Islamic Finance and Law

Theory and Practice in a Globalized World

Maha-Hanaan Balala

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To the Almighty:
He who has sustained me every day of this
undertaking, and continues to do so.

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PREFACE

This book considers legal aspects of Islamic finance within the context of a securitisation transaction; and the viability of an Islamic finance securitisation within the context of global finance. The 'principle-centric' approach adopted emphasises enquiry into the principles that govern Islamic law of contract and finance and de-emphasise adherence to the current rules. It suggests that whilst the principles remain constant (the general framework), the rules may change and are not 'carved in stone'.

In recognition of the equitable and social aspect of the law – at the root of its legal and judicial aspect – this book undertakes more than just presenting a synthesis of literature on legal aspects of Islamic finance and their comparable equivalent under the common law. It stresses the need for fresh interpretation of the principles examined herein and their contextual application. It goes further to re-examine from fresh angles the textual sources on *gharar*, *riba* and *bay al dayn* (sale of debt/receivables) which are central to Islamic commercial and financial law. In this sense, the book is not merely descriptive, but also prescriptive as to how a certain rule or concept ought to be applied to serve social welfare and economic progress. Available literature and publications do not provide much detail on what Islamic finance really is beyond the hype, jargon and statistics. What makes it substantially different from conventional modes of finance? And what is currently missing, generally or in certain jurisdictions, the presence of which would ensure the sustainability of its development both in product array and market confidence? Therein lies the key to the development of Islamic finance structures and products and this book has suggested answers, albeit non-conclusive, to these questions.

1

ISLAMIC LAW AND THE ROLE OF INTERPRETATION

Few if any disciplines can be divorced from their social effects; a correlation that is more pronounced in law both as a discipline and as a body of rules. Laws, in any society, must apply and develop along lines that serve and facilitate individual and social existence and expansion, neither objective being secondary to the other. In Islamic law, this function is served by the principles of maslaha or istislah (facilitating ease/social welfare) being applied to fill any lacunae in the law, as well as to mitigate or remove any resulting hardship (raf' al haraj). Maslaha or istislah are juristically extrapolated principles drawn from the *Quran* and sunna (practices/traditions of Muhammad). They place emphasis on ease and social welfare as the basis of social rights and rules. They are applied to realise the objectives of the sharia (maqasid al-sharia')[1] and can be said to grease the cogs of the legal system so as to ensure the removal of hardship caused by any rigidity or inappropriate effect of the law.

The principles of *maslaha* and *istislah*, thus, moderate the overarching principle of permissibility in commercial transactions and serve the principle of contractual fairness,[2] as demonstrated by Muhammad's repeated concern toward, and repudiation of, contracts that flaunted (or threatened to flaunt) this principle of fairness: the intended outcome in every case being equity between the parties and social justice. The overarching principle of permissibility governing commercial affairs between individuals can be likened to the principle of freedom of contract and the general laissez-faire approach to commercial transactions under the common law.[3] *Maslaha* and *istislah* find parallels in the principles of equity that have long since applied to commercial transactions.

In recognition of the equitable and social aspect of the law – at the root of its legal and judicial aspect – this book undertakes more than just presenting

a synthesis of literature on legal aspects of Islamic finance and their comparable equivalent under the common law. It stresses the need for fresh interpretation of the principles examined herein and their contextual application. It goes further to re-examine from fresh angles the textual sources on *gharar*, *riba* and *bay al dayn* which are central to Islamic commercial and financial law. In this sense, the book is not merely descriptive, but also prescriptive as to how a certain rule or concept ought to be applied to serve social welfare and economic progress. It is this equitable application of principles and concepts in light of today's context that distinguishes the prescriptive approach taken from what is currently applicable.

I refer mainly to the *Quran* and the *sunna* (traditions) or *hadith* (sayings) of Muhammad in supporting my arguments on issues of Islamic law. The *Quran*, like any other scripture is a living text, deriving life from the interpretation and extrapolation of the principles therein according to the current needs and circumstances at any given stage of human civilisation. Without this 'breath of life' through ongoing contemplation and tailored application, the *Quran*, remains an amazing stream of parables and principles with no grounded application today. Approached in this manner, the *Quran* serves only one of its myriad purposes; that of being a liturgical recitation as one form of exalting Allah, no more. Its other functions as a guiding text of wisdom and profound truths, its nature as a penal, moral, economic, spiritual and social welfare code as well as a bastion of liberation and empowerment, literally become suspended because of a lack of grounding in current existence. This is because whilst the *Quran* is a highly sophisticated code embodying universal principles and truths, these are, in various instances, couched in terms local to the very issue it was revealed to address at that point in time. It is for this reason that the *Quran* also relays to us varied stories of past peoples and prophets always stressing that they are *signs* or *indications* for those who 'know' and 'understand', indicating the central role of human intellect in extrapolating and localising universal principles in a manner that befits the circumstances at hand.

Accordingly, our function is not to take the parables or stories in the *Quran* or the sayings and traditions of Muhammad at face value but, rather, it is incumbent upon us to unravel the wisdom and principles behind them that we may then apply to whatever similar or disparate situations we face. An apt illustration comes to mind: the *Quran* repeatedly mentions the fact that Abraham was a Muslim (as was Adam and all the other prophets named or unnamed therein) and it was he who coined the name 'Muslim' (meaning one who yields to the will of God or the Creator)[4]. Yet, in his submission to God, Abraham did not suspend reason; to the contrary, it is his heightened

introspective questioning of God's existence and logical challenge of the actions of his biological father and social community at large that led him to the altar of submission and to the will of God.[5] The *Quran* indicates great wisdom in Abraham's persona.[6] Further, given Abraham and all other 'men of God' before Muhammad are expressly acknowledged in the *Quran* as having yielded in faith to the Will of Allah[7] and having knowledge of and applying the same universal truths,[8] why is it that the *Quran* revealed local contextualised solutions to the social ailments and grievances at the time of Muhammad? If the currently endorsed mode of non-analytical application of the immutable and universal truths of the *Quran* (that the *Quran* stresses had all been previously revealed) is correct, why was Muhammad not simply satisfied with drawing from the books of the Christians and Jews (that the *Quran* stresses and Muhammad acknowledges as valid revelations of God) in addressing the spiritual, moral, economic and social needs that arose within his, and surrounding, communities? Indeed, Muhammad attempted to do so initially only to be left dissatisfied and disappointed with the solutions of the past,[9] causing him to turn to the Source within him in origination of fresh solutions to current social needs and circumstances. This Muhammad did through independent reasoning and proclamation of judgements, either in the form of revelation (the *Quran*) or recorded *hadiths*.[10]

The *sunna* (practices) of Muhammad are sometimes also taken by Muslims as a source of law since Muhammad is believed to have been guided and thus whatever he did was in alignment with that Higher law that guided him. Yet, as any biography or history of Muhammad will reveal to the reader, Muhammad was a revolutionist in his time, certainly not a conformist.[11] His clan and the people of Makkah plotted to kill him which eventually caused Muhammad to flee to Madina (along with hundreds of others) precisely because he was perceived to be blaspheming against the traditions of their 'forefathers' among whom were Abraham and Ishmael and Isaac, all of whom the *Quran* identifies and exalts as Muslims. We have mentioned above that the *Quran* states that Abraham coined the word 'Muslim' and, further, the *Quran* specifically states that Muhammad was inspired to follow the tradition of Abraham. How is it then that Muhammad was a Muslim, guided enough that the very words of the *Quran* were revealed through him, yet he abandoned specific ways and traditions of Abraham? Muhammad certainly did not pray or trade in the manner Abraham's community did, he did not dress the way they did, nor interact with and organise his community the way that of Abraham was, etc. How then was Muhammad following the way of Abraham? The answer is quite simple. The *Quran* urges not the conformity and copying of rules and practices of Abraham that

were formulated and existed centuries (or more!) before Muhammad, but rather urges the emulation of the spirit of Abraham by being true to one's self and Allah, and in that, not fearing or 'bowing' to any human (or social) authority or associating the worship of Allah with that of mortals, creatures or inanimate objects.

The key point in the foregone explanation is that it is not sufficient simply to mirror past solutions and discoveries in present circumstances. For instance, the encouragement that parties to any future debt/commercial obligations record their dealings in writing and to be witnessed in the presence of two witnesses as stated in the *Quran* (*Baqara*: 282) was a commercial quantum leap in the context of seventh century AD indicating a progression in the laws to cater for the advancing commercial realities of Muhammad's time. It is clear, therefore, that in times of change and progress a return to principles and the original Source, both at a personal and collective level, must be undertaken so as to consider their intended purpose and how best they can be applied to changing contexts through fresh or existing rules and practices. This is the key role played by interpretation. As Kamali puts it:

> The sharia shows the way to justice and this way must be followed as far as possible. In the event however that the established rules of the sharia do not offer sufficient guidelines to administer justice, one may take any route, including those of natural rights and natural justice or the general rules of equity and fairness or that of a judicious policy (*siyasa shar'iyyah*) in order to secure justice and the result that is arrived at is a *fortiori* in accordance with the sharia and cannot be held to be contrary to it.[12]

Given the central role of interpretation, this chapter proceeds to consider the balance between form and substance in Islamic law.

1.1 Form versus substance in the *Quran*

Islam is full of prescribed forms and rituals governing all aspects of life and worship. Underpinning the structures and forms, however, is the substance that the *Quran*, at several instances, emphasises as taking precedence over form. *Al-Baqara*: 177, for instance, states that it matters not which direction one faces in prayer but rather what matters is faith and works of goodness. *Al-Hajj* 37 refers to the sacrifice made during the hajj pilgrimage and Allah states that neither the flesh nor the slaughter of the sacrifice matters but rather the God consciousness within one's self. In matters of commerce, *al-Baqara*: 175 is the quintessential reference stressing substance over form,

as shall be discussed in greater detail in chapter 6. The retort exhorted from people upon the prohibition of *riba* was that 'sale/trade is like *riba*' and the response in the *Quran* was that Allah permitted trade and prohibited *riba*. This verse underscores the similarity of the forms of trade and *riba* but that in substance, one was prohibited whilst the other permitted. The point in drawing out these verses is to emphasise that Islam is not concerned with forms as long as the welfare of the people, individually and collectively, is served. Ultimately, what Allah is concerned with is the substance of any matter. Moreover, if substance takes precedence over form in matters of ritual/worship, what more of commerce in which Muslim societies throughout the ages have demonstrated fluidity and a willingness to evolve practices and structures to reflect the times and needs of the people?

1.1.1 Form versus substance in Islamic finance transactions

An enquiry into the purpose/s of the commercial forms of transactions employed by Islamic finance (a summary of all is provided in chapter 3) is not common. Most of these structures pre-date the Islamic civilisation. Others, like the *salam* contract (advance payment for future delivery of agricultural produce) and *istina'* contract (commission to manufacture), are innovations of society a few generations after Muhammad. Both the *Salam* and *Istina'* contracts were created as exceptions to the general rule of contract law because they involve the sale of not-yet-existent objects or what the common law terms 'potential property'.[13] The *salam* contract, for instance, was an invention of the agricultural people of the Hijaz/Iraq – a contract otherwise characterised as 'speculative' for purposes of *gharar*[14] and includes a price discount for time which is an element of *riba* as currently defined[15] – yet the contract was permitted due to the social need it fulfilled.[16] This, again, tallies with the common law position. Oditah explains that the permissibility of transferring 'potential property' as an exception to the general rule of transferring present property was confined almost exclusively to agricultural produce – mainly crops and livestock. That, '[t]he Common law courts never recognised that goods which a company may manufacture tomorrow or receivables expected from their sale, were things in potential'.[17] Today, however, Muslims have widely applied the *salam* concept to structured financial transactions for future delivery of goods that society demands, proving that Islamic law concepts can be applied dynamically and progressively in light of the underlying principle they serve.[18] Contrary to common perception, both the above named forms of transactions were neither revealed nor developed at the time of the prophet Muhammad; they simply comprise modes of transaction practiced by Muslim societies because

they did not oppose any fundamental principle of Islam. Muhammad did not need to sanction them personally, it is sufficient that he did not specifically prohibit them, as he did the *riba* sale or the *gharar* sale, to deem them permissible. Moreover, as we shall discuss in detail in chapters 4 and 5, in prohibiting the *gharar* or *riba* sales, Muhammad prohibited not the form, because these were often identical to perfectly permissible transactions, but the economic substance that the transactions in question effected.[19] The various forms (whether invented before the time of Muhammad or after) existed simply for purposes of serving a real and practical need within the society and commercial community.

Within this broad domain of 'social need', Islamic law of commerce plays a pivotal role of regulation by decreeing the twin principles of *riba* and *gharar* that seek to secure the twin objectives of equity between transacting parties and efficiency in transactions. The point this chapter stresses therefore is that Islamic contractual and financial structures must guard to serve above all else the principle of contractual fairness and social welfare. In this light, adherence to form must only be to serve the substance by effecting equity and social justice. For clarity, by substance it is here meant economic substance as opposed to legal or procedural substance – a key distinction between Islamic law and common law as we shall see in section 1.3 below.

El-Gamal suggests the achievement of such economic substance, today, through 'marking to market', that is, marking the terms of trade to market prices. He explains that, in the context of credit sales and lease to purchase financing, the substantive prohibition of *riba*, that is, aiming to ensure equity in exchange, dictates that credit in such transactions must be extended at the appropriate (market) interest rate. Thus, it is said, that conventional finance has played an important role for contemporary Islamic finance by determining the market interest rates for various borrowers and, further, that such benchmarking of the implicit interest rates (built into the Islamic finance structures) is quite appropriate for purposes of equity through efficiency.

Contrary to El-Gamal's allusion, the 'marking to market' concept is neither alien nor foreign to Islamic commercial practice.[20] Muhammad prescribed the 'marking to market' formula of efficiency in the sixth century ad, before common law commercial principles even came into existence, when he specifically asked Bilal to sell his inferior dates at market price and with the proceeds buy the superior dates he wanted instead of bartering two portions for one, respectively. Implicit in the disapproval of the barter transaction is the potential for inequity in bartering two portions of inferior dates for one portion of superior dates without an objective criterion to

determine the appropriateness of the measures. This caused Muhammad to characterise the transaction as 'the very essence of *riba*'. Note, Muhammad did not say, 'ah, that is a *riba* transaction' because there was nothing wrong with the legal form of the transaction itself: instead, he said, 'the very *essence* of *riba*' meaning the economic effect of the transaction (inequity) was *riba*. One who is concerned with understanding the depth of this tradition will appreciate that through his direction to Bilal, Muhammad endorsed the use of market mechanisms, including 'marking to markets' as a cure for any inequity that may be (potentially or actually) effected through transactions, regardless of the legal form the transaction assumes. The same applies for securitisation transactions today. They are simply another form of transaction invented after the demise of Muhammad (as the *salam* transaction was) to serve a patent social need. As long as a securitisation is equitable in economic effect, there is nothing in the sharia that prohibits it (see chapters 7 and 8 for greater detail).

It is unsettling therefore that El-Gamal inadvertently proceeds to justify the emphasis on legal form in Islamic finance which insists on non-loan structures of finance simply to avoid charging interest yet effectively attain the same goal as a loan would and at the same financial margins/charges. Many of these so-called 'Islamic finance' transactions are also 'the very essence of *riba*' if one enquired into the economic substance of the forms employed. Further, El-Gamal's defence of the 'equity' of 'bundled' forms Islamic finance assumes in present-day practice, contradicts both his theory negating interest as riba and his acknowledgement of most Islamic finance structures as arbitrage – that is, structured finance transaction conjured to attain the same economic end as a counterpart conventional finance transaction.[21]

It is here proposed therefore that Islamic finance should redevelop its standards and criteria of 'compliance' to reflect the intended economic substance in light of modern commercial reality. It is the economic substance of any transaction, be it sale, lease or loan, which must be the focus of the industry and Islamic scholars if Islamic finance is to pride itself on being Islamic (ethical). Its products should be for purposes of creating access to finance for the general public/society much along the lines of the Tabung Haji scheme in Malaysia, the Egyptian Mit Ghamr scheme in the mid-twentieth century, and more recently the Grameen bank project in Bangladesh. The 'Islamic' nature of finance need have little to do with high profile, multi-billion dollar transactions of the kind emblazoned in our minds by the industry and media. Its focus should be 'local before global'. To go about it, as the industry is doing currently, is to put the cart before the

horse, the consequence of which has been not only to alienate the majority of the Muslim population both in and outside Islamic banking jurisdictions, but also cause widespread disillusionment regarding the industry – a cost that has begun to weigh down heavily on the industry as precipitated by the potential default of Dubai World to its creditors and the failure to effectively communicate this to the market. This fact has been widely reported in the *Financial Times* in November and December of 2009.

1.2 The role of interpretation under the common law:

The English legal system, referred to as a 'common law' legal system, has its primary legal principles (mainly) made, and developed, progressively by judges (rather than the legislature) from case decisions in what is called a system of precedent, whereby the lower courts are bound to follow principles propounded by the higher courts in previous cases. The common law is as equally important as the law made by Parliament. For example, there is no Act of Parliament stating that murder is a crime; it is a common law crime that has been refined over the centuries by judges. Likewise, and especially, the principles and rules governing contracts and commercial transactions were almost exclusively developed by the courts. A distinctive feature of the common law is, therefore, that it represents the law of the courts as expressed in judicial decisions.[22]

In developing the law the judiciary plays an important role; that of statutory interpretation and contextual application in light of the facts before them. Whilst the meaning of law in a statute should be clear and explicit, this is not always so. Many cases come before the courts because there is a dispute over the meaning of a word in a statute. For instance, it is judicial interpretation that confirmed the independent existence of arbitration clauses in commercial contracts as demonstrated by the contrast between the decisions of the House of Lords *May and Butcher v Regis*[23] and *Fiona Trust & Holding Corporation and others v Privalov and others.*[24]

In *Fiona Trust* the relevant issue was whether the arbitration clause survived the rescission of the charter party agreements (Shelltime 4). This called for an interpretation of s. 7 of the Arbitration Act 1996, which provides:

> Unless otherwise agreed by the parties, an arbitration agreement which forms or was intended to form part of another agreement (whether or not in writing) shall not be regarded as invalid, non-existent or ineffective because that other agreement is invalid, or did not come into existence or has become ineffective, and it shall for that purpose be treated as a distinct agreement.

The House of Lords held that:

> On its proper construction, cl. 41 of the Shelltime 4 form contained nothing to exclude disputes about the validity of the contract, whether on the grounds that it was procured by fraud, bribery, misrepresentation or anything else. The principle of severability enacted in s. 7 of the Arbitration Act 1996 meant that the invalidity or rescission of the main contract did not necessarily entail the invalidity or rescission of the arbitration agreement. The arbitration agreement had to be treated as a 'distinct agreement' and could be void or voidable only on grounds which related directly to the arbitration agreement. There might be cases in which the grounds on which the main agreement was invalid were identical with the ground upon which the arbitration agreement was invalid … Even if the allegation was that there was no concluded agreement, that was not necessarily an attack on the arbitration agreement. If the arbitration clause had been agreed, the parties would be presumed to have intended the question of whether there was a concluded main agreement to be decided by arbitration.

Lord Hoffman provided his reasons for the above judgement as follows:

> A proper approach to construction therefore requires the court to give effect, so far as the language used by the parties will permit, to the commercial purpose of the arbitration clause. But the same policy of giving effect to the commercial purpose also drives the approach of the courts (and the legislature) to the second question raised in this appeal, namely, whether there is any conceptual reason why parties who have agreed to submit the question of the validity of the contract to arbitration should not be allowed to do so.

There was for some time a view that arbitrators could never have jurisdiction to decide whether a contract was valid. If the contract was invalid, so was the arbitration clause. In *Overseas Insurance Ltd v AA Mutual International Insurance Co. Ltd* [1988] 2 Lloyd's Rep 63, 66, Evans J said that this rule 'owes as much to logic as it does to authority'. But the logic of the proposition was denied by the Court of Appeal in *Harbour Assurance Co. (UK) Ltd* v. *Kansa General International Insurance Co. Ltd* [1993] QB 701 and the question was put beyond doubt by section 7 of the Arbitration Act 1996.

Contrast the approach of Lord Hoffman in *Fiona Trust* with that of Lord Buckmuster of the House of Lords in the case of *May and Butcher v Regem*[25] where it was held, on the question of whether the arbitration clause survived the contract being rendered void:

> The next question is about the arbitration clause, and there I entirely agree with the majority of the Court of Appeal and also with Rowlatt J. The arbitration clause is to refer disputes 'with reference to or arising out of this agreement'. But, until the price has been fixed, the agreement is not there. The arbitration clause relates to the settlement of whatever may happen when once the agreement has been completed and the parties are regularly bound. There is nothing in the arbitration clause to enable a contract to be made which, in fact, the original bargain had left quite open.

In *May and Butcher*, the House of Lords, clearly adopted an interpretation that negated the seperability of an arbitration clause in a contract. Given this approach, it is no wonder that the legislature had to step in to remedy the unwillingness of the judiciary to give commercial effect to the intention of the parties expressed through the inclusion of an arbitration clause. This is now expressed in section 7 of the Arbitration Act 1996. The case of *May and Butcher* v. *Regem*[26] is discussed in greater detail in section 4.6.

Another illustration of the role of interpretation under the common law is gleaned from the interpretation of what constitutes a wagering contract. Under the common law, bets were enforceable and by a series of statute from 1710 to 1892, wagering contracts were rendered void[27] (these statutes now stand repealed by sections 334 and 356 of the Gambling Act 2005). A wagering contract was defined in *Carlill* v. *Carbolic Smoke Ball Co*,[28] which later received unqualified approval from the Court of appeal.[29]

However, the case of *Ellesmere* v. *Wallace* demonstrated that, though wagering contracts were prohibited by statute, what comprised a wagering contract and the consequent determination of whether the contract was void for illegality, was dependant on the interpretation of the court on the facts of the case. Thus, in *Ellesmere* v. *Wallace*, it was held that a bet placed with the Horse-racing totalisator was not a wagering contract within the meaning of the Gaming Act 1845, since the Board can neither win nor lose on the transaction. The Court of Appeal held that the money placed on the bet was recoverable.[30] Further, the Court observed that though an essential feature of a wagering contract is that the stake is the only interest which the parties have in the contract,[31] the question whether the parties are interested

in something more than the mere winning or losing of the stake depends on the substance of the agreement, not upon its outward form. Thus, the Court in *Carlill v Carbolic* observed:

> In construing a contract with a view to determining whether it is a wagering one or not, the Court will receive evidence in order to arrive at the substance of it, and will not confine its attention to the mere words in which it is expressed, for a wagering contract may be sometimes concealed under the guise of language which on the face of it, if only the words were to be considered, might constitute a legally enforceable contract.[32]

Similarly, where there is a present price agreed, though the value of the article is unascertained at the time the contract for its sale is made, the transaction is not a wager.[33]

1.3 Form versus substance under the common law: the Exfinco scenario

A key feature of securitisation, as we shall see in chapter 7, is that the value of securities issued will be determined by the performance of the pool of segregated assets, and not by the continuing credit worthiness of the originator. The separation of the credit risk of the originator and the credit risk of the SPV in this way often enables the originator to obtain lower-cost financing through securitisation than it would otherwise be able to obtain. For example, before the advent of the credit downturn commencing September 2008, many originators with corporate credit ratings of BBB (the lowest investment grade rating at Standard & Poor) had securitised assets resulting in an issue of AAA-rated securities. Securitisation may also achieve other objectives; for example, it may allow a regulated entity to remove assets from its balance sheet for regulatory capital purposes, and thus do more business, by structuring a transaction as a sale rather than a loan. It is important to note therefore, in contrast to the emphasis this book has placed on economic substance in Islamic law, that in examining the question of whether a structured transaction is a sale or a loan, the courts enquire into the *legal* substance of the transaction and not the *economic* substance. (emphasis added) This is not to say that the common law does not concern itself with the economic substance of a transaction; it does so through equitable doctrines of unconscionable dealings and equitable principles generally. However, within the strict realm of financial transactions, the Court looks to the legal substance of the transaction for purposes of

characterising the transaction as a (true sale) securitisation or loan. In other words, the Court pays no regard to whether the parties structure the transaction as a sale or a loan as long as, legally, the transaction is what they say it is and not a guise for something else. This is also the current approach of the Islamic finance industry, as this book argues, for a shift from, to a focus on, economic substance in line with the principles of Islam.

The Court of Appeal in *Welsh Development Agency* v. *Export Finance Co Ltd*[34] *(*aka *Exfinco)* considered the question of whether a transaction described by the parties as a sale of goods could be characterised as a secured loan. The court had regard to the manner in which the parties had described their transaction in the documents as evidence of what, in substance, the parties had agreed, and held that despite similarities to a mortgage or charge, the agreement was what it purported to be, that is, a sale transaction. However, the court indicated that its decision was not applicable where the transaction was a sham. The court examined the detailed terms of the documents and identified the legal substance of the matter, as set out in those terms, as being in accordance with the form – a sale and not a secured loan. Slaughton LJ pointed out that '*in such cases one was seeking to ascertain the legal nature of the transaction and not its economic effect*' (emphasis added). He identified two ways of examining the question: the external and internal route. The external route involved an allegation that the written document did not truly represent the agreement of the parties in that it was a sham or pretence. The internal route involved the examination of the written agreement in order to ascertain its legal nature from the terms contained in the document.

Under English law, for a transaction to be deemed a sham the parties must have intentionally executed documents that give the appearance of creating legal rights and obligations different from those which the parties intended to create.[35] Slaughton LJ observed[36] that 'the task of looking for the substance of the parties' agreement and disregarding the labels they have used' may arise in a case where their written agreement is a sham intended to mask their true agreement. The task of the courts there is to discover by extrinsic evidence what their true agreement was and to disregard, if inconsistent with the true agreement, the written words of the sham agreement. Slaughton LJ's analysis in the Exfinco case was applied by the Court of Appeal in *Lavin* v. *Johnson*[37] and found that the legal nature of one part of the document was in conformity with the form (a sale) whilst that of the other part of the document was not and thus represented a security transaction. In *Dutton* v. *Davis*,[38] the Court of Appeal again held that the legal nature of the transaction was in accordance with the form

of the transaction and thus did not involve the grant of a security which could be redeemed.

Goode explains, with relevance to current Islamic finance practice, that an agreement that is in substance a loan may readily be disguised as a purchase to evade either the Money Lenders Act (now repealed) or, where the 'seller' is a company, the registration requirements embodied in section 395 of the Companies Act 1985 (now section 860 of the Companies Act 2006). Where an allegation of such disguise is made, the court must inquire into the facts of the case and, where necessary, look behind the labels given to the transaction by the parties.[39] He continues to say:

> The question to be decided is not whether the transaction would have the effect of avoiding the relevant statute – for parties are free to organise their affairs in any such way as to ensure they escape the legislation they consider burdensome – but what is its legal nature …
>
> The external route is to show that the document does not record the real agreement between the parties – in other words, that the document is a sham and is designed to conceal the true nature of the transaction. … But even where the document is a true record of the parties' agreement, the court may conclude from an examination of its terms that its legal character is that of a security, not a sale. This is the internal route. … But in each case it is the legal *substance* to which the court has regard, not the economic *effect*.[40]

In the recent case of *Brighton & Hove City Council* v. *Audus*[41] Morgan J explains that, 'there are many ways of raising money besides borrowing. If the transaction is not in the form of a loan it is not to the point to say that its object was to raise money or that the parties could have produced the same result more conveniently by borrowing and lending money'.

This explanation is critical to understanding the distinct approaches taken by the common law courts and Islamic law regarding re-characterisation. This is because while it is also the case that under Islamic law the issue of re-characterisation does not turn on whether the *effect* of the transaction is to evade a prohibiting statute or law – Muhammad's advice to Bilal to sell his inferior dates so as to purchase superior from the proceeds of his sale had the effect of evading the prohibition of *riba* that was otherwise triggered by Bilal's barter – it does enquire into the economic effect of the transaction. Muhammad was not preferring a market transaction over a barter transaction other than in economic effect, which rendered a market sale transaction, on the facts, preferable (equitable) as opposed to a barter transaction.

Conclusion

Interpretation of the *Quran* and the sayings/practices of Muhammad play a central role in Islamic law generally. Interpretation is to be undertaken in line with the principles and spirit of the primary sources so as to uphold the principle of contractual fairness and bring about social justice. In this light, a consideration of form versus substance is undertaken both for comparative purposes as well as to stress the emphasis placed on the substance of Islamic commerce and contractual dealings. The spirit of equity and justice, as the centrepieces of an Islamic society, necessitates that adherence to the substance of any undertaking be paramount to the form it serves or mimics.

2

SCOPE, METHODOLOGY AND OBJECTIVE

This book considers legal aspects of Islamic finance within the context of a securitisation transaction – the process of converting illiquid assets into tradable securities so as to create liquidity and/or raise funds.[1] It considers the viability of securitisation as an Islamic finance structure within the context of global finance. In doing so, the book considers the following questions:

- What are the principles of Islamic contract law and commerce?
- What is the meaning and effect of *gharar* (i.e. whether conceptual or evidential uncertainty) in Islamic law?
- How is the prohibition against *riba*[2] to be interpreted and applied today?
- What is the meaning and legality of the 'sale of debt' in Islam?
- Is debt proprietary in nature? And if so, how does such proprietary nature affect current Islamic finance theory and practice?
- How can securitisations be structured so as to be compatible with both Islamic finance and conventional finance and what are the issues that arise in doing so?
- What function does the label 'Islamic' serve? And what is the way forward?

2.1 Scope

Of the several issues this book discusses within the analysis of greater viability of securitisation in Islamic finance, emphasis is placed on discussions of *gharar* (speculative risk), *riba* (increased returns on loans) and *bay al dayn* (the sale of debt obligations/receivables). This is because these three issues are of fundamental significance to the development and sustainability of an Islamic capital market: a feature that is necessary for the wider viability

of securitisations. The great Andalusian philosopher and jurist Averroes or Ibn Rushd (d. 1198) is known to have said that there are four causes of invalidity intrinsic to the concept of sale: illicitness of the object (e.g. sale of pork or wine); *riba*; *gharar*; and 'those terms that conduce to one of the last two or some combination of them'.[3]

To illustrate briefly, the fundamental components of any true securitisation transaction comprise a contract (sale), a securitised asset/s and securities tradable on the secondary market. These raise three main issues under Islamic law: (i) any contract must guard against being tainted with excessive[4] *gharar* (uncertainty) lest it be vitiated, (ii) any asset that is to be securitised must be *halal* (permitted under Islamic law) thus triggering the issue of the proprietary nature of debt with regards both to the securitisation of debt/receivables and the sale of the securities on the secondary market, and (iii) securities sold (bonds, shares, loan notes, etc.) must be asset backed lest they be considered invalid objects for violating the rule stipulating the non-proprietary nature of debt as well as violating the rule against *riba* (interest or increased return on debt/loan). Similarly, should the parties take loans to fund the securitisations, any increase charged or paid triggers the rule against *riba*, and if the securitisation is structured and transacted before the underlying asset comes into being, again, this triggers the issues of *gharar* and the validity of sale of debt obligations.

Consider, based on the above, that whilst the securitisation of debt is a popular mode of securitisation and the sale of debt or receivables a common feature of securitisation structures in conventional finance, it is prohibited in Islam by virtue of debt not being recognised as proprietary and therefore not qualifying as an asset for sale even in an asset backed securitisation.[5] The nullity of such a sale may in turn lead to the transaction being re-characterised as a loan and any increased return would be caught by the *riba* (interest) prohibition which renders the transaction void. Consider further that a securitisation structure may involve certain levels of uncertainty, risk and speculation and Islamic law theory, as it stands, prohibits contractual uncertainty and speculative risk (*gharar*). It is thus pertinent to clarify the status and effect of *gharar, riba* and the sale of receivable (debt) securities under Islamic law.

2.2 Methodology

The methodology used in conducting the research for this book is comparative. The comparison is conducted at two levels: A comparison of the current rules and practices of Islamic finance with the principles in the *Quran* and the traditions of Muhammad that the rules are ascribed to; and

a comparison of the position within Islamic law with that of the common law, to the extent possible.

Reference to the common law throughout implies English case law and the rules of Equity, which are the sources of contract and commercial law in England and to this day form the foundation for statutory law in this regard. The comparison is conducted on a concept by concept basis, where possible, by drawing similarities between the underlying principles of law in Islamic law and common law. However, where a distinction exists, attention is drawn to it and a contrast is made.

2.3 Objective

The objective of the comparison is to examine the practices and framework applied within the common law for potential compatibility and application to the development of Islamic law. Questions may be raised as to why a comparative study with the common law? Why not a comparison with the civil law given that the legal system in most Middle Eastern and North African (MENA) countries are deemed more aligned with civil law? This is done for four main reasons:

First, with the intention of appreciating the development of certain concepts and practices of the common law, thereby drawing lessons for the development of Islamic law of contract in an age where rapid growth and expansion of application and innovation is expected of Islamic law. This is done with the confidence that Muslims, throughout the ages, more so during the golden age of Islamic civilisation and at the time of the prophet Muhammad, have always been receptive and responsive to the ideas and cultures of other civilisations. The prophet Muhammad encouraged Muslims to pursue knowledge 'even in the land of China' (China being the farthest land one could then travel to) and incorporated many Christian, Jewish and pagan Arab practices within the daily practices of the Muslim community as long as the practices did not conflict with the principles outlined in the *Quran*. Wherever Muslims migrated to, during and after the time of Muhammad, they readily incorporated the commercial and customary practices of the land. Islamic law is inclusive, not exclusive, and the underlying message of the *Quran* requires that mankind strive to create a just and egalitarian society in which all people, especially the vulnerable, are treated justly.[6] Muslims today are free to emulate the same and shed their claims to exclusivity and/or superiority in consonance with the practice of the prophet and his companions. In fact, Muhammad (as all other men of God) was known for his practicality and forward-looking personality. He was quick to shed any encumbering custom if that would facilitate ease and egalitarianism among the people.

Second, a comparison with the common law is undertaken because it is the law most frequently used in drafting the legal and contractual documents in a securitisation transaction in Islamic finance (as is true for most global financial transactions). This is because the common law is generally more progressive and permissive than the civil law. Furthermore, though the MENA region may be civil law inclined, Islamic law finds many parallels with the common law, for instance, juristic reliance on precedent and legal reasoning based on analogy.[7] It, therefore, makes greater sense to compare the principles of Islamic law with the common law; a comparison which enables the examination of parallels that provide insight into potential trajectories for Islamic finance.

Third, the legal nature of Islamic jurisprudence on contract and commerce is similar to that of the common law. For instance, both are founded on the principle of laissez-faire whereby everything is permissible unless expressly prohibited. Similarity also extends to the methodology of legal inference based on reasoning by analogy and judicial judgements based on judicial precedent. Where the cannon is silent on a particular issue, Muslim jurists formulate law applicable to the specific situation in similar fashion to common law judges formulating the law for cases in which no precedent exists. This may explain the relative success of Islamic finance in countries that were historically ruled by the British (Bahrain) and more so in countries that retain the common law as their legal framework (Malaysia).[8] Likewise, contemporary developments in Islamic finance are owed more to juristic understandings of the primary texts and previous juristic decisions rather than to the text itself.

Fourth, and perhaps more importantly, drawing out commonalities between Islamic and common law principles allows for better regulation of Islamic finance products and markets by aligning them to conventional market standards and practices contrary to the exclusivity Islamic finance has inclined towards within the global financial fabric. By recognising that in essence the transactions in both spheres are the same, they can also be regulated alike. This should be welcomed news for Islamic finance jurisdictions because they would not have to worry about issues of double taxation or legal certainty in cases of dispute, as Islamic finance transaction would elicit similar legal treatment as conventional finance. Further, the commonality in essence also allows for uniformity in regulation of financial transactions within national frameworks. For instance, this would allow for uniformity in regulation of both conventional and Islamic finance investments by the Malaysian securities commission and other equivalent jurisdictional regulatory bodies. Such uniform regulation serves to instil public confidence in

Islamic finance products, especially in the current global financial climate, because of the greater legal and regulatory certainty it creates for Islamic finance products.[9]

2.4 Approach

The approach adopted here is one that focuses on principles rather than rules. This approach allows for the subsequent extrapolation of rules that are applicable to Islamic contract and finance contexts. In coining a term, this approach is called the 'principle-centric' approach in that it emphasises enquiry into the principles that govern Islamic law of contract and finance and de-emphasise adherence to the current rules. This approach suggests that principles are distinct from rules and argues that rules are derived from, and formulated to express, principles. Whilst the principles remain constant (the general framework), the rules may change and are not 'carved in stone'. This is particularly true in Islam and is emphasised by the very nature of the Faith that whilst governing every facet of Muslims' lives, provides mainly a framework of principles to be fleshed out according to the current need and context. In other words, the rules governing different areas of life are to be fleshed out according to the prevalent social needs whilst using the principles as a yard stick of keeping within the overall framework intended. Further, flexibility is provided for through the principle that new rules that fit new times and circumstances can be extrapolated from existing principles; this process is known as *qiyas* (analogical deduction).

Muhammad, in his lifetime, demonstrated the distinction between principles and rules repeatedly, mainly in the distinct judgements he passed in different situations regarding the same issue. For example, prayer is amongst the five pillars of Islam, yet different people throughout the ages have prayed in different manners whilst still being Muslims and acknowledged as such by the *Quran*. This is true of Adam, Abraham, Moses, Jesus and Muhammad – each of these messengers and their people prayed in a different manner according to their times, yet all were adhering to the same principle of prayer. Further, the *Quran* provides variations and concessions on prayer depending on different circumstances. For instance, one is excused from ritual prayer when ill and may choose to pray however one can best pray. Likewise, a traveller receives concession from prayer by being allowed to shorten as well as join two consecutive prayers. Thus, the principle of prayer endures in all circumstances but the form and format it takes changes according to the time and context of application. This flexibility is even greater outside the sphere of ritual, as in commercial transactions, where the operative principle is that everything is permissible that is not expressly prohibited by a clear

text of the *Quran* or saying of the Prophet. The companions of the Prophet and early Muslim societies thereafter demonstrated this distinction through, for instance, *bay al-salam* (pre-paid contract of agricultural produce – long before harvest). *Salam* was permitted, despite its apparent uncertain and speculative (*gharar*) nature, because of both the presence of a pressing social need (i.e. to keep up with the rising levels of commercial development and growth in demand of agricultural products) and the acknowledged absence of a deceptive element in the transaction that the principle of contractual fairness guards against.[10]

I prefer the 'principle approach' because it brings balance back to commercial application. After the 'closing of the gates of Ijtihad'[11] increased emphasis was laid on rules (as opposed to the principles) of Islam with an insistence on the adhering of rules available at that time without the permission to partake in any thought process of analogy, deduction or extrapolation of other rules from underlying principles pertaining to the various (often novel) issues and aspects of life in Muslim societies. This led to a sharp decline in the intellectual vibrancy within the religion in the subsequent centuries, which contributed to the eventual decline of the Islamic civilisation. The point, therefore, is that rules need not remain the same; they may be modified, changed or done away with completely, as long as we remain within the principles and general framework of Islam. It acknowledges that achieving the objectives of Muslim societies today is part and parcel of the objectives of the sharia. Accordingly, this book also considers the argument that in attempting to replicate the substance of contemporary financial practice using pre-modern contract forms, Islamic finance fails to serve the objectives of the sharia both in terms of efficiency of contractual dealing and equity between the contracting parties.[12] The principle-centric approach proposes, wherever possible, that there should be minimal hesitation towards the adoption of contemporary financial practice for purposes of replicating the substance of Islamic finance. This 'return to principles' approach receives express sanction in the *Quran* where Allah says:

> O you who believe! Obey Allah, and obey the Messenger and those charged with authority among you. If you differ in anything among yourselves, refer it (back) to Allah and His Messenger, if you do believe in Allah and the Last Day: That is the best, and the most suitable course for final determination.[13]

Conclusion

In closing, I draw attention to the possible origins of the common law in Islamic law. This has been verified by credible studies in the recent past as well as the logical deduction drawn from the fact that the decline of the Islamic civilisation at the turn of the fourteenth century coincides with the rise of the Christian civilisation. This crossing in history is marked by the crusades that saw many a Muslim city and people destroyed. In doing so, many books and manuscripts were burnt or otherwise destroyed but many yet survived to be translated and studied by Christian missionaries and scholars, eventually becoming a basis of scientific and philosophical enquiry and the common law rooted in precedent and juristic analogy as we know it today.[14] One of the earliest studies in this area traced the British system of trusts to the Islamic institution of *waqf* (charitable trusts).[15] A more recent study by John Makdisi traced the origins of many innovations in British contract law to Islamic origins.[16] One can, thus, conclude that in drawing from the common law, Muslims today may in fact be drawing from their own origins. Part of the purpose of this book, therefore, is to reconcile aspects of Islamic finance with conventional finance. It acknowledges that the systematic emphasis of differences whilst ignoring similarities is unproductive.

3

ISLAMIC FINANCE

AN INTRODUCTION

Islamic finance is depicted as (and, in essence, ought to be) an ethical and equitable mode of financing that derives its principles from the sharia (Islamic law). Over a period of 45 odd years,[1] a variety of financial institutions have developed sophisticated methods to advance capital to both the private and public sector in a manner compatible with the sharia. However, it is only recently that tradable sharia compliant financial instruments have come to market in considerable amounts. In this respect, the development of an Islamic bond (*sukuk*) market has been the primary area of growth, providing an avenue for short and medium term placements of funds by investors.[2] The growth of this market has been fuelled not only by the desire of corporate and government entities to raise sharia compliant funds (as an alternative source of funding) but also by investor demands for sharia compliant products so much so that in 2004, for instance, a European federal institution with no Islamic constitutional links,[3] issued sharia compliant securities to attract Middle Eastern investors. Such investor appetite for alternative securities has inspired the creation of a sharia compatible securitisation market. As was reported, 'the Islamic financial industry's journey towards the mainstream has now reached a stage where several of the big investment banks think they miss out if they are unable to do the translation'.[4]

With the above backdrop, this chapter turns to examine the principles and the basis upon which Islamic finance operates, setting the ground for discussion in the ensuing chapters generally, and specifically chapter 8, on structuring securitisation deals to be compatible with both the sharia and conventional finance.

3.1 Principles governing contract and finance in Islam

Islamic Finance is governed by two main principles:

- *Contractual Fairness and Social Justice*.The *Quran* sets out principles of equity, justice, fairness, morality and social welfare, among others, as preferable underpinnings of any human society. We have called them 'Islamic' principles. The *Quran*[5] explains that Allah (God) creates and owns everything and human beings therefore hold wealth on *amanah* (Trust) for God to be spent and dealt with accordingly. The beneficiary of such wealth, held by any human being, is the collective community of humans whose interest must be served in spending or dealing with money. Contractual dealings, whilst governed primarily by the principle of permissibility and recognising the freedom of the individual to contract freely, was nonetheless to operate within the ambit of fairness as between the parties and social justice.
- *Permissibility*. The *Quran* grants substantial freedom in almost every aspect of life, including matters of commerce,[6] and property may be freely held or traded. In general, it is accepted that in all matters (*mu'amalaat*) other than faith ('*ibadaat*) the operating principle is that of permissibility (*ibaha*) unless there is a clear text in the primary sources to the contrary.[7] The principle of permissibility does not operate in a vacuum but rather goes back, and is linked, to the notion of human beings as trustees or stewards of God's wealth/creation on earth. Permissibility is therefore tempered by rules enunciated in the *Quran* which indicate, broadly, the extent to which contracting parties are free in deciding their terms and conditions.[8] Chief among these rules are that any given transaction should be devoid of *riba* or *gharar,*[9] both of which are defined briefly below and are dealt with in separate (ensuing) chapters of this book. It is a concern of Islamic law of contract and finance that no party suffers undue burden in any given transaction when it is possible, through care and proper investigation, to dispel risks of *riba* and *gharar*. Therefore, the principle of contractual fairness counterbalances the principle of permissibility with the objective of attaining social justice or equity between the parties. Within the principle of permissibility is the accommodation of divergent views and expanding perspectives. Thus, in order to declare an act or transaction valid or permissible, there is no requirement to establish affirmative textual evidence in support. All one needs is to ascertain that there is no clear text that prohibits it. Further, and importantly, the contracts and transactions endorsed by Islam (some existing before and others after the lifetime of Muhammad) are not exhaustive.

> Novel transaction are permissible and valid as long as no clear text in the primary sources exists prohibiting it and even this may be waived if the social need for it (benefit) outweighs the perceived detriment (as was the case of *bay al-salam*). As Kamali explains, 'it is essentially incorrect to extend and apply a medieval juristic opinion to something that was not even known in those times'.[10]

These two principles provide a platform from which Islamic finance is to be applied in compliance with the objectives (*maqasid*) of the sharia.[11] Among the objectives of the sharia is the creation of ease (*maslaha*), both in this world and the hereafter (i.e. the material and spiritual spheres of existence), which is derived from the concept of *taysir* (making things easy) and relates closely to the concept of *raf' al haraj* (the removal of hardship).[12] These objectives of the sharia are meant to ensure that there is no hardship in the practice of the religion as the report by Tirmidhi about the prophet Muhammad that 'You [Muhammad] have been sent in order to make things easy, not as one who makes them difficult'.[13] An understanding of the *maqasid* therefore allows for practice in consonance with the principle of permissibility that governs contractual and commercial transactions in the context of Islam. As one author notes, Ibn Taymiyya wrote that 'Unless God and His Prophet have decreed them to be forbidden … they are permitted … But God, the most high, never prohibited a contract in which there is a benefit for the Muslims and does not inflict any harm upon them', there is no need therefore to search for affirmative evidence in the original sources to declare a transaction valid.[14]

3.2 Specific rules of the sharia governing contract and finance in Islam

The principles, in brief, whose parameters define the scope and nature of Islamic finance, are examined below through a discussion of the treatment pertaining to *riba*, gambling, *gharar*, hoarding, financial assets, predetermined profit, and prohibited transactions.

3.2.1 Riba

The *Quran* categorically prohibits the practice of *riba* as is evident in the following verses of the *Quran*:[15]

> …they say that trade is like *riba*, but God hath permitted trade and forbidden *riba*.[16]

> O ye who believe! Fear Allah, and give up what remains of *riba*, if ye are indeed believers.[17]
>
> What you give in *riba* to increase in people's wealth, does not gain anything with God. But if you give charitably, seeking God's pleasure, these are those who receive manifold reward.[18]

Riba has been, and remains, interpreted as any return on money that is predetermined in amount[19] and therefore includes present day forms of interest-based financing.[20] Since *Riba* is repeatedly discouraged in the primary sources,[21] any return on money employed is required to be linked to the profits of an enterprise or joint endeavour. Islamic finance therefore prefers deferred payment at a premium to spot price plus loan structures, be they sale or lease contracts, as the only viable (profitable) option to banks and financial institutions in the wake of the interest prohibition on financial transactions. Consequently, modern scholars encouraged asset-based financing where the return to the financier is linked either to the provision of an asset to the client or to the acquisition of an asset. Any higher returns earned are (supposed to be) linked, commensurately, to the assumption of risk – which emphasises the fact that Islam is not against higher returns on investments.

One of this book's premises, however, is that the concept of *riba* has little to do with the act of charging an increased return on finance extended and much to do with deceptive forms of transaction and a discouragement of the human obsession with monetary gains (in contrast to charitable spending in the cause of God that brings greater, albeit not immediate, returns). The *Quran*'s emphasis, wherever *riba* is addressed, pertains to equitable transactions and a general encouragement towards giving charitably, rather than focusing on making an increase of returns on an investment or money lent; this is the principle behind the prohibition.[22]

*3.2.2 Gambling (***maysir***)*

The caution against gambling (*maysir*) in the *Quran* is the basis upon which the sharia prohibits any form of speculation.[23] This has essentially deterred many Islamic financial institutions from participating in derivative transactions.[24] Speculative investments on the capital market in general are viewed suspiciously by sharia committees and avoided by financial institutions. Caution must, however, be taken not to confuse risk with speculation. Risk taking is inevitable in commercial and investment transactions (the basis for making a profit/increased returns). Speculation may on the other hand be viewed as excessive and/or avoidable risk taking. The prohibition of *gharar*

derives from the prohibition against gambling and it is thus linked to speculative transactions.

3.2.3 Prohibited transactions/investments

Islam prohibits transactions involving prohibited elements such as pork, alcohol, armaments, activities involving speculation, gambling and any sort of immorality. By extension, Islamic institutions may have reservations about (and refrain from) investments involving businesses such as hotels and the entertainment industry (where alcohol and pork may be served and gambling may take place).

3.2.4 Predetermined profit

As a general rule, profit cannot be guaranteed or predetermined in amount and an Islamic financial institution must assume at least part of the risk of a given transaction.[25] There can be no guarantee of a fixed return and similarly, depositors/investors may not invest in Islamic financial institutions on the guarantee of a fixed return. Security may, however, be taken to guard against the eventuality of negligence, wilful wrongdoing, or breach of contract by contractual parties.[26]

3.2.5 **Gharar**

Gharar is often, and insufficiently, translated as uncertainty. It is much wider than uncertainty and encompasses speculation, excessive risk, ignorance and generally hints at consumer/investor protection. As a concept, it is predicated on the principles of equity and efficiency in transactions. The current position on *gharar* is that its existence in a contract is prohibited and may render the contract void. Hence, contracting parties must disclose all the terms and details of the contract. However, while scholars are at pains to stress that *gharar* is prohibited, there is little clarity on what *gharar is*.[27] G*harar* is examined in greater detail in chapter 4.

3.2.6 Hoarding

Islam recognises that trade and enterprise generates wealth for society and is encouraged between people in any profit and loss sharing capacity. Hoarding, on the other hand, in whatever form, is strictly prohibited as it creates a sense of lack and erodes social welfare.

3.2.7 Financial assets

Money and financial assets in general are deemed merely media of exchange, not commodities that can be traded in (i.e. they are not deemed property).[28]

The sale of currency is therefore prohibited (both as a medium of exchange and/or a highly speculative investment) while the sale (through securitisation, restructuring or otherwise) of any debt remains largely doubtful in legality due to the scholastic consideration of debt as money. The legality of the sale of debt in Islam and issues involved in or surrounding financial assets are discussed in chapter 6.

3.3 Transactions in Islamic finance

Islamic finance is said to prefer equity financing over debt financing and that it is fundamentally asset-based because, according to the prevailing interpretations of Islamic law, profit and loss sharing (equity) contracts are not only consistent with Islamic beliefs, they are also superior to debt based financial instruments. Conventional debt financing (interest-based lending or conventional bonds) is deemed not to have a place in Islamic finance because it draws interest.[29] Accordingly, unlike conventional finance where the risk is reflected in the amount of interest paid by the borrower, Islamic finance requires sharing of both profit and loss and hence sharing the risk in general. The classical equity sharing transactions in Islamic law require partnership and profit sharing to which the contemporary structures of venture capitalism, investment management and project financing can be compared. Four of the sharia compliant financing and investment structures that have been developed are discussed here.

3.3.1 Musharaka

It may be defined as equity participation or profit sharing and simply means partnership. It is the umbrella financial structure of financing that encompasses other partnership arrangements like *mudharaba*. In the common form of *musharaka*, both parties provide capital and the contractual conditions are flexible enough to allow the creation and sale of participation notes to the investors or Islamic bank that provide the funding, which represents their share of their investment. The technique is therefore suitable for joint venture investments and can be used to package portfolios of assets whose returns, real property lease payments for example, are subsequently shared among the partners.

3.3.2 Mudharaba

Mudharaba or participation financing is a special form of partnership that has been developed and is now used by modern Islamic financial institutions to provide fund management services. It falls within and utilises the Islamic principles of profit and risk sharing and is characterised by one party (*rabb*

al mal) entrusting his money to another party (*mudharib*) who is akin to a fund manager and whose contribution in the partnership is the provision of skill, managerial expertise or the necessary experience. The *mudharib* (fund manager) uses the capital in a mutually agreed fashion and subsequently returns the capital and profit (if any) to the *rabb al mal* (financier) and retains a predetermined share (as opposed to amount) of the profit for himself.

The operating principles of *mudharaba* are:

- The profits are divided on a predetermined proportional basis;[30]
- Any loss is borne by the *rabb al mal* only to the extent of the principle amount;
- The *mudharib* bears the loss of his time and effort in the enterprise.

A *mudharaba* transaction may be entered into for a single investment or on a continuing basis with the financial institution acting as a fiduciary. *Mudharaba* investments may also be made for a fixed term and arranged through negotiable instruments called investment deposit certificates or *mudharaba* certificates and in such situations, may have characteristics akin to shares. A number of Islamic banks have formed funds applying the rules of *mudharaba* to buy real estate assets.[31]

3.3.3 **Murabaha**

It may be defined as a sale at an agreed profit margin. It is one of the most common forms of Islamic financing, and although it is most applicable to trade financing transactions requiring short-term liquidity instruments, it can also be used for longer-term investments. In its modern day use, *murabaha* involves the purchase of a specific commodity by a financial institution upon the request of a client. The client then purchases the commodity from the financial institution on a deferred payment basis at an agreed mark-up that is structured to cover the cost of purchasing the commodity, the risk undertaken in financing the client and a profit margin.

This mark-up profit has been widely used as a substitute for the charging of interest by parties or institutions that wish to adapt interest-based banking to Islamic finance requirements. The calculation of the mark-up or profit may be in the form of a fixed lump sum or it may be calculated as a percentage (often not dissimilar to the market rate of interest at the time) of the financed amount. Nonetheless, this type of financing is deemed compliant with the sharia because the financial institutions initially takes title to the commodity (albeit briefly) at a risk to itself as well as to the buyer. The compliance with the sharia is thus deemed indisputable[32] on the basis

that a *murabaha* transaction involves a sale and the passing of title on the basis of a literal reading of the *Quran* that: '…they [non-Muslims] say that trade is like *riba*, but God hath permitted trade and forbidden *riba*'.[33]

Some banks today prefer *murabaha* to *mudharaba* which they deem to be less risky. They argue that in a *murabaha*, there is no element of *riba* (as currently defined) because the element of assuming business risk in *murabaha* justifies the profit margin charged and distances the transaction even further from *riba*. The Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) allows the acquisition of assets that will be sold under *murabaha* contracts. Once sold, however, the certificates or *sukuk* may not be resold as the asset will then become ownership interests in debts (deemed similar in concept to money) and hence dealing in *riba*.[34]

3.3.4 **Ijara**

Ijara or leasing is very similar to and shares many characteristics with lease financing and/or hire purchase. A typical *ijara* structure involves a lessor (financial institution) purchasing an asset and renting it to a lessee for a specific time period at an agreed rental or receiving a share of the profits generated by the asset.

There are two main types of lease under the *ijara* structure. One involves a longer-term lease that usually ends with transfer of ownership in the property to the lessee (*ijara wa iqtina'*) which is similar to common law hire purchase contracts. The second type is short term and will normally end with the financial institution retaining ownership of the asset which is similar to an operating lease. In accordance with the sharia, the leased item should not be a prohibited item and must be used in ways permissible in the sharia (for example, the lease of a warehouse or premise for purposes of storing pork products or to operate a casino or bar is prohibited).

Apart from the above modes, Islamic finance also permits investing in certain stock and equity funds as long they conform to certain guidelines (that are similar in many respects to ethical or socially responsible investment). Generally, equity investments that discourage speculation and preclude short selling are deemed sharia compliant while conventional debt equities and derivatives are not. The reasons for this are based on the prohibition of *gharar, riba* and the legality of *bay al dayn* in Islamic law as will be discussed in detail in chapters 4, 5 and 6 respectively.

3.4 *Sukuk* (Islamic bonds) and the development of a *sukuk* market

Suk (or its plural *sukuk*) is a transferable instrument with bond-like qualities. It represents proportionate beneficial ownership in an underlying asset

for a defined period with the risk and returns associated with the cash flows generated by the particular asset/s belonging to the investors (*sukuk* holders). Though sometimes referred to as Islamic bonds, they are better described as Islamic investment certificates.[35] This distinction is deemed crucial so as to avoid *sukuk* being regarded as substitute for conventional interest-based securities. Ideally, the aim of Islamic finance is not simply to engineer financial products that mimic fixed rate bills, bonds and floating rate notes as understood in conventional finance but rather to develop innovative types of assets backed securities that comply with the sharia.[36]

The *Fiqh* Academy of the Organisation of the Islamic Conference (OIC) first considered the question of Islamic investment certificates at their fourth annual plenary session[37] held in Jeddah in February 1988.[38] After noting that the sharia encourages the documentation of contracts[39] they went on to rule that:

> Subject to proper legal documentation … Any collection of assets can be represented in a written note or bond. This note or bond can be sold at a market price provided that the composition of the group of assets represented by the security, consists of a majority of physical assets and financial rights, with only a minority being cash and interpersonal debts.[40]

Fifteen years later, in May 2003, the sharia board of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) adopted sharia Standard No. 17 on Investment *Sukuk*.[41] Therein, investment *sukuk* is defined as: 'Certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity'.

The standard makes it clear that *sukuk* must be asset backed and subject to a sharia compliant contract. It is worth stressing here that the key concepts are:

- transparency and clarity of rights and obligations;
- income from securities must be related to the purpose for which the funding is used, and simply not comprise interest; and
- securities should be backed by real underlying assets, rather than being paper derivatives and the assets must be *halal* (permissible) in nature and being utilised as part of a *halal* activity.[42]

The growth of the *sukuk* market may be attributed to the potential for liquidity management it provides, which has been identified as one of the

key ingredients necessary for the further development of the Islamic banking and finance industry. Over the past seven years, *sukuk* have created new possibilities for the short- and medium-term placement of funds. The market is, however, very young compared to other bond sectors; and though sovereign and quasi-sovereign entities such as banks and state agencies have fuelled early growth in the asset class, maintenance of the upward trend depends on whether the other sectors, particularly the private sector, jump on the *sukuk* band wagon. It is likely, however, that the market's growing appetite will persist with the continuing need for financing coming out of the Middle East and issuers both globally and locally increasingly turning to *sukuk* to raise funds. However, the growing awareness and understanding, among both Muslim and non-Muslims, of the details of Islamic finance transactions is causing disillusionment towards the industry. To sustain long-term growth Islamic finance, therefore, may be forced to turn inward and focus on providing the substance its title alludes to instead of modified versions of conventional transactions at a surcharge.[43]

3.5 Distinguishing *sukuk* from conventional bonds

The obvious benefit of *sukuk* is the provision of a sharia compatible alternative to conventional bonds that earn interest which is perceived to be prohibited by the sharia. Furthermore, conventional bonds may be financing activities and industries considered *haram (*prohibited*)* either directly (e.g. through the production and sale of alcohol, gambling, etc.) or indirectly (through the securitisation of assets used in the production of prohibited goods or financed from the proceeds of sales of prohibited activities). Similarly, companies that are highly leveraged with bank debts may seek refinancing through bond issues (i.e. the sale and securitisation of debts) but as will be discussed in chapter 6 pertaining to 'the sale of debt', such companies are not regarded as suitable for Islamic investments.

The aim of bond trading is usually to make capital gains from the rise in price of the fixed interest bond when variable market interest rates fall. Bond trading may therefore be considered to be largely about exploiting interest rate developments and trading in paper that is usually unrelated to the real value or existence of any underlying asset. The major risk for holders of conventional bonds is of payment default, but this risk is usually assessed solely based on credit ratings by the rating agencies rather than the bond purchasers estimating the actual risk involved. Hence, the bonds are often regarded as pieces of paper with third parties estimating the risk and the purchaser at best only making a risk return calculation without any reference to the business being financed. The recent economic downturn