves different currencies. However, this does not mean that the elements of contract do not apply to any other financial instruments.

Some of the general principles that can be applied to financial transactions are directly derived from the underlying principles of contract law.

Consciousness. Parties should consciously and willingly agree on the conditions of contract without compulsion or duress. An implication of this is that any agreement made in a state of unconsciousness (such as under the influence of intoxicants or imposed by force) is not valid.

Clarity. Parties must be aware of all the implications of the conditions laid down in a contract. Any ambiguity (except triviality) will make the agreement invalid.

Capability. Parties must be reasonably certain that they are capable of complying with all conditions of the contract. One of the implications of this is that sale of any goods (or services) that are not owned and possessed by the seller at the time of the contract is not valid.

Commitment. Parties must have the intention and commitment to respect the terms of a contract both in letter and spirit.

For Islamic financial transactions, with two exceptions, the other elements of contract such as ownership and existence of the asset also apply, which results in the fact that Islamic financial transactions typically have an asset or enterprise bias.

2.6 *SHARIA'A* AND PROHIBITIONS

Sharia'a, and hence also the prohibitions therein, do not just apply to Islamic finance, but govern every aspect of a Muslim's life. In commerce, following the ethics of *Sharia'a* is seen as an important choice of business. The ethical framework recognises that capital has a cost associated with it and is in favour of wealth generation. However, making money with money is deemed immoral, and wealth should be generated via trade or investments.

Financial transactions are strongly based on the sharing of risk and reward between the provider of funds (the investor) and the user of funds (the entrepreneur). In addition, it is not the credit itself that is the starting point of any transaction, but productivity. Creditworthiness, however, plays an important role in the funding decision process, and collateral and other risk mitigants are widely accepted.

Sharia'a identifies three major prohibitions, each of which will be described in further detail in this section.

Usury

As detailed in Section 2.2, the prohibition on usury is not unique to Islam. *Riba* is generally interpreted as the predetermined interest collected by a lender, which the lender receives over and above the principal amount it has lent out. Although a small minority of philosophers argue in favour of interest, the general opinion is that the Quranic ban on *riba* is absolute and without rationalisation. *Riba* comes in various guises, but two main forms are distinguished:

- Excess compensation from predetermined interest (*riba al naseeyah*). This form of *riba* is the most basic form of interest and is the monetary compensation for an amount provided to a borrower.
- Excess compensation without consideration (*riba al fadl*). This form of *riba* occurs when the price in a sale transaction is in excess of a fair market price or, put differently, when there is inequality of the exchanged countervalues.

Riba applies not only to money but also to commodities that used to have a similar function to money – gold, silver, wheat, barley, dates and salt.

The prohibition of *riba* in Islamic finance means that no interest can be charged or received, which is different from conventional finance, where interest is deemed to reflect growth, economic circumstances and the availability of capital. It is a widely accepted view that the word *riba* is derived from *raba*, which is generally translated as "increase". The majority of scholars conclude that *riba* is prohibited because it creates unfairness for either the lender or the borrower, or even the economy. In Egypt, however, interest payments are allowed for groups of the population that cannot lose their capital, such as orphans and widows.

Recent research[132] is taking this line of thinking further and looking at the severity of the punishment associated with *riba*, which implies that it is more than an economic or financial sin. Other economic crimes such as theft carry lesser punishment, which could lead to the conclusion that *riba* is associated with self-generation, which is deemed to be a transgression to the divine domain and hence attracts the most severe punishment. This is in line with Thomas Aquinas (money does not reproduce itself) and St Bonaventure (in itself and by itself money does not bear fruit but the fruit comes from elsewhere). Others argue that interest is only prohibited when it is usurious since that would result in unfairness.

Uncertainty and Gambling

Gharar is generally translated as "uncertainty", but different schools of thought have different views on what *gharar* includes. The literal meaning of *gharar* is to unknowingly expose oneself or one's property to jeopardy, and it is interpreted in each of the following ways:

1. *Gharar* applies exclusively to cases of doubtfulness or uncertainty as in the case of not knowing whether something will take place or not, which, for instance, applies to uncertainty over the asset of the sale and can be extended to uncertainty of specifications or ownership.

[132] Dr Azeemuddin Subhani, PhD research, McGill University, Montreal. From an interview in *New Horizon*, 168, 10–12.

UNFAIRNESS OF *RIBA*

Riba can be viewed as unfair from three different perspectives as outlined in this box.

FOR THE BORROWER

Riba creates unfairness for the borrower when the enterprise makes a profit that is less than the interest payment, turning the profit into a loss. Consequently, a consistent loss may result in bankruptcy and loss of unemployment while the loan and the interest still have to be paid back.

FOR THE LENDER

Riba creates unfairness for the lender in high-inflation environments when the returns are likely to be below the rate of inflation. In addition, unfairness for the lender occurs when the net profit generated by the borrower is significantly higher than the return on capital provided to the lender.

FOR THE ECONOMY

Riba can result in inefficient allocation of available resources in the economy and may contribute to instability of the system. In an interest-based economy, capital is directed to the borrower with the highest creditworthiness. In an environment where profit and loss determine the allocation of capital, the potential profitability of the project is dominant and the allocation of capital could be more efficient.

2. *Gharar* only applies to the unknown, not to cases of doubtfulness. This view is adopted when the purchaser does not know what he has bought or the seller does not know what he has sold.
3. *Gharar* applies to a combination of the above-mentioned, which covers both the unknown and the doubtful. *Gharar* occurs, for example, when the outcome of a contract is unknown. This approach is favoured by most jurists.

Uncertainty regarding the asset, price or delivery date all cause *gharar.* In essence, *gharar* refers to acts and conditions in exchange contracts, the full implications of which are not clearly known to the parties. The prohibition of *gharar* does not relate to situations where it is not possible to reveal all details simply because it is in the nature of the asset that not all exact details are known.

Maysir occurs when there is a possibility of total loss to one party in the contract, and is associated with games of chance or gambling. It has elements of *gharar*, but not every *gharar* is *maysir*. Anything related to uncertainties of life and business activities involving an element of chance and risk taking are not subject to either *gharar* or *maysir*. One of the distinguishing features of Islamic finance is the sharing of risk between entrepreneurs and

EXAMPLE: GHARAR

Recently my friend Mirjam made an offer on a house that was built in the 1850s. The seller, who has owned the house for 10 years, informed her that there were no structural problems and no damp issues. On inspection, the surveyor found that half of the beams underpinning the floor and a large part of the wall were seriously decayed as a result of a major damp problem, which, given the state of the beams, was estimated to have existed for at least 5 years. This is a case of *gharar* since it is reasonable to assume the seller must have known of this condition, and has deliberately withheld this information.

My friend Edith, on the other hand, has just bought a house built in the 1960s and has asked the seller for information regarding the foundation of the house. The seller told her that as far as he was aware it was a solid concrete foundation. Although there is uncertainty involved, this is deemed to be trivial *gharar* and is permissible. Some trust has to exist in this case between buyer and seller, as the seller is not deliberately withholding any information but is relaying the information as he knows it.

financiers, and hence not all types of risk taking are prohibited. The following risk types are generally defined:

- Entrepreneurial risk incurred in the normal course of business. Enterprises make profits and occasionally incur losses. Generally profits tend to outstrip losses, since otherwise no society would have any entrepreneurs at all. Willingness to take an entrepreneurial risk is not deemed to be a moral evil, and Islam encourages investment. It is fulfilling a need that a society cannot do without, and the risk and associated uncertainty are permissible.
- Possibility of natural disasters and calamities occurring. These risks are completely outside the control of an individual or business and are acceptable risks to take. Protection against these risks, also known as *force majeure*, by means of mutual insurance is permissible.
- Risks that arise from uncertainties related to activities voluntarily undertaken, which are not part of everyday life and arise from types of "games" people devise. The risks involved are unnecessary for the individual (the risk does not have to be taken) and unnecessary for society (taking the risk does not add any economic value to the wealth of the society). These risks are akin to gambling, which is prohibited.

Ethics in Islamic Finance

Islamic financial transactions are subject to the same rules and regulations that apply to other commercial transactions. These rules and regulations extend beyond the well-known prohibitions on *riba*, *gharar* and *maysir* (gambling). Equally important are the regulations related to fair trade and transparency and the concept of *jahala* (ignorance). *Jahala* occurs when one of the parties to a transaction is unaware of market values or market practices allowing one party, intentionally or not, to unjustly benefit from another. Transactions need to be free from *jahala* in order to avoid possible future disputes.

In addition to the guidance covered in Section 2.4, there are a number of principles that are of particular interest in relation to financial transactions:

- **Generosity and leniency in business transactions**. Benevolence or kindness. This is further divided into six different categories:
  1. Sell a person in need what he needs against as small a profit as possible, and preferably without taking any profit. This does not, however, mean that the seller should accept a loss.
  2. Purchase something from a poor person at a small loss to oneself by paying in excess of the price.
  3. Allow debtors in need additional time to settle their debt and, if necessary, reduce or restructure the loan to provide relief.
  4. Returning of goods should be permitted.
  5. Pay a debt as early as possible without being asked to do so.
  6. Do not enforce the payment of a debt when the buyer is unable to pay.
- **Speculative activities**. All forms of speculation and unnecessary uncertainty are prohibited since they are akin to gambling. Speculative transactions are not tied to real economic activity and have a tendency to distort the demand and supply equilibrium. Short selling, a relatively widely used structure in hedging in conventional finance, is therefore not permitted. For the same reason options and non-deliverable futures are not permitted, although the purchase of deliverable futures is acceptable as long as the instruments are held until delivery of the asset takes place. The delivery does not have to be physical. In the case of grain, for example, delivery is signified by the grain elevator receipt.

Ethical requirements that apply to market players such as truthfulness, justice and respect for all stakeholders equally apply to Islamic financial services. Investments in *haram* goods and services such as alcohol, pork and weapons need to be avoided. This obligation extends beyond direct investments and also applies, among others, to the use of real estate and goods transported. A property owned by an Islamic financial institution cannot be rented out to a conventional financial institution.

Price Stability

The aim of price stability is to ensure that every market participant gains without causing injustice to others. In other words, neither the buyer nor the seller should suffer from a transaction: the seller should not be forced to sell below market price and the buyer should not be charged a price significantly in excess of market value. Although the general principles of Islamic law support freedom of individuals to price their goods and services, there are regulations that need to be taken into consideration, which could result in price controls and market intervention.

The principles related to price stability can be summarised as follows:

- **Prohibition of hoarding**. Hoarding is prohibited because it causes scarcity of goods in the market and thus results in price increases. As such it affects price stability and leads to excessive price volatility, hardship and inefficient markets. Hoarding creates artificial shortage of goods, which is explicitly prohibited.
- **Prohibition of *gish* (cheating)**. Deceiving customers in relation to the products and services offered is prohibited. This applies, for example, to the sale of a good with a known

defect without disclosing it, or the sale of an imitation as if it is real. In the case of Islamic financial institutions, offering a client a product that is not suitable for their needs falls under this prohibition.

- **Prohibition of *ghobn* (inequity, injustice)**. Charging prices significantly in excess of market value causes inequity and injustice and is specifically prohibited. In the event prices are based on a market valuation, and the valuation process needs to be controlled carefully to ensure the valuation is fair and accurate. Similarly, when a bank distributes profit to investment account holders, the amount distributed to them should not be lower than what they are entitled to according to the agreed profit ratio. In the event that the client raises a complaint, they are entitled to reimbursement of the difference between the two amounts. *Ghobn* also occurs when goods are forcibly sold at prices significantly below market value, particularly in relation to debt recovery.

Marketing

There are a number of ethical issues that need to be adhered to in the marketing of products and services.

- **Marketing of harmful goods and services**. Marketing of any product or service associated with harmful goods or services is prohibited. Harmful products and services are those that are harmful to intellect and body, and include, but are not restricted to, alcohol, conventional banking and finance, adult entertainment, pork and other *haram* food production, and weaponry.
- **Use of marketing materials that are not *Sharia'a* compliant**. Any marketing material needs to adhere to *Sharia'a* principles. All information needs to be true, right, clear and accurate in its description of the products, services, risk, expected returns, quality, fees and maturity. Images and voices used need to be appropriate for the purpose.
- **Use of seductive material**. Marketing materials may not be misleading or attempt to seduce a (potential) client into committing bad behaviour. In the same vein, advertisements should not be placed in magazines and newspapers that promote, for example, nudity and gambling.
- **Advertisements causing dispute and social unrest**. Activities and actions inciting hate and social unrest are specifically prohibited. Any advertising aiming to degrade competitors and other parties need to be avoided. The main principles in *Sharia'a* such as the prohibition of *riba*, *gharar*, *jahala* and short selling are aimed to eliminate hate and social unrest.

Implication of Ethics on Business Conduct

Islamic financial institutions consider social goals as important as making profit. According to Warde, "Islamic financial institutions are those that are based, in their objectives and operations, on Quran's principles (principles of the Muslims' holy book)."[133] As such, they are expected to uphold the objectives of *Sharia'a Islami'ah*, which is concerned with promoting

[133]Warde, I. (2000) *Islamic Finance in the Global Economy*. Edinburgh: Edinburgh University Press.

justice and welfare in society (*al-adl* and *al-ihsan*). Haniffa and Hudaib suggest five distinctive features that differentiate Islamic financial institutions from their competitors (conventional banks): (a) different underlying philosophy and values; (b) provision of interest-free products and services; (c) they are restricted to transactions acceptable within *Sharia'a*; (d) they focus on developmental and social goals; and (e) they are subject to additional reviews by the *Sharia'a* supervisory board.[134]

The main implications of ethics on business conduct of Islamic financial institution can be summarised as follows:

- **Truth and honesty in business transactions and honouring obligations**. Islamic financial institutions play an important role in economic regeneration and social justice[135] in their role of safe keepers of depositors' and shareholders' capital, with the responsibility to put these funds to good use. They are both financially and morally accountable for their business, which implies their operations and behaviour need to be in line with *Sharia'a*; investment and financing activities need to comply with *Sharia'a* principles; and contractual relationships with all stakeholders need to be fulfilled.[136] Management and employees of an Islamic financial institution need to abide by these principles and have sufficient knowledge of *Sharia'a*, particularly in relation to business transactions (*fiqh al-muamalat*).
- **Generosity and leniency in business transactions**. Lenders are required to be lenient with debtors in need. Credit policies of Islamic financial institutions need to reflect the spirit of *Sharia'a* and not put excessive pressure on borrowers to repay when their circumstances do not permit. There is, however, an obligation on solvent borrowers to meet their obligations and repay their debts.
- **Fair treatment of employees**. Employees need to be paid fair wages, should not be overworked and should have the opportunity to fulfil their spiritual obligations. In addition, their privacy needs to be respected and the recruitment process needs to be fair. Providing adequate training to ensure employees are sufficiently prepared to fulfil their position falls within the responsibility of employers.
- **Responsibility to society**. Social responsibility and social justice are inherent in *Sharia'a*, and Islamic financial institutions therefore have a stronger emphasis on social responsibility than their conventional counterparts. This is evident from their contribution to charity in the form of *zakat* (mandatory charitable contributions) and *saddaqat* (charity), as well as their management of these funds and the issuance of *qard-hassan* (benevolent loans) funds.

Impact of Prohibitions on Islamic Finance

All transactions provided by Islamic financial institutions need to abide by the principles of *Sharia'a*, which implies that they need to be fair, equitable and transparent. In addition, they need to be free of *riba*, *gharar* and *jahala*, and should not be related to *haram* activities. As a

[134] Haniffa, R. and Hudaib, M. (2007) Exploring the ethical identity of Islamic financial institutions via communication in the annual reports, *Journal of Business Ethics*, 76(1), 103–122.

[135] Siddiqi, M.N. (1985) *Partnership and Profit Sharing in Islamic Law*. Leicester: Islamic Foundation.

[136] Haniffa and Hudaib (2007).

result of the prohibitions in *Sharia'a* the majority of conventional financial instruments are not suitable for Islamic finance in their existing form. Rather than lending money at interest, Islamic banks provide financing on a profit- and loss-sharing basis, and take ownership of the underlying asset. The prohibition on *gharar* and *maysir* results in the fact that forward contracts and other derivatives are not permitted. In addition, short selling is prohibited since the seller needs to own the asset.

CHAPTER 3

Islamic Finance Products Explained

Due to the prohibitions on interest, gambling, uncertainty and short selling, Islamic financial products are not the same as conventional financial products. Accumulation of wealth is encouraged, but not by making money with money. There always has to be an underlying asset or enterprise that requires financing. Generally it can be stated that Islamic finance is in many ways similar to merchant banking, is conservative and applies solid banking principles. There are a number of products in Islamic finance, and the main ones are explained in this chapter. Here the focus is solely on the technical framework in which these transaction types work. How they can be applied in practice is elaborated on in later chapters.

3.1 DEFINITIONS

The definitions in Table 3.1 are only associated with transaction types and parties to the transaction. A more comprehensive list is provided in the Glossary. These are by no means all the terms used in Islamic finance, and different words can be used to identify the same subject. In addition, due to the fact that Arabic is a phonetic language, the spelling of a word in Table 3.1 represents what the word sounds like, but different spellings may be used in different languages.

TABLE 3.1 Selected word list

Word	Description
Hawala	Transfer of money from one person to another. The recipient may charge an administration fee, which should not be proportionate to the sum of money.
Ijara	Bilateral contract allowing the sale of the usufruct for a specified rent and a specified period. A lease.

(*Continued*)

TABLE 3.1 (*Continued*)

Word	Description
Ijara wa iqtina	Lease with transfer of ownership at the end of the lease period or finance lease. Variations exist such as the *ijara muntahia bittamleek*, which is a finance lease structure in which the lessee has the option to exercise his right to purchase the asset at any time during the lease period.
Istisna	Sale with deferred delivery. Payment can be in a lump sum in advance or gradually in accordance with progress made. Delivery of good is deferred.
Kafala	Guarantee or third-party obligation.
Mudaraba	Partnership contract. Subset of *musharaka*.
Mudarib	Party in a contract providing knowledge and skill.
Murabaha	Deferred payment sale or instalment credit sale.
Musharaka	Partnership contract in which all parties provide both capital and skill and expertise.
Musharik	Partner in a *musharaka* contract.
Qard	Interest-free loan.
Qard al hassan	Interest-free loan. Often used in charitable context. Recipient has the moral obligation to repay the principal.
Rab al mal	Party in a contract providing finances.
Rahn	Collateral pledged.
Salam	Sale with deferred delivery. Payment is paid in full and upfront, delivery of good is deferred.
Sarf	Purchase and sale of currency. Only allowed at spot for equal value.
Sukuk	Plural of *sakk*. Represents partial ownership in assets. *Sukuk* are technically neither shares nor bonds but have characteristics of both. Profit is based on the performance of the underlying assets or projects.
Tawarruq	Purchase of a commodity that is immediately sold on to a third party (usually using the original seller as agent) on spot for cash. A form of reverse *murabaha*.
Wa'd	Unilateral promise. Undertaking or promise by one party to do or not do something in the future.
Wakala	Agency contract. Often applied to brokerage, asset management and investment activities.
Wakil	Agent in a *wakala*.

3.2 THE ASSET

Any Islamic financial transaction needs to be free of interest, gambling and uncertainty, and in addition needs to be associated with either an asset or an enterprise. The asset of the transaction needs to fulfil a number of criteria:

- **Permissibility**. The asset needs to be permissible in the eyes of *Sharia'a*, which means it should not be any of the forbidden items such as conventional banking and insurance, alcohol, pork and non-compliant food production, gambling, tobacco, adult entertainment, and weapons, arms and defence manufacturing.

- **Existence**. The asset should be in existence at the time the counterparties enter into the contract. Exceptions to this criterion exist when the purpose of the contract is to grow, build or construct the underlying asset.
- **Ownership**. The asset should be owned by the seller. This does not imply that the seller needs to have the goods with him there and then. Ownership could also be constructive. Under constructive ownership, the goods are under the direct control of the owner even though he may not physically have them with him. However, a contract to sell a car that is currently owned by my brother under the assumption that he will sell it to me would be void. Under the same principle that one cannot sell what one does not own, short selling, which is particularly popular with hedge funds, is prohibited.
- **Ability to deliver**. The seller has to be able to deliver the goods; absolute inability to deliver the goods results in the contract being void. Non-absolute inability to deliver applies to immovable goods or where possession is constructive. For example, I have bought a crane, which is currently awaiting instructions for delivery at the factory. In this case, I am the owner, have taken constructive possession and am in a position to sell. Even though I cannot deliver the crane here and now, my inability to deliver is non-absolute. Either the buyer or I can, after all, instruct the factory directly with the delivery details. This also applies to goods in transit.
- **Specificity**. The subject must be specific and determined without any uncertainty. There are several ways to determine the asset, which largely depend on the type of transaction and how it is conducted. The easiest example is when you purchase something in a shop. You pick it from the shelf, and therefore the asset is as specific as it can be. Alternatively, it is possible to specify all details in a contract (e.g. the plans when buying real estate that still needs to be developed) or the distinguishing parts for mass-produced goods (e.g. 100-watt Phillips light bulb, pear shaped, clear glass).

The general prohibitions, the contract elements and the restrictions on the asset do not just apply to trade; they equally apply to financial transactions. As a result, the transaction types in Islamic finance differ from those in conventional finance. Short selling and speculative transaction types such as futures, options and other derivatives are not permissible. In addition, the transaction always needs to be associated with an underlying asset or business. For non-Arabic speakers, an additional complexity is added with the Arabic names of the different products. On top of this, the English spelling of the names differs, which is due to the fact that Arabic has a different alphabet and the language is phonetic. The remainder of this chapter deals with the different products available in Islamic finance.

3.3 TRANSACTION TYPES

Various transaction types are available within Islamic finance to cater for a wide range of financial instruments.

The transaction types available for funding purposes can be subdivided into two main categories: profit- and loss-sharing partnership methods, on the one hand; and transactions with a more predictable or fixed return structure such as leasing and deferred payment sales, on the other hand. Partnership transactions are favoured by scholars due to the fact that they are designed to share risk and reward, which is in line with Islamic economic thought. Partnership transactions require continuous close working relationships between the partners to ensure all partners are comfortable with the way the project or company is run and its profitability.

Banks and their regulators favour transactions with predictable returns which do not require significant monitoring by the bank to ensure they receive the correct profit share.

In addition to the financing-type contracts, other financial instruments are available such as foreign exchange, letters of credit, agency contracts and guarantees. The remainder of this section considers three categories: partnership contracts, structures with predictable returns and other contract types. *Sukuk*, or Islamic bonds, are covered in Section 3.4.

Partnership Contracts

There are two different structures for the partnership contracts, *musharaka* and *mudaraba*, with *mudaraba* being a subset of the *musharaka* contract. The main difference between the two structures is related to what the partners provide to the partnership.

Joint Venture

Musharaka means sharing, which in financial instrument terms translates to a partnership or joint venture arrangement. In a *musharaka* all parties provide capital as well as skill and expertise to the project, and share the profits and losses. Skill and expertise could range from labour to management. Although more than two parties can be involved in the partnership, the general rule is that each and every one of the partners provides a share of capital as well as skill and expertise to the joint venture. However, it is possible for any partner to be exempted from being actively involved in the day-to-day operations of the partnership and become a sleeping partner who solely contributes capital. Some scholars argue that the profit share of the sleeping partner should be in strict proportion to his capital contribution. Other scholars would advocate that the sleeping partner receives a lower proportion of the profit, thus recognising the additional efforts of the other partners. In this case, the proportion of capital is not the only factor to be considered in determining the profit sharing ratio. The liability of the partners is technically unlimited.

Musharaka transactions (see Figure 3.1) are typically suitable for investments in business ventures or specific business projects, and need to consist of at least two parties, each of which is known as *musharik*. Once the contract has been agreed between the partners, the process can be broken down into the following two main components:

1. **Cash and expertise**. All partners bring a share of the capital as well as expertise to the business or project. The partners do not have to provide equal amounts of capital or equal amounts of expertise.
2. **Profits and losses**. In a perfect world, the project will accrue profits, which will be shared between the partners according to the ratios agreed in the original contract. Any losses that the project might incur are distributed to the partners strictly in proportion to capital contributions. Although profits can be distributed in any proportion by mutual consent, it is not permissible to fix a lump-sum profit for any single partner.

Musharaka transactions are generally for a relatively long term and can be terminated due to liquidation, sale or one of the partners buying out the other.

Diminishing *Musharaka*

The diminishing *musharaka* is a special form of a *musharaka* transaction in which it is agreed between the parties at the outset that one of the partners will, over time, purchase units in the *musharaka* venture from one of the other partners at a pre-agreed unit price. At the start of the agreement, the project is divided into a number of equal units. The repurchase agreement

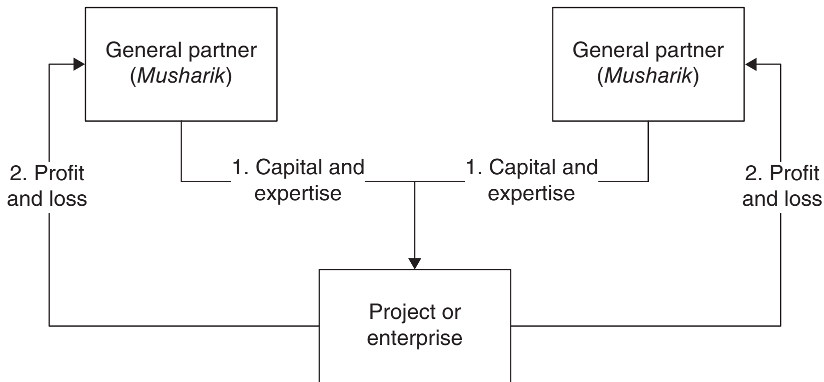

FIGURE 3.1 Simple *musharaka* transaction

can be gradually over time at a fixed or increasing number of units per period. Alternatively, the repurchasing of units could be as and when it suits the purchasing party. In a diminishing *musharaka*, the repurchasing agreement is part of the contract.

As the purchasing party to the project accumulates more units, his proportionate share of the capital increases and hence his liability for any loss. Profit ratios will be revised either at each purchase or on a periodic basis depending on the agreement between the partners.

Passive Partnership

The *mudaraba* transaction is a partnership transaction in which only one of the partners contributes capital (the *rab al mal*), and the other (the *mudarib*) contributes skill and expertise. This transaction type is a subset of *musharaka.* Although the investor can impose certain mutually agreed conditions in the contract, he has no right to interfere in the day-to-day operations of the business. Due to the fact that one of the partners is running the business and the other is solely providing capital, the relationship between the partners is founded on trust, with the investor having to rely heavily on the *mudarib*, his ability to manage the business and his honesty when it comes to profit share payments.

Mudaraba transactions (see Figure 3.2) are particularly suited to private equity investments or for clients depositing money with a bank and are often the underlying transaction

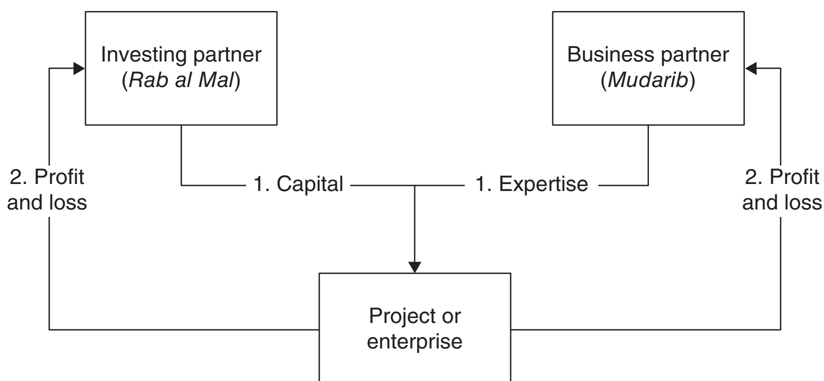

FIGURE 3.2 Simple *mudaraba* structure

type for the restricted and unrestricted investment accounts. Once the contract has been agreed between the partners, the process can be broken down into the following main components:

1. **Capital injection**. The investor, also known as *rab al mal*, provides the entire capital to the project or company. Generally, an investor will not provide any capital unless a clearly defined business plan is presented to him.
2. **Skill and expertise**. The *mudarib* or business manager's contribution to the partnership is his skill and expertise in the chosen industry or area.
3. **Profit and loss**. If all goes well, the project will accrue profits, which will, similarly to the *musharaka* transaction, be shared between the partners according to the ratios agreed in the original contract. Any losses are solely attributable to the investor due to the fact that he is the sole provider of all capital to the project. In the event of a loss, the business manager does not receive any compensation (*mudarib* share) for his efforts. The only exception to this is when the business manager has been negligent, in which case he becomes liable for the total loss.

Contrary to the *musharaka* in which partners have unlimited liability, the investor or *rab al mal* in a *mudaraba* transaction is only liable to the extent of the capital he has provided. As a result, the business manager or *mudarib* cannot commit the business for any sum over and above the capital provided.

The *mudaraba* contract can usually be terminated at any time by either of the parties giving a reasonable notice. Typically, conditions governing termination are included in the contract so that any damage to the business or project is eliminated in the event that the investor would like to take his equity out of the venture.

Instruments with Predictable Returns

Instruments with predictable returns are typically favoured by banks and their regulators since the reliance on third-party profit calculations is eliminated. There are four main instruments in this category: *murabaha*, *ijara*, *istisna* and *salam.* In addition, agency agreements (*wakala*) also provide the option for a predictable return.

Deferred Payment Sale

A *murabaha* transaction is a deferred payment sale or an instalment credit sale and is mostly used for the purchase of goods for immediate delivery on deferred payment terms. In its most basic form, this transaction involves the seller and buyer of a good, as can be seen in Figure 3.3.

As part of the contract between the buyer and the seller, the price of the goods, the mark-up, the delivery date and payment date are agreed. The sale of the good is immediate, against future payment. The buyer has full knowledge of the price and quality of goods he buys. In addition, the buyer is also aware of the exact amount of mark-up he pays for the

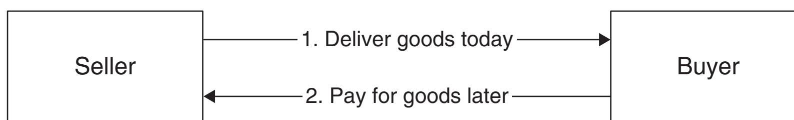

FIGURE 3.3 Simple *murabaha* structure

convenience of paying later. In the context of trading, the advantage to the buyer is that he can use the goods to generate a profit in his business and subsequently use the profit to repay the original seller. The underlying asset can vary, and can include raw materials and goods for resale.

In Islamic finance, the *murabaha* transaction can be applied to trade finance or interbank liquidity. Further details on the application in Islamic finance can be found in Chapter 8 and Section 7.1, respectively.

Leasing

An *ijara* transaction is the Islamic equivalent of a lease and is defined as a bilateral contract allowing for the transfer of the usufruct, which basically means that one party (lessor) allows another party (lessee) to use his asset against the payment of a rental fee. Two types of leasing transactions exist, operating and finance leases. Both are called *ijara* in Arabic, but a finance lease has the addition of *wa iqtina* to signify that at the end of the transaction period the ownership of the asset is transferred to the lessee. The only distinction between the two is the presence or absence of a purchase undertaking from the lessee to buy the asset at the end of the lease term. In a finance lease, this purchase undertaking is provided at the start of the contract. Under no circumstances can the lease be conditional on the purchase undertaking (i.e. the lessor cannot stipulate he will only lease the asset if the lessee signs a purchase undertaking).

Not every asset is suitable for leasing. The asset needs to be tangible, non-perishable, valuable, identifiable and quantifiable. In an operational lease, depicted in Figure 3.4, the lessor leases the asset to the lessee for a pre-agreed period, and the lessee pays pre-agreed periodic rentals. The rental or lease payments can either be fixed for the period or floating with periodical refixing. The latter is usually done by linking it to a conventional index such as LIBOR.

At the end of the period, the lessee can either request to extend the lease or hand the asset back to the lessor. The lessor takes a view of the residual asset value at the end of the lease term, and takes ownership risk. When the asset is returned to the lessor at the end of the period, he can either lease it to another counterparty or sell it on the open market. If the lessor decides to sell the asset, he may offer it to the lessee.

In a finance lease, as depicted in Figure 3.5, the process is the same as for an operating lease, with the exception that the lessor amortises the asset over the term of the lease and at the end of the period the asset will be sold to the lessee.

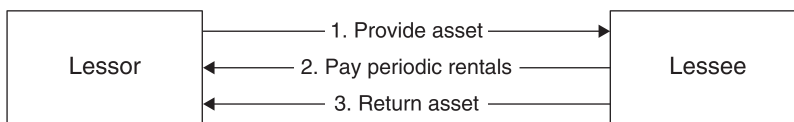

FIGURE 3.4 Operating lease

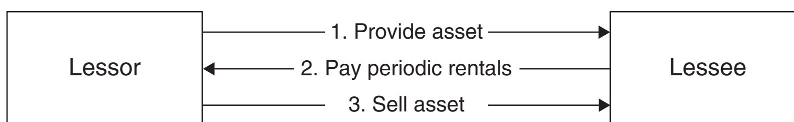

FIGURE 3.5 Finance lease

As with an operating lease, rentals can be fixed for the period or floating. As part of the lease agreement, the lessee provides the lessor with a unilateral purchase undertaking, which specifies the amount at which the lessee will purchase the asset upon expiry of the lease. Three options are possible:

1. **Gift**. In this case, the lessor has completely amortised the asset and, once all rentals are paid, there is no further payment required from the lessee to obtain the asset.
2. **Against fixed payment**. At the end of the lease, the lessee becomes the owner of the asset once he has paid the purchase amount agreed in the contract.
3. **Against market value**. At the end of the lease, the lessee becomes the owner of the asset once he has paid the market value to the lessor.

In practice, options 1 and 2 are most common.

In both forms of lease or *ijara* the lessor is the owner of the asset and incurs all risk associated with ownership. Whilst the lessee bears the responsibility for wear and tear, day-to-day maintenance and damage, the lessor is responsible for major maintenance and insurance. Due to the fact that the lessee is using the asset on a daily basis, he is often in a better position to determine maintenance requirements, and is generally appointed by the lessor as an agent to ensure all maintenance is carried out. In addition, the lessee is, in some cases, similarly appointed as agent for the lessor to insure the asset.

In the event of total loss of the asset, the lessee is no longer obliged to pay the future periodic rentals. The lessor, however, has full recourse to any insurance payments.

Short-Term Production Finance

A *salam* contract is a purchase contract in which payment is made now against future delivery of an asset. The *salam* contract is exempt from two of the conditions of contract that normally apply: at the time of contracting the asset does not have to be in existence, and the seller does not need to have ownership. In its simplest form, *salam* is a contract between a buyer and a seller for which payment of the full transaction amount occurs today for goods to be delivered in the future. This is depicted in Figure 3.6.

Salam contracts are typically short-term (1–3 months), but could be entered into for longer periods. Due to the fact that the goods still need to be produced, they can only be transacted on the basis of their attributes such as type, quality and quantity but cannot be attributed to an individual supplier, factory, batch or field. Any good that cannot be specified by its quality and quantity (e.g. precious stones) cannot be the subject of a *salam* transaction. As a transaction type, it is most suitable for the financing of agriculture or small construction and manufacturing projects. The seller has a contractual obligation to deliver the specified quantity and quality at the agreed delivery date. This means that, in the event that the seller has not managed to manufacture or grow the required quantity and quality, he will have to go to the open market to buy the difference and fulfil his contractual obligation. Hence the goods involved must be commodities that are freely available in the market.

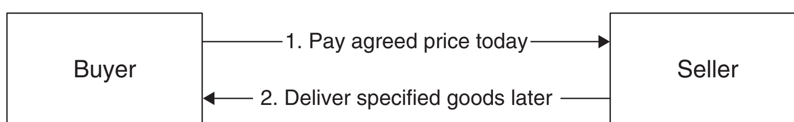

FIGURE 3.6 Simple *salam* structure

The advantage to the seller lies in the fact that he will have the funds to enable him to produce the underlying asset. The buyer, on the other hand, obtains an asset in the future and is working on the expectation that the future price of the asset will be higher than the current price he is paying for it. The buyer takes a business risk in this transaction, and it is therefore not subject to any of the prohibitions regarding uncertainty and gambling.

Long-Term Production Finance

Like a *salam* contract, an *istisna* contract is a purchase contract for future delivery of an asset, and is exempt from the same two conditions regarding the asset, ownership and existence. Unlike the *salam* contract, in an *istisna* contract, the payment to the producer or contractor of the asset does not have to be in full in advance. Payment is likely to be in various instalments in line with the progress made on the development of the asset and is therefore well suited to project finance and construction.

The asset typically needs to be manufactured, constructed or processed and is of a significant size and capital outlay. The *istisna* contract is generally longer-term. Under the simple *istisna* structure depicted in Figure 3.7, it is assumed that the buyer has sufficient funds available to pay for the asset during its construction. However, this is not necessarily the case and the seller (manufacturer) or a financier could lease the asset to the buyer for a pre-agreed period of time.

In the event that a financier or bank is involved, the structure is often known as a *parallel istisna*, in which the buyer commissions the financier to manufacture the specified asset for the purchase price. In parallel, the bank commissions a third party, the contractor, to manufacture the same asset for a lower price. The parallel *istisna* is depicted in Figure 3.8.

Like the *salam* transaction, the buyer takes a business risk in this transaction, and it is therefore not subject to any of the prohibitions regarding uncertainty and gambling. Further details on how this structure can be applied to financing can be found in Sections 7.2 and 7.3.

Other Instruments

Besides the profit- and loss-sharing instruments and the financing options with a predictable return outlined earlier, there are other financial structures that do not necessarily fall into either of these categories.

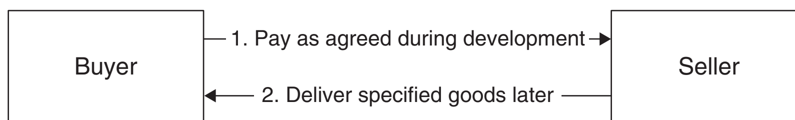

FIGURE 3.7 Simple *istisna* structure

FIGURE 3.8 Simple parallel *istisna* structure

Contract of Exchange

A contract of exchange concerns the buying and selling of any asset between two or more parties in a single transaction. There are three forms of contracts of exchange:

1. **Goods for goods**. The exchange of one asset for another without any money changing hands. This form of trade is also known as barter trade.
2. **Goods for money**. The exchange of an asset in return for payment in money.
3. **Money for money (*sarf*)**. The purchase and sale of one currency for another.

Options 1 and 2 cover the most basic trades involving purchase and sale. Both could be conducted in a shop, over the phone, via the internet or any other medium acceptable to the parties involved. Offer and acceptance and validity requirements as outlined in Section 2.5 have to be met, and the asset has to meet the eligibility criteria in Section 3.2.

Option 3 has, in addition, a few other characteristics that are worth mentioning. To begin with, these contracts apply not only to money in its current form of coins and banknotes, but also to the money-like commodities of the olden days (i.e. gold, silver, barley, wheat, dates and salt). In addition:

- The counter values have to be of an equal amount and have to be exchanged immediately. In a finance context, this means that foreign exchange spot transactions are acceptable, but forward contracts are not.
- The contract of exchange should not be subject to conditional options such as "I will sell you £2,000 in return for €2,500 if the rate moves above €1.25 per pound".
- Payment does not have to be in physical cash. Payments over account, cheques, using online banking and so on are equally acceptable as long as the relevant account is in credit.
- Netting of amounts in different currencies between the same parties and settling the net amount is allowed.

What is not acceptable, however, is entering into a foreign exchange transaction using a credit line provided by the bank, since that amounts to selling something you do not own.

Letters of Credit

Letters of credit as an Islamic financial instrument are similar to conventional letters of credit and are an undertaking by a bank to make a payment to a named party against the presentation of the stipulated documents. Letters of credit are often used in combination with trade-type transactions such as *murabaha* and *salam*, and, depending on which party requests it, provide certainty that the goods are delivered before payment is made or transfers the risk of non-payment to the financial institution issuing or confirming the letter of credit. Although the bank may charge an administration fee, this fee cannot be proportional to the amount covered by the contract.

The main advantage of a letter of credit is that it provides security to both the exporter and the importer. This does, however, come at a price and the benefit must be weighed against the additional costs resulting from bank charges. From the perspective of the exporter, the letter of credit is conditional, and payments will not be made until such a time that all terms of the credit are met.

The importer enters into a letter of credit to ensure that the exporter does not receive payment until the ownership of the goods has been transferred. An exporter enters into a letter of credit if he wants to transfer the risk of non-payment by the buyer to the issuing bank – and, if applicable, the confirming bank. As long as the terms of the credit are met, a letter of credit is the most secure method of payment in international trade.

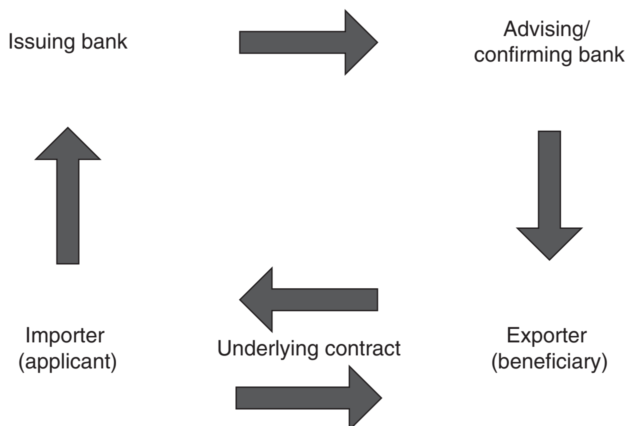

FIGURE 3.9 Parties involved in a letter of credit transaction

The parties in the letter of credit process are outlined in Figure 3.9. It is important to note that all parties in the letter of credit transaction deal with documents, not goods.

The description in this section applies to conventional letters of credit, but the concepts are equally valid for letters of credit based on Islamic principles. Although it is specifically mentioned that the parties deal with documents, not goods, there is always a physical underlying asset that is represented by the documents. Different types of letters of credit exist, such as irrevocable, confirmed and stand-by.

Guarantee

A financial guarantee is a guarantee provided by one party (the guarantor) to cover any shortfall in a third-party payment. An example of a guarantee is when parents provide a guarantee to the bank for their child's payments under a home purchase plan. In the event that the child misses a payment, the parents will automatically be liable.

Contrary to conventional finance, in Islamic finance, guarantees cannot be used to assure profits or to guarantee business performance, but only to guarantee payment in the event of shortfall or default by a named counterparty. In Islamic finance, the guarantor cannot charge a fee for providing the guarantee.

Unilateral Promise

A *wa'd* is a unilateral promise from one party to another, and can, for example, be structured along the lines of "I promise to pay you £15 next week if you help me organise my brother's birthday party". Acceptance by the other party is not required, since this is not a bilateral contract. The conditionality in this phrase is also acceptable for the same reason. However, in order for this to turn into a contract the second party needs to signify his acceptance.

Bilateral promises on the same goods, for the same price, between the same counterparties and for the same future date are not accepted by the majority of scholars due to the fact that this is deemed to mimic a forward contract. An example of a bilateral promise would be when one party promises to buy €125 against £100 in 30 days and the other party promises to sell €125 against £100 on the same date. Forward contracts are prohibited since they are deemed speculative.

Down Payment

An *arbun* represents a non-refundable down payment on a purchase, which signifies the buyer's intent to buy the asset and is typically made towards a good that will be delivered at a later date. It is depicted in its most simplistic form in Figure 3.10.

The down payment forms part of the overall price agreed between buyer and seller, but is non-refundable in the event that the buyer later decides not to take delivery of the asset. Simplified, the steps are as follows:

1. Buyer and seller agree a price and buyer makes a down payment (e.g. 20% of the purchase price). The asset is specified and the delivery date is agreed.
2. On the agreed delivery date, the seller delivers the asset to the buyer, or the buyer collects the asset from the seller.
3. On the agreed delivery date, after inspecting the asset, the buyer pays the remaining purchase price (e.g. 80% of the original purchase price).

Agency Agreement

A *wakala* agreement is the agreement that governs the principal–agent relationship between two parties where one party is requesting another to act on its behalf. The application of the *wakala* agreement is varied and can range from appointing an agent (*wakil*) to purchase or sell an asset, to the investment of funds. The *wakil* is entitled to a fee for his services. In addition, any profit made by him over and above a pre-agreed anticipated profit rate could be granted to him as an incentive. In Islamic finance, a *wakala* is often used to govern restricted and unrestricted investment accounts as described in Section 5.3 or interbank placements as described in Section 6.1.

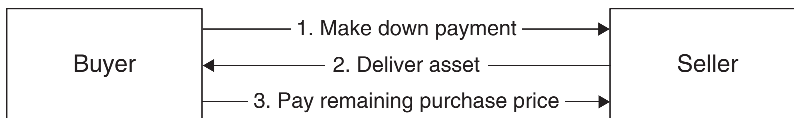

FIGURE 3.10 Simple *arbun* structure

EXAMPLE: ARBUN

My brother recently agreed to buy a motorbike from Biker's Best, a specialist motorbike garage, for €4,995. The motorbike is not new, and has been in the showroom for a few weeks. The seller needs to check the motorbike before it is collected and service it to ensure that it is roadworthy.

Although the deal is done, the seller would like some sort of guarantee, and does not want to be in a position where he has done all the work only to find the buyer has changed his mind. The seller requests a down payment, and they agree on €995. When my brother went to collect the motorbike, he paid the remaining €4,000.

If he had pulled out of the purchase, he would have lost his €995, which the seller would have kept to cover the work he had done in making the motorbike ready for sale.

Fees for Services Rendered

Under an *ujra* transaction, one party pays another fees for services rendered. The fees could apply to any type of service agreed between the parties.

Trust Agreement

A *waqf* agreement is often used to replicate a conventional trust agreement. However, the *waqf* is subject to strict rules, and its purpose needs to be beneficial to those in need. As such, applying it to trust-type transactions in the conventional finance sense of the word is not appropriate.

3.4 BOND-LIKE INSTRUMENTS

Sukuk is currently probably the most widely known word in the Arabic language, especially in the financial world. *Sukuk* translates to legal instrument or deed and is the plural of *sakk*, which means cheque. *Sukuk* are often classified as the Islamic equivalent of bonds, although there are a few differences. This section highlights the most common features of bonds and contrasts them with *sukuk*.

Bonds

Bonds are tradable financial instruments issued by a company, corporation or government, are typically long-term and allow the holder to receive interest before the distribution of profits to the shareholders. Bonds have been around for several centuries and were popular with kings who needed to borrow heavily to finance their war efforts. The variety of bonds is too large to describe here in detail. The main characteristics will, however, serve a purpose when comparing bonds and *sukuk*.

- **Coupon**. The coupon, which represents the interest rate payable of the bond, can be either a fixed rate for the life of the bond, or linked to a benchmark rate such as LIBOR plus a mark-up. The coupon is typically paid either annually or semi-annually.
- **Credit rating**. Any rating is primarily based on the issuer. To enhance the credit rating, and hence the chances of the holders being repaid in the event of default, bond structures can have collateral attached to them.
- **Market**. Bonds can be bought either directly from the issuer (the primary market) or from another bond holder (the secondary market). In the secondary market the pricing of the bond is based on the view buyers and sellers have on the movement in interest rates in combination with the coupon of the bond, creditworthiness and other economic circumstances.
- **Ownership**. The holder of a bond does not have any ownership interest over the company or a specific asset and as a result does not incur any ownership risk. The bond holder has a security interest in the underlying asset.
- **Redemption**. Redemption of the nominal value of the bond is either at the due date or upon liquidation, and could be either in cash or, in the case of convertible or exchangeable bonds, in shares. In the event of default, bond holders have priority for repayment over share holders.

Sukuk

From the viewpoint of Islam, conventional bonds have two major draw backs and as a result are prohibited: first, they pay interest; and second, there is generally no underlying asset. *Sukuk* are an Islamic security that are, to a degree, comparable to conventional covered bonds. They are, however, not a debt instrument.

Contrary to conventional bonds, *sukuk* are generally linked to an underlying tangible or intangible asset. Intangible assets are increasingly accepted by scholars, but not yet widely applied. The (beneficial) ownership of the underlying asset is transferred to the holder of the *sukuk* certificates together with all ownership benefits and risks. This gives *sukuk* characteristics of both equity and bonds. *Sukuk* currently issued have a shorter term than conventional bonds, typically 3–5 years.

The *sukuk* holder owns a proportional share of the underlying asset, and has a financial right to the revenues generated by the asset. However, as mentioned before, the holder is also subject to ownership risk, which means he is exposed to any risk and potential losses associated with the share of the underlying asset. Conventional bonds, on the other hand, remain part of the issuer's financial liability.

Sukuk are not a separate instrument, but are more like structures facilitating the funding of large projects, which would be beyond the capability of either an individual or a small group of investors. *Sukuk* can be listed on recognised exchanges and, with the exception of the *sukuk al salam,* are tradable. Like conventional bonds, *sukuk* can be bought from the issuer or in the secondary market. Unlike the conventional bond market, however, *sukuk* tend to be held to maturity and the secondary market is not very active. Although quotes are provided by some market makers, the spreads between bid and asking price are particularly wide and availability of issues is currently thin.

Generic Structure

At the heart of the *sukuk* structure lies a special purpose vehicle (SPV) that purchases the asset from the original owner on behalf of the *sukuk* holders. The SPV is often set up as part of the group of companies selling the asset and hence raising the funds. In the interest of the *sukuk* holders, the SPV needs to be bankruptcy remote, which means that any insolvency of the original seller of the asset does not affect the SPV. In addition, the SPV should not attract any negative tax implications and will need to be established in a tax-friendly jurisdiction. With the exception of *murabaha*, any of the earlier mentioned partnership and predictable return structures, as well as a *wakala*, can be the underlying structure for a *sukuk. Murabaha* is not applicable for securitisation since the asset has already been delivered but payment is deferred; securitising these transactions would therefore amount to debt trading. The exception to this is in Malaysia where, following the Shafi'i school of thought, regulators and market players have permitted this type of securitisation.

The generic underlying *sukuk* structure is depicted in Figure 3.11, although it should be taken into consideration that variations occur depending on the underlying transaction type. Although the steps differ for the different structures, the underlying principles remain the same and involve the following steps once the SPV is in place:

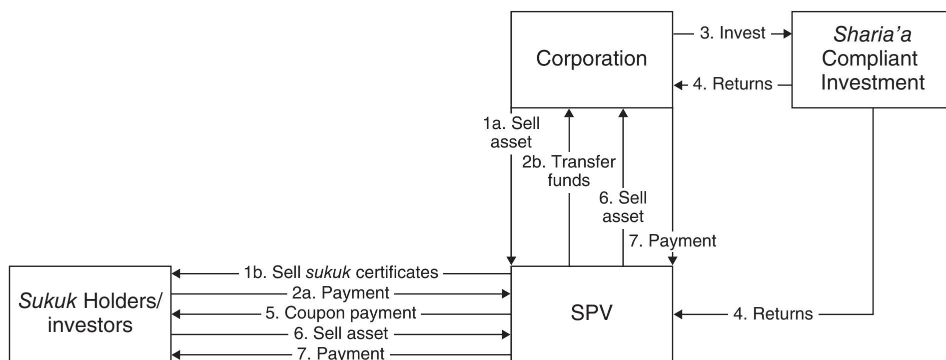

FIGURE 3.11 Generic *sukuk* structure

1. The corporation sells an asset to the SPV, which the SPV divides up in equal units of usually $1,000 or £1,000 and transfers on to the *sukuk* holders. In the event that the underlying transaction is a *musharaka* or *mudaraba* the underlying asset can be represented by a share in the corporation or partnership.
2. The *sukuk* holders transfer the funds representing the number of certificates they bought to the SPV, which transfers the total proceeds minus any costs to the corporation.
3. The corporation invests the funds in the *Sharia'a* compliant investment stipulated in the contract.
4. The *Sharia'a* compliant investment either generates profits and losses (for partnership type contracts) or pays a return (for predictable return type instruments).
5. The SPV collects profits and losses or returns and pays (typically quarterly) coupons to the *sukuk* holder.
6. At maturity, the *sukuk* holder sells the asset to the SPV, which in turn sells it back to the corporation.
7. Money flows from the corporation to the *sukuk* holders through the SPV.

Sukuk are issued not only by corporations, but also by governments and other sovereign entities and public enterprises in which case the "corporation" in the above-mentioned structure can be replaced accordingly.

New AAOIFI *Sukuk* Rules

Before going into more detail on the individual structures, it is worthwhile to have a brief look at the *sukuk* rules issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The role of the AAOIFI is described in more detail in Section 13.1, and only the *Sharia'a* standards for *sukuk* are included here.

From an accounting perspective, *sukuk* must be clearly defined and bankruptcy remote. In addition, any transaction in which ownership of an asset is involved requires a true sale. The only exception to this rule would be in countries where for legal or regulatory reasons it is more efficient to keep the asset on the balance sheet of the issuer of the *sukuk*.

In February 2008 the AAOIFI *Sharia'a* supervisory committee refined the *sukuk* rules and incorporated the following restrictions:

- **Purchase undertaking**. A purchase undertaking by the issuer is typically part of the structure and serves as a guarantee to the *sukuk* holders that their investment will be returned to them at the end of the period. Only in *sukuk al ijara*, which are based on a sale and lease-back transaction, is it allowed to have a purchase undertaking at a price pre-agreed at the start of the transaction. In *sukuk al mudaraba*, *sukuk al musharaka* and *sukuk al wakala* a purchase undertaking is allowed. The price cannot be agreed in advance, but is the market price of the underlying partnership or asset on the maturity date.
- ***Sukuk* manager guarantee**. The *sukuk* manager cannot provide a guarantee to make good the shortfall of any income to the *sukuk* holder. Due to the fact that there is no longer a guarantee in case of a default, *sukuk* will rank *pari passu* with ordinary secured debt.
- **Reserves**. The *sukuk* manager is entitled to build up reserves out of the profit or rentals to cover any potential future shortfall, which partly offsets lack of a guarantee. However, amounts will have to be appropriated to the reserve before distributing the profit to the *sukuk* holders. This provides potential to offer different tranches, which will allow investors to invest according to their risk appetite.

The tightening of the rules will result in enhanced *Sharia'a* compliance of *sukuk* issued and increased transparency.

Sukuk Based on Partnership Transactions

Sukuk based on partnership transactions are based either on a *musharaka* or a *mudaraba* transaction. The underlying transactions work in the same way as described in Section 3.3, with the difference being that one of the partners is now the SPV instead of an individual investor.

On the maturity date, the sale of the units needs to be at market value, which will need to be established by an independent surveyor.

In both structures, the risk to the *sukuk* holder is similar:

- **Contract is making a loss**. In this case, the SPV and hence the *sukuk* holders are responsible for the loss in proportion to the capital provided. The investor is not responsible for any losses in excess of the capital provided, or for losses caused by negligence of the managing partner.
- **Managing partner cannot buy the units at maturity**. This leaves the *sukuk* holders with the units and they do not receive their original investment back. Due to the fact that the *sukuk* holders own the shares in the project, they could instruct the SPV to find another buyer, which could result in a lower sales price and will most certainly have an impact on when the investors will get their capital back.

Sukuk al musharaka

In *sukuk al musharaka* the underlying transaction type is a partnership or *musharaka,* and both partners are a *musharik* to the transaction, although the SPV, on behalf of the *sukuk* holders, typically is a sleeping partner and is not providing any skill or expertise in managing the partnership. Graphically this transaction can be depicted as in Figure 3.12.

Both partners invest in a project or company governed by a *musharaka* agreement. The *musharik* share of the SPV is divided into equal units and sold to the *sukuk* holders. At the end of the period, the *sukuk* holders sell the units in the partnership to the other partner.

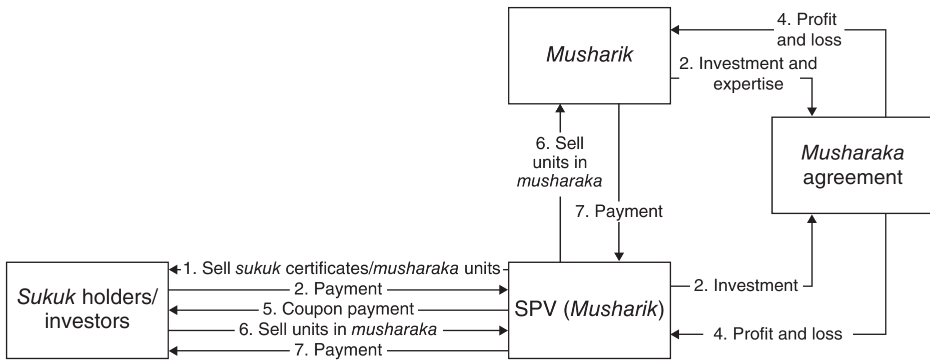

FIGURE 3.12 *Sukuk al musharaka*

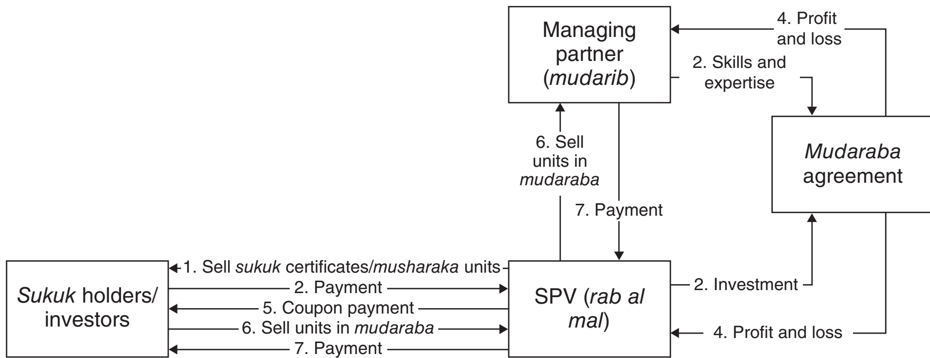

FIGURE 3.13 *Sukuk al mudaraba*

Sukuk al mudaraba

In *sukuk al mudaraba* the underlying transaction type is a partnership or *mudaraba* in which only one of the partners, the SPV on behalf of the *sukuk* holders, provides the capital and acts as the *rab al mal*. Graphically this transaction can be depicted as in Figure 3.13.

The SPV invests in a project or company governed by a *mudaraba* agreement. The investment of the SPV is divided into equal units and sold to the *sukuk* holders. At the end of the period, the *sukuk* holders sell the units in the partnership to the managing partner.

***Sukuk* Based on Predictable Return Transactions**

Sukuk based on predictable return type transactions are based on an *ijara*, *salam* or *istisna* transaction. The underlying transactions work in the same way as described in Section 3.3, with the difference that one of the partners is now the SPV instead of an individual investor. *Tawarruq* and *murabaha* transactions are less suitable for securitisation since they could easily result in debt trading, which is not permitted. However, *murabaha*-based *sukuk* are possible as long as the asset will remain with the *sukuk* holder.

Sukuk al ijara

In *sukuk al ijara* the underlying transaction type is a lease or *ijara*, and is typically a sale and lease-back structure. Generally, the funds released by the sale and lease-back will be invested

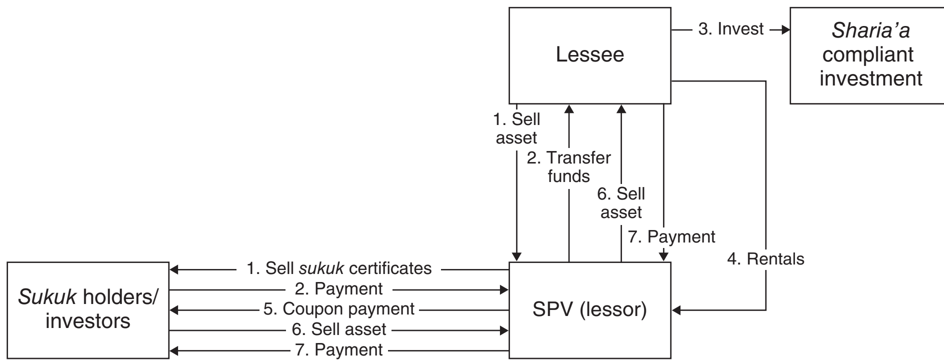

FIGURE 3.14 *Sukuk al ijara*

by the lessee in *Sharia'a* compliant projects, and can, for instance, be applied to expansion of the company. Graphically this transaction can be depicted as in Figure 3.14.

The lessee sells the beneficial title of an asset to the SPV under a sale and lease-back agreement, and signs a purchase undertaking to buy back the asset at maturity at the same price. The SPV divides the asset into equal units and sells the beneficial ownership to the *sukuk* holders. Maintenance and insurance obligations are generally transferred to the lessee by means of an agency agreement. At the end of the period, the *sukuk* holders as lessor sell their shares of the asset back to the lessee via the SPV.

As in an *ijara* transaction, the rental can be either fixed or floating, with a periodic reset based on a recognised benchmark such as LIBOR. The lessee is not necessarily dependent on the investment to ensure he can honour his rental obligations. However, the success of the investment will have an impact on the ability of the lessee to buy back the asset at the end of the period.

The risks to the *sukuk* holder are:

- **Lessee cannot pay rentals**. In the event that the lessee cannot pay the rentals, the *sukuk* holder does not receive any coupon payment. Although it is in the interest of all parties that any default in payment will be resolved between them, the situation could occur that the lessee becomes insolvent. In this case, the *sukuk* holder has first recourse to the proceeds of the sale of the asset.
- **Asset becomes impaired**. If the asset is damaged beyond repair, the lessee is no longer responsible for the rental payments. The *sukuk* holder has full recourse to the insurance payout. However, insurance claims tend to take a long time to pay out.
- **Lessee cannot buy back the asset at the end of the lease period**. Even though a purchase undertaking is in place, a situation could occur where the lessee cannot buy back the asset, for instance due to insolvency. In this case, the SPV can sell the asset to another party and pay the *sukuk* holder from the proceeds of the sale. This may result in a lower sale price and hence a loss to the investors, and will most certainly have an impact on when the investors will get their capital back.

Sukuk al salam

In *sukuk al salam* the underlying transaction type is a short-term (typically 1–3 months, with a maximum of 12 months) production finance transaction as described in Section 3.3. Under this structure, the *sukuk* holder funds the seller during production and is paid out of the

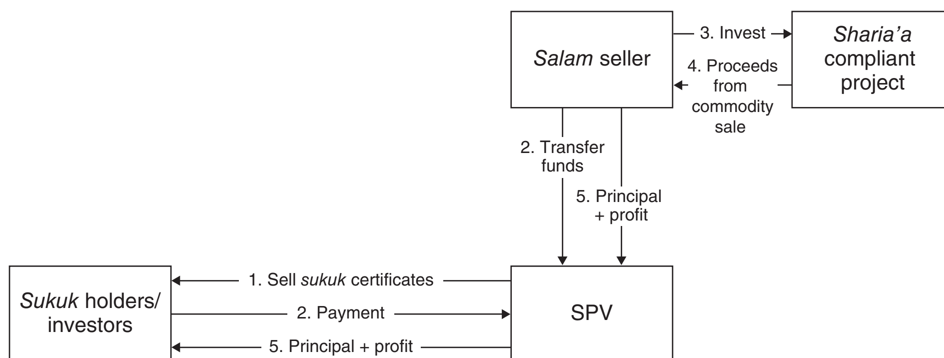

FIGURE 3.15 *Sukuk al salam*

proceeds of the sale of the asset at the end of the period. Graphically this transaction can be depicted as in Figure 3.15.

The SPV funds a *salam* seller spot for the future delivery of a commodity. This could involve agriculture, construction or manufacturing. On the maturity date, the *salam* seller sells the commodity to the end buyer and pays the principal plus a pre-agreed mark-up to the *sukuk* holders via the SPV.

The *sukuk al salam* is similar to a zero coupon bond, which pays a return higher than the original investment, but does not pay any interim coupons. Due to the underlying principles of the transaction, the asset is not transferred to the *sukuk* holder at any point in the transaction, and trading the *sukuk* is not permitted as it would be akin to debt trading. The *sukuk al salam* needs to be held to maturity.

The risks to the *sukuk* holder are:

- **Commodity cannot be delivered**. In the event the seller cannot produce the total amount of the commodity agreed in the contract, he will technically have to obtain the commodity in the open market and deliver the same to the buyer. However, if the seller's crop fails, for instance, there is a significant probability that others' crop will have failed too and he will not be able to obtain the required quantity. In this case it will be up to the SPV on behalf of the *sukuk* holders and the seller to come to a reasonable arrangement.
- **Commodity cannot be sold**. In the worst case, the seller cannot sell the commodity and will not be able to redeem the *sukuk*. Technically, the *sukuk* holders could seize the asset, but will then be left with an illiquid asset. Under these circumstances the *sukuk* holder will not receive any payout.
- **Commodity cannot be sold at a profit**. In this case, the commodity is sold at a price below the estimated price and the *sukuk* holder receives a smaller profit than expected, or, if the price is below the production price, receives only part of his principal back.

Sukuk al istisna

In a *sukuk al istisna* the underlying transaction type is a long-term production or construction finance transaction or *istisna.* The asset is usually a fixed asset such as plant or machinery and is built exactly to the buyer's specification. Due to the significant capital outlay associated with these types of transactions, the *istisna* contract is often directly followed by a finance lease. Both components of the transaction are combined in the *sukuk al istisna*. Graphically this transaction can be depicted as in Figure 3.16.

EXAMPLE: *SUKUK AL SALAM*

The Central Bank of Bahrain (CBB) issues *sukuk al salam* on a monthly basis. This *sukuk* is a Bahraini dinar (BHD) denominated debt instrument issued on a monthly basis and has a 3-month (91-day) maturity. The issue amount is BHD 6 million ($16 million).

The *sukuk al salam* is issued through a fixed-rate tender procedure where all eligible financial institutions are invited to participate. The auction procedure is executed as follows:

- Invitation letters including details on the forthcoming issue are circulated to the institutions entitled to participate in the tender.
- Tender bids are submitted to the CBB indicating the requested quantity.
- Tenders are then allotted *pro rata* according to quantities requested.
- Settlement of the resulting transactions takes place through debiting the participating banks' accounts with the CBB.

At the end of the period, the underlying asset (aluminium) is delivered and sold. This results in a return, which is used to pay the participating institutions their original principal plus profit.

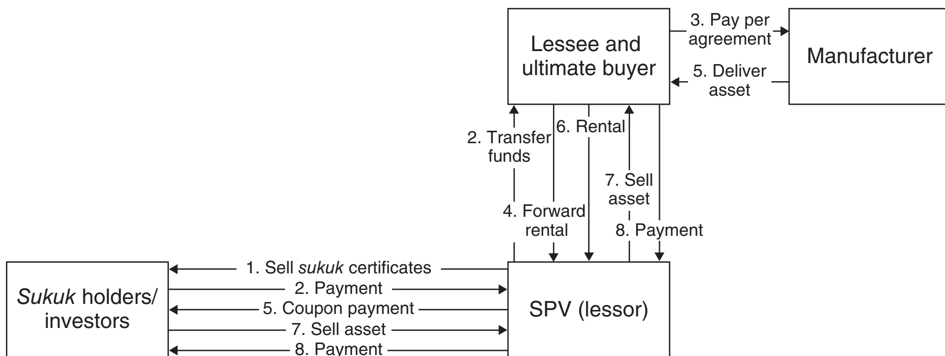

FIGURE 3.16 *Sukuk al istisna*

The specification and cost of the asset are agreed between the buyer and the manufacturer under an *istisna* contract. The funds from the *sukuk* holders are transferred to the buyer in full on the issue date, but only paid to the manufacturer in accordance with the schedule agreed in the contract. Once the funds have transferred to the buyer (steps 1 and 2 in Figure 3.16), the following steps take place:

3. The buyer manages the relationship with the manufacturer as agent on behalf of the SPV and pays the manufacturer as agreed in the contract.
4. During the manufacturing process, the SPV and the buyer have a forward rental agreement under which the ultimate buyer pays a forward rental fee.

5. The physical asset is delivered to the buyer; the beneficial title will be delivered to the SPV.
6. Once the asset has been delivered, the forward lease ceases to exist and is replaced by a lease agreement in which the ultimate buyer is the lessee and the SPV the lessor. The lessee provides a purchase undertaking and pays rentals to the SPV.
7. At maturity, the SPV sells the asset to the lessee on behalf of the *sukuk* holders.
8. The lessee pays the full settlement amount to the SPV who repays the *sukuk* holders for their initial investment.

The risks to the *sukuk* holder are:

- **Asset not delivered by manufacturer**. If the asset is not delivered by the manufacturer, the forward lease agreement ceases to exist. The buyer will negotiate the next steps, on behalf of the SPV and the *sukuk* holders. In the event the manufacturer has become insolvent, a claim for monies paid has to be made with the administrator. In any other situation, any funds paid to the manufacturer will have to be reclaimed. Non-delivery of the asset is likely to have an impact on the length of the forward lease, or may result in the transaction folding altogether.
- **Lessee cannot pay rentals**. In the event that the lessee cannot pay the rentals for either the lease or the forward lease, the *sukuk* holder does not receive any coupon payment. Although it is in the interest of all parties that any default in payment will be resolved between them, the situation could occur that the lessee becomes insolvent. In this case, the *sukuk* holder has first recourse to the proceeds of the sale of the asset.
- **Asset becomes impaired**. If the asset is damaged beyond repair, the lessee is no longer responsible for the rental payments. The *sukuk* holder, however, has full recourse to the insurance payout, notwithstanding that any insurance claims tend to take a long time to pay out.
- **Lessee cannot buy back the asset**. Even though a purchase undertaking is in place, a situation could occur where the lessee cannot buy back the asset, for instance due to insolvency. In this case, the SPV can sell the asset to another party and pay the *sukuk* holders from the proceeds of the sale. This may result in a lower sale price and hence a loss to the investors, and will most certainly have an impact on when the investors will get their capital back.

CHAPTER 4

Distribution of Islamic Products

Islamic financial products are offered not only by banks that are fully *Sharia'a* compliant (commonly known as Islamic banks) but also by conventional banks deploying specific distribution channels. The question that arises is whether this makes a difference. One of the questions that is often raised is whether or not Islamic financial instruments offered by Islamic banks are better than those offered by conventional banks. Although there are differences in the offering, this does not necessarily make either of them better or worse. In the end, each offering will need to be reviewed on its own merit. This chapter outlines the differences in distribution channels and how Islamic and conventional banks can work together to provide the best possible financing solutions for their clients.

4.1 DISTRIBUTION CHANNELS AND *SHARIA'A* COMPLIANCE

In order for a financial product to be *Sharia'a* compliant it needs to satisfy, at a minimum, the criteria of *Sharia'a* regarding the avoidance of *riba*, *maysir* and *gharar*. Once these are satisfied and the bank obtains *Sharia'a* supervisory board (SAB) approval, the product or structure can be marketed as *Sharia'a* compliant. As far as conventional banks are concerned, this is where *Sharia'a* compliance stops. It does not, for example, prevent the bank from employing non-Islamically raised funds to invest in Islamic structures. Conventional banks go to market with these products via the following distribution channels:

Window. The term *window* is used for conventional banks carrying out Islamic financial activities and delivering them via the same distribution channels, such as branches, they also use to distribute conventional financial products. Operations and accounting, however, are segregated from the conventional operations. Examples of this in the UK are Lloyds and TSB.

Branch. The branch structure is similar to windows, but uses separate branches instead of the conventional branch network to distribute Islamic financial products. A combination of branches and windows can be used by the same bank. HSBC Amanah, for instance,

provides Islamic financial products via its conventional branch network, but also provides these services via dedicated branches.

Subsidiary. A subsidiary is a separate legal entity that manages its own strategy within the parent's overall guidelines. Subsidiaries typically prepare separate annual reports, which are reported on a consolidated basis in the parent's annual report and accounts. An example of a subsidiary is Citi Islamic Investment Bank, incorporated in Bahrain in 1996 in response to US regulations, which stated that American banks are allowed to offer Islamic financial services, but only via offshore entities.

A fully *Sharia'a* compliant or *Sharia'a* based bank takes compliance with *Sharia'a* a step further. Not only do individual products have to meet all the requirements, but all operations within the bank are required to be compliant with *Sharia'a* as well. This extends to contracts with suppliers, rental contracts and labour contracts. The bank is completely set up to work in line with the ethical framework of *Sharia'a.* Therefore, it is more likely to be able to structure all products to meet *Sharia'a* requirements. Moreover, there is no commingling of conventional and Islamic raised funds since all funds are raised in line with *Sharia'a* requirements

4.2 *SHARIA'A* COMPLIANT VERSUS *SHARIA'A* BASED

It is the personal preference of any investor, depositor, *sukuk* issuer or other client of a bank as to what they would consider to be an appropriate level of *Sharia'a* compliance. Other factors anyone will need to consider are size, reputation and historical track record of the bank. In the end, a large conventional bank with a proven track record may generally provide a relatively higher degree of comfort than a newly established Islamic bank, although current market conditions may lead to a different view on this issue. In addition, large conventional banks have the advantage of the backing of a big balance sheet and structuring capabilities that, at least at the moment, are beyond the potential of Islamic banks. This becomes immediately clear when comparing the total assets of the largest Islamic banks with the total assets of the largest conventional banks. The largest Islamic bank (Bank Meli Iran) had total assets of $34 billion as of March 2007, closely followed by Al Rajhi bank with total assets of $33.4 billion at the end of December 2007. In contrast, the largest conventional bank by total assets at the end of 2007 was Royal Bank of Scotland with assets nearing $4 trillion, followed by Deutsche Bank, BNP Paribas, Barclays, HSBC, Crédit Agricole, Citigroup and UBS, all with assets in excess of $2 trillion each at the end of December 2007.[1] Even allowing for the deterioration in balance sheets as a result of the credit crunch, conventional banks are significantly larger than Islamic banks. Their large balance sheets allow them to underwrite large *sukuk* issues and to structure sizeable project finance structures, something that Islamic banks are not yet able to do. On the other hand, conventional banks provide Islamic finance as part of a broader range of financial products, and although the individual offerings are *Sharia'a* compliant and the distribution channel is different from other financial products, a conventional bank is likely to commingle funds raised in an Islamic manner with conventionally raised funds.

[1]Timewell, S. (2008) Top 1000 World Banks, *The Banker*, July.

Conventional banks can also hedge positions using innovative financial products, which are often not allowed in Islamic banks, due to the speculative nature of most hedging products.

A small, relatively young Islamic bank does not have a long track record and may therefore be deemed by investors and depositors to carry a higher risk. Although some comfort can be found in the fact that the bank is regulated, this is not a unique feature of an Islamic bank. Small, newly established conventional banks encounter the same issue. As a result of the smaller balance sheet size, Islamic banks are, at the moment, not in a position to underwrite large Islamic finance transactions unless they are part of a syndication effort, and even then some transactions are out of their scope due to large exposure regulations and size limitations. A *Sharia'a*-based bank, however, operates completely within the remit of the ethical framework defined by *Sharia'a*, something that should be of significant interest to Muslims. A fully Islamic bank will not only be audited by the internal and external auditors, but will also be subjected to a review by the SAB in its capacity as an independent third party to ensure ongoing *Sharia'a* compliance for the whole of the bank's business, and not just for individual transactions. This should also go a long way to counteract any reservations about dealing with Islamic banks from the perspective of investors and borrowers. An Islamic window or branch of a conventional bank likely goes through this type of ex-post compliance audit as well, but the bank does not have to report the results in its annual report.

4.3 COMPETITION OR OPPORTUNITY

The years since 1975 have seen the establishment of many more banks and the development of the industry into a multibillion-dollar market. It is no longer just small banks offering Islamic finance. These banks themselves are growing, and large conventional banks are offering Islamic finance through their Islamic windows, each with their own advantages:

- **Balance sheet size and structuring capabilities**. The large balance sheet size of a conventional bank and its extensive structuring capabilities can be deployed to back large Islamic financial transactions.
- **Proven track record**. Conventional banks have been around for a long time and have built up a proven track record, which generally provides a relatively higher degree of certainty than a newly established Islamic bank. However, given the current market turmoil in which banks have announced large losses and are rescued by their respective governments, a long-established bank is no longer likely to have this advantage over a newly incorporated entity.
- **Specialised knowledge and expertise**. Islamic banks operate completely within the ethical framework of *Sharia'a* and offer skill and expertise in structuring *Sharia'a* compliant instruments, which conventional banks do not necessarily possess.

The two types of players are highly complementary, and by working closely together they can achieve high market penetration and work on reaching the full potential of the market. Fully *Sharia'a* compliant banks and conventional banks are actively working together to offer Islamic finance, utilising some of the structuring and distribution capabilities of the large banks, in combination with the specific expertise the Islamic banks bring to the table.

CHAPTER 5

Application of Islamic Products in Retail Finance

Retail financial services for Islamic banks are typically offered in the same way as for conventional banks. Islamic banks have banking halls, automatic teller machines and offer debit cards, credit cards and chequebooks with current accounts. Modern means of banking such as telephone and online banking and text messaging services are also considered to be part of the package.

Retail clients are not only those who are served by the banks that are referred to in the UK as "high street banks", but equally encompass high net worth individuals who have requirements for similar types of products.

5.1 CURRENT ACCOUNTS

One of the basic banking requirements for retail and corporate clients alike is the current account, which allows a client to receive and pay funds and is usually the entry point into a banking relationship. Although the total offering varies from bank to bank and from country to country, current accounts tend to be accompanied by additional facilities such as debit cards, credit cards and chequebooks as well as online and telephone banking facilities and other features of modern current accounts.

In Islamic finance, current accounts are mainly offered using either of the following structures:

- *qard al hassan*; or
- *amanah* or *wadia*.

Qard al Hassan

The *qard al hassan* is an interest-free loan, historically provided for charitable purposes. Often the *qard al hassan* is intended to assist with matters such as the payment of school fees, weddings or the purchase of land to build a home. The loan has a charitable intention, but

even though the recipient does not have to pay a return on the funds, he is morally obliged to repay the principal in full. The provider of the loan is not compensated for inflation.

When applied to current accounts, the client is lending funds to the bank without any requirement for interest or any other form of return. The bank is under all circumstances morally required to repay the capital, but while the funds are held by the bank, they can be freely invested to fund any of the bank's day-to-day operations.

Amanah or *Wadia*

The words *amanah* and *wadia* literally translate as "trust", and in the context of finance this is deemed to represent safe keeping. When a bank accepts money in trust for the client these funds cannot be commingled with other deposits or the bank's own capital and cannot be used by the bank to apply to their day-to-day operations. The bank may request the client for authorisation to use the funds in their day-to-day operations, but can only do so if the client expressly approves this. *Amanah* and *wadia* are closely related to the original duties of safe keeping that temples and early bankers used to provide. Due to the fact that the sole purpose is safe keeping, the bank has the moral obligation to repay the capital under all circumstances, even if the client authorises the bank to use the funds.

General Features

Both types of account have an implicit obligation for the recipient of the funds to guarantee that the capital is paid back in full, but without any further compensation.

Overdrafts are generally not allowed, but in the event that a client accidentally goes overdrawn, the bank may charge an administration fee, which is equivalent to the operational cost of remedying this situation. A penalty in proportion to the size of the overdraft may not be charged.

Historically, the *qard al hassan* has been a popular tool for current accounts, and remains so in the Middle East and Europe. In Asia, however, the *amanah* or *wadia* instruments are rising in popularity, which is probably due to the fact that the *qard al hassan* is originally associated with charitable purposes contrary to the purpose of a current account.

In most countries banks are legally required to guarantee deposits for conventional as well as Islamic current accounts.

5.2 CREDIT CARDS

Credit cards are currently probably one of the most popular methods of payment when it comes to consumer transactions. From an Islamic finance perspective, credit cards generally have one major drawback in that they charge interest on the outstanding balance. Although clients could rely solely on debit cards and cash, this does not give them the flexibility of the payment options associated with a credit card. In addition, a credit card is widely accepted, especially when it comes to online payments, and provides a level of security against bankruptcy of the supplier prior to delivery of the goods or services.

Different types of Islamic credit cards are offered in the market, typically around the following structures:

1. **Periodic service charge**. In this structure, the card issuer charges the card holder a monthly or annual charge, which is generally a fixed fee per period. Additional charges can be included, for instance, when the card issuer allows the client to only pay off part of his balance. Periodic service charges can be structured by means of *ujra* transactions, which allow for the payment of a fee for services rendered.
2. **Deferred payment sale**. In this structure, the card issuer allows the customer to use his card to pay for a good or service under a *murabaha* type transaction. The sequence of events is as follows:
   - **a.** The client uses the card to pay for a good or service.
   - **b.** The card issuer becomes the owner of the good or service, and takes responsibility for the payment to the merchant.
   - **c.** The card issuer immediately sells the good or service on to the client at the original purchase price plus a mark-up for payment at the end of the period.
   - **d.** The client pays the original purchase price plus a mark-up to the card issuer at the agreed future date.
3. **Lease purchase agreement**. In this structure, the card provider is the owner of the asset until the card holder makes the final payment. The client can be charged a rental fee.
4. **Prepaid credit card**. In this structure, the client deposits an amount of money on his card and uses the card to pay for goods and services. Due to the nature of the card, the client cannot pay for goods in excess of his debit balance and credit balances do not occur. Hence any interest type charges are easily avoided. The card issuer can invest the excess balances to generate a return as long as the investments are *Sharia'a* compliant.

Variations on these structures are available and include, for instance, loyalty programmes.

Contrary to conventional credit cards, where the card issuer charges interest on any outstanding balance, Islamic credit cards do not attract any interest. In addition, the card issuer cannot charge the client a penalty for late payment although an administration fee may be charged to cover any costs involved with recovering the debt. In the event that the card issuer charges a penalty in excess of their costs, the difference will be donated to charity.

Islamic credit card issuers often require collateral such as cash deposits to reduce their exposure, and share any profits from the investment of these amounts with the client.

Islamic credit cards cannot typically be used to purchase non-*Sharia'a* compliant items.

5.3 DEPOSIT ACCOUNTS

Unlike current accounts, where clients do not necessarily expect a return, savings or deposit accounts do offer a return on capital. Deposit accounts are typically offered as investment accounts, which are governed by *wakala*, *mudaraba* or *murabaha* contracts between the bank and the client.

When applying *wakala* or *mudaraba* transactions, the depositor is the *rab al mal* and the bank is either the *wakil* or *mudarib*, depending on the type of transaction. Graphically these structures can be depicted as in Figure 5.1.

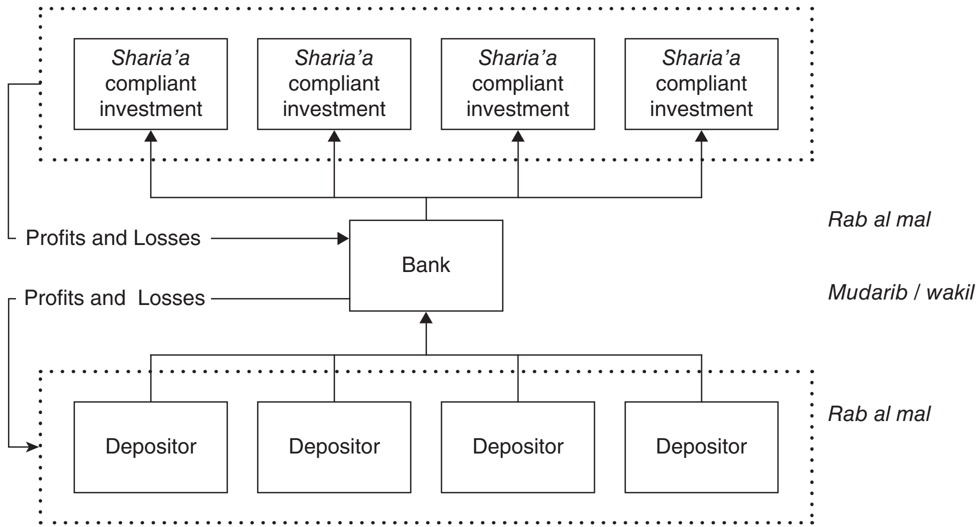

FIGURE 5.1 Two-tier *mudaraba* or *wakala* structure for savings accounts

In the first part of the contract, the depositors are the investors or *rab al mal* providing capital to the bank, which is acting as the *wakil* or *mudarib* providing investment management expertise. The bank's responsibility is to identify appropriate *Sharia'a* compliant investments, which provide the maximum returns given the appropriate risk level. The relationship between the depositor and the bank takes the form of either a restricted or an unrestricted investment account.

The top part of Figure 5.1 governs the relationship between the bank and the clients to which it provides financing. The bank pools assets from the individual depositors with their own funds and invests in *Sharia'a* compliant assets. The transactions the bank invests in vary between retail banks, which mainly fund retail clients for personal finance or home finance, and investment banks, which invest in projects, property, leases, trade finance and treasury transactions.

Restricted and Unrestricted Investment Accounts

The deposit accounts typically offered to clients are either restricted investment or unrestricted investment accounts. In both cases, the bank can commingle the funds from different account holders with their own funds, in which case the bank is both the *mudarib* and the *rab al mal*, and invest in a range of investment opportunities.

Under a restricted investment account, the client restricts the range of assets the bank can invest his money in. Technically the restrictions could be anything that is agreed between the bank and the client as long as the transaction is *Sharia'a* compliant. In practice, however, the bank will not allow a large variety of restrictions, with a typical restriction being based on the length of time the investment is held. It is, however, not unheard of to have restrictions in place regarding the type of transaction (e.g. only leasing) or industry (e.g. no telecommunications). The type of restricted investment account that is most appropriate for individual clients

depends on their investment profile, which includes time horizon, liquidity requirement and risk appetite.

In the case of unrestricted investment accounts, the client authorises the bank to invest his money in anything the bank deems to be a suitable investment, as long as it is *Sharia'a* compliant. The investment decisions are made entirely by the bank.

When governed by a *mudaraba* agreement, the bank is paid a *mudarib* share for its investment skills and expertise, which is determined based on gross income minus expenses incurred. The remaining profit share is distributed to investors *pro rata* depending on the capital provided. In the event that the bank has also invested its own funds, the bank collects a profit share on behalf of the shareholders. The *mudarib* share in combination with any profit on the bank's own funds is an operational profit for the bank and is distributed to shareholders in the form of dividend or retained in the bank for future development.

In the event of a loss, the bank does not receive a *mudarib* share, and all losses are passed on to depositors in proportion to the funds provided. In the event that the bank is negligent, however, the loss is completely for the account of the bank.

Capital Certainty and Capital Adequacy

Restricted and unrestricted investment accounts are most commonly governed by *mudaraba* or *wakala* contracts, which implies that profits are shared between the bank and the depositors on the basis of a contractually agreed profit ratio, and losses are distributed in accordance with the proportion of capital provided. The capital of investment account holders is hence not guaranteed, although commercial and, in some cases, regulatory and legal pressures effectively mean that banks do anything possible to avoid passing on a loss to depositors, or not paying them a reasonable return. Different situations occur, for example:

- **Malaysia**. Banks have a legal obligation to repay the capital and provide a reasonable return.
- **Bahrain and other Gulf Cooperation Council countries**. Capital guarantees and steady returns are not a legal requirement, but are deemed to be a commercial responsibility of the bank by the regulating bodies. Regulations are in place to ensure adequate monitoring and mitigation techniques to avoid any loss of capital.
- **United Kingdom**. Banks are allowed to pass on any loss to their account holders, but only after the bank has announced the loss, and the account holder has expressly confirmed his desire to bear the loss for religious reasons.

From the perspective of the Islamic Financial Services Board (IFSB), a bank has no obligation to keep the capital intact and hence banks are not required to hold any capital to cover any eventualities associated with restricted and unrestricted investment accounts. Not all regulators follow the same line of thought, however, and take the commercial risk associated with loss of capital into account when determining the capital adequacy treatments. Bahrain, for example, applies a capital adequacy ratio of 12% instead of the Basel II requirement of 8%. Malaysia and the UK, on the other hand, apply a capital adequacy ratio of 8%, but consider restricted and unrestricted investment accounts to have the same characteristics as conventional savings accounts. Capital adequacy for Islamic banks is described in more detail in Chapter 14.

Accounting Treatment

Comparing the annual reports of different Islamic banks, it becomes obvious that there is a large difference in how investment accounts are reported on the balance sheet. Although the AAOIFI has created standards to enhance the transparency surrounding this, these standards are not mandatory in every country. The following three main reporting treatments are observed in the market:

1. **Equity**. Due to the fact that investment account holders can lose all their money, their investment has similar characteristics to the investment of a shareholder except that, contrary to a share, the balance in the investment account cannot be sold in an open market. On the other hand, investment account holders can, within the terms and conditions of the agreement, withdraw their funds and take their business elsewhere.
2. **Off-balance sheet**. Treating investment accounts as off-balance sheet instruments can be justified on the basis that the bank manages the funds on the client's behalf, but all losses are due to the client. This treatment is particularly suitable for fund management activities.
3. **Liability**. Treating investment accounts as a liability is justified in countries where Islamic banks cannot pass any loss on to depositors and the investment account behaves like a conventional deposit or savings account. This treatment applies regardless of whether the prohibition to pass on any losses to investment account holders is incorporated in the law or deemed to be a regulatory or commercial issue.

In addition, a combination of any of the above-mentioned reporting treatments is found in different banks' balance sheets. Some banks, for instance, report restricted investment accounts as a combination of liabilities and off-balance sheet instruments, and unrestricted investment accounts as equity. However, it needs to be noted that with the development of the industry and the accounting standards, transparency on the reporting guidelines has increased.

In the UK, where Islamic financial institutions have to follow the International Financial Reporting Standards (IFRS), investment accounts are treated similarly to conventional deposit accounts.

Reserves

Prior to the introduction of the AAOIFI standard in 2001 to regulate profit smoothing, banks often used to apply hidden reserves in order to smooth the profits paid to unrestricted investment account holders in line with market expectations. The AAOIFI standard was not introduced to eliminate the profit smoothing practice, but rather to make the process more transparent. It is in the banks' interest to avoid any losses for investment account holders, at the same time paying account holders a profit share in line with their expectations. Prior to the introduction of the AAOIFI profit smoothing standard, banks typically varied the *mudarib* share to allow for this. Under the new standard, which was introduced in 2001, banks appropriate part of the profits attributable to unrestricted investment account holders to two different reserves:

1. **Profit equalisation reserve (PER)**. The bank appropriates funds to the PER from the profit distributable to unrestricted investment account holders and shareholders prior to

the distribution of profits between the bank, in its capacity as provider of investment expertise, and the depositors and investors. The PER has a shareholder portion and an unrestricted investment account holder portion and is used at the bank's discretion to pay a return to unrestricted investment account holders and shareholders in years when income is low.

2. **Investment risk reserve (IRR)**. The bank appropriates funds to the IRR from the share of profit allocated to unrestricted investment account holders after the bank has taken its *mudarib* share. Amounts are released to unrestricted investment account holders at the bank's discretion to cover any losses incurred.

Although the reserves are created to cover losses and ensure profitability for investment account holders, the reserves are not owned by them, and when an unrestricted investment account holder leaves the bank, the bank will pay his account balance, but not a part of the PER or IRR. Both reserves remain with the bank.

5.4 FUNDS

Within Islamic finance, funds are typically offered under a *mudaraba* or *wakala* agreement between the client and the fund manager, similar to restricted and unrestricted investment accounts, as can be seen in Figure 5.2.

Although most funds currently available in the market require a minimum investment amount of $100,000 or more, the growth of the Islamic finance market makes it possible to also start offering funds with a smaller minimum capital. Investors have the opportunity to invest in index tracking funds or equity strategies for a minimum investment of £500, $500 or any denomination and minimum amount offered depending on the fund.

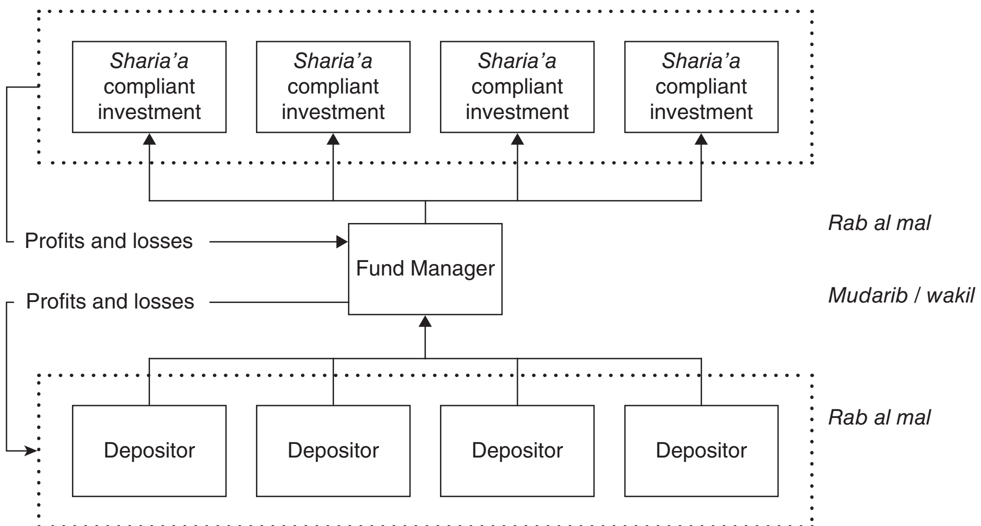

FIGURE 5.2 Two-tier *mudaraba* or *wakala* structure for fund management

5.5 MORTGAGE PRODUCTS

Islamic mortgage products, or *home purchase plans* as they are sometimes called, are generally based on either one of the following structures:

1. **Diminishing *musharaka***. In this structure, the client and the bank jointly purchase the property. The client pays a periodic rental for the use of the part of the property he does not own, which can be either a fixed rate for the duration of the contract or based on a floating rate. The part of the property owned by the bank is divided into equal units, which are gradually sold to the client over time. The purchase of units by the ultimate home owner is governed by the agreement and can be monthly, quarterly or as and when it suits the ultimate buyer. The responsibility for maintenance and insurance is passed on to the end buyer under an agency agreement.
2. **Lease**. In this case, the bank buys the property and leases it to the client. Any maintenance and insurance issues are passed on to the client under an agency agreement. The rental payments can be either fixed for the duration of the lease or reviewed periodically. Typically the lease amount includes a progressively increasing payment towards the value of the property, which will be 100% owned by the client at the end of the lease.
3. ***Murabaha***. In this structure, the bank buys the property and sells it on a deferred payment basis to the client. In some countries this can be a solution to overcome the common issue of double stamp duty. In the Netherlands, for instance, the rule is that if a property is sold within 6 months after the original purchase, there is no requirement for stamp duty land tax on the second sale. In the UK, on the other hand, any property sale attracts stamp duty land tax, even when it is sold on after a short period. There are two drawbacks to this structure, which are inherent to the characteristics of the *murabaha* transaction. First, it cannot be extended unless there is full movement of funds, that is, the client would have to repay the full amount to the bank prior to any new facility being extended. Secondly, although the mark-up can be paid in instalments, the amount is fixed for the agreed period.
4. **Diminishing *musharaka* combined with lease**. In this structure the diminishing *musharaka* governs the transfer of the ownership from the bank to the ultimate buyer. The client leases the part of the property he does not yet own from the bank against a fixed or floating rental payment. Although a rental fee can be incorporated in a diminishing *musharaka*, and it is possible to have a repayment portion in the periodical lease payments, there might be regulatory or tax issues that would lead to the necessity to specifically combine a diminishing *musharaka* and a lease.

The diminishing *musharaka* and lease structures can be extended beyond the original lifetime of the transaction without the (remaining) principal being repaid in full. Unlimited early repayments are permitted under each of the above-mentioned transactions, and late payments attract an administration fee, but this is only to cover the actual cost and cannot be in proportion to the outstanding amount of the transaction.

The Financial Services Authority (FSA) in the UK recognises two types of home purchase plan: the diminishing *musharaka* and the lease structure.[1] Specific amendments have been made in the UK Finance Act in order to ensure there is no double stamp duty land tax associated with these transactions.

[1] For more information, see https://www.moneyadviceservice.org.uk/en/articles/sharia-compliant-home-purchase-plans.

5.6 PERSONAL LOANS

Generally Islamic banks prohibit overdrafts, but permit personal loans as long as there is an associated asset that is financed. As in conventional finance, both secured and unsecured personal loans are offered and the mark-up will depend on the client's credit rating as well as any collateral pledged. The main difference between Islamic and conventional personal loans is the fact that the transaction is based around an asset of which the bank has some form of ownership during the transaction.

Secured Personal Loans

A secured personal loan is a loan that directly finances the asset the client wants to acquire. The bank typically has ownership of the asset during the transaction and keeps the asset as collateral to protect against any negative impact of default. The most common forms of secured personal finance are:

- **Lease and hire-purchase contracts**. In lease and hire-purchase contracts the client identifies the asset and all its specifications and requests the bank to purchase the asset. The client then leases the asset from the bank and pays an agreed rental for an agreed period of time. The lease contract typically includes a repayment and a rental fee, and once all payments have been made at the end of the period, the asset belongs to the client. The bank has no specific expertise regarding the asset and often requests the client to act as agent to order the asset from the supplier. As can be seen in Figure 5.3, the seller delivers the asset to the bank, which will lease it to buyer. In practice, the asset is typically delivered directly to the end buyer, but the legal title to the asset is delivered to the bank.

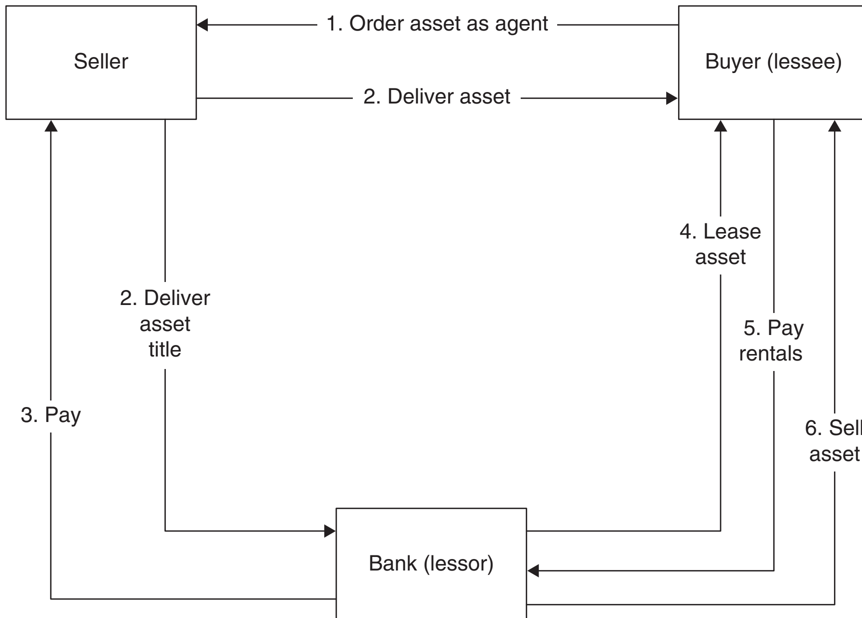

FIGURE 5.3 Lease for personal finance

- ***Murabaha* or deferred payment sales**. In a deferred payment sale, the client identifies the assets and all its specifications, and requests the bank to purchase it. The bank subsequently sells the asset on to the client on a deferred payment basis. The asset, the original purchase price, the mark-up for deferred payment and the payment date are all agreed in the contract. The bank has no specific expertise regarding the asset and often requests the client to act as agent to order the asset from the supplier. As can be seen in Figure 5.4, the seller delivers the asset to the bank, which will sell it on a deferred payment basis to the buyer. In practice, the asset will be delivered directly to the end buyer, but legal ownership is with the bank until the end of the lease period.

Unsecured Personal Loans

Unsecured personal loans are provided to clients when they require cash that is not necessarily associated with a particular asset to be financed. The client could, for instance, require an amount

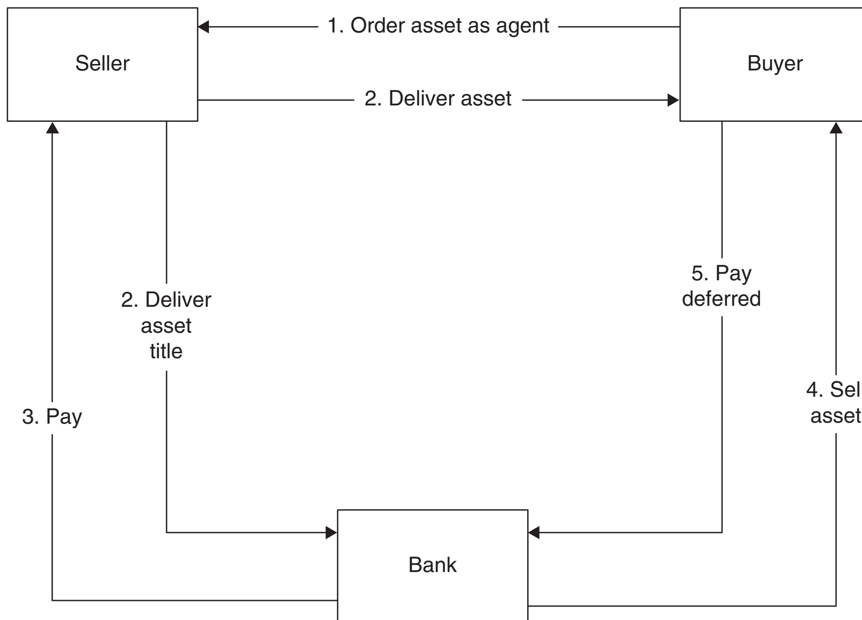

FIGURE 5.4 *Murabaha* for personal finance

EXAMPLE: *MURABAHA* FOR PERSONAL FINANCE

Al Rajhi Bank, one of the largest Islamic banks, is the owner of a number of car dealerships throughout the Kingdom of Saudi Arabia. In the event that a client wants to finance the purchase of a car, the bank first assesses the amount of finance it is willing to provide. The client is then informed of the maximum amount he can spend on a car in one of the showrooms, the mark-up for deferred payment and the repayment criteria.

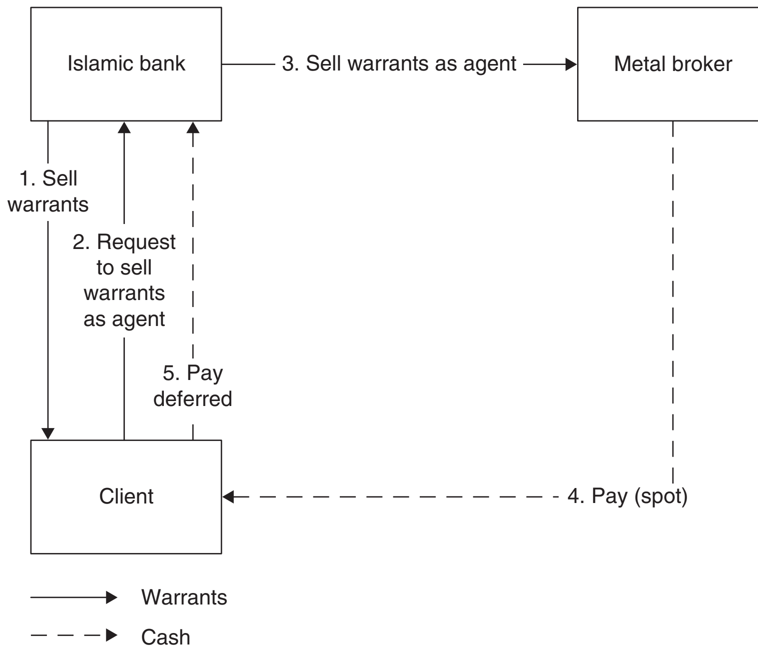

FIGURE 5.5 Commodity *murabaha* for personal finance

of cash to pay for school fees or to pay for building works to be done to his home. Although collateral may be requested, unsecured personal finance is typically of higher risk to the bank due to the absence of an underlying associated asset. Unsecured personal loans are generally provided on the basis of commodity *murabaha*, which is graphically depicted in Figure 5.5.

Although there are a variety of approaches available, the transaction flow outlined in Figure 5.5 is fairly common. Due to the fact that the client is unlikely to have a relationship with a metals broker, the bank is likely to act as an agent on behalf of the client to sell the commodities and facilitate receipt of funds into the clients account. In order to avoid any price risk, the purchase and sale of the commodity by the client take place on the same day. The end result of this is that the client has an amount of money in his account that needs to be repaid on a pre-agreed date in the future with a pre-agreed mark-up.

5.7 TRANSFERS

Transfers can be made for a variety of reasons, including the payment of bills, to give someone money or to transfer amounts to and from a deposit account. Transfers can be between two accounts held by the same person, or held by different people or organisations.

The majority of transfers will be in the same currency, but there are circumstances in which a transfer from an account in one currency to an account in a different currency is required, for instance, when paying a bill in a different country. When transferring in a foreign currency, it is permissible to request the bank to transfer an amount of money in one currency to be paid to another person in a different currency. The bank will in this case take care of the exchange from one currency to another, and this type of transaction is a combination of a

EXAMPLE: PAYING A BILL IN A DIFFERENT CURRENCY

Every now and then I transfer money to my brother in the Netherlands to pay for materials he needs to redecorate my house in that country. Given that I am based in the UK, my accounts are all in British pounds (GBP). My brother's accounts, however, are in euros. When I transfer money, I instruct my bank to transfer from my GBP account to my brother's euro account without my having to first exchange from pounds to euros and then transfer.

Let us assume I have to pay my brother €1,000.

1. I instruct my bank to transfer €1,000 to my brother's account from my GBP amount.
2. The bank transfers the €1,000 and debits my account with the equivalent GBP amount.
3. My bank charges me a fee of £25.00.
4. My brother's bank charges him a fee for receipt of funds originating from a foreign country of €25.00.

currency exchange and a transfer of money, and the bank may charge an administration fee. The fee should only be charged to cover the expenses incurred by the bank and should not be in proportion to the amount transferred.

Transferring money has not always been the responsibility of banks, but used to be done by *hawala* brokers. Under the *hawala* system, someone goes to a broker in a particular city and gives him money to be transferred to a person in a different city or country. The *hawala* broker will request another broker in the city of the recipient to make the payment, typically less a small commission. The payment instruction is normally accompanied by a request for a password, a particular document or other proof required to identify the recipient. The first broker promises the second broker to settle with him at a later date, which is similar to the promissory notes in conventional finance. Strong evidence exists that the *hawala* system has been around since at least medieval times, but potentially a lot longer.

The *hawala* system has by no means died out and is still extensively used by migrant workers. In 2006 the International Monetary Fund (IMF) estimated that $100 billion in transfers per year is not transacted via the regular banking system and an unknown part of this figure is transferred using the *hawala* system. In its current form, *hawala* brokers often keep an office in the back of a shop or a community centre, and they often import from or export to the same countries as the ones they transfer money to. A common way to settle the differences therefore is by paying inflated invoices for goods received. The *hawala* banking system works perfectly for migrant labourers with families in very remote areas of the world who are, in addition, often confused by the banking system in their adoptive country, which is further compounded by the language barrier. The main problem is that the *hawala* brokers are not regulated in the same way as other banks and financial institutions and as such constitute a large risk for the financial infrastructure, and they are a tempting target for those with less honourable intentions. This has, for example, become evident in investigations into the funding of terrorism activities.

CHAPTER 6

Application of Islamic Products in Treasury

The treasury function, also known as the markets division, of a bank is responsible for funding the other divisions, managing the bank's mismatch and liquidity risks, and making markets to customers in foreign exchange and *sukuk*. In addition, this division of the bank assists clients in managing their money market and foreign exchange exposures using a variety of *Sharia'a* compliant contracts.

6.1 INTERBANK LIQUIDITY

The commodity *murabaha* is the instrument most commonly used by Islamic financial institutions to provide short-term interbank liquidity. A commodity *murabaha* is, like the basic *murabaha* transaction, a deferred payment sale or instalment credit sale and uses a commodity, usually a base metal, as the underlying asset for the transaction. In its most basic form, this transaction involves two banks, one as the buyer of a commodity and one as the seller as can be seen in Figure 6.1.

As in the *murabaha* transaction detailed in Section 3.3, the price of the commodity, the mark-up, the delivery date and repayment date are agreed upfront. The intention of this transaction is to replicate conventional money market transactions (i.e. the interbank market), and the banks do not typically hold the underlying commodity nor have a requirement for it. The metals are purchased and sold solely to facilitate interbank liquidity in accordance with *Sharia'a* principles.

Two types of commodity *murabaha* transactions occur, deposit given and deposit taken, each of which are reviewed in more detail in the following sections. Due to the fact that

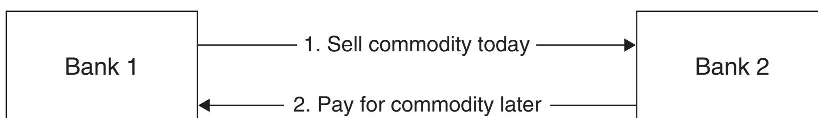

FIGURE 6.1 Simple commodity *mudaraba* structure

commodity *murabaha* transactions are fixed rate, they typically have short terms with a maximum term of 1 year. In addition to commodity *murabaha,* interbank liquidity is sometimes provided using a *tawarruq* transaction. All these transaction types are executed using a commodity as the underlying asset.

The criteria for a commodity to be considered suitable are that it should be non-perishable, freely available and uniquely identifiable. Any commodities that were originally used as a means of exchange or money (i.e. gold, silver, barley, dates, wheat and salt) are not acceptable. The majority of commodity *murabaha* and *tawarruq* transactions use LME base metals as an asset since they meet all the criteria for commodities and are easily identifiable via warrants.

In comparison to conventional deposits, commodity *murabaha* and *tawarruq* transactions attract an additional cost associated with the purchase and sale of the warrants, which could be dependent on volume and contract size. For longer-dated contracts, this is not necessarily an issue as the additional cost is spread over a longer period. It does, however, significantly increase the price of shorter-dated deposits.

Deposit Given

The aim of the commodity *murabaha* is for the Islamic bank to provide a deposit to their counterparty to generate a return. The process flow is as follows in Figure 6.2.

In this structure, the following actions take place:

1. **Counterparty buys warrants from Islamic bank**. The counterparty accepts the offer from the Islamic bank to purchase warrants on a deferred payment basis, where the mark-up and the repayment date are pre-agreed.
2. **Ownership of warrants transfers to counterparty**. The counterparty is now the owner of the warrants but does not make a payment until a later date.
3. **Counterparty requests Islamic bank to sell warrants on its behalf**. The Islamic bank now acts as an agent to sell the warrants at spot to another buyer. Alternatively, the counterparty could sell the warrants in the open market. Ownership of the warrants transfers to the end buyer.
4. **Payment from end buyer to counterparty**. Whether the counterparty requests the Islamic bank to sell the warrants on their behalf or itself arranges to sell to a third party, the counterparty will be paid the spot counter value of the warrants.
5. **Payment from counterparty to Islamic bank**. This payment takes place at a pre-agreed time in the future and consists of the principal of the original purchase plus a pre-agreed mark-up.

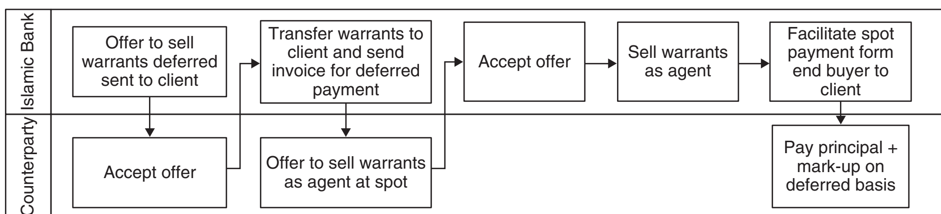

FIGURE 6.2 Commodity *murabaha,* deposit given

The net result of the above-mentioned movements of warrants and cash is that the counterparty now holds an amount of money against an offsetting payment to the Islamic bank for a pre-agreed principal plus a mark-up at a pre-agreed future date, thus creating a synthetic deposit.

It is important to note that each of the steps has to take place in the correct sequence and that the ownership of the warrants will have to transfer from one party to the next before the next action can take place.

The flow of cash and warrants in a commodity *murabaha* is as in Figure 6.3. In steps 1–3 the Islamic bank buys the warrants as a principal and subsequently sells them to the client on a deferred payment basis. The client now owns the warrants and requests the Islamic bank to act as an agent on his behalf to sell the warrants in the spot market. The Islamic bank arranges for the sale to a metal broker, resulting in a synthetic interbank deposit placed by the Islamic bank with the client.

Deposit Taken

The aim of a reverse commodity *murabaha* is for the Islamic bank to take a deposit from the client and to repay it at a pre-agreed time including a mark-up. The process flow is as in Figure 6.4.

In this structure, the following actions take place:

1. **Islamic bank buys warrants as agent on behalf of counterparty**. The counterparty accepts the offer from the Islamic bank to purchase warrants on the counterparty's behalf.
2. **Ownership of warrants transfers to counterparty from current owner via Islamic bank**. The counterparty is now the owner of the warrants and pays for them at spot.
3. **Counterparty offers to sell warrants to Islamic bank**. The counterparty is now the owner of the warrants and offers to sell them to the Islamic bank against deferred payment. Ownership of the warrants transfers to the Islamic bank.
4. **Islamic bank sells warrants to end buyer against spot payment**. The Islamic bank sells the warrants to an end buyer and receives the counter value at spot.

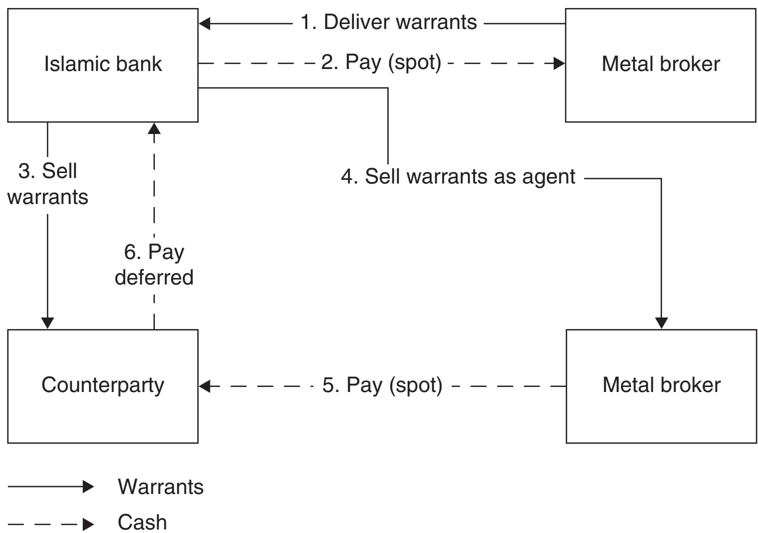

FIGURE 6.3 Commodity *murabaha*, cash and warrant flow

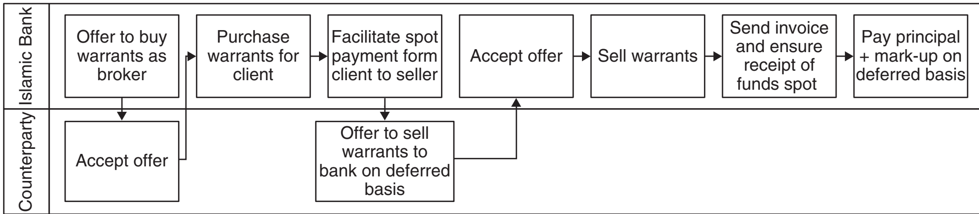

FIGURE 6.4 Reverse commodity *murabaha*, deposit taken

5. **Payment from Islamic bank to counterparty**. This payment takes place at a pre-agreed time in the future and consists of the principal of the original purchase plus a pre-agreed mark-up.

The net result of these movements of warrants and cash is that the Islamic bank now holds an amount of money against an offsetting payment to the counterparty for a pre-agreed principal plus mark-up at a pre-agreed future date, thus creating a synthetic deposit taken by the Islamic bank.

As with deposit given, it is important to note that each of the steps has to take place in the correct sequence and that the ownership of the warrants will have to transfer from one party to the next before the next action can take place.

The flow of cash and warrants in a reverse commodity *murabaha* is as in Figure 6.5. In steps 1–4 the Islamic bank is acting as an agent on behalf of the client. The client now owns the warrants and sells them to the Islamic bank on a principal-to-principal basis, against a deferred payment of the principal plus a mark-up. The Islamic bank, as the owner of the warrants, subsequently sells them to a metal broker against spot payment, resulting in a synthetic interbank deposit placed by the client with the Islamic bank.

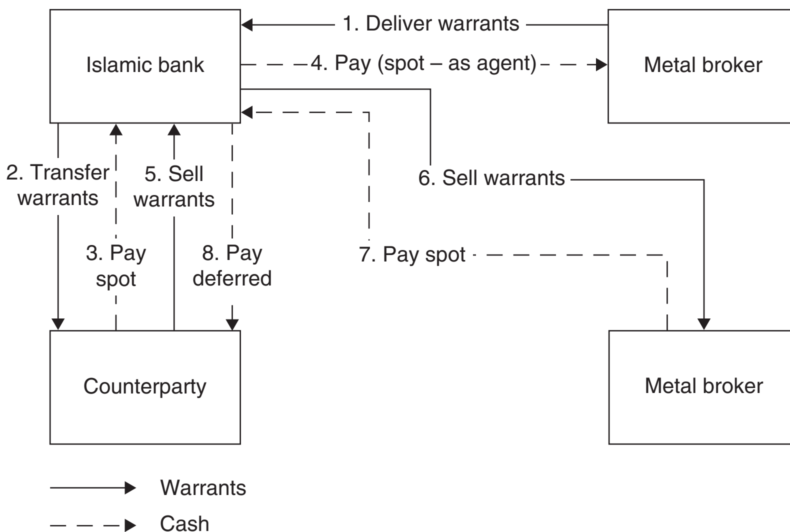

FIGURE 6.5 Reverse commodity *murabaha*, cash and warrant flow

Variation on Commodity *Murabaha*

Like commodity *murabaha*, *tawarruq* is a commodity-based transaction for interbank liquidity purposes. The *tawarruq* has, however, some *Sharia'a* issues associated with it. The main *Sharia'a* issue with *tawarruq* transactions is related to the fact that the intention behind the purchase of the commodity is not to own and use the commodity. Instead, the commodity is sold instantaneously in order to obtain the required funds. Historically, although the minority of the schools of thought in Islamic jurisprudence have rejected the *tawarruq* for that reason, the majority have approved it subject to certain conditions such as an auditable ownership transfer of the commodity and separation of the purchase and sale arrangements.

Some banks that are using *tawarruq* structures have, however, not adhered to these conditions, for example by combining the sale and purchase into one single transaction in which the bank buys from and sells to the same broker as an agent on behalf of the client. Due to the fact that sale, purchase and appointing the bank as agent are all combined into a single contract, it is almost impossible to see who owns the commodity at any point during the execution of the transaction.

Despite differences of opinion among scholars, the *Sharia'a* council of AAOIFI has approved *tawarruq* and has issued a separate standard to regulate this instrument to ensure that it is *Sharia'a* compliant. Although *tawarruq* may not be the most perfect instrument and has serious *Sharia'a* issues associated with it, it does serve a purpose when value added tax (VAT), stamp duty or other taxation rules pose limitations on Islamic finance, and the *tawarruq* is more often than not the only feasible transaction type available.

Graphically, the *tawarruq* can be depicted as in Figure 6.6. Contrary to the commodity *murabaha,* in which each of the steps has to take place in the correct sequence, and ownership of the warrants will have to transfer from one party to the next before the next action can take place, in a *tawarruq* there is only one agreement in which both parties agree that the Islamic bank will sell the warrants to the client and simultaneously sell them on behalf of the client to a metal broker. Consequently, if the transaction falls through at any point, ownership of the asset is not clear.

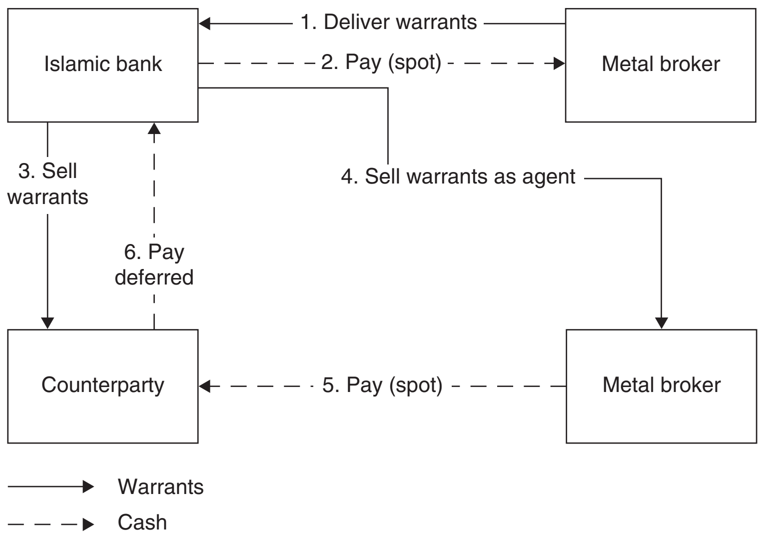

FIGURE 6.6 *Tawarruq*

Agency Contract

Between Islamic banks, interbank liquidity can be managed using a *wakala* or agency contract. Under a *wakala* agreement a bank places funds with another bank for it to invest in suitable *Sharia'a* compliant projects. The structure is similar to the investment accounts for retail products and fund management structures and can be depicted as in Figure 6.7.

The *Sharia'a* compliant investments in Figure 6.7 can be any financing the bank undertakes and can, for instance, include commodity *murabaha*, *sukuk* and leasing. The *wakala* contract is a trust contract whereby money can be placed with an Islamic institution, which then pays a return based on the assets on its balance sheet. *Wakala* contracts are more restricted in their application than commodity *murabaha* transactions, since they can only be offered to other Islamic financial institutions whose assets are all *Sharia'a* compliant.

6.2 HEDGING

Like conventional banks, Islamic banks manage their risks carefully and do not leave themselves open to unnecessary exposures. Several structures can be applied to mitigate or hedge risks, the most common of which are described in this section.

Derivatives

The prohibitions regarding gambling and uncertainty mean that options, futures and other derivatives are not generally accepted by Islamic scholars. Even forward foreign exchange contracts are generally not permitted, since they include an element of uncertainty and are priced by reflecting an interest differential. Derivatives, with their inherent uncertainty and speculative characteristics, are not acceptable in the *Sharia'a* framework, but this does not

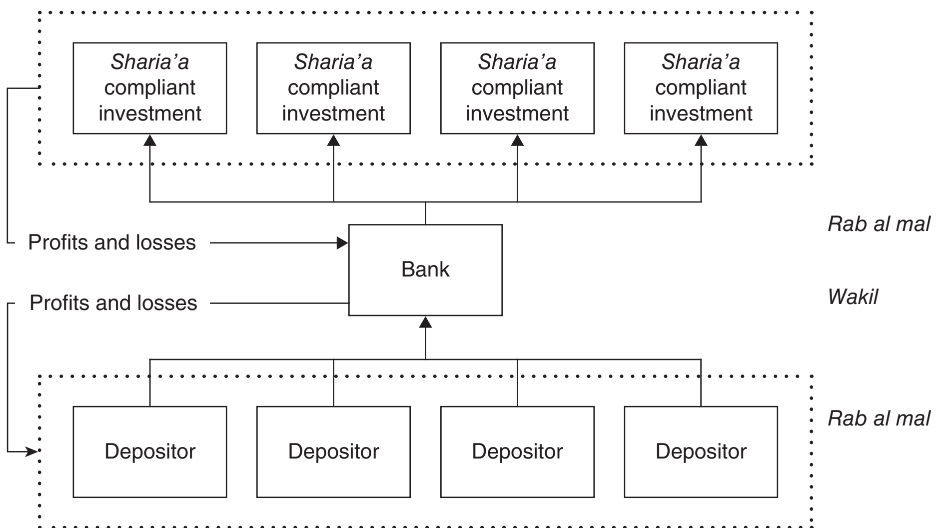

FIGURE 6.7 Two-tier *wakala* structure for liquidity management

mean that Islamic investors do not have any possibility of hedging their exposures. On the contrary, within the *Sharia'a* framework taking measures to mitigate risk is seen as good stewardship, and hence promoted.

In the absence of options, futures and other derivatives, other contracts need to be applied, and there are two main basic contracts available to the Islamic investor to hedge against risks that occur within the normal course of their business. First, there is the *arbun* contract, which is outlined in Section 3.3 and is a down payment on a sales contract. In this case, the buyer and seller agree a price and date and a down payment is made. If the buyer pulls out of the transaction, he loses his deposit. If the buyer takes delivery of the asset, the down payment becomes part of the total price and only the difference is payable. This is different from an option premium, which represents an amount separate from the actual exercise price.

A second type of contract that can be used for hedging purposes is the *salam* contract. This is a contract executed with spot payment in full for the purchase of assets. This can only apply to assets promised for future delivery that have commodity-like characteristics and must be fungible, such as base metals. The *salam* contract has characteristics of a conventional futures contract but, unlike a conventional futures contract, a *salam* contract must be physically settled by the delivery of the asset at the end of the contract.

Both the *arbun* and the *salam* contracts can, in combination with other available products, provide a considerable level of risk mitigation. However, the complex derivative instruments available to the conventional investors are, at this point in time, far out of reach for the Islamic investor.

Option to Buy or Sell

The down payment or *arbun* as described in Section 3.3 can be applied to finance to achieve a result similar to a conventional option. The down payment has some characteristics of an

EXAMPLE: DOWN PAYMENT

The Bank of London and The Middle East plc (BLME) has an equity stake in a *Sharia'a* compliant company that it would like to sell and has identified a potential buyer who would like to purchase the shares in 1 month's time at a price agreed today. The following are the details of the transaction:

- Current share price £2.50
- BLME's expected share price in 1 month £3.00
- Client is willing to agree a price of £3.20

The client is making a down payment of £0.20 per share in order to purchase the shares in 1 month's time at a price of £3.20. After 1 month, the following scenario's can occur:

1. If the share price rises to £3.20 or above, the client will pay an additional £3.00 per share to BLME (£3.20 – £0.20) and becomes the owner of the shares.
2. If the share price after 1 month is below £3.20, the client will not purchase the shares and loses his £0.20 per share.

option and provides the right to buy an asset at a price agreed today, a right which is secured by the down payment. Similar to an option, if the buyer does not purchase the asset at the agreed date, he loses the down payment. Unlike an option, however, if the buyer purchases the asset at the agreed date, he only pays the difference between the agreed price and the down payment.

Like any other form of contract, the seller needs to have ownership of the asset and the asset needs to be in existence. In a financial context, the bank could, for instance, make a down payment on equity or *sukuk* in the secondary market.

Foreign Exchange Requirements

One of the forms of a contract of exchange is the foreign exchange contract in which one currency is exchanged for another. In Islamic finance, exchanging one currency for another is permissible when both parties take immediate possession of equal amounts of the counter values. The contract should not be subject to any conditional options. The contract, also known as *sarf*, is a binding obligation between the counterparties to buy or sell a specified amount of foreign currency at an agreed spot exchange rate.

The stipulation of "immediate possession" implies that only spot trading is allowed, which includes not only the exchange of the amounts in physical cash, but also transfers, debiting and crediting a customer account in the different currencies or the presentation of any cheque.

Due to the prohibitions on gambling and uncertainty, forward contracts are generally not allowed since forward contracts are associated with speculative trading and the pricing includes an interest component. However, discussions are going on among scholars, and quite a few are of the opinion that forward foreign exchange transactions should be permitted as a risk mitigating tool for companies having a genuine business requirement to cover forward currency exposure.

Currency Swaps

An exchange of deposits can be applied to satisfy any liquidity requirement in a particular currency while at the same time placing excess liquidity in another currency with another

EXAMPLE: FORWARD FOREIGN EXCHANGE AS A RISK-MITIGATING TOOL

My Bike is based in the United Kingdom and imports bicycles from the Netherlands to sell in the UK market. My Bike receives monthly invoices from the exporter in euros, which need to be paid within 30 days. Based on experience, My Bike can estimate its payments in euros for the next 3–6 months with reasonable accuracy.

On the other hand, My Bike sells the bicycles in GBP, and all other expenses such as rent and staff cost are in GBP.

My Bike would like to cover their euro exposure, which occurs in the normal course of business but is by no means speculative since it is, after all, in the business of selling bikes, not managing currency exposures.

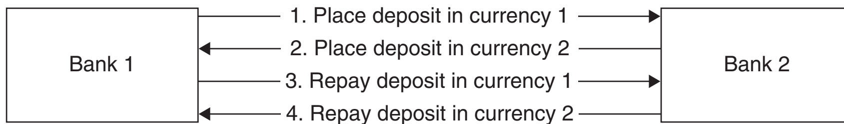

FIGURE 6.8 Exchange of deposits

bank. Both deposits are placed on either a commodity *murabaha* or a *wakala* basis at a profit rate of 0%. Any profit margin as well as exchange rate expectations are included in the calculations of the amounts. The amounts are exchanged at the start of the contract and repaid in full at maturity, and the transaction can, in its simplest form, be depicted as in Figure 6.8.

Although the exchange of deposits satisfies a requirement with regard to the availability of currencies, because of the inclusion of the forward differential the two amounts can vary widely and do not represent equal counter values at the current exchange rate. This structure can be improved by combining two commodity *murabaha* transactions with a spot foreign exchange transaction, or by two commodity *murabaha* transactions at a normal profit rate.

Profit Rate Swap

A profit rate swap is entered into by a bank in order to transform a fixed rate income stream to a floating rate income stream or vice versa. Any surplus floating rate exposure (either paying or receiving) can be transferred to a fixed rate exposure using a combination of fixed and floating *murabaha* contracts. The bank typically wants to engage in this type of structure to create certainty between incoming and outgoing profit streams. These discrepancies occur in the normal course of business as a result of the bank's investments.

Two structures are typically observed in the market, both combining a series of commodity *murabaha* transactions with a promise (*wa'd*). Although the promise is legally not binding, the likelihood of either of the counterparties not honouring their promise is deemed low due to the significant commercial risk associated with breaking a promise. The two structures can briefly be described as follows:

1. At the start of the contract, counterparties enter into one long-term and one short-term commodity *murabaha*. The counterparty that places the short-term commodity *murabaha* provides a *wa'd* to enter into all the subsequent short-term transactions, until such a time that the maturity date of the long-term commodity *murabaha* is matched.
2. Counterparties promise to enter into a sequence of periodic commodity transactions where the mark-up is defined based on the swap fixed rate for one leg and a floating rate for the other leg. The swap fixed rate is agreed for the duration of the transaction. For the floating rate leg, the mark-up over a benchmark rate (e.g. cost of funds) is agreed.

The profit rate swap is beneficial for both counterparties for the duration of the transaction. However, in the event of early termination, either one of the parties could be unfairly disadvantaged as a result of the loss of commercial benefits of the transaction. This element of unfairness, which is naturally built into the contract, can be resolved in the contract between parties.

EXAMPLE: PROFIT RATE SWAP

Bank A has an outgoing fixed rate profit payment obligation of 7.5% for 1 year and an incoming profit stream benchmarked to, for instance, 3-month LIBOR plus a mark-up of 2.5%.

Looking at the first structure, a profit swap can be achieved using one *murabaha* transaction for the total term of the transactions and a series of shorter-term *murabaha* transactions with the same counterparty for the same amount, effectively replicating a floating profit rate. The individual shorter-dated *murabaha* transactions require full movement of funds.

Graphically, this structure is as in Figure 6.9, assuming the cash flows in and out on the floating transactions will be netted.

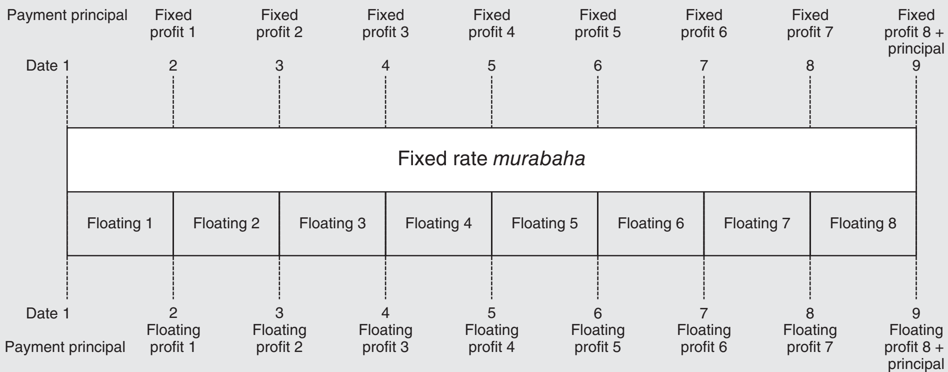

FIGURE 6.9 Profit rate swap

Selling an Asset Forward

As described in Section 3.3, a *salam* contract is a structure in which an asset that is not yet in existence and not yet owned is sold against a current price for delivery at a forward date. Some Islamic financial institutions have obtained approval from their *Sharia'a* supervisory board to apply a *salam* structure to sell equities forward.

6.3 COMBINATION OF TRANSACTION TYPES

As can be seen from some of the transaction types described earlier, combinations of transaction types are possible. The profit rate swap, for instance, combines different *murabaha* transactions and a *wa'd,* and a foreign exchange solution could be structured using a spot foreign exchange transaction with one or more commodity *murabaha* transactions. The combinations are theoretically unlimited, as long as it is being taken into consideration that even though the different transaction types are wrapped up in a single structure, none of the contract elements are conditional upon each other, which would not comply with *Sharia'a* principles.

6.4 ASSET-BASED SECURITIES

As described in Section 3.4, *sukuk* are created by the establishment of an SPV, which is set up to acquire an underlying asset or group of assets. The SPV then issues certificates, which represent participation rights in the cash flows generated by the assets for a defined period. Since they pay regular coupons, *sukuk* are generally regarded as the equivalents in Islamic finance of fixed income securities in the conventional market. The role of a treasury division is to assist customers wanting to invest in *sukuk* and those who would like to raise financing by issuing *sukuk.*

Market making in *sukuk* is typically done by conventional banks. This is not because Islamic banks do not wish to take on this role, but because a market maker is always required to quote firm bid and offer prices, even when not holding any of the security, and is required to buy and/or sell at the quoted prices. Due to the restrictions on selling an asset one does not own, an Islamic bank would not be able to provide a firm offer price for a *sukuk* issue it does not own, hence defeating the objective of providing liquidity in the market.

6.5 SYNDICATION

Loan syndication services are offered to clients who require credit facilities that go beyond what can be provided by a single institution. There are a number of roles in the syndication process, each with a different level of involvement. The bank taking on the majority of the work, and often the largest stake in the transaction, is the lead arranger or book runner whose role encompasses the following:

- negotiation and preparation of the term sheet, documents and information memorandum;
- interaction with potential interested parties throughout the syndications process;
- resolution of issues related to closing and funding; and
- ongoing assistance with potential waiver and amendment requests that occur after the initial loan closing.

The main reason for banks to join a syndicate is risk mitigation, which is achieved by the fact that the banks in the syndicate share the risk of large, indivisible investment projects. Similar to conventional banks, Islamic banks participate in syndicated transactions, and do so for the same reasons, which are summarised as follows:

- **Diversification of exposures**. By participating in syndications, a bank can diversify its investments and avoid excessive single-name exposure. In addition, syndication can be applied when a bank is looking to reduce some of its exposure in order to take on new business or to facilitate a strategic redirection.
- **Diversification of income**. Different types of fees such as agency and underwriting fees apply, which not only enhance the return on a transaction, but also result in a diversification of the fee income of the participants.
- **Relationship management with clients and other banks**. The lead arranger maintains a close relationship with the client and has a strong view on other financial requirements. From the lead arranger's perspective it is important to maintain this relationship. For other members in the syndicate, it could be important to be affiliated with either the client or the lead arranger for future business, or from a reputational perspective. Additional financial opportunities may arise between the banks.

- **Flexibility**. Not only can any instrument outlined in Chapter 3 be subject to syndication, but also the conditions are highly negotiable. Underlying assets, collateral, documentation and repayment structures can all be adapted to the specific requirements of the transaction. In addition, the amount of financing that can be raised is flexible and not solely dependent on the credit appetite of an individual institution.
- **Market entry**. Syndication provides an easy entry into a particular market for debut borrowers who can benefit from the knowledge and expertise of the lead arranger and other parties in the syndicate.
- **Comparative advantages**. Each of the members in the syndicate brings different advantages to the table in terms of financing. In addition, the book runner typically has much greater insight into market conditions and pricing affecting the client, which other participants benefit from.
- **Reputation**. A well-run syndication can raise significantly a bank's profile, resulting in further business opportunities.

The syndication process itself is in all respects similar to the conventional bank syndication process, with the sole exception that the underlying transactions have to be *Sharia'a* compliant. In summary, the syndication process can generally be described in terms of three phases:[1]

1. **Pre-mandate phase**. The borrower approaches different institutions to provide an offer to arrange and manage the syndication. Based on the offers, taking into consideration the ability to attract participants, structuring capability and experience, the borrower appoints one or more arrangers and mandates them to form the syndicate. The preliminary terms of the transaction are negotiated, including, but not restricted to, amount, tenor, repayment structure and collateral.
2. **Post-mandate phase**. The arranger and the borrower prepare an information memorandum, which contains an overview of the facility, sector, creditworthiness of the borrower and key transaction details. The information memorandum is shared with potentially interested market participants. Interested banks are requested to confirm the amount they would like to participate with by the deadline. Once the deadline is reached, the arranger allocates shares in the syndicated transaction to the individual banks.
3. **Post-completion phase**. The transaction is now active and becomes operational and is binding on both the syndicate and the borrower.

[1]Esty, B. (2001) Structuring loan syndicates: A case study of the Hong Kong Disneyland project loan, *Journal of Applied Corporate Finance*, 14, 80–95.

CHAPTER 7

Application of Islamic Products in Corporate Finance

The definition of "corporate finance" varies considerably across the world,[1] with the USA probably using the broadest definition. Generally, corporate finance describes activities, decisions and techniques that deal with many aspects of a company's finances and capital.

Corporate finance includes, but is not restricted to, activities associated with: capital and debt-raising; the financing of joint ventures; project finance; infrastructure finance; public–private partnerships and privatisations; financing of management buyouts; restructuring debt; and other forms of working capital financing.

The activities a bank undertakes as part of corporate finance depend on its internal structure and the country it is based in. This chapter outlines some of the functions and provides examples of how Islamic financial products can be applied.

7.1 TRADE FINANCE

The trade finance division typically arranges bespoke and structured financing arrangements to provide trade and inventory financing solutions. Inventory and stock finance, receivables finance, international trade finance and working capital finance are all part of the financial services offered by the trade finance division. Trade finance, which is generally associated with any form of trade, is, like the majority of activities within corporate finance, very well suited to the *Sharia'a* principles due to the fact there is an asset flow underlying the transaction. Islamic banks issue guarantees and letters of credit, just like their conventional counterparts, although, contrary to conventional finance, a guarantee cannot attract a charge. Besides letters of credit

[1]The Institute of Chartered Accountants in England and Wales addresses this question at http://www.icaew.com/index.cfm/route/122299/icaew_ga/en/Technical_amp_Business_Topics/Faculties/About_the_faculty/What_is_corporate_finance.

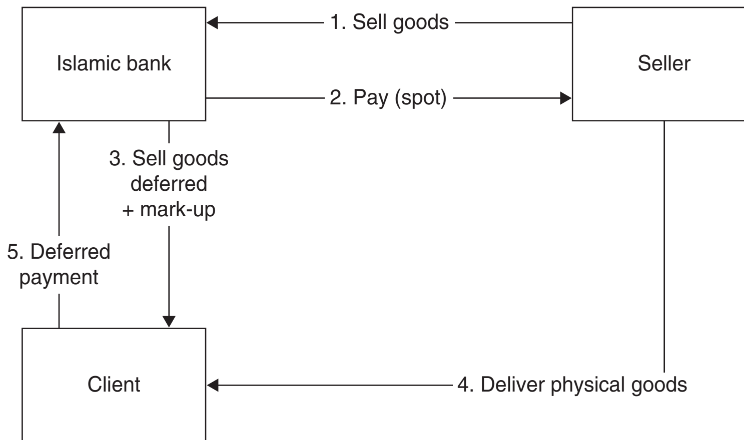

FIGURE 7.1 *Murabaha* in trade finance

and guarantees, Islamic banks typically apply the following transaction types when it comes to trade finance:

- ***Murabaha* or deferred payment sales**. This transaction type (Figure 7.1) is particularly suitable for inventory and stock finance in which the bank purchases the stock and sells it to the client on a deferred payment basis.

  Because the client has better knowledge of the market than the bank, the client, more often than not, acts as an agent negotiating the price and quality of the purchase. All details of the transaction are fully transparent to the client and the bank, including the original purchase price, the mark-up and the repayment date. Although the title to the goods transfers from the seller to the Islamic bank, the physical goods are generally delivered directly to the client on the instruction of the bank.

  There can, however, be VAT implications attached to this structure, which vary on a country by country basis.
- ***Ijara* or lease**. Leasing transactions, as described in Section 3.3, can be applied to finance plant or equipment. Finance lease, operating lease, and sale and lease-back structures can be offered, combined with fixed or floating rental payments. The lessee pays the rentals from the income the asset generates.
- ***Tawarruq***. From a regulatory and tax perspective, it is not always possible to apply any of the above-mentioned structures, in which case banks may have to resort to applying the *tawarruq* structure. As described in Section 6.1, *tawarruq* is a variety of the commodity *murabaha*, in which a commodity (usually a base metal) is purchased and sold in order to generate a cash flow. Although there are notable issues with *tawarruq* transactions, the majority of *Sharia'a* scholars approve of *tawarruq* as long as an auditable ownership transfer of the commodity and a separation of the purchase and sale arrangements are taking place. Graphically, the *tawarruq* can be depicted as in Figure 7.2.

  Although *tawarruq* may not be the most perfect instrument and has serious *Sharia'a* issues associated with it, it does serve a purpose when VAT, stamp duty or other taxation

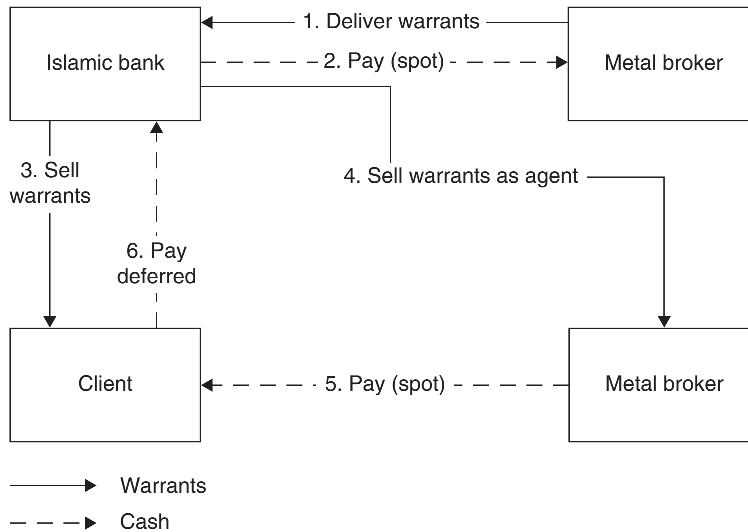

FIGURE 7.2 *Tawarruq* in trade finance

rules pose limitations on Islamic finance and the *tawarruq* is more often than not the only feasible transaction type available.

7.2 PROJECT FINANCE

The project finance division of a bank provides customers with financial advisory, arranging, structuring and underwriting services for limited-recourse project financing on a *Sharia'a* compliant basis. Customers are wide ranging and include sponsors, contractors and public sector authorities. Project finance in Islamic finance will, like all other aspects of Islamic finance, have to comply with *Sharia'a* principles. Although some projects are financed in a fully *Sharia'a* compliant way, it is more common to see Islamic tranches within conventional project finance transactions, which is mainly to do with the fact that currently the transaction size is generally too large for Islamic financial institutions to handle.

Sectors requiring project finance include:

- infrastructure and public–private partnerships;
- transportation infrastructure and shipping;
- water, waste and environmental;
- oil and gas;
- petrochemicals;
- power and energy, including renewable energy; and
- telecommunications.

This section provides more details on project finance and its development and the *Sharia'a* compliant transaction types that can be applied.

What is Project Finance?[2]

In its basic form, project finance can be defined as:

> *A funding structure that relies on future cash flow from a specific development as the primary source of repayment, with that development's assets, rights, and interests legally held as collateral security.*[3]

A more accurate definition for a new project or development would be:

> *Project [f]inancing is an option granted by the financier exercisable when an entity demonstrates that it can generate cashflows in accordance with long-term cashflow forecasts. Upon exercise of the option, the entity's parent(s) or sponsor company(s) balance sheet is no longer available for debt service. The assets, rights and interests of the development are usually structured into a special-purpose project vehicle . . . and are legally secured to the financiers as collateral.*[4]

Historically major infrastructure projects were not undertaken by governments but by entrepreneurs using private investments. The development of the railways is a good example. In 1891 Jean Louis Pierson and his investment firm arranged the financing for a railway in Manitoba, Canada. Not only was he paid a profit share on his investment, he also had a station named after him, which over time developed into a town. Not only railways, but also roads, bridges, power plants, ports, water works and gas-distribution systems were being built all over the world by private entrepreneurs. These projects were financed largely by private capital, provided by entrepreneurs willing to risk all in return for high rewards. Some were profitable, but others were not. Projects that were privately financed included ambitious ventures such as the Suez Canal and the Trans-Siberian Railway.

Over time, private sector entrepreneurship disappeared and projects were financed through public sector borrowing, with the state and public utility organisations as the main clients. After World War II most infrastructure projects in industrialised countries were built under the supervision of the state and funded out of sovereign borrowings and tax revenues.

Project finance is seen as an alternative source of funding for both small and large infrastructure and industrial projects. As a financing technique, it was perfected in the 1970s, and is now applied globally to a wide variety of privately promoted infrastructure projects, including power stations, gas pipelines, waste-disposal plants, waste-to-energy plants, telecommunication facilities, bridges, tunnels, toll roads, railway networks, city-centre tram links and the building of hospitals, education facilities, government accommodation and tourist facilities.

During the 1980s, governments started to review opportunities to privatise some of their activities and services, recognising the fact that private companies are motivated by profits, which in turn leads to enhanced efficiency and productivity as well as the ability to implement projects more efficiently. This has in turn led to the development of what is commonly known

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[2]This section provides an overview of project finance based on the information available from the International Project Finance Association. For further details, see http://www.ipfa.org/.

[3]Tinsley, C.R. (1996) Introduction and glossary. In *Practical Introduction to Project Finance*. London: Euromoney Books.

[4]Tinsley, C.R. (2000) *Advanced Project Financing: Structuring Risk*. London: Euromoney Books.

as build–own–operate–transfer (BOOT), in which projects are financed on a limited-resource basis and built and then operated under a concession from the state or similar public body as a private venture. At the end of the concession the project is transferred back to the state or public body.

BOOT is a method to involve the private sector in large-scale infrastructure investments and consists of the following components:

- **Build**. During this phase of the contract, the asset is built by the contractor who takes on the responsibility for constructing the asset and is expected to build the project on time, within budget and according to a clear specification.
- **Own**. During the lifetime of the concession, the concessionaire owns or possesses the assets. A concession agreement between the government and the concessionaire governs the extent to which ownership and control of the asset lies with the concessionaire. An ownership component is not always preferred. It is not, for instance, preferable for the concessionaire to own a hospital, hence giving him the right to change the use of the building if he feels other purposes could be more profitable.
- **Operate**. An operator will maintain the asset and operate it on a basis that maximises profits or minimises costs on behalf of the concessionaire during the lifetime of the concession.
- **Transfer**. At the end of the concession period, the asset reverts to the government. The transfer may be at book value or free of charge, depending on the conditions of the concession.

There are a few varieties on this theme, some of which do not have an ownership component:

- build–own–operate (BOO);
- build–own–transfer or build–operate–transfer (BOT);
- build–rent–transfer (BRT);
- build–lease–transfer (BLT);
- build–transfer (BT); and
- build–transfer–operate (BTO).

Over time, financial markets have become increasingly sophisticated in structuring financing packages to finance almost any type of reasonably predictable revenue stream.

In addition, public–private partnerships (PPP) and private finance initiatives have been developed where the emphasis is not on developing an asset, but rather on providing a service, although a capital expenditure component of some kind over the life of the concession is typically required.

Appropriate Islamic Products

Project finance transactions are generally of a significant size and scale, and are often financed by a consortium of multiple financial institutions. The most appropriate *Sharia'a* compliant structure depends on the size of the project, in combination with whether the whole project or only part of it is financed in a *Sharia'a* compliant way. When selecting the most appropriate structure, tax and legal issues will need to be taken into consideration. The following are the most commonly used structures.

EXAMPLE: PPP/PFI

The contract to maintain the A69 Carlisle–Newcastle road, an 84-kilometre stretch of single and dual carriageway, was awarded to a consortium of six companies operating under the name Road Link for a period of 30 years.

Road Link's concession included the construction of the Haltwhistle bypass and the operation and ongoing maintenance of the existing road. The payments are calculated on the number of vehicle kilometres travelled on the road. There is no direct payment of tolls by road users.

The bypass (built to relieve traffic using the A69 through Haltwhistle and reduce accidents, congestion, air pollution, noise and vibration) is approximately 3.5 kilometres long and required the construction of three major structures: two bridge crossings of the South Tyne river and a bridge crossing the Newcastle to Carlisle railway.[5]

Syndicated Partnership Transactions

Both the *mudaraba* or passive partnership and *musharaka* or active partnership, as described in Section 3.3, are suitable for project finance. When multiple banks are involved, the transaction could be offered on a syndicated basis. The financier typically does not get actively involved in the running of the partnership and is, in the case of a *musharaka*, usually a sleeping partner. From the financier's perspective, a *musharaka* structure will be preferable due to the fact that all partners provide a share of the capital.

Musharaka transactions need to consist of at least two parties (Figure 7.3), and all partners are known as *musharik*.

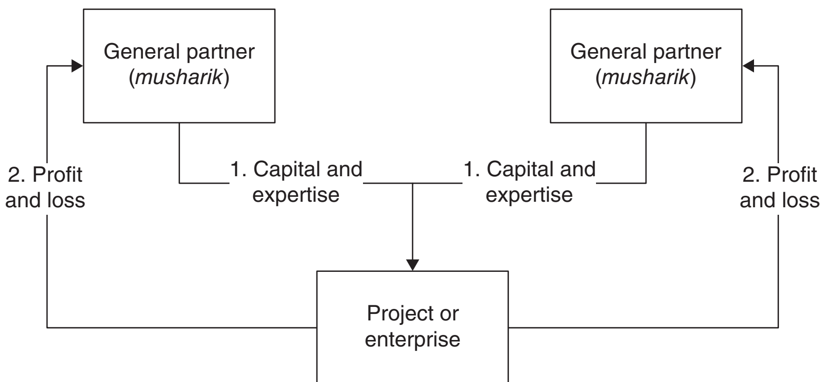

FIGURE 7.3 *Musharaka* transaction in project finance

[5] This information is a summary of the full project information available on the Highways Agency's website at http://www.highways.gov.uk/roads/projects/5222.aspx, http://www.highways.gov.uk/roads/projects/5095.aspx.

Once the contract has been agreed between the partners, the process can be broken down into the following two main components:

1. **Cash and expertise**. All partners provide a share of capital and expertise.
2. **Profits and losses**. Profits are shared between the partners according to the ratios agreed in the contract. Any losses are distributed in proportion to capital contributions, although in the event of negligence all losses are borne by the managing party. The provider of funds will seek to limit his exposure by applying collateral and other risk-mitigating covenants.

The underlying project is usually transferred to one of the participating partners, due to which a diminishing *musharaka* could be a suitable structure. As described in Section 3.3, in a diminishing *musharaka* transaction the project is sold to one of the partners over the lifetime of the transaction.

Istisna for the Build Period Combined with a Lease

In order to cover the build, own and operate phases, the project financing could be structured as a combination of a long-term production finance (*istisna*) contract for the build phase and a lease for the own and operate phases. This transaction can be structured as a syndicated facility, but could equally be wrapped up in a *sukuk*. Graphically this transaction can be depicted as shown in Figure 7.4.

The specification and cost of the asset are agreed between the concession holder and the contractor under an *istisna* contract. The funds are usually drawn by the concession holder as and when payments to the contractor are required. During the build period, the concession holder pays a forward rental fee to the financier. Once the asset is finished, the concession holder takes possession of the physical asset for the operate phase, and passes the title of the asset to the financier. During this phase, the concession holder leases the asset from the financier. At the end of the concession period, the asset is transferred to the ultimate owner, which is usually a government.

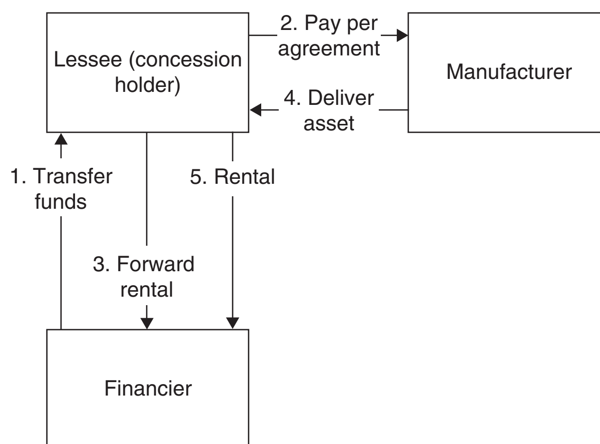

FIGURE 7.4 *Istisna* in project finance

The risks to the financier are the same as the risks incurred in conventional project finance, and include, but are not restricted to, the following:

- Delays during the construction of the asset due to unforeseen circumstances, although this is typically mitigated by liquidated damages provisions.
- Cost overruns. Although the construction contract usually has a fixed price, not all components can always be fixed.
- Political risk consisting of adverse legislation or expropriation, currency inconvertibility and war or civil unrest. This risk can be mitigated by taking out insurance cover.
- Foreign exchange risk, if more than one currency is involved.
- The asset cannot be delivered by the contractor.
- The lessee cannot pay rentals.
- The asset becomes impaired.
- Operational risk when revenue realisation is below expectation.

The Project Finance Market

In the current market, projects outside the Middle East and Asia are generally not subject to Islamic finance structures, and even in those jurisdictions the Islamic finance component is, more often than not, only a slice of the total financing required. The size of the majority of project finance transactions is currently still prohibitive for Islamic financial institutions, due to the fact that Islamic banks generally have a relatively small asset base in comparison with conventional banks.

Outside the Middle East and Asia, concession holders and banks are starting to consider including Islamic financial tranches in their project finance structures to enable them to access Middle Eastern capital and to diversify their sources of funding.

Currently, the majority of Islamic project finance has been in the Middle East region, with a main focus on the Gulf Cooperation Council countries. In the current market, conventional banks are limited in their ability to finance, and borrowers and their advisers are actively considering alternatives including Islamic finance. In addition, other markets such as North Africa are opening up more.

A combined *istisna* and *ijara* structure is most commonly applied, and, as described earlier, works well for project finance. Transactions with specific identifiable assets (e.g. a power station or a petrochemical plant) are easiest to structure, although there is no reason why assets such as roads should not be financed this way.

A recent example of Islamic project finance is the Doraleh Container Terminal in Djibouti, which is being financed through a *musharaka* with an underlying *istisna* and *ijara* structure.

7.3 PROPERTY FINANCE

Property finance within corporate finance goes beyond individual home purchase plans, and deals with the funding of large real estate purchases. Although property finance can include the purchase of stately homes and building new developments, it is certainly not limited to those and also encompasses commercial real estate such as shopping malls, garden centres, hotels and office blocks. From an Islamic finance perspective real estate is a very suitable asset class and is favoured by many investors.

Suitable Transaction Types

Not all transaction types explored in Chapter 3 are suitable for large-scale property finance. This section explores the potential ways of funding real estate and reviews the reason why the most used transaction type is the one scholars like the least, the *tawarruq*.

For real estate already in existence, there are three main transaction types suitable to provide funding:

- ***Murabaha* or deferred payment sale**. Similar to the *murabaha* transaction described in Section 3.3, the bank purchases the property and sells it on to the client for a deferred payment, which consists of the principal plus a mark-up. The mark-up can be paid to the bank on a periodic basis. The main drawback of this transaction type is its lack of flexibility in payment structures and extension possibilities. The mark-up is fixed for the duration of the contract, and the contract cannot be extended. If the client requires an extension of the funding, the first contract will have to be paid back, after which the bank and the client can enter into a new contract.
- ***Ijara* or lease**. In this contract, the bank will purchase the property and acts as the lessor to lease the property to the client, most likely under a finance lease construction, as described in Section 3.3 and shown in Figure 7.5.

  Alternatively, a sale and lease-back could be considered in which the client purchases the property, sells it to the bank and leases it back, as shown in Figure 7.6.

  In both cases, the rental payments could include an amount towards the purchase price of the property, and rentals can either be fixed or reviewed periodically.
- **Diminishing *musharaka* or reducing partnership**. In this scenario, the bank and the client both invest in the property, and the property is divided into equal units, which the client will purchase from the bank over time. Similar to the diminishing *musharaka* detailed in Section 3.3, the purchase of units by the client is flexible and can be arranged in the contract. The client pays a rental fee for the part of the property he does not own, which can be reviewed periodically.

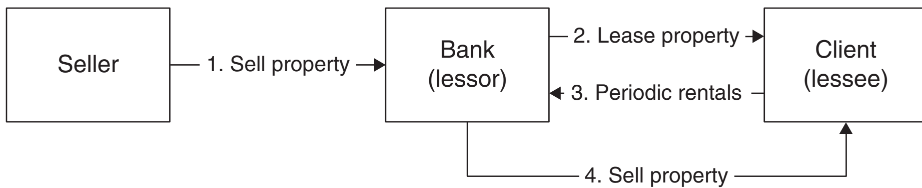

FIGURE 7.5 Lease applied to property finance

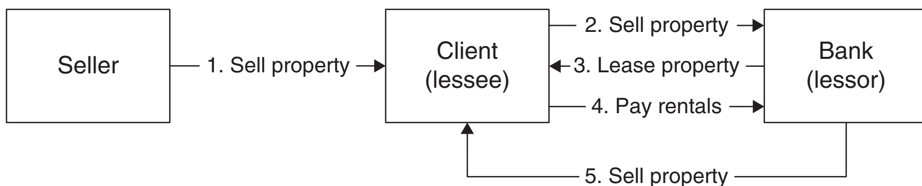

FIGURE 7.6 Sale and lease-back applied to property finance

Each of the above-mentioned transaction types can be applied, although the lease and the diminishing *musharaka* offer significantly more flexibility for both the bank and the client. For new developments, these transaction types are not suitable since the property is neither owned nor in existence. As a result, new developments require a different approach to meet the funding requirements. The financing of new developments can, for instance, be funded as follows:

- ***Salam* or short-term production finance**. As described in Section 3.3, the *salam* contract is a purchase contract for future delivery of an asset and is exempt from the conditions regarding ownership and existence of the asset (Figure 7.7). At the time of contracting, the asset does not yet have to exist, and it does not have to be owned by the seller. When applying a *salam* contract to property finance, the bank provides the full amount of funding upfront and will be paid out of the proceeds of the sale of the property.

  The developer repays the bank out of the proceeds of the sale on a pre-agreed date in the future. The disadvantage of a *salam* transaction applied to property development is that there is no flexibility in the contract itself. The full amount has to be paid upfront and delivery of the asset has to take place on a pre-agreed date. Because financial regulators typically do not look favourably on banks taking any exposure to commodities, the transaction will be structured such that the developer takes responsibility for the sale of the property to an end buyer, and the payment from the developer to the bank will be the principal plus profit.

- ***Istisna* or long-term production finance**. Like a *salam* contract, an *istisna* contract is a purchase contract for future delivery of an asset, and is exempt from the same two conditions regarding the asset, ownership and existence. In an *istisna* contract, the payment to the property developer does not have to be in full in advance. Payment is likely to be in various instalments in line with the progress made. The *istisna* contract is typically for a longer term than a *salam* contract.

  Under the *istisna* structure depicted in Figure 7.8, it is assumed that there is a third-party ultimate buyer with sufficient funds available to pay for the asset as and when payment is required. The buyer could, for instance, obtain these funds by entering into a mortgage contract. Given that the bank is unlikely to be willing to wait until the

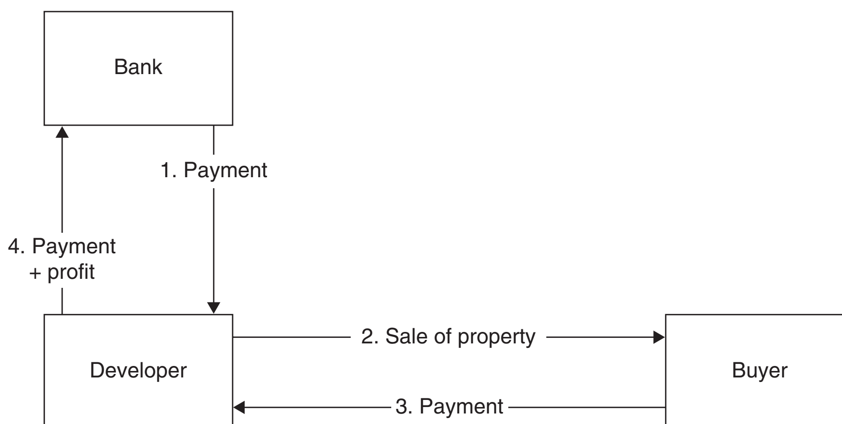

FIGURE 7.7 *Salam* for property development

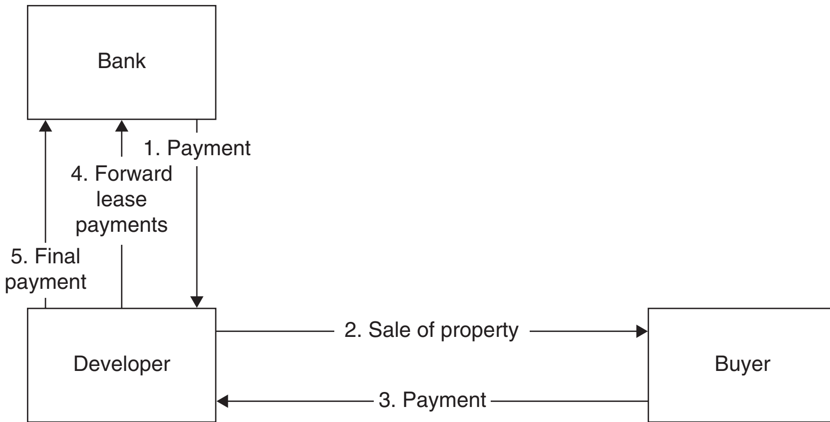

FIGURE 7.8 *Istisna* in property finance, financing developer

development is sold, it is often agreed in the contract that the property developer pays forward lease payments during the construction period. These payments are made out of the sales proceeds. A final payment from the developer to the bank at the end of the period could be part of the structure.

In the transaction outlined in Figure 7.8, it is assumed that the property will be sold on to an ultimate buyer and that financing is only required during the construction period. Alternatively, the buyer could be the bank's client, in which case the transaction can be depicted as shown in Figure 7.9.

In this structure, the following steps take place:

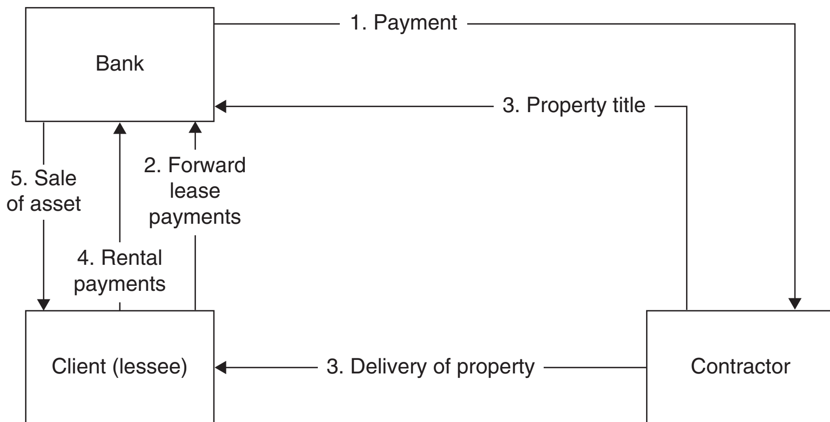

FIGURE 7.9 *Istisna* in property finance, financing end client

1. **Payment**. From the bank to the contractor or developer, in accordance with the contract.
2. **Forward lease**. The end buyer pays forward lease payments during the construction phase of the property.

3. **Delivery of property**. The property title is delivered to the bank (which becomes the lessor), and the client (who becomes the lessee) takes delivery of the property itself. Once the property is delivered, the forward lease ceases to exist and the lease comes in to effect.
4. **Rental payments**. The client pays periodic rentals to the bank for the duration of the lease. The rentals may include a payment towards ownership of the asset.
5. **Sale of asset**. At the end of the lease, the client buys the asset from the bank.

Compared to the *salam* contract, the *istisna* contract is more flexible due to the fact that payment terms can be negotiated to meet the requirements of the client and the property developer. In addition, by introducing staged payments in line with progress, there is an additional incentive for the developer to manage the building process efficiently.

Although the above-mentioned transaction types are preferable from an Islamic finance and *Sharia'a* perspective, they cannot automatically be applied in every jurisdiction. Issues with double stamp duty land tax and VAT can make these types of funding very tax inefficient and hence less attractive to the client. In order to enable the funding of property therefore, the *tawarruq* structure is often favoured by banks and clients alike. As described in Section 6.1, *tawarruq* is a variety of the commodity *murabaha*, in which a commodity (usually a base metal) is purchased and sold in order to generate a cash flow. There are, however, *Sharia'a* issues with *tawarruq*. The main issue is the fact that the intention behind the purchase of the commodity is not to own and use the commodity, but solely to generate a cash flow. The majority of *Sharia'a* scholars approve of *tawarruq* as long as an auditable ownership transfer of the commodity and separation of the purchase and sale arrangements are taking place. Graphically, the *tawarruq* can be depicted as in Figure 7.10.

In a *tawarruq* there is one agreement in which both parties agree that the Islamic bank will sell the warrants to the client and simultaneously sell them to a metal broker on behalf

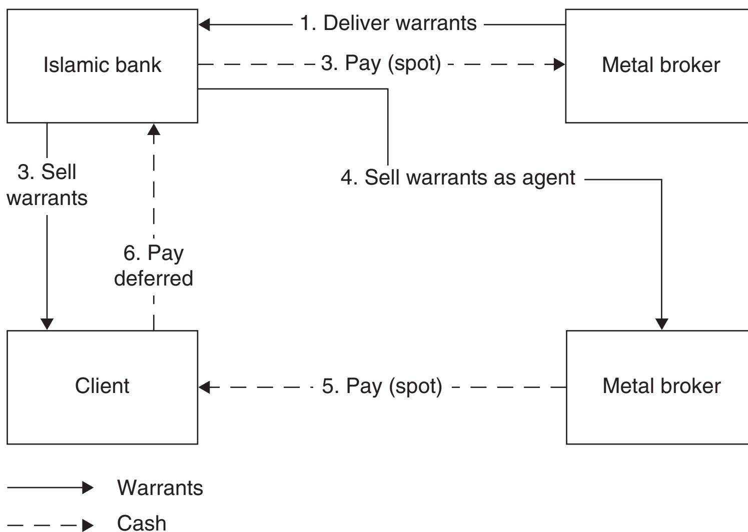

FIGURE 7.10 *Tawarruq* in property finance

of the client. Due to the fact that sale, purchase and appointing the bank as agent are all happening in one schedule, it is almost impossible to see who owns the commodity at any point during the execution of the transaction. Consequently, if the transaction falls through at any point, ownership of the asset is not clear. The majority of *Sharia'a* scholars approve of *tawarruq* as long as an auditable ownership transfer of the commodity and separation of the purchase and sale arrangements is taking place.

Although *tawarruq* may not be the perfect instrument and has serious *Sharia'a* issues associated with it, it does serve a purpose when VAT, stamp duty or other taxation rules place limitations on Islamic finance and the *tawarruq* is more often than not the only feasible transaction type available.

7.4 LEASING

By their nature, leasing transactions always have an underlying asset and are based on risk and reward sharing, which makes them extremely suitable for Islamic finance. As described in Section 3.3, an *ijara* transaction is the Islamic equivalent of a lease, which is defined as a bilateral contract allowing for the transfer of the usufruct. This means that one party (the lessor) allows another party (the lessee) to use his asset against the payment of a rental fee. In Islamic finance two types of leasing transactions exist, operating and finance leases. *Ijara* is the general term for lease and signifies an operational lease. *Ijara wa iqtina* is a lease ending in ownership and is equivalent to a finance lease. In Islamic finance the assets that are subject to a lease are varied, and include car fleets, trucks, ships and machinery.

Although Islamic leasing transactions are typically based on *Sharia'a* compliant legal documentation, there are situations where this is legally not possible due, for instance, to the jurisdiction of the client. In the event that conventional leasing documentation needs to be applied, the Islamic bank and the client can opt to have an additional contract in place that deals with anything that is not *Sharia'a* compliant such as penalty clauses and insurance. For example, it is not permissible to charge a late-paying client a penalty over and above the cost incurred by the bank to address this issue. If a penalty interest clause is included in the contract, the bank can collect such interest but must give it to charity. The responsibility for insuring the asset is typically passed on to the lessee via an agency agreement. A typical leasing structure can be represented as in Figure 7.11.

An operating lease is similar, but does not have the sale of the asset to the lessee incorporated in the structure.

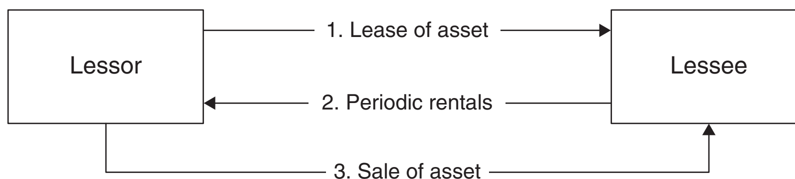

FIGURE 7.11 Finance lease

Determination of Rental Payments

The rental amount due on a lease incorporates a variety of different factors, which are summarised in Table 7.1.

TABLE 7.1 Rental payment components

Component	Finance lease	Operating lease
Term, repayment profile and payment in advance or in arrears	√	√
Deduction or inclusion of servicing fees	√	√
Fees and commissions payable	√	√
Cost of funds	√	√
Counterparty credit risk	√	√
Value of the underlying asset	√	√
Country and other risks	√	√
Residual value risk		√
Residual value realisation		√

The residual value is only of importance in an operating lease, since the lessor takes a view on the value at which he can sell the asset at the end of the lease term.

In an operating lease, the lessee and lessor have the following options at the end of the lease term:

1. **Renew the lease**. In this case, the lease is extended for the same rental amount on the same equipment. The lessee typically only does this if it is more beneficial to his operation than returning the asset and leasing a new one.
2. **Return asset to lessor**. If the lessee no longer wishes to use the asset it can be returned to the lessor at the end of the lease period. The lessor can then chose to lease the same asset to a different counterparty, or sell it in the market.
3. **Purchase at fair market value**. The lessee can request to buy the asset from the lessor at the current market value.

CHAPTER 8

Application of Islamic Products to Private Equity

Private equity is not always a separate division within a bank, but can also occur as part of the corporate finance division or treasury. Due to the fact that a private equity investment represents a direct investment in an enterprise and the investor is taking a business risk, investments in public as well as private equity are looked upon favourably by *Sharia'a* scholars. The two different structures as described in Chapter 3 that are suitable for private equity investments are *musharaka* and *mudaraba* transactions.

In a joint venture of *musharaka* structure, all partners provide capital and skills and expertise to the project. Profits are shared based on a contractually agreed ratio between the partners and any losses are distributed in accordance with the proportion of capital provided. The bank often opts to become a sleeping partner and leaves the running of the business to the other partners, potentially in return for a lower share in the profits.

Musharaka transactions (Figure 8.1) are typically suitable for investments in business ventures or specific business projects, and need to consist of at least two parties, and all partners are known as *musharik*.

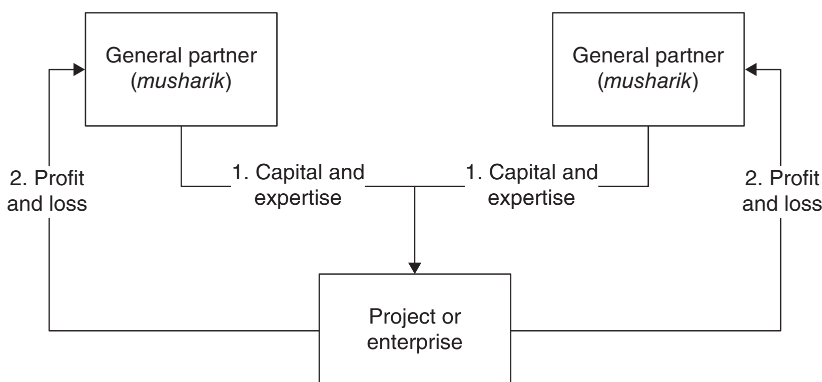

FIGURE 8.1 *Musharaka* transaction for private equity

Another option for private equity investment, besides the *musharaka* transaction, is the *mudaraba,* a partnership in which only one of the partners contributes capital (the *rab al mal*), and the other (the *mudarib*) contributes skills and expertise. Like the *musharaka* transaction, the profits are shared between the partners according to the ratios agreed in the original contract. Any losses are solely attributable to the investor due to the fact that he is the sole provider of all capital to the project. In the event of a loss, the business manager does not receive any compensation (*mudarib* share) for his efforts. The only exception to this is when the business manager has been negligent, in which case he becomes liable for the total loss.

Contrary to the *musharaka* in which partners have unlimited liability, the investor or *rab al mal* in a *mudaraba* transaction is only liable to the extent of the capital he has provided. As a result, the business manager or *mudarib* cannot commit the business for any sum over and above the capital provided.

CHAPTER 9

The Role of the London Metal Exchange

The underlying asset for commodity *murabaha* and *tawarruq* transactions is more often than not a base metal such as aluminium or nickel. The base metals are generally associated with the London Metal Exchange (LME), which is due to the fact that the exchange is by far the largest player in the market. Although not a physical market, the LME controls the issuance of warrants that represent ownership of the metal. The commodities in a commodity *murabaha* and *tawarruq* transaction are often referred to as "LME base metals" even though in their current form the contracts that are traded on the exchange are not an appropriate underlying asset to a transaction, as will become clear in this chapter.

9.1 THE LONDON METAL EXCHANGE

Although trading of metals has taken place at the Royal Exchange since its opening in 1571, the London Metal Exchange Company was not established until 1877. The Industrial Revolution in the eighteenth and nineteenth centuries led to a significant increase in the demand for metal and a requirement for imports. The merchant sourcing these materials invested large sums of money and was exposed to high financial risk due to the fact that journeys were long and dangerous. In order to mitigate any risk of prices falling during the journey, a market developed in which metal could be sold for delivery at a future date estimated based on the ship's arrival time, at a price agreed on the trade date. The LME was established to formalise this process through the creation of a single market place with recognised trading times and standardised contracts.[1]

The LME is not the natural source for physical metal, however. It is rather a financial futures market used mainly for limiting future price risk, supported by delivery as a last resort. The warrants underlying the commodity *murabaha* transactions are traded not on the exchange, but over the counter.

[1] For more information, see http:// www.lme.com.

9.2 WARRANTS

The asset underlying a commodity *murabaha* is typically any of the LME base metals, ownership of which is represented by an LME warrant. An LME warrant is a certificate for a specific metric tonnage of an approved brand of metal stored in an LME approved warehouse. The warrant is a bearer document and signifies ownership of the underlying metal by the holder. An LME warrant contains the following information:

- **LME warrant identification**. This is the unique warrant number, warrant id and the date the warrant is created.
- **Location of warehouse**. Specifying the name and exact location of the warehouse, as well as the company operating the warehouse.
- **Metal details**. This includes the type of metal, the shape, brand, quantity, country of origin and net weight in kilograms.
- **Rental and insurance**. The bearer of the warrant is due to pay an annual rent for storage of the metal which is included in the purchase price. In addition, the bearer has the responsibility to insure the metal.

An LME warrant is issued by a London agent on behalf of an LME approved warehouse upon receipt of the goods from the supplier. The physical warrants are stored in a specialised repository and do not leave the repository until they are checked out by the owner for physical delivery. Ownership of the warrants is registered in the SWORD system, a secure electronic transfer system developed as a joint initiative between the LME and the London Clearing House. All LME warrants are produced to a standard format with a barcode. Warehouse companies issuing these warrants ensure that the details are known to SWORD, which acts as a central database, holding details of ownership, and is subject to stringent security controls. The ownership of LME warrants can be transferred between SWORD members in a matter of seconds and all rent payments are automatically calculated.

Warrants are sold over the counter and are available for a multitude of LME products, though not all are acceptable from a *Sharia'a* perspective, since the underlying asset needs to be non-perishable. Plastic, for example, does not meet this requirement. Base metals, however, are widely accepted by *Sharia'a* boards as an asset in a commodity *murabaha* as it is documented as a warrant in a warehouse.

From a commodity *murabaha* perspective, the warrants most often used are aluminium and copper. This is primarily because of the large contract size and relatively higher price per warrant, which ensures that the number of warrants that need to be purchased is low.

In commodity *murabaha* and *tawarruq* transactions, commodity price risk is avoided in two ways:

1. **Timing of purchase and sale**. All commodity purchase and sale transactions take place on the same day.
2. **Premium warrants**. To mitigate the risk of any price movement during the day, the warrants that are used within these transactions are those that are trading at a premium to the market price. The reason why these warrants trade at a premium is often due to the location of the warehouse.

EXAMPLE: WARRANT PREMIUMS

In the course of a contract, a bridge builder in the North East of England has a requirement for 15,625 tonnes of aluminium. A single warrant of aluminium represents 25 tonnes, and as a result, he requires 625 warrants. The bridge builder will need the aluminium to be delivered to the building side and has the following options:

- Buy 625 warrants at the current market price of $2,751 located in a warehouse in Singapore.
- Buy 625 warrants at the premium price of $2,950 located in a warehouse in Tyne and Wear.

Given the time involved in shipping the physical metal from Singapore and the associated cost, the bridge builder is likely to pay the premium price for the warrants that are stored near him.

9.3 LME BASE METALS

Warrants are available for the base metals in Table 9.1.

TABLE 9.1 LME base metals

Metal	Description	Contract size (tonnes)*
Aluminium	Aluminium is light, non-toxic and can be easily formed, machined and cast. Although in its purest form it is soft and lacks strength, its alloys with small amounts of copper, magnesium, silicon, manganese and other elements have very useful properties.	25
	Aluminium alloy and North American special aluminium alloy (NASAAC) are derivatives of aluminium and trade in contract sizes of 20 tonnes.	20
Copper	Copper is reddish with a bright metallic lustre. It is malleable, ductile and a good conductor of heat and electricity (second only to silver). The most important compounds are the oxide and the sulphate (blue vitriol). It is relatively soft and moderately reactive.	25
Lead	Lead is a dense, relatively soft, malleable metal with low tensile strength. It is a poor conductor of electricity and heat.	25
Nickel	Nickel is a hard, malleable, ductile, lustrous, silver-white metal, which exhibits magnetic properties and is a fairly good conductor of heat and electricity. The major use of nickel is in its alloys.	6

(*Continued*)

TABLE 9.1 (*Continued*)

Metal	Description	Contract size (tonnes)*
Zinc	Zinc is brittle and crystalline at ordinary temperatures, but when heated to between 110°C and 150°C it becomes ductile and malleable; it can then be rolled into sheets. It is used principally for galvanising steel consumer goods.	25
Tin	Tin is very soft (only slightly harder than lead) and malleable; it can be rolled, pressed or hammered into extremely thin sheets (tin foil). Its main commercial uses are in tinplating steel products for the food packaging industry.	5
Plastic	Plastic is the general term for a wide range of synthetic or semi-synthetic polymerisation products. There are many natural polymers generally considered to be "plastics", which can be formed into many different types of objects, films or fibres. The name is derived from the malleability, or plasticity, of many of them. The word derives from the Greek *plastikos*, or "fit for moulding", which in turn comes from *plastos*, which means "moulded".	24.75
Steel	Steel is an alloy consisting mostly of iron, with carbon content between 0.2% and 2.04% by weight, depending on grade. Carbon is the most cost-effective alloying material for iron, but various other alloying elements are used.	65

* Actual weight per warrant is in a range of plus or minus 2%.

CHAPTER 10

Asset Management

Within Islam, investing in enterprises and assets is encouraged not only because of the wealth increase for the individual investor, but also because it advances the economy and at the same time allows others to increase their wealth. This in turn results in better wealth distribution.

Conventional and Islamic investors have common objectives such as capital preservation, yield maximisation and ensuring a balance between liquidity and profitability, in addition to which Islamic investors also look for *Sharia'a* compliance. Not all investors have the time to manage their investments actively, and, like conventional investors, Islamic investors often turn to fund or asset management solutions.

Like conventional investment managers, Islamic investment managers can invest in a wide range of Islamic and conventional products and asset classes, including shares and other securities. The main difference between conventional and Islamic investment managers is that the latter will have to ensure that his individual investments, as well as his fund, remain compliant with *Sharia'a*. In addition, Islamic fund managers cannot use derivatives, pay or receive interest, or apply stock lending techniques.

Fund structures are typically similar to conventional structures, although again *Sharia'a* compliance is a key factor. A *Sharia'a* supervisory board (SAB), which is typically made up of three to five members, is involved from the start of the fund. The SAB is not responsible for any operational or strategic decisions the fund manager makes as long as the fund continues to be *Sharia'a* compliant. The SAB is, however, involved in the definition of the framework the fund operates in and defines issues such as which industries are deemed compliant.

The remainder of this chapter outlines the AAOIFI *Sharia'a* standards for the selection of *Sharia'a* compliant investments and presents a view on how Islamic asset management can successfully be applied in practice.

10.1 SELECTION OF *SHARIA'A* COMPLIANT INVESTMENTS

When investing in a company, there are two basic screening processes that need to be applied before deciding whether or not a stock should be allowed to be part of the investment universe. Within *Sharia'a*, a number of business activities are deemed to be *haram*, in which one should not invest.[1]

Industry Screen

The first selection when deciding whether to accept a share in the investment universe is often referred to as the "industry screen". Although it is preferable to allow only fully *Sharia'a* compliant funds in the universe, increasing globalisation, diversification and market demand do not always make this possible. As a result, a particular share or business can be a *Sharia'a* compliant investment opportunity, even when an insignificant amount of its turnover is deemed to be *haram*. Although the definition of "insignificant" varies between SABs, it is generally accepted to be 5% or less of total turnover.

The industry screen is meant to eliminate any *haram* businesses from the investment universe and excludes the following business activities:

- **Conventional banking and insurance**. Conventional banking and insurance are associated with interest and therefore not permissible.
- **Alcohol**. The prohibition of alcohol extends to distilling, marketing and sale and includes working in the industry. Medicinal alcohol and alcohol used in the production of perfumes are not prohibited.
- **Pork-related products and non-compliant food production**. Non-compliant food production covers everything not prepared in a *halal* way and covers, among others, meat that is not slaughtered in an acceptable fashion.
- **Gambling**. This covers casinos and betting shops, but also bingo halls and online betting.
- **Tobacco**. As with alcohol, this includes the production, marketing and sale of tobacco and associated products.
- **Adult entertainment**. Any activity associated with adult entertainment including escort services, brothels and movies with explicit sexual content.
- **Weapons, arms and defence manufacturing.**

These industries or sectors should not form part of the portfolio of any Islamic investor.

Financial Screen

In addition to the industry screen, companies that use too much leverage are also excluded from the investment universe by what is referred to as the "financial screen". Although the exact financial ratios can vary between SABs, the generally accepted financial ratios are as follows:[2]

- conventional debt / market capitalisation < 30%;
- interest-bearing deposits / market capitalisation < 30%; and
- (total interest plus income from non-compliant activities) / income < 5%.

[1] AAOIFI *Sharia'a* standard 21.

[2] AAOIFI *Sharia'a* standard 21.

Application of the Industry and Financial Screen

Although not all scholars agree on this, the general approach is that any income from *haram* activities should be purified via dividend payments. This is a pragmatic approach to allow Islamic funds to be set up and operate within the *Sharia'a* framework. The *Sharia'a* compliant indices that have been developed over time may use more lenient or more stringent criteria. Dow Jones, for instance, uses the following for the Dow Jones Islamic Markets index:

- **Industry screen**. Exclude alcohol, tobacco, pork and pork-related products, financial services, defence/weapons and entertainment.
- **Financial screen**. The financial screens are all taken over market capitalisation and apply a 24-month rolling average to enable a smoother picture, and any firm should meet the following criteria:
  - total debt / trailing 24-month average market capitalisation < 33%;
  - (cash plus interest bearing securities) / trailing 12-month average market capitalisation < 33%; and
  - accounts receivable / 24-month average market capitalisation < 33%.

On the other hand, the FTSE Global Islamic Index Series (GIIS) applies the following rules:

- **Industry screen**. Exclude alcohol, tobacco, pork and pork-related products, banking or any other interest-related activity, arms manufacturing, life insurance and gaming.
- **Financial screen**. Any company within the index will have to pass the following criterion: gross interest-bearing debt / total assets < 33%. In addition, the FTSE GIIS specifically mentions that the percentage used represents the maximum allowed under *Sharia'a*, which is currently set at 33%.

The exact screening criteria applied to an individual fund or index strongly depend on the framework of the fund or index and the opinion of the *Sharia'a* scholars.

Non-compliance

No matter how thorough the screening, a situation could occur in which a share becomes (temporarily) non-compliant. It is the responsibility of the fund manager to report this to the SAB together with his recommendation on how to proceed. If the stock is deemed to be temporarily non-compliant, the SAB could allow the stock to remain part of the investment universe. All income from the stock in that period will need to be purified for as long as the non-compliance occurs.

Some SABs, however, do not allow any period of non-compliance and a share that becomes non-compliant will need to be sold within a given number of days, whether it is expected to return to compliance or not. However, once a share is compliant again it can be added to the fund, although the fund manager will probably incorporate the fact that a share was non-compliant and the likelihood of this occurring again in his decision making.

Where permanent non-compliance occurs, divestment will always be required. However, within the framework of the fund, and in order to protect investor's interests, the SAB is likely to allow this to be a phased process.

10.2 TYPES OF FUNDS

The number of *Sharia'a* compliant funds is increasing rapidly, with new funds regularly being announced. By far the majority of the currently available funds are structured as unit trusts or mutual funds, and more than half of funds invest in equity. Although most equity funds use some form of benchmark to track their performance against, the majority of funds appear to have an active management strategy. Unsurprisingly, the main investment regions of these funds are Asia and the Pacific, the Middle East and Africa.

Generally, the types of funds offered are very similar to those offered in the conventional world. The funds fall into the following broad categories:

1. **Fixed income funds**. Fixed income or money market funds typically have low risk and thus lower expected returns. They invest in money market type instruments with an appropriate mix of liquidity, security and return, and can invest in a combination of assets to generate a return including cash, *wakala*, commodity *murabaha, sukuk* and *ijara.*
2. **Lease funds**. Lease funds invest in a series of lease transactions and, due to the asset ownership, are generally considered to be slightly riskier but with a potential for a higher return than fixed income funds. The underlying assets are owned by the funds, and the leases are typically undertaken on a finance lease basis without a residual risk on the asset.
3. **Commodity funds**. Commodity funds invest in eligible commodities, which must be owned by the fund. Forward and short sales are generally not permitted.
4. **Real estate funds**. Real estate funds invest in commercial and residential real estate and generate a yield from rental income and increase in value. Properties have to remain compliant in their use while owned by the fund.
5. **Public and private equity funds**. Equity funds, whether private equity, direct investments, public equity or index trackers, attract the highest level of risk and are subject to high potential gains and losses. All equity needs to be *Sharia'a* compliant.
6. **Exchange traded funds**. These track an index, commodity or basket of assets and trades on an exchange. As a result, liquidity is provided by the market and the fund can be fully invested.
7. **Hedge funds**. Due to the prohibition on short selling, hedge funds are still contentious. Some scholars have permitted the use of structures including *salam*, *arbun* and *wa'd* to overcome the prohibition of short selling, although these are not generally accepted.

CHAPTER 11
Risks in Islamic Banks

The ethical framework governing Islamic finance prohibits gambling, uncertainty and interest. Although at first glance this sounds like a risk manager's dream, it does not at all mean that an Islamic bank runs little to no risk. Like other banks and financial institutions, Islamic banks face risks inherent in the financial industry, and in most countries they have to abide by the same rules as other financial institutions for the calculation of regulatory capital. However, Islamic banks also have their own set of unique risk management challenges.

Conventional banks are subject to a wide range of risks, which are described in Table 11.1. The need to quantify these risks has resulted in the development of what is currently the most widely used risk measure for banks, *value at risk* (VaR). VaR attempts to measure the downside risk of either a portfolio or, in aggregation, a firm by one single number, taking into account financial leverage and diversification effects. The result of the VaR equation is represented in the maximum amount a bank is likely to stand to lose on a given day or over a number of days (e.g. a week), generally with a confidence interval of 95% or 99%. It incorporates traditional risks and risks related to adverse market movements of financial derivatives and structured products. In addition, VaR may also be used as a basis for calculating the amount of economic capital required to support a business, which is an essential component of economic value added measures. VaR mainly provides an indication of the maximum risk a bank is exposed to under predictive conditions (e.g. the assumption that the distribution of the underlying price data is approximately normal), and may not necessarily be suitable as an internal measure to control risk or to determine profitability. VaR is, for instance, used in the calculation of regulatory capital required to support market risk under the Basel capital accords. Besides VaR, risk-adjusted return on capital (RAROC) is often used as a risk measure by banks. The purpose of RAROC is to adjust trading profits by the remuneration of risk capital, and it recognises that trading positions with a higher risk profile require a larger amount of economic capital to absorb larger potential losses.

Any risk taken by a bank will have to be evaluated against its risk management system, as well as the cost of the measures in place. The complexity of banks seriously hinders simple assessment of the risks taken and how they are controlled. However, it will not be possible to incorporate safeguards against all risks within the risk management system of a bank. A more

TABLE 11.1 Types of risks for conventional banks

Type of risk	Description
Liquidity risk	The risk of insufficient liquidity for normal operating requirements, i.e. the ability of the bank to meet its liabilities when they fall due.
Interest rate risk	The risk arising from interest rate mismatches in volume, maturity and type (fixed versus floating) of interest-sensitive assets, liabilities and off-balance sheet items.
Credit risk	The risk that an asset or a loan becomes irrecoverable in the case of outright default, or the risk of delay in the servicing of the loan.
Settlement or counterparty risk	The risk that occurs if one party to a transaction pays funds or delivers assets before receiving its own funds or assets, hence exposing it to a potential loss.
Price risk	The risk that the market price of an instrument traded in a well-defined market will be volatile. Market risk occurs in relation to debt securities, derivatives, equity derivatives and currency transactions held by a bank.
Leverage risk (capital adequacy)	The risk related to the extent to which the assets of a bank may decline before the positions of its depositors and other creditors are jeopardised.
Event or operational risk	The risk of certain events occurring, e.g. disaster, regulatory or political events, or the (temporary) unavailability of IT systems.
Business risk	The risks related to products, macro-economic cycles and technology changes.

complex risk management system may actually make the situation worse, due to the increasing complexity that is introduced.

The absence of interest, and hence of interest rate risk as such, does not imply that an Islamic bank can be considered to bear lower levels of risk. Like conventional banks, Islamic banks incur liquidity, credit, settlement, leverage, operational and business risk. In addition, different types of risk can be identified for Islamic banks in the form of changes in asset and liability returns and value, due to changing economic circumstances affecting the investments that are part of the portfolio of the bank. Instead of fixed-rate interest rate risk, which is a balance sheet (fair value) exposure, Islamic banks face a rate of return risk, which is an income statement (cash flow) exposure, similar in nature to floating-rate interest rate risk in conventional banks. Rate of return risk is mainly related to sale-based instruments such as *murabaha*, *salam* and *istisna* as well as *ijara* instruments. Although the risks are considered to be small for short-term *murabaha* contracts, the risk increases for transactions with a longer maturity. One of the risk mitigation techniques in use is to link *ijara* rentals to a benchmark such as LIBOR or an inflation index and periodically adjust the rental amounts.

In order to measure the risk of an Islamic bank properly, the applicable conventional bank risks need to be taken into consideration, and complemented by additional risk types that cater specifically for the risks undertaken by Islamic banks such as the following:[1]

Fiduciary risk. Specifically, risk related to the nature of the *mudaraba* contract, which places liability for losses on the *mudarib* (or agent) in the case of malfeasance, negligence or breach of contract on the part of the management of the *mudaraba*.

[1]Archer, S. and Karim, R.A.A. (2006) On capital structure, risk sharing and capital adequacy in Islamic banks, *International Journal of Theoretical and Applied Finance*, 9(3), 269–280.

Displaced commercial risk. This risk type is related to the common practice among Islamic banks of "smoothing" the financial returns to investment account holders by varying the percentage of profit taken as the *mudarib* share, which can be compared to an arrangement or agency fee.

Rate of return risk. The risk of a mismatch between yields on assets and the expected rates of both restricted and unrestricted investment accounts, which may in turn lead to displaced commercial risk

Generally, the differences between the operations of conventional and Islamic banks result in a different level of risk on the bank as a whole. The riskiness of Islamic banks is perceived to be higher than that of conventional banks, for instance due to the profit- and loss-sharing modes of financing and the related increased potential for moral hazard, the potential incentive for risk taking without adequate capital levels, the lower levels of risk-hedging instruments and techniques, and underdeveloped or non-existent capital markets. A significant part of the higher perceived risk levels is, however, associated with the fact that most Islamic banks are based in jurisdictions that are considered to be emerging markets. With Islamic finance gaining popularity in the Western world, more banks are starting to operate out of financial centres such as London. These institutions need to be authorised and regulated by Western financial regulators and will have to compete in a rounded financial environment. The risk levels of these banks are not higher than those of their conventional counterparts, and could even be considered lower due to the absence of speculative instruments that caused such large disruption in the financial markets around the end of 2007 and continue to have an impact on the global economy.

CHAPTER 12

Governance

Islamic financial institutions typically have the same governance structure as conventional financial institutions, consisting of a more senior, or supervisory, board chaired by the chairman of the company, and a lower board, or executive committee, responsible for the day-to-day running of the bank. Remuneration committees, audit committees and risk committees are all standard components of the governance structure. However, Islamic financial institutions have an additional organ of governance in the SAB. Five main elements are generally identified when considering the role of the SAB in the governance structure:

- **Independence**. Independence of the SAB and SAB members is a fundamental requirement and is an issue frequently discussed and debated. In order for an SAB to function effectively, its members must be independent of the management of the bank. As a result, the SAB members are usually appointed by the shareholders at the annual general meeting.
- **Confidentiality**. Due to the nature of the SAB members' work and duties, they are exposed to a great deal of proprietary information. Their presence, as is common, on many boards dictates a detailed confidentiality requirement.
- **Competence**. Due to the multifaceted nature of the SAB members' role, they are required to have a specialist knowledge and expertise. This includes not only *Sharia'a* knowledge and expertise, and in particular *fiqh al muamalat* (Islamic law of contracts), but also an understanding and knowledge of modern financial and banking practices and products.
- **Consistency**. The SAB should also remain consistent in its decisions, guidelines and advice in order to build up and maintain consumer confidence. This is an important requirement and is mutually beneficial for both the client and the bank.
- **Disclosure**. Disclosure and transparency are a vital part of the SAB roles and functions. By disclosing procedures, decisions, *fatawa* (religious decrees) and structural details, the SAB encourages and promotes confidence not only for shareholders but also for the industry and the wider public.

All the above-mentioned elements are an integral part of their work as the industry grows, and show the instrumental nature of the SAB within the organisation.

The IFSB *Sharia'a* governance standard (no. 10) defines the governance system as the set of institutional and organisational arrangements through which an Islamic finance institution ensures effective, independent oversight of *Sharia'a* compliance and includes:

- issuance of *Sharia'a* resolutions;
- dissemination of information related to *Sharia'a* resolutions to management; and
- *Sharia'a* review and audit.

The SAB meets two principal demands. Firstly, the financial institution needs to ensure that the products and services it offers are genuinely *Sharia'a* compliant and thus in line with the institution's standards, principles and shareholders' requirements. Secondly, investors and clients need to be able to ensure their investments are in line with *Sharia'a*. Ultimate responsibility for *Sharia'a* compliance remains with the senior management of the organisation.

Over time, the role of the SAB has developed and become more noticeable. Whereas initially it was common practice to turn to Muslim scholars specialising in Islamic law and jurisprudence who were purely engaged to provide an opinion on an individual structure, current scholars typically also have a strong knowledge base in finance, and are more and more involved in advising on and structuring more innovative products.

In order to obtain a full understanding of the roles and responsibilities of the SAB, this chapter provides a review of their different functions, analyses the mechanics of selecting the SAB, discusses the governance issues surrounding the SAB and looks at the challenges facing them.

12.1 ROLES

The roles and functions of the SAB can be divided into three main areas: the advisory role, the approval role and the audit role. While operating in these areas, the board must conform to set guidelines of Islamic jurisprudence as well as taking into consideration industry standards such as the AAOIFI standards mentioned in Section 13.1, as and when required.

The Advisory Role

In the event that an Islamic bank requires clarification or an opinion on specific or general *Sharia'a* principles, it will turn to a *Sharia'a* scholar for advice. In line with industry best practice and AAOIFI recommendations, this is often an in-house *Sharia'a* specialist with in-depth knowledge of *Sharia'a* teachings. Having an in-house specialist enhances the knowledge available within the institution, and can improve the effectiveness of the SAB. Issues can, in the first instance, be referred to the in-house specialist, thus achieving maximum utilisation of the SAB while productively managing resources.

The Approval Role

The SAB approval process spans several steps. The SAB first reviews the initial structures and concepts to ensure they are in line with *Sharia'a.* Once approval is obtained, and the product is structured, further approval is required in light of the legal documentation required. This

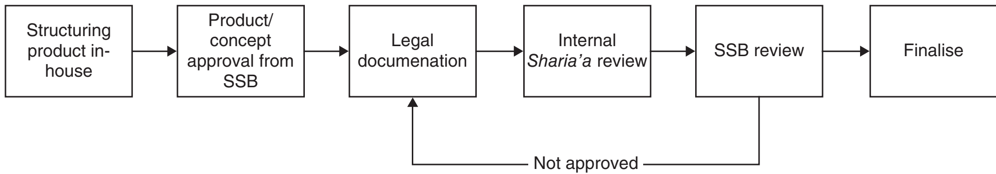

FIGURE 12.1 *Sharia'a* approval process for a new product or structure

process can extend to several revisions, depending on the transaction and the legal and SAB requirements. Final approval is also required for specific transactions where the structures are highly individual in nature and for more complex structures, such as syndications. Figure 12.1 illustrates best practice for *Sharia'a* support. The process outlined is a generic process and can differ from transaction to transaction.

It is worth bearing in mind that approval for a structure does not automatically equate to approval of the associated documentation. Prior to issuing a *fatawa,* the SAB needs to ensure approval is obtained on the final structure as well as the documentation.

The process for changes to an existing structure that has previously been approved is shorter and is depicted in Figure 12.2.

The Audit Role

It is the responsibility of the SAB to ensure ex-post compliance by verifying that all transactions and operations of the Islamic financial institution have indeed complied with the SAB guidelines and associated *fatawa*.

When undertaking the *Sharia'a* audit, the SAB not only operates as an ex-post compliance medium but also satisfies the shareholders of the institution. The audit process varies from institution to institution but is generally done on the basis of a departmental audit. The regularity may vary depending on the size of the institution and the number of transactions it executes. The audit can take place annually, semi-annually or quarterly. Part of the SAB audit and control function is the calculation of *zakat* obligations. Depending on the institution and local regulations, *zakat* contributions are either made by the institution or delegated to shareholders. Either way, the SAB provides the *zakat* obligations on a per-share basis.

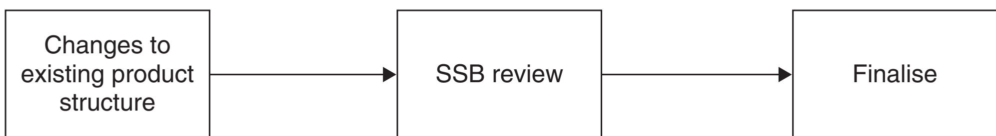

FIGURE 12.2 *Sharia'a* approval process for changes to an existing product or structure

12.2 SOCIAL RESPONSIBILITIES

In adopting its rules and duties, the SAB fulfils not only its responsibility within the financial institution but also its wider responsibility in implementing the social elements of Islamic financial services. Ethical behaviour and *Sharia'a* compliance are the responsibility of the SAB members, and by fulfilling their role in a financial institution and the industry in general, SAB members are seen to perform a wider religious obligation.

SAB members contribute to the development of the industry through the development of products and the implementation of *Sharia'a* rules and guidelines. As such they are valuable contributors to the progress of the industry, with a unique role in the centre of the developments of the industry, as shown in Figure 12.3.

As *zakat* is regarded as a mechanism of wealth purification and income redistribution in Islam, the SAB's role in calculating *zakat* payable by the institution's shareholders is also regarded as a social responsibility for the greater benefit of the society. This method of wealth redistribution is seen not only as a fulfilment of one of the major religious principles but also as a method of purification for the institution. The SAB will also ensure that any penalty payments paid to the institution are directed to a charity or scientific or educational cause. This also applies to any non-*Sharia'a* compliant revenue.

SABs also have the responsibility of maintaining confidence in the institution. Reputational risk is an important aspect in the financial industry, and equally so among Islamic financial institutions, and the opinions and advice of the SAB are clearly mentioned and relied upon. Thus, shareholders rely on SAB decisions, and it is the duty of the scholars to ensure that they maintain the bank's reputation through maintaining best practice.

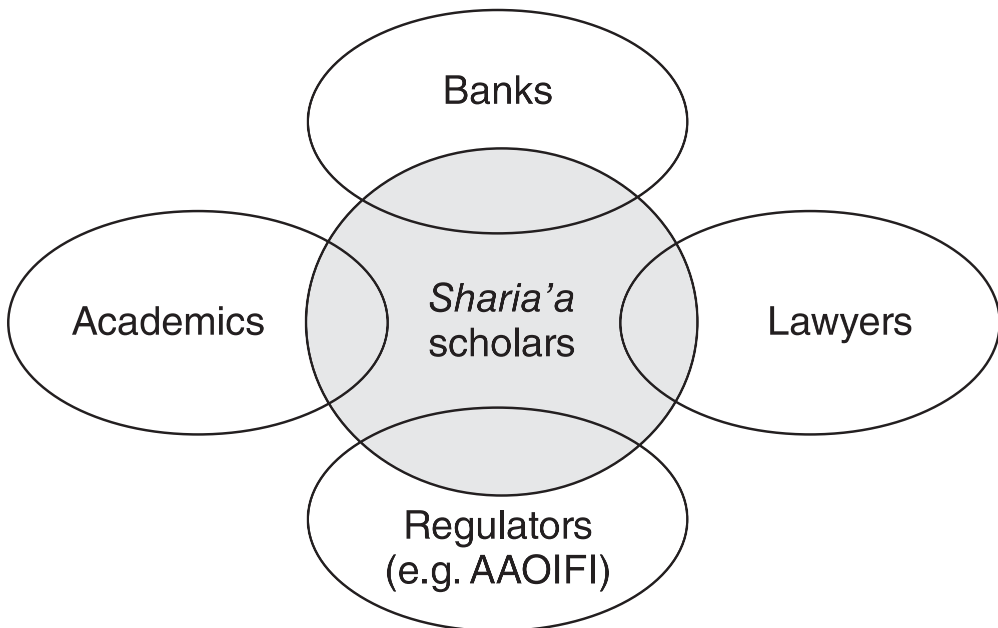

FIGURE 12.3 Role of the SAB within the industry

12.3 STRUCTURES AND VARIATIONS OF *SHARIA'A* SUPERVISORY BOARDS

Due to the various needs and the differing nature of both Islamic and conventional financial institutions requiring *Sharia'a* compliance, there are similar alternative structures to SABs as well as certain factors that should be considered when selecting SAB members. Although there is not much substantive difference of opinion between the main schools of thought in Islam when it comes to principles of Islamic finance, many Muslims tend to follow a certain school of thought in their day-to-day religious practice and consequently extend this to specific financial transactions. As such, they would prefer to invest in certain products, which have been approved by a scholar who adheres to their particular school of thought. This is particularly apparent in certain countries where, incidentally, the Muslim population generally belongs to a particular school of thought, for example, the Shafi'is in Malaysia and the Hanafis in Pakistan. Thus, in Malaysia, for example, investors might require approval by a Shafi'i scholar before investing in a certain transaction; similarly, in Saudi Arabia, an investor may decide not to invest in the same product if it has not been approved by a Hanbali scholar. In order to overcome this hurdle, and to provide comfort to their clients and investors, institutions tend to select SAB members from each school of thought. This provides such clients with the added reassurance they require, knowing that any product offered to them by the institution would have been certified as *Sharia'a* compliant by a scholar from their school of thought. This can be addressed in a variety of ways. Large international institutions, for example, could choose to create regional SABs comprised of regional scholars prevalent in those regions while simultaneously appointing a central SAB consisting of a member from each school of thought. Institutions operating in a single jurisdiction may choose to appoint a single scholar who is highly respected and reputable in their jurisdiction, and provides the institution with unparalleled access. Alternatively, the SAB could consist of local scholars rather than better-known and experienced scholars who may not be able to provide the same level of time and attention that the institution may require. This also provides such scholars, who are mostly less well known, with a platform to establish themselves in the industry.

Another approach taken by some institutions is to create a further executive committee within the SAB. This would usually be composed of two members who would have the additional responsibility of acting on behalf of the SAB on urgent matters and assume delegation on certain issues. The executive committee would generally contain the chairman of the SAB.

Although the AAOIFI standard on the appointment of the members of the SAB for Islamic financial institutions requires the SAB to have a minimum of three members, this is not always the case in practice. Having said that, there does not appear to be any substantive conflict between the AAOIFI standard and the alternative approaches adopted with regard to the number of members on SABs as those institutions which opt for less than three members do so for specific reasons, whether it be that the level of business is sufficient to be covered by less than three scholars, that they are in the process of expansion or that they are subject to a higher supervisory board.

12.4 SERVING ON MULTIPLE BOARDS

Scholars who are in the unique position of combining an understanding of *Sharia'a* principles and *fiqh al muamalat* together with knowledge of financial products and services are highly

sought after. This has naturally led to the presence of the same highly qualified scholars on several SABs. Although this has been raised frequently as a criticism of scholars and as a shortcoming of the industry, it is important to bear in mind several reasons for this. The experience of the scholars as *Sharia'a* advisors for banks and financial institutions increases their demand. Furthermore, the high level and specialist nature of their position is not easily met and results in a limitation of available resources. Although there are many academics and commentators on Islamic finance and related issues, the industry lacks scholars with practical experience. It is the responsibility of all players in the industry to ensure new scholars are exposed to the practical implementation of Islamic financial services and thus build up skills and expertise in this field.

CHAPTER 13

The Islamic Financial Infrastructure

Islamic financial institutions generally operate within the conventional regulatory environment, in some cases with additional regulation that caters to the specifics of the Islamic financial industry. Although different regulatory and advisory bodies govern the workings of Islamic financial institutions, this does not mean that their regulations are mandatory in every jurisdiction. This chapter reviews how Islamic financial institutions are regulated, additional regulatory bodies and some of the lesser known types of institutions in the Islamic financial market place. Finally, the case is made for the suitability of LIBOR as a benchmark when determining the profit margin on an Islamic financial transaction.

13.1 REGULATORY INSTITUTIONS

Besides financial regulators, there are four main institutions directly associated with Islamic finance, each of which is explored in more detail.

Financial Regulators

Islamic financial institutions are generally regulated in a similar way to other financial institutions, although the application varies from country to country. Three different models for financial regulation can generally be observed in the market:

1. **Fully Islamic**. In this model, all financial institutions operating in a country are fully Islamic, and no conventional financial institutions are authorised to operate. A fully Islamic financial system is, for instance, operational in Iran.
2. **Dual regulation**. In this case, both conventional and Islamic financial institutions operate in a country, and they are typically authorised and regulated by the same financial regulator, but using a different set of regulations for each. The separation of regulatory environment recognises the fact that there are differences between conventional and Islamic institutions and allows the regulator to take Islamic bank specifics into

consideration. This does not, however, imply that there are two distinct organisations for conventional and Islamic financial institutions. The regulatory body is typically the same organisation. Dual regulation is, for instance, operational in Malaysia and Bahrain.

3. **Single regulation**. In this case, Islamic banks are regulated by the same regulator applying the same regulations that apply to conventional banks. This is, for instance, the case in the UK where the regulator works on the basis of "no obstacles, no special favours", resulting in a situation that regulations equally apply across all types of institutions.

The International Islamic Fiqh Academy

Fiqh is the Arabic word used to indicate the understanding or interpretation of *Sharia'a* and is generally used to represent the opinion of scholars trained in Islamic jurisprudence. Based in Jeddah, the International Islamic Fiqh Academy was established to provide a uniform view of the permissibility of Islamic financial products. Although individual scholars still have different views on the acceptability of individual transactions, the academy's rulings are well respected by the majority of scholars and *Sharia'a* supervisory board members.

Islamic Development Bank

The Islamic Development Bank (IDB) became operational in 1975 and is based in Jeddah, with the remit to organise funding for projects in member countries. The IDB raises funds from other Islamic institutions to finance the projects, and often works closely together with development assistance agencies such as the World Bank.

Islamic Financial Services Board

The Islamic Financial Services Board (IFSB) was established in Malaysia in 2002 and advises regulators on how Islamic financial institutions should be managed. The IFSB provides guidelines for capital adequacy, risk management and corporate governance for Islamic financial institutions, which regulators can adopt. The financial regulators in Malaysia and Bahrain, for instance, have largely adopted the capital adequacy guidelines for Islamic banks.

IFSB members are global regulators and other market participants, and new guidelines and best practices are developed continuously.

Accounting and Auditing Organization for Islamic Financial Institutions

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is based in Bahrain and is responsible for the development of accounting, auditing and *Sharia'a* standards. The AAOIFI standards are largely based on the IFRS and prescribe additional guidelines for Islamic financial institutions where the IFRS do not sufficiently reflect the specifics of Islamic finance.

AAOIFI standards are mandatory in some countries and are used in others as guidelines. Western Islamic financial institutions, however, are generally obliged to apply the IFRS and can chose to also present their financial reports in accordance with AAOIFI standards, but this is on a voluntary basis.

International Islamic Financial Market

The International Islamic Financial Market (IIFM) was established in Bahrain with the support of the central banks of Bahrain, Brunei, Indonesia, Sudan and the IDB. The IIFM's mandate is to take part in the establishment, development, self-regulation and promotion of an Islamic capital and money market. The IIFM is working on initiatives with the international Swaps and Derivatives Association and the International Capital Market Association to develop Islamic financial master agreements and on standardisation of contracts within the industry.

International Islamic Liquidity Management

The International Islamic Liquidity Management Corporation (IILM) is an international institution established by central banks, monetary authorities and multilateral organisations. Its objective is to create and issue short-term *Sharia'a* compliant financial instruments to facilitate effective cross-border Islamic liquidity management.

13.2 SOCIALLY RESPONSIBLE INVESTMENTS AND MICRO-FINANCE

Socially responsible investing and micro-finance fit very well within the Islamic finance framework due to their focus on social responsibility and wealth distribution.

Socially Responsible Investments

Socially responsible investing, also known as sustainable or ethical investing, encompasses an investment strategy that seeks to maximise both financial return and socially responsible or ethical behaviour. Faith and conscience are probably the most important factors for people in making ethical investment decisions, and socially responsible investors generally favour investments that promote environmental stewardship, consumer protection, human rights and diversity. In addition, some investors actively avoid investing in any businesses that are involved in alcohol, tobacco, gambling, and weaponry and defence. Due to the prohibitions in *Sharia'a*, Islamic investments avoid the following industries:

- **Conventional banking and insurance**. Conventional banking and insurance are associated with interest and are therefore not permissible.
- **Alcohol and alcohol production**. This includes any distilling, marketing and sales activities.
- **Pork-related products and non-compliant food production**. Non-compliant food production covers everything that is not prepared in a *halal* way and covers, among others, meat that is not slaughtered in an acceptable fashion.
- **Gambling**. This covers casinos and betting shops, but also bingo halls and online betting.
- **Tobacco**. As with alcohol, this includes the production, marketing and sale of tobacco and associated products.
- **Adult entertainment**. Any activity associated with adult entertainment, including escort services, brothels and movies with explicit sexual content.
- **Weapons, arms and defence manufacturing**.

In addition, highly leveraged investments are avoided since these generally involve an element of interest income or payment.

Besides the prohibitions on certain industries, interest, gambling and uncertainty, there are other elements that make *Sharia'a* investing fit well with ethical investments. *Sharia'a* acknowledges the right of an individual to create wealth, but discourages hoarding, monopolistic activities and excessive materialism. In addition, *Sharia'a* encourages social justices without hampering entrepreneurship.

Although the industries individual investors wish to avoid will depend on their personal preference and view on ethical investments, the principles of *Sharia'a* generally sit very well with non-Muslim investors seeking socially responsible investment opportunities and offer a viable alternative to other opportunities available in the market.

Micro-finance

By its nature, Islamic finance is very suitable for micro-financing type projects. The investments are typically in a tangible business venue and have a high level of social responsibility attached to them.

There are a wide range of structures in Islamic finance that lend themselves to micro-finance initiatives, with the partnership contracts such as *musharaka* and *mudaraba* potentially the most suitable. Micro-financiers tend to have a very close relationship with their clients, which makes a partnership ultimately viable. The bank will not only supply money, but also expertise related to the setting up and successful running of a company. It is highly likely that the client will initially only put in expertise and will take his profit share. However, from experience with conventional micro-finance, it appears that entrepreneurs are likely to want to obtain full ownership over their business, which could become a feature of the contract. Looking at a $100 investment, a suggested structure could be as follows:

- The bank invests $100 and receives 40% of the profit for its input of both capital and expertise.
- The bank holds 20% of the profit in a savings account, which can be used as a buffer for unforeseen circumstances or to purchase units in the partnership from the bank.
- Forty per cent of the profit is paid directly to the entrepreneur.

The advantage of this is that it provides a form of security to the entrepreneur and encourages savings to be built up. The entrepreneur should, however, be free to use other funds (e.g. excess profits) to repurchase units.

In the Middle East and Asia entrepreneurial loans on this scale are often granted on an informal basis by small groups of friends, neighbours and family. The intensive nature of micro-finance, in combination with the fact that clients typically are not deemed creditworthy and the subsequent additional capital charge, does not necessarily make micro-finance a viable business proposition to large banks. On the other hand, however, it should not be overlooked that the peer pressure on lenders as well as their motivation is extremely high and that the default rates are negligible, which makes it an attractive proposition even in spite of the small ticket sizes.

There is, however, a notable lag between the perceived and the actual demand for *Sharia'a* compliant micro-finance,[1] which is mainly due to two reasons. Although the

[1] https://responsiblefinanceforum.org/publications/toward-inclusive-islamic-finance/.

purpose of micro-finance is the development of a business, it needs to be acknowledged that the loan proceeds are, more often than not, also used for other purposes such as to meet household expenses. *Murabaha* or *musharaka* transactions do not allow for this in the same way as straightforward conventional loans where the recipient has all the funds at their disposal. The transaction structures currently offered in micro-finance are, therefore, typically not fit for purpose.

The majority of micro-finance providers tend to charge more for *Sharia'a* compliant transactions than for conventional loans of the same size and structure. Clients of micro-finance institutions are generally poor and do not have the luxury of being able to pay more to meet their religious beliefs and thus either borrow the money against interest or forgo taking out a loan completely.

13.3 THE CASE FOR LIBOR

The use of the London Interbank Offer Rate as a benchmark for the pricing of Islamic financial transactions is often received with scepticism, but still widely used in the absence of an alternative Islamic benchmark. A few alternatives have been reviewed, but none holds up like LIBOR as a determinant of cost of funds, even though banks are at the time of writing paying over the LIBOR rate due to the absence of available liquidity in the market. Desirable or not, there are a few strong reasons why LIBOR is still the benchmark of choice:

- **Availability of alternatives**. So far no viable alternative to LIBOR has been found that provides the same economic result of representing the cost of capital or cost of funds.
- **Incorporation of economic circumstances**. LIBOR as a measure of cost of funds incorporates the current economic climate as well as the growth expectation of the economy.

In addition, the majority of scholars are of the view that as long as the transaction fulfils all the requirements of *Sharia'a*, using LIB0OR as a benchmark to determine the profit of the underlying transaction is permissible. It does not render the transaction invalid since the transaction itself does not contain an interest element. Whether one is for or against, for now it remains the most viable benchmark for determining the cost of funds.

CHAPTER 14

Capital Adequacy Concerns

Since the Islamic financial industry is young and the balance sheet size of the average Islamic bank is still relatively small, issues associated with the calculation of regulatory capital are in part similar to those faced by small, locally operating, conventional European and North American banks. However, because of the transaction structures employed, Islamic banks may face higher charges for regulatory capital, particularly in relation to the profit sharing investment accounts.[1]

For conventional banks, part of regulatory capital is absorbed by interest rate risk in the banking book. The absence of interest in Islamic finance means that Islamic banks are not subject to interest rate risk, but instead face rate of return risk, which is in some ways analogous to "interest rate risk in the banking book". Islamic banks are not subject to lower levels of risk and subsequently regulatory capital than conventional banks.

Similarly to conventional financial institutions, Islamic banks incur liquidity, credit, settlement, leverage, operational and business risk. Liquidity risk for Islamic banks is more difficult to manage and more expensive than for conventional banks due to the absence of liquid and accepted primary liquidity instruments (i.e. certificates of deposit, commercial paper and Treasury bills). Government securities such as Treasury bonds and gilts as well as eurobonds and domestic bonds are not permissible, and although few instruments such as the Bahraini government 90-day *sukuk al salam*, which is a type of non-negotiable Treasury bill, are available, they are still limited. In addition, as noted in Chapter 11, Islamic banks also incur risks that are not common in conventional banks, such as fiduciary risk, displaced commercial risk and rate of return risk.

14.1 CHALLENGES WITHIN THE BASEL CAPITAL ADEQUACY FRAMEWORK

The Islamic banking sector faces a number of generic challenges with the implementation of the Basel capital adequacy framework.

[1] Basel Committee of Banking Supervision (2006) *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, June. Basel: Bank for International Settlements.

Balance Sheet Size and Loss Data History

Although the Islamic financial industry has grown substantially over the past decade, it remains small when compared to the overall financial sector. Indeed, the size of an individual Islamic bank is typically not large enough to justify the investment required for the advanced risk measurement approaches. As mentioned earlier, this is not a problem that is exclusive to Islamic banks, but the relative small size of the Islamic financial industry makes it more difficult to lobby for changes in global regulatory policy, such as the Basel capital accords.

The absence of significant amounts of loss data is one of the problems that hinder smaller sized banks that need to comply with Basel II and III. Islamic banks – most of which have only recently been established and have not yet seen a complete economic cycle – do not have a long enough history and hence cannot meet the Basel II requirement for 7 years of loss data. Although this is a problem for all new smaller banks, conventional European and North American banks have the opportunity to join one of the established data consortia – such as the Pan European Credit Data Consortium or the North American Loan Loss Database – to gain access to a larger data set with a longer history of loss data. The IFSB is currently working on a similar database for Islamic banks, but it is not yet available.

Equity Treatment

Within the Basel regulations, significant equity positions are treated separately from other (i.e. debt) financing. The underlying principle of the Basel Committee on Banking Supervision's (BCBS) stance on equity holding is that a bank is exposed to higher risk when ownership and the provision of debt funding are in the same hands. This causes a challenge for Islamic banks, because *mudaraba* and *musharaka* financing assets that are based on profit-sharing principles may be deemed to be similar to holding equity positions in the banking book from a regulatory perspective.

As a result of the introduction of the new framework, banks that hold equity positions (e.g. *mudaraba* and *musharaka* assets) may be heavily penalised in terms of regulatory capital. Specifically, under the Basel II standards on capital adequacy, transactions that are based on profit-sharing and loss-bearing modes carry a very high risk weight of 400%. The IFSB guidelines on capital adequacy[2] translate the Basel II framework to specific Islamic financial products, and incorporate the same view on equity type positions. Alternatively, however, the IFSB standard includes risk weights based on the "supervisory slotting" criteria in Basel II for specialised financing, which can be applied to *mudaraba* and *musharaka* assets at the discretion of the supervisor. The treatment of the individual transaction types for capital adequacy is outlined in more detail in the next section.

14.2 IFSB CAPITAL ADEQUACY STANDARDS

The IFSB capital adequacy standards deals with all types of products an Islamic bank offers. Most current IFSB standards only apply to Islamic financial institutions solely offering Islamic financial services and explicitly exclude insurance institutions. However, separate

[2]Islamic Financial Services Board (2005) *Capital Adequacy Standard for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services*, December.

standards for governance and capital adequacy for insurance companies are being developed and a standard for business conduct, which is currently being finalised, will apply to both financial services and insurance companies.

The Definition of Capital

The IFSB guidelines define capital as consisting of Tier 1 and Tier 2 capital, made up of the following components:

1. **Core capital** (basic equity or Tier 1 capital). This consists of equity capital, disclosed reserves, retained profit, unrealised net gains from fair valuation of equity and minority interests in subsidiaries. Equity capital consists of issued and fully paid-up ordinary shares. Core capital should comprise at least 50% of the bank's total capital base. The shareholders' portion of the profit equalisation reserve is technically a category of retained profit, and would therefore classify as Tier 1 capital.[3]
2. **Supplementary capital** (Tier 2). This consists of other capital elements that may be considered by the regulator:
   - **(a)** Current interim retained profits.
   - **(b)** Revaluation reserves arising from the revaluation of fixed assets and real estate in line with changes in market values. Revaluation reserves have to be subject to a 55% discount to historic book value to reflect concerns about market volatility and tax charges in the event of realised profits.
   - **(c)** Unrealised gains arising from fair valuing equities, subject to a discount factor of 55%.
3. **Deductions from capital**. These consist of goodwill, interim cumulative net losses, unrealised gross losses arising from fair valuation of equity securities and reciprocal cross-holdings of other banks' capital.

Contrary to the BCBS, the IFSB only recognises Tier 1 and Tier 2 capital.

Credit Risk Mitigation

Any credit risk attached to a transaction and its counterparty can be mitigated by applying a number of techniques, which can be summarised as follows:

- **Security deposit**. A refundable security deposit taken by the bank as a deposit prior to concluding the contract. This deposit will cover any opportunity cost incurred in the event that the client decides not to execute the contract. The security deposit only offers limited recourse, and any cost over and beyond the amount of the security deposit cannot be recovered.
- **Deposit**. Financial deposits held for the duration of the contract accrue to the investor if the client breaches the contract part way through.

[3] The investment account holder portion of these reserves does not qualify as capital due to the fact that it is not attributable to shareholders. Under the Basel II capital rules the shareholder portion could be classified as Tier 1 capital as it is a classification of retained earnings. It could, however, be considered more prudent to treat this portion of the reserve as Tier 2 capital due to lack of transparency in appropriations to the reserve. The investment risk reserve does not have a shareholder portion, and as such does not qualify as capital.

- **Third-party guarantees**. Guarantees provided by a third party to cover any claims in the event of a default. Guarantees can be limited in time and amount.
- **Assets pledged**. Assets pledged as collateral need to be *Sharia'a* compliant, fully owned and saleable. Any assets pledged only qualify as collateral if the pledge is legally enforceable.
- **Leased assets**. Any leased assets are owned by the bank and can be used to mitigate any risk.

Generally, collateral will reduce the risk of the bank and consequently reduces the capital charge a transaction attracts, although for capital adequacy purposes not all collateral is eligible for capital relief. Any unsecured portion of the transaction attracts the risk weight of the counterparty. Capital relief can be granted according to the following two approaches:

- **Simple approach**. In the simple approach, the bank substitutes the risk weight of the counterparty with the risk weight of the collateral, subject to a minimum risk weight of 20%. A 0% risk weight may be applied when the collateral is in cash on deposit in the same currency, or in the form of sovereign securities eligible for 0% risk weight and for which the market value is discounted by 20%.
- **Haircuts**. Both the original exposure and the collateral are adjusted by a haircut that is either defined by the supervisor or calculated internally.

Market Risk

Market risk represents the risk that the bank's position – whether on- or off-balance sheet – becomes impaired. The IFSB capital adequacy guidelines recognise three forms of market risk:

- **Equity position risk**. Equity exposures attract specific risk and general market risk. Specific risk attracts a capital charge of 8% of all long equity positions calculated on a mark to market basis. For highly liquid and diversified portfolios this may be reduced to 4%. The capital charge for general market risk is 8% of all long equity positions on a mark to market basis.
- **Foreign exchange risk**. This is the risk of impairment of an asset due to a deterioration in the exchange rate between the currency of the asset and the bank's base currency. The capital charge is 8% on the overall net position.
- **Commodities and inventory risk**. This is the risk associated with holding or taking long positions in commodities. The capital charge can be calculated using a maturity ladder approach or the simplified approach. In the maturity ladder approach the capital charge is based on the sum of the net position for each time band. Offsetting between time bands is permissible, subject to a surcharge. Any net position after offsetting attracts a capital charge of 15%. In the simplified approach, the net position in each commodity attracts a 15% capital charge to cater for directional risk plus an additional charge of 3% of the gross positions to cater for basis risk.

Operational Risk

Operational risk is defined as the risk of losses resulting from inadequate or failed internal processes, people and systems or from external events. Under the IFSB capital adequacy guidelines this not only includes legal risk, but also *Sharia'a* compliance risk. In line with the Basel II accord, operational risk excludes strategic and reputational risks.

The IFSB guidelines allow for either the basic indicator approach or standardised approach as defined in Basel II. Under the basic indicator approach, the capital charge is calculated as 15% of annual average gross income averaged over the previous 3 years. Under the standardised approach the percentage varies from 12% to 18%, depending on the line of business. However, the lines of business as defined in Basel II may not be directly applicable to Islamic banks, and it is therefore suggested to apply the basic indicator approach for the time being.

Capital Adequacy for Different Transaction Types

For each of the different transaction types outlined in Chapter 3 the capital adequacy treatment is defined by the IFSB in its capital adequacy standard. Summarised, the following treatments apply:

- ***Salam***. The risk weight in a *salam* transaction is based on the counterparty or guarantor[4] rating, with unrated counterparties attracting a risk weight of 100%. The market risk on the commodity is measured separately, by applying a maturity ladder approach in which the capital charge is dependent on the maturity of the transaction, or by applying the simplified approach in which the capital charge equals 15% of the net position plus 3% of the gross long plus short positions. If a parallel *salam* is in place to cover the commodity exposure, only the 3% charge is applied to cater for any potential losses in the event that the commodity cannot be delivered.
- ***Istisna***. The risk weight of an *istisna* transaction depends on the characteristics of the transaction. In both cases, the risk weight is initially based on the rating or the ultimate buyer.
  - **Full recourse *istisna* and *istisna* with parallel *istisna***. In this case, the bank has full recourse to the buyer of the asset. If no rating is available, the transaction will attract a 100% risk weight.
  - **Limited and non-recourse *istisna***. In this case, the bank has only limited or even no recourse to the ultimate buyer. If no rating is available, the risk weight will depend on the supervisory slotting approach for specialised financing. An additional 20% risk weight may need to be added to cater for the price risk to which the underlying contract is exposed.
  - ***Ijara***. Under an *ijara wa iqtina* or finance lease, the risk weight is based on the rating of the lessee since the residual value risk of the underlying asset is not borne by the bank. Under an operating lease, the bank is exposed to the credit risk of the lessee for payment of the rentals and market risk for the residual value.
  - ***Musharaka***. The risk weight of a *musharaka* transaction depends on the intent of the underlying transaction.
    - **Private commercial enterprises with an identifiable underlying asset** (i.e. for trading activities). The investor's exposure is in the first instance to the asset. In the event of default, the bank will be paid out of the proceeds of the sale of the asset. If the proceeds are below the original investment, the *sukuk* holder has an exposure to the counterparty for the residual. The risk weight is determined based on the market risk of the underlying asset.

[4] It is worth noting that in Islamic finance, guarantees cannot be bought or sold, but only provided free of charge.

  - **Private commercial enterprises to undertake a business venture**. In this type of transaction there is no identifiable underlying asset. The risk weight is based on the equity stake in the underlying venture, and as such this type of transaction is treated as an equity investment, resulting in a risk weight of 400%.
  - **Joint ownership of real estate or movable assets**. These transactions are typically structured as diminishing *musharaka.* The partnership is for a definite timescale, is not a going concern, and has an identifiable underlying asset (e.g. real estate, cars). The investor's initial exposure is to the asset. In the event of default, the bank will be paid out of the sales proceeds of the asset. If the proceeds are below the original investment, the bank has an exposure to the counterparty for the residual. The risk weight is dependent on the counterparty rating, with unrated counterparties attracting a 100% risk weight.
- ***Mudaraba***. Risk weight is based on the equity stake in the underlying asset, and as such this type of transaction is treated as an equity investment, resulting in a risk weight of 400%.

Any risk mitigants will be taken into consideration in the determination of the risk weight.

Capital Adequacy for *Sukuk*

The popularity of *sukuk* warrants some specific attention regarding their capital adequacy treatment. As defined in Section 3.4, *sukuk* are certificates of beneficial ownership rights in a pool of underlying assets, which allow for the underlying assets to be considered either as collateral (asset-backed *sukuk*) or not (asset-based *sukuk*). The impact of the Basel II rules and the derived IFSB capital adequacy standards on the *sukuk* portfolio is dependent on whether they are considered to be asset-backed or asset-based, and in addition on how the regulator views the instrument. This will differ for regions where the IFSB standards are followed and those where these are not taken into consideration.

The current capital adequacy standard only applies to *sukuk* purchased by the financial institution, not to *sukuk* originated, issued or serviced by the bank (i.e. securitisation exposures). Securitisation exposures are covered in a separate exposure draft.[5] The new IFSB exposure draft covers asset-based *sukuk*, which attract the risk weight of the obligor subject to any credit enhancement. Summarised, the following treatments apply.

Sukuk held as investment in the banking book

The treatment of the *sukuk* for capital adequacy purposes depends on the underlying transaction type and the counterparty rating:[6]

- ***Sukuk al salam***. Until delivery and sale of the asset, the risk weight in a *sukuk al salam* is based on the counterparty or guarantor rating. Unrated counterparties attract a 100% risk weight. Market risk does not apply as it is mitigated by the inclusion of a parallel *salam* contract, which is a *Sharia'a* compliant hedge.
- ***Sukuk al istisna***. Risk weight is based on the counterparty rating with unrated counterparties attracting a 100% risk weight. An additional 20% risk weight will be added to cater for the price risk to which the underlying contract is exposed.

[5] Islamic Financial Services Board (2007) *Capital Adequacy Requirements for Sukuk Securitisations and Real Estate Investments*, December.

[6] It should be noted that *salam, ijara* and *musharaka sukuk* are treated using the so-called "look-through" principle, which means that the exposure is to the underlying asset.

- ***Sukuk al ijara***. Under an *ijara wa iqtina* or finance lease, the risk weight is based on the rating of the lessee since the residual value risk of the underlying asset is not borne by the *sukuk* holders.[7]
- ***Sukuk al musharaka***. The risk weight of a *sukuk al musharaka* depends on the intent of the underlying transaction.
  - **Private commercial enterprises with an identifiable underlying asset** (i.e. for trading activities). The investor's exposure is in the first instance to the asset. In the event of default, the *sukuk* holder will be paid out of the sales proceeds of the asset. If the proceeds are below the original investment, the *sukuk* holder has an exposure to the counterparty for the residual. The risk weight is determined based on the market risk of the underlying asset.
  - **Private commercial enterprises to undertake a business venture**. In this type of transaction there is no identifiable underlying asset. The risk weight is based on the equity stake in the underlying venture, and as such this type of *sukuk* is treated as an equity investment, resulting in a risk weight of 400%.
  - **Joint ownership of real estate or movable assets**. These transactions are typically structured as diminishing *musharaka.* The partnership is for a definite timescale, is not a going concern, and has an identifiable underlying asset (e.g. real estate, cars). The investor's initial exposure is to the asset. In the event of default, the *sukuk* holder will be paid out of the sales proceeds of the asset. If the proceeds are below the original investment, the *sukuk* holder has an exposure to the counterparty for the residual. The risk weight is dependent on the counterparty rating, with unrated counterparties attracting a 100% risk weight.
- ***Sukuk al mudaraba***. Risk weight is based on the equity stake in the underlying asset, and as such this type of *sukuk* is treated as an equity investment, resulting in a risk weight of 400%.

Any risk mitigants will be taken into consideration in the determination of the risk weight.

Sukuk in the trading book

Sukuk held in the trading book is treated similarly to bond positions and attracts specific risk as well as general market risk. The provision for specific risk depends on the risk weight of the issue and the residual time to maturity, as outlined in Table 14.1.

TABLE 14.1 Risk weight for *sukuk* in the trading book (IFSB)

Counterparty type	Residual maturity	Risk weight (%)
Government		0.00
Investment grade	6 months or less	0.25
	6–24 months	1.00
	Exceeding 24 months	1.60
Others		8

[7] Under an operating lease, the *sukuk* holders own the asset at the end of the lease, which results in added uncertainty regarding the value of the *sukuk* at maturity. This is often resolved by the presence of a purchase undertaking from the lessor to purchase the asset at a pre-agreed price. This has attracted considerable resistance from a group of scholars who take the stance that the purchase price should be the market value at time of sale. This debate is currently ongoing.

The provision for general market risk depends on the residual time to maturity or to the next repricing date, and varies on a sliding scale from 0% for residual terms of less than 1 month to 6% for residual maturities of over 20 years.

Sukuk origination

Sukuk originated by the bank are treated in line with the requirements for securitisation. If the ownership of the underlying asset is transferred to the holders, the Islamic financial institution may benefit from reduced capital requirements provided that criteria regarding risk transfer and control over the asset are satisfied. In the event the financial institution provides support for the issue, holds a part of the issue, or provides liquidity facilities or credit enhancements, partial capital relief is possible as follows:

- If the originator provides implicit support, the originator must hold capital against all of the exposure associated with the securitisation position.
- If the originator holds part of the issue, the originator is required to deduct any holding from capital.
- Liquidity facilities attract a risk weight of 20% for maturities lower than 1 year and 50% for maturities exceeding 1 year. At the discretion of the supervisor, servicer cash advance facilities can be assigned 0% risk weight.
- If the originator holds a small equity share in the underlying pool of securitised assets, the originator's residual equity share is treated as a deduction from capital.

14.3 CAPITAL ADEQUACY FOR ISLAMIC BANKS AROUND THE WORLD

Whether or not the IFSB capital adequacy guidelines have implications for individual banks is mainly associated with their country of incorporation, and it largely depends on the regulatory system. In those countries where Islamic banks are regulated under a separate framework the IFSB guidelines often apply in part or in full. In countries where Islamic banks are regulated under the same framework as conventional banks, however, this is not necessarily the case, and the Basel II guidelines may be applied instead. Although this may result in some transaction types attracting a higher risk weight and hence a higher capital requirement than equivalent products in conventional finance, regulators are often actively engaged with the banks – Islamic and conventional – to ensure a level playing field exists for the banks in their jurisdiction.

Malaysia and Bahrain, for instance, have dual banking systems and regulate conventional and Islamic banks separately. For Islamic banks, they follow the IFSB rules reasonably closely. The UK, on the other hand, does not have a dual banking system and the FSA authorises and regulates Islamic banks within the same framework as conventional banks. In the European Union, the Basel II and III frameworks are been incorporated into the law by means of the Capital Requirements Directive IV, which applies to all member states.

For Islamic financial institutions the main challenge with the new capital adequacy regulations is twofold. On the one hand, profit-sharing investment accounts are treated as an equity-type transaction and, therefore, attract higher capital requirements. On the other hand, there is a need to hold an increasingly higher amount of high-quality liquid assets. Due to the relative short history and small size of the Islamic financial industry, these types of assets are less developed, often of shorter maturity, and the overall market is shallow in comparison with the conventional markets.

14.4 EXPECTED FUTURE DEVELOPMENTS IN CAPITAL ADEQUACY

The IFSB has worked closely with the BCBS in the past and will continue to work with it to seek regulatory improvements for Islamic banks in the future. However, no changes to the Basel accord's regulatory capital treatment of *mudaraba* and *musharaka* transactions are expected. The structures of *mudaraba* and *musharaka* transactions are capital intensive – and are therefore more expensive from the bank's perspective. Consequently, Islamic banks have to take the cost of capital into consideration when they are advising clients and when they are developing new transaction types in the future. In fact, one of the questions that must be addressed as part of the advisory function of an Islamic bank is whether the client's interest can be served equally well with structures separate from the *mudaraba* and *musharaka. Mudaraba* and *musharaka* transactions give the holder a share in the underlying asset, which could potentially become impaired. The holder will have no claim against this impairment and as a result the equity treatment is justifiable. As a result, the *mudaraba* and *musharaka* transaction types and the *sukuk* based on these transaction types will be a disadvantage to clients since the additional cost of capital will be passed on to the client.

The treatment of *sukuk*, on the other hand, is broadly comparable to conventional bonds, due to which Islamic banks holding *sukuk* are, depending on the underlying transaction type, neither advantaged nor disadvantaged compared to bond holders. If the underlying transaction type is a *mudaraba* or *musharaka*, however, the equity treatment equally applies, resulting in a higher capital charge. Contrary to bonds, the holder of an asset-based *sukuk* is the owner of the underlying asset, which behaves like collateral. However, in the majority of jurisdictions the law does not give effective recourse to the underlying assets in these transactions. Consequently, the exposure of the *sukuk* holder is to the obligor and not the asset. Asset-based *sukuk*, on the other hand, are similar to bonds and are not collateralised, in which case the holder has direct recourse to the obligor. As a result, in the majority of international jurisdictions, a level playing field is created between conventional bond holders and *sukuk* holders.

CHAPTER 15

How to Value a Bank[1]

The requirement to measure current and future (expected) profitability and thus the ability to determine the value of a firm is not just a concept of recent years, but rather one that has evolved over the past two and a half centuries. As early as 1776, Adam Smith describes, in his epic tome *The Wealth of Nations*, how the owner of capital will always invest in those projects that provide a return over and above his cost of capital, and will refrain from investing in anything that does not at least meet his cost. In addition, his return should compensate for any risk he takes.

In the late nineteenth and early twentieth centuries, the ownership structure of companies started to change, and management and ownership of the corporation became increasingly segregated. This, combined with the general increase in company size, resulted in a situation where the ability to provide an accurate valuation for a company became more and more important.

Although the management often owns shares in the company, the average shareholder, or owner of the capital, has only limited control over the management of the firm he invests in, especially when it comes to large companies. Beyond the shareholders' annual general meeting, his control is limited to voting with his feet: if he is not convinced the company is run very well, the only choice he has is to sell his shares. Having said that, institutional investors are becoming more vocal when it comes to company performance and, given that their shareholding is large enough, they can influence the company's direction.

The shareholder's decision to invest in a share or not will largely depend on his estimate of the company value compared to the share price, and it therefore remains important for any investor to be able to independently determine the value of a firm as part of his investment decision-making process. The share price of a company factors in the estimation of the value of the company, as well as any expectations regarding the profitability for the period since the last results, and is generally accepted as the purest market indicator of the value of the firm. However, it is subject to market sentiment and, although it is a good benchmark, the share price hardly classifies as an independent valuation.

[1]An earlier version of this chapter, focusing solely on the valuation of banks, was published in Timewell, S. and Caplen, B. (eds) (2008) *How to Run a Bank*. London: Financial Times Business.

All is not lost, however. Over the past few decades, a multitude of different valuation tools have been invented and subjected to extensive research. Some were discarded as soon as they started to appear, but others have shown a remarkable resilience. Interestingly enough, those models that have been around for a long time seem to hold up to scrutiny best. This chapter identifies the components that need to be considered in a good valuation model and which models are easily applicable to value a company from a third-party perspective. Banks are a special class of companies and are generally excluded when valuing companies, and the possibility of applying a valuation model to them is reviewed at the end of this chapter.

15.1 THE COMPONENTS

Any model that is used as a tool for company valuation will have to incorporate returns, capital and cost of capital. Interlinked with these three components are sustainable growth and risk. Each of these components is described in further detail in what follows:

Growth

In order for expected future growth to have any impact on the valuation of a firm, it needs to be sustainable over prolonged periods of time. The sustainable growth rate is generally measured by multiplying the proportion of income the firm retains for reinvestment by the return on equity. The underlying assumptions are as follows:

1. **Speed of growth**. A firm is managed in order to grow as fast as possible.
2. **Capital levels**. There is no requirement to issue new equity in order to sustain growth.
3. **Capital structure**. Growth can be sustained while maintaining the current capital structure and dividend policies.

Risk

Running a business is associated with taking a view on a particular development in the market or an industry and is inherently incorporating a risk in some shape or form. Unfortunately, there is no such thing as a company that does not run any risk at all, and an equity investment could result in total loss of the capital provided. Investors are only interested in higher-risk assets if they fit within their risk profile, although the fact that the return needs to reflect the additional risk they are taking is of equal importance.

Returns

Based on the generally accepted notion that a company's value is closely linked to the net present value of the potential cash distributions it is expected to generate, earnings are the most logical measure of returns. Earnings have their own limitations as a result of the application of realisation and matching principles in accounting, which result in recognition of earnings in different periods than the receipt or disbursement of the underlying cash flows.

However, even after taking these limitations into account, current earnings still provide the strongest indication of the profitability of a firm. Future earnings estimates need to incorporate micro-economics of the firm as well as competitive interaction of the firm with firms in the same industry.

Capital and its Cost

The capital of a firm consists of equity capital and, where applicable, long- and short-term debt. The cost of capital is one of the most critical parts of any valuation model, and represents the opportunity cost of the investment in the firm's existing assets. The cost of capital needs to reflect the perceived risk of the firm.

Differences in risk levels and the potential availability of collateral result in a situation where equity and debt require a different return. Lower-risk debt logically attracts a lower return then higher-risk debt, which in turn attracts a lower return than equity. For valuation purposes, the weighted average cost of capital is generally applied to provide a reasonably accurate approximation to determine the total cost of capital of a firm.

15.2 THE MODELS

The two main streams of valuation models most commonly used by analysts are residual income and discounted cash flow models, each with their own advantages and disadvantages.

Discounted cash flow models determine the value of a company as the present value of all expected future cash distributions discounted at the opportunity cost of capital. They do not, however, incorporate any upside the company may have generated by reinvesting part of its profits back into the company, which may provide an even higher return going forward.

Residual income models calculate the value of a firm at a certain point in time as the book value of capital at that point in time plus the expected future earnings over and above the cost of capital for the indefinite future. However, given the competitive nature of most markets, any excess earnings have a tendency to revert to the mean over a period of three years and do not need to be forecast beyond this period. Instead, they can be substituted by a continuing value for the going concern, which makes the model infinitely more useful from a practical perspective. Residual income models have been around for a long time and have certainly proved their worth when it comes to general accuracy and reliability of results. In addition, these models can be applied using publicly available accounting data and do not require too many assumptions, which makes them highly acceptable for practical application.

Does it Work?

The proof, as the saying goes, is in the pudding. How accurate is the model in determining the value? Given an efficient market where all publicly available information and future expectations are reflected in the share price and assuming rational investor behaviour, it would be safe to state that the resulting value from the residual income model divided by the number of shares should be the same as the current share price, or at least within an acceptable variation.

Frankel and Lee[2] have executed extensive testing on a large population of firms to prove this and have found that the residual income model does, within reasonable limits, provide a very accurate result. They have, however, specifically excluded financial institutions from their research.

15.3 THE SPECIAL CASE OF BANKS

What is it about banks that makes most researchers run a mile, and why do they remain inherently difficult to value? For starters, banks run additional risks, such as liquidity and settlement risk, which do not exist in other firms. In addition, banks have the funds of depositors at their disposal that are applied to their day-to-day operations. Even though this results in the situation where clients are major liability holders, these funds are not considered to be part of the capital base of a bank, and should rather be viewed as a key source to fund loan and investment operations. Hence, for valuation purposes, only equity capital and reserves should be taken into consideration as capital when valuing a bank. In addition, the risks a bank runs are different in nature from those of other organisations.

Although all these issues make banks more difficult to value, research[3] has proved that, given the right application of the components, the residual income model produces a reasonably accurate value compared to the market price for banks as well as for other types of organisations. So, perhaps banks are not really that different when it comes to valuing them.

15.4 THE SPECIAL CASE OF ISLAMIC BANKS

Islamic banks generally have similar issues to those outlined for conventional banks, and it should therefore, in principle, be possible to value them using the same model. However, due to the limited availability (or in some cases complete absence) of information required, such as the market and risk-free rates of return, as well as analyst consensus forecast data for Islamic banks, some of the elements of the residual income model need to be substituted by estimations. The issues associated with the valuation of Islamic banks can be summarised as follows:

- **Market efficiency**. Islamic banks operate in markets that are, at best, weak-form efficient, and where the market rate of return is less reliable.
- **Market prices**. For Islamic banks listed on a stock exchange, the prices are not considered to provide an accurate representation of the value, and the market is highly illiquid.
- **Data availability**. Islamic banks are generally not listed on a stock exchange and are not necessarily required to publish their annual reports.

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[2] Frankel, R. and Lee, M.C. (1998) Accounting valuation, market expectation, and cross-sectional stock returns, *Journal of Accounting and Economics*, 25, 283–319.

[3] Schoon, N. (2005) *Residual Income Models and the Valuation of Conventional and Islamic Banks*. Doctoral thesis, University of Surrey.

- **Definition of capital**. Unrestricted investment accounts have characteristics of share capital and should on that basis be included in capital. On the other hand, they typically have stable returns and capital is informally guaranteed, which would imply they should be treated as deposits in conventional banks.
- **Lunar or solar calendar**. The length of the financial year may differ where the financial year is based on the lunar calendar.

The same research has shown that with careful estimation of the values, it is possible to value Islamic banks by applying the residual model and to compare the valuation of Islamic banks with those of conventional banks.

15.5 CAN A BANK BE VALUED?

The residual income model may be old-fashioned and, while it may not have a lot of bells and whistles, it is both in practice and in theory the most widely used and tested model to determine the value of any firm. It applies publicly available data, is easy to use, has a good degree of accuracy and can be applied to any industry. Using the right methodology to estimate growth, risk and return with a reasonable degree of accuracy over a period of approximately three years, combined with a continuing value for the going concern, the residual income model not only can provide a reasonable estimate of the value of a firm, but equally can be applied to banks.

CHAPTER 16

The Future

The principles underlying Islamic finance such as profit and loss sharing, justness in exchange, transparency and the prohibition of usury go back a long time, and are not just associated with Islamic finance. Early philosophers debated the same issues, and during the nineteenth century the UK implemented an anti-usury law for a while. Islamic finance has remarkable similarities with what is known as merchant banking, a way of doing business that has come to be seen as old fashioned and conservative. Given the 2007 and 2008 market turmoil, banks may well have to reconsider their approach to lending and take some of the more old-fashioned principles such as "do not lend to those who cannot afford the payment" into consideration again.

Faith-based banking is not a new phenomenon, but rather one that has been around for a long time. Every religion has an impact on society, and many religious beliefs have found themselves incorporated into the banking system for at least some time during the history of finance. In addition, it does not just appeal to those of a particular religion. The application of principles of fairness and justness is attractive to a large and diverse investor and depositor base, regardless of religion. On the other hand, faith-based banks are typically small compared to their conventional counterparts, with only a fraction of the balance sheet size. Although the interest in faith-based and socially responsible investing exists, it is expected to remain a subset within the conventional mainstream financial markets.

Islamic finance is undoubtedly experiencing remarkable growth in Muslim countries and is attracting increasingly significant interest in the West. At the time of writing, the UK's FSA has licensed four Islamic banks, one investment company and one insurance company, and interest in Islamic financial solutions is generally high.

Over the past few years the UK government has made amendments to tax legislation in successive Finance Acts to allow for Islamic finance products to be treated in a similar fashion for tax purposes as conventional products. However, some issues still exist such as double stamp duty land tax for properties that are subject to *sukuk*. In the 2008 Budget, further measures to avoid double taxation for alternative investments were announced that were incorporated in the 2009 Finance Act, opening up opportunities for banks and corporates to issue *sukuk* in the UK.

At present, however, there are no marketable, liquid instruments available to Islamic financial institutions, which puts them at a disadvantage in comparison to the Islamic windows of conventional banks when it comes to accessing and managing liquidity in the market at any time and particularly at times of market stress.

In short, while knowledge is improving and coverage is increasing, there is still much to do with regard to tax and regulation before Islamic finance becomes more comparable to conventional finance in terms of scope and depth.

Although the Islamic finance transactions all have exotic names and they take *Sharia'a* principles into consideration, their underlying structures are not so far away from conventional banking structures. When applying the different structures to modern finance, however, it needs to be ensured that any transaction is compliant with *Sharia'a* and is associated with an underlying asset.

The Islamic financial market is relatively young and growing at an incredible pace, which is, at least in part, to do with the large inflows of money into the Middle Eastern countries. Not only do they have funds available for investment, they also heavily invest in infrastructure and other projects in their economies.

The risks Islamic banks face, although partly different, are in many respects similar to conventional financial institutions. As long as Islamic banks are largely incorporated in emerging markets, their risk levels are likely to be higher than those of the overall conventional financial industry. Increasing sophistication and incorporation of banks in developed jurisdictions are likely to lead to a situation where the risk levels of Islamic and conventional banks are roughly similar.

With around 15–20% annual growth over the past decades, and a similar estimated growth rate for the coming years, it is clear that the Islamic financial industry, or at least the principles it represents, is here to stay. However, although growing, the Islamic financial industry still has a way to go. The banks are relatively young and most have not yet gone through a full economic cycle. *Sharia'a* compliance differs by country and can even differ between banks. Work has started on standardisation, which, although still a way off, will eventually result in a more efficient industry and a more level playing field. In addition, standardisation will lead to a reduced cost base across the industry. The demand for Islamic financial products does not just come from Muslims. The underlying principles attract a wide range of investors and parties looking for financing. The pricing, however, will need to be competitive in order to ensure continuing demand.

Demand is increasing, but so is the supply, which results in a more competitive environment. Islamic banks are competing not only with each other, but also with conventional banks and their Islamic windows and subsidiaries. Equally important, an improved regulatory environment will assist the banks operating in the Islamic financial industry to achieve stability and give them the chance not only to get through the current rocky economical environment, but also to achieve a long-term sustainable Islamic financial industry that coexists alongside the conventional financial industry.

Most recently, a trend to remove "Islamic" from brand names has been observed, which, in part, is the result of a desire to offer an inclusive service aimed not only at Muslims. In addition, an alignment with socially responsible and ethical finance has been observed, which appears to be gaining traction. The nature of ethical finance is, after all, very close to the principles of *Sharia'a*. It is certainly a welcome trend, but only time can tell how it will progress.

Glossary

Unlike the specific definitions provided in the relevant chapters, this glossary provides an overview of all Arabic definitions, accompanied by a brief description. Additional definitions not necessarily included in the text can also be found in this list.

Aq'd Contract or transaction that is executed between two or more parties for mutual benefit.

Arbun Down payment on a sales contract in which the buyer has not paid the full price or taken possession of the goods. Deposit is non-refundable. Buyer can opt to cancel the contract.

Fatwa Declaration in Islam provided by an Islamic legal specialist.

Fiqh Understanding of the (Islamic) law.

Fiqh al muamalat Islamic commercial jurisprudence.

Gharar To deceive, cheat, delude, lure, entice and create uncertainty. Also defined as "the sale of probable items whose existence or characteristics are not certain".

Hadith Narrative record of the sayings and actions of the Prophet.

Halal Permitted.

Haram Prohibited.

Hawala Transfer of money from one person to another. Recipient may levy administration charges, which should not be proportionate to the sum of money.

Ijara Bilateral contract allowing the sale of the usufruct for a specified rent and a specified period. A lease.

Ijara wa iqtina Lease with transfer of ownership at the end of the lease period or finance lease. Variations exist such as the *ijara muntahia bittamleek*, which is a finance lease structure in which the lessee has the option to exercise his right to purchase the asset at any time during the lease period.

Istisna Sale with deferred delivery. Payment can be in a lump sum in advance or progressively in accordance with progress made. Delivery of good is deferred.

Kafala Guarantee or third-party obligation.

Muamalat Activities not explicitly governed by *Sharia'a* with respect to worship.

Mudaraba Partnership contract. Subset of *musharaka*.

Mudarib Party in a contract providing knowledge and skills.

Murabaha Deferred payment sale or instalment credit sale.

Musharaka Partnership contract.

Parallel salam Parallel contract to an existing *salam* contract to hedge the *salam* position. Often outright sale (with deferred delivery), but could be arranged with payment at a later date using a letter of credit or guarantee to secure the payment.

Qard Loan.

Qard al hassan Interest-free loan. Often used in charitable context. Recipient has the moral obligation to repay the principal.

Quran Book of God.

Rab al mal Party in a contract providing finances.

Rahn Collateral pledged.

Re-takaful Islamic reinsurance undertaken to reduce excessive concentration risks.

Riba Interest.

Riba al fadl Excess compensation without any consideration (e.g. monies passing between the parties) resulting from an exchange of sale of goods.

Riba al naseeyah Excess resulting from predetermined interest a lender receives over and above the principal amount he has lent out. Primary form of *riba*. It is the addition of a premium paid to the lender in return for waiting for his money (time value of money).

Sadaqat Voluntary charitable contribution, guided by the goodwill of the donor.

Salam Sale with deferred delivery. Payment is paid in full and upfront, delivery of good is deferred.

Sarf Purchase and sale of currency. Only allowed at spot for equal value.

Sharia'a Ethical framework of Islam, often referred to as Islamic law.

Sukuk Plural of *sakk*. Represents partial ownership in assets. *Sukuk* are technically neither shares nor bonds but have characteristics of both. Profit is based on the performance of the underlying assets or projects.

Sunnah Words or acts of the Prophet.

Tabarru' Non-commercial donation or gift. Any benefit that is given by a person to another without getting anything in exchange.

Takaful Islamic insurance comparable to mutual insurance.

Tawarruq Purchase of a commodity that is immediately sold on to a third party (usually using the original seller as agent) for cash. A form of reverse *murabaha*.

Wa'd Unilateral promise. Undertaking or promise by one party to do or not do something in the future.

Wakala Agency contract. Often applied to brokerage, asset management and investment activities.

Wakil Agent in a *wakala* or agency contract.

Zakat Obligatory donation to charity for those who can afford it.

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