Islamic Finance: Business as Usual

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Abstract

Like all contracting laws, Islamic law presents two classes of principles that govern contracts: general and objective specific. First, general principles of contracting include civil aptitude, consent, and moral foundation. These are common between all legal systems and societies, although there are variations in some respects. For instance, while Islamic law defines civil competence for financial contracts at age 18, some states or countries carry the age limit to 21. Also, while all laws are founded on moral values, they differ on the extent to which they promote/incorporate moral values within the texture of law. The second group of principles reflects a specific viewpoint. In this regard, the Islamic law has a strong and detailed moral/ethical commitment and screening, prohibits the practice of interest in all its forms, and sticks to the crude reality or real-life validity.

I. Introduction: Why Islamic Finance?

The objective of this paper is to define Islamic finance and compare it with conventional finance. This will be done on theoretical and empirical grounds based on practice in the Middle East and Southeast Asia.

As the title indicates, this article argues that Islamic finance is essentially “business as usual” because the requirement of the Islamic law in financing transactions are developed and derived by human rationale and these transactions are set in a way that makes them consistent with the human nature.

The mission of any religion is to reformulate or to reconstruct all aspects of human behaviour in accordance with its teachings and axioms of faith. One of these aspects is the economic and financial behaviour of the faith’s adherents. Nowadays, it is reasonably understood by Muslims and non-Muslims alike that Islam is not merely a relation between humans and God but a total way of life whose world view is founded on four basic pillars: Oneness of God; Accountability on the Day of Resurrection of all women and men for their deed and creed; Need for Divine guidance to follow and obey through Messengers (the last of them is the Prophet Muhammad); and Vicegerency, which means that humans are authorized or rather enabled and assigned to use and develop the universe that is created to serve them.

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Thus, for Muslims, Islam is a way of life: divine, final, and comprehensive. The need for Islamic finance arises from the desire of many Muslims to regulate their finances in accordance with the requirements of their faith.

Accordingly, the Islamic way of life as derived from the Qur'an and the traditions of the Prophet Muhammad is expressed in the form of ordinances and rulings known as the shariah— the Islamic law. The word "shariah" means "a way or a path"; its general objective is to promote, preserve, and protect women and men and the human race as defined in five fundamentals of human beings: life, mind or reason, religion, property, and posterity or future generations.[1]

In regard to property, the shariah aims at promoting and protecting private property and private earnings. It also promotes and protects public property and its appreciation as the Islamic economic system proposes a co-existence between the two kinds of properties. Hence, the four basic pillars of the Islamic economic and financial system are economic freedom, protection from aggression by other individuals or by the government, a delicate balance between rights of obligations of owners, and the right of God in the wealth of the rich that is given to the poor and social works. The minimum extent of this last pillar, the right of society to the wealth of its richer members, is well-determined in the shariah; it is called Zakah and everything above the minimum is left to be voluntary and called Sadaqat.

This article consists of three sections. The first section discusses the principles of Islamic finance the following section tries to explain the alternative Islamic contracts approved by the shariah as tools of financing. Finally, it introduces the most recent creature in Islamic financing, the Sukuk or Islamic bonds.

II. Principles of Islamic Finance

Like all contracting laws, Islamic law presents two classes of principles that govern contracts: general and objective specific. First, general principles of contracting include civil aptitude, consent, and moral foundation. These are common between all legal systems and societies, although there are variations in some respects. For instance, while Islamic law defines civil competence for financial contracts at age 18, some states or countries carry the age limit to 21. Also, while all laws are founded on moral values, they differ on the extent to which they promote/incorporate moral values within the texture of law. The second group of principles reflects a specific

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[1] See Shaykh Muhammad Taher, *Khutbah – The Objectives of the Islamic Sacred Law*, available online at http://www.leedsgrandmosque.com/khutbahs/khutba-20040319.asp (visited Sept 10, 2006).

viewpoint. In this regard, the Islamic law has a strong and detailed moral/ethical commitment and screening, prohibits the practice of interest in all its forms, and sticks to the crude reality or real-life validity. This section discusses this second group of principles.

A. Detailed moral screen

To be acceptable under shariah, a finance contract must pass a two-stage moral screen. First, both the contractual relationship must be morally sound. This implies the prohibition of contracts for gambling, contracts based on substantial ignorance and uncertainty, misleading information, obvious imbalances in the respective obligations of the parties, and bad faith in implementation. Second, the objective of financing must be acceptable under shariah. This implies the prohibition of financing certain activities that are immoral according to the Islamic religion such as drinking alcohol and smoking cigarettes, pornography, casinos, and pork production and distribution.

B. Prohibition of *Riba*

Islam, like other monotheistic religions, condemns and prohibits *riba*. The prohibition of *riba* in Islam is given in strong and clear-cut terms. The Qur'an says "But God has permitted the sale and forbidden the Riba";[2] and, "God destroys/eliminates the Riba";[3] and, "O ye who believe, fear God and quit what remains of the Riba if ye are indeed believers; but if ye do it not, take notice of war from God and His Messenger.".[4] No other sin is prohibited in the Qur'an with such a notice of war from God and His Messenger!

The Traditions of the Prophet Muhammad contain several statements that condemn *riba* and consider its practices as one of the gravest sins that invoke a curse or wrath from God. In one of the Sayings, the Prophet mentions: "The Wrath of God is on the taker of Riba, its giver, its writer and its two witnesses."

Riba is an Arabic word that means increment or increase. But the Qur'an did not mean any increase. It refers to a specific sort of transaction; the *riba* that was practiced and known among the Arabs and other nations at the time of revelation. For this reason, the reference in the Qur'an came with the article "the." "The" *riba* means a specific transaction known to the audience. It was done in one of two ways: deferring an already existing and due debt to a new maturity, provided the amount of debt is increased, or giving a loan that is due for repayment in a future date with an

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[2] Qur'an at 2:275.
[3] Qur'an at 2:276.
[4] Qur'an at 2:278–79.

increment. In other words "the *riba* refers to an increase in the amount a debtor owes his creditor due to the passage of time.

This understanding is based on the text of the Qur'an itself, which states: "But if ye repent ye shall have your principal, doing no injustice (against others) and no injustice is done against you."[5] This verse has two important indications. First, it defines *riba* as any increment above the principal of a debt or a loan; and second, it describes such increments as unjust. The exclusion of profit, being another kind of increase that is an increase in the amount received for a good over its cost, is given by Verse 2:275: "But God made sale permissible."[6]

To be exact, in regard to financial transactions, *riba* is defined as any increment above the principal of a loan that increases as a function of time—that is, interest.[7] Both legally and financially, interest is defined as an increment paid by the debtor to the creditor for granting a loan or for extending the maturity of an existing debt. The shariah does not recognize a counterpart for this increment. Consequently once a debt is created, any payment above the principal of the debt is interest and is "Prohibited *Riba*" according to the terminology of the Qur'an.

C. Why interest is prohibited

A debt is the outcome of a contract that creates a liability on one party that is an abstract asset of the other. This liability/abstract asset is created in exchange for service, good or cash provided by one party to the other. For the creditor, the owner of the abstract asset, creating a debt represents a transformation of money, goods or services into an abstract asset. The nature of a debt is such that it is not liable to increase or decrease. Debt cannot create value, because it has no intrinsic utility at the level of either consumption or production. It is only an ingredient of wealth. In other words, a debt cannot have different values at different times and places unless additives are created in the form of assumptions. That is done by creating a debt market and valuating or assessing debts in relation to time. Additionally, the amount of the increment in debts is also assumptive; it depends on the conditions and externalities in an imaginary market that we create for debts.

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[5] Qur'an at 2:279.

[6] Qur'an at 2:275.

[7] *This definition excludes* riba al buyu', *that is known and discussed in the Islamic literature, because it is irrelevant to financing since the time element is not necessarily an ingredient of it.* Riba al buyu' *is discussed in Muslim Jurists' literature as an increment in exchange contracts of certain items such as currencies, wheat, barley, date, salt, and the like. It is not a matter of finance as we know finance today.*

This may sound astonishing to those who are accustomed to talking and hearing about debt markets and interest. Are debts, in fact, able to increase or decrease or to create value? Of course they are not because they are abstract and mute assets; but once we create a market for anything there will be speculative demand and supply that will interact, in much the same way as people trade indices that represent ownership of nothing!. It is important to remember that the shariah recognizes real things and real growth or increment that comes about from the nature of real assets or by the effect of real market forces (that are founded on intrinsic value rather than assumptive speculation) on real assets, goods, or services.

Additionally, all real assets that may grow may also loose value, thus exposing owners to losses created by the same factors that create the growth; that is, real assets give their owner entitlement rights to any growth that they may create and at the same time expose her to losses that result from physical deterioration or from the demand and supply forces. But a debt, among all assets, is not liable to decrease and does not expose its owner to such kind of losses. Some people may argue that exposure to default risk is similar to the loss of value exposure of real assets. This argument does not hold because of two reasons: One, in principle every debt is secured by various kinds of guarantees and collaterals. Hence default risk becomes virtually zero; and two, the nature of default risk is different from that of the risk of increase or decrease that results either from natural factors or from the play of real market forces. A default risk is a qualification of the debt itself; it is of the kind of a faulty product or a product that does not maintain its normal characteristics for the entire period of the contract. A defaulted debt is like delivering a rotten apple in a sale contract. This kind of risk is very different from the price risk that affects the owner of the apple. This is why the default risk is compensated by a risk premium over and above interest that is "the price of money" or to put it more accurately "the price of time in debts."

It is also argued that a creditor has made a sacrifice, and thus deserves compensation to induce her to bear the load in the first place. While the idea of a sacrifice is legitimate, the basic fundamentals of private ownership prevent legitimizing any entitlement claim by any party, creditor included, to any part of the increase in value of the debtor's property. This is an immediate and "sacred" principle of private ownership: the owner is the only one who is entitled to all and any increase in her property. Once a loan is given, lent money becomes a property of the debtor and she uses it at her own risk, to her own benefit and by her own decision. The fact that she is under a personal liability to the creditor must not obscure her full right to the return of her property! This is not an Islamic specialty, this is all laws and all systems specialty and this is why Islamic finance is business as usual. The debtor did use the creditor property but she uses her own property, doesn't she? As for the creditor's

property, it has been transformed from cash to an abstract asset called debt![8] Consequently, a personal loan must remain personal as it is given on personal basis, touch and relations between the loan giver and loan recipient; it deserves thanks, gratitude, and appreciation from the borrower, and it may also deserve a reward from God—but it does not create value because the property of the lender is transformed into a mute abstract asset.

D. Realism or Real-life Validity

Lastly, the principle of realism or validity means that all financing contracts must be founded on "real" transactions or exchanges. In other words, Islamic finance create value from sale of goods for deferred payments, or from leasing assets that produce utility through time or from sharing in business projects that create value through innovation à la Chumpeterian sense. This principle means that Islamic finance is asset- and-goods-based and prohibits speculative contracts.[9] Interest itself is one example, both in its very existence and in its rates. Other examples include gambling and trading indices such as DJI or NASDAQ, because an index is a mere mental calculation that does not represent any real ownership.[10]

III. Shariah Compatible Finance Contracts

While shariah prohibits interest and other similarly unreal methodologies of financing, it holds on to the basic financing contracts that are known to human being since day one. It is difficult to call them "Shariah Alternative Contracts" because they are neither shariah-invented nor alternatives to interest. They are real methodologies of finance that have always existed in all societies; they are the financing as usual! Studying these contracts that are compatible with shariah can help determine the

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[8] This is in contrast to giving the same sum on the basis of venture capital by a sleeping partner. In this case the owner of the cash becomes an owner of the asset that is in the hand of the active partner, even after the original capital is transformed into intermediate goods or final goods because the active partner uses the cash property in the capacity of an agent of its owner. Consequently, capital owner deserves increments that may be generated by her property.

[9] This is not a Fatwa on the prohibition of speculation. It is rather an explanation of what is meant by realism in Islamic finance. Speculation means here "pure speculation" such as gambling or creating prices (and profits and losses) out of non real assets such as indices. Otherwise any trade has an element of speculation because you buy or produce and don't know what is your sale price is going to be.

[10] On the other hand, one can own and trade units in an indexed fund because the fund owns shares in companies that are included in the index.

exact boundaries of riba and demarcate the objectives of its prohibition. There are three major kinds of these "alternative" contracts: sharing-based, sale-based and lease-based.

From a historical point of view, Islamic financing contracts can be classified in two categories: classical contracts that have existed for centuries; their specific conditions are derived from the practice of the Prophet Muhammad's community in Madinah, and hybrid contracts that have developed over the past half a century and are practiced in contemporary Islamic finance and banking.[11]

A. Classical Financing Contracts

Classical writings on shariah, some of which date back twelve centuries, mention three essential sharing-based financing contracts: equity sharing (*musharakah*), equity sharing with a silent partner (*mudarabah*), and crop-sharing (*muzara'ah*). They also mention three sale-based financing contracts: deferred or installment payment sale (*al bay' al 'ajil*), forward sale with cash advance (*salam*), and manufacturing financing sale ('*istisna'*). Lastly, classical writings also mention leasing (*ijarah*) as a form of financing. All these seven contracts are within the group of contracts that is known in the literature as the nominate contracts [*al 'uqud al musammat*.]

1. Sharing Financing Contracts

Equity sharing may be de facto or a result of a contract that aims at making profit. De facto equity sharing happens either involuntarily, such as between heirs who share the ownership of property bequeathed to them, or voluntarily, as when a person buys part of an indivisible asset such as a horse or a plot of land that is marked by county master plan as one indivisible unit. De facto equity co-owners are independent from each other; no co-owner is authorized to make any decision regarding the property of the other. Consequently, the use of the indivisible asset is divided between the owners in proportion to what their properties which makes co-ownership a form of time sharing. In contemporary Islamic finance, de facto equity sharing [or co-ownership] is

[11] It should be noted that the shariah is not coded as articles of law in a manner similar to legal codes in the Western world, because Islam does not establish a religious hierarchy that is authorized to give the law. Rather shariah rulings, made over time, are found in the writings of shariah specialists/scholars. This is why those seeking shariah guidance or precedents must search for what is known as "nominate contracts" in shariah literature; that is the contracts that are mentioned in the famous writings of shariah scholars over the last twelve centuries or so. It is also the main reason why Islamic banks and financial institutions resort to appointing their own shariah advisors or shariah advisory boards.

used as the foundation for creating s*ukuk* and a secondary market for Islamic financial leases.

On the other hand, contractual equity sharing creates a partnership that aims at profit making. This, obviously requires an agreed upon process of decision making. Hence, the contractual equity sharing implies an authorization by each partner to the agreed upon manager, who may or may not be one of the partners, to make decisions on behalf of all partners regarding the use of their properties for achieving the partnership objectives. Management in equity sharing is undertaken on the basis of the *wakalah* (agency or empowerment to take decisions) contract. This has an important implication that characterizes contractual equity sharing as a contract that can be dissolved at will because you cannot force a person to maintain empowering others to decide for her/him. In other words, a partner can withdraw from contractual equity sharing at any time provided, of course, that such a withdrawal either does not hurt other parties or the withdrawing party is willing to compensate them for any harm caused by her/his action.

In contractual equity sharing, the contributions of partners may be of the same or different kinds. When all partners provide properties and management,[12] the contract is called *musharakah*; but when the contributions of partners are of different kinds, such as one puts in a property and the other puts in only managerial work or one puts in a land and the other provides the farming, we then have *mudarabah* and *muzara'ah* respectively. In other words, *musharqakah, mudarabah* and *muzara'ah* are variants of the contractual sharing contract.

Capital can be money, goods or inventory, or fixed assets but it cannot be a debt. Debt cannot be used as capital because, by its nature, a debt does not produce value added. A debt is neither a factor of production, nor it is capable of producing increments or profits. What can a manager do with a debt, being a liability on another person?? A quick answer may be to collect it and use the money for trading, but the moment it is collected it is no longer debt. Certainly it is permissible to request a manager of an equity sharing contract to collect a debt and once the cash is on hand, it can be taken as a principal. In other words, because a debt is not liable to grow or even to change, it cannot serve as a principal in an equity sharing contract. This is despite the fact that a debt is an asset but alas, a non-growable asset.

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12 In the classical literature and *Mudarabah* and on sharing in general, jurists use the term 'amal [work]; it mainly means managerial word in the area of decision taking but it may also include physical labor as known in craftsmanship where the manager and worker are same and one person.

Furthermore, according to shariah, people who share contracts must always share profits, under all and any potentialities. Profit sharing can take any ratio in recognition of partners who work more than others, but because a loss is defined solely as a reduction in principal by accounting standards, losses must be distributed in accordance with the shares in capital. Any condition otherwise is null and void. This is not the case in most Western commercial laws whereby it is permissible, in partnerships, to distribute losses at ratios different from the ratios of capital contributions

Musharakah is an equity sharing contract in which each partner provides capital and management. In *musharakah* the *wakalah* in management does not invalidate managerial contributions of other partners. Furthermore, in Musharakah, partners must share the net profit according to the agreement while losses are distributed only according to capital shares.

Mudarabah is a special case of *musharakah* whereby a sleeping partner provides capital but does not share in the management while the active partner does not provide any capital but puts in all the managerial work of the contract. Like *musharakah*, net profit is subject to distribution according to the agreement but losses are in proportion to capital that is all provided by the sleeping partner. In other words, in *mudaramah*, the sleeping partner bears all the losses.

Muzara'ah is a partnership on crops between a land-owner and a farmer. Here the gross revenue, not the net profit, is distributed according to agreement and land is due back to its owner at the end of the contract. The essential two features of *muzara'ah* are: 1) distribution of gross profit; and 2) the return of the fixed asset to its owner as is. These two features serve as a basis for creating a contemporary Islamic financing contract outside agriculture. An example of such a gross revenue-sharing contract is financing is financing the ownership of infrastructure such as a toll bridge, an airport or a railroad project on the basis of a percentage of its gross revenues.

2. Sale-based financing contracts

There are three major sale-based financing contracts that are discussed in the classical literature on shariah: deferred or installment payment sale, forward sale with immediate payment, and manufacturing sale.

Deferred or installment payment sale financing is practiced daily by all businesses in every corner of the world; it requires immediate delivery of the property or service sold with delayed or periodic payments. When an employee accepts payment at the end of every two weeks, she is financing the employer by giving him labor services against deferred payment. The same is done be a wholesaler who gives three-month credit on merchandise delivered to a retailer.

The permissibility of deferred payment financing sale is mentioned in no less than the Qur'an itself. Verse 2:275, quoted above, begins: "They [*riba* takers] say: 'Sale is just like *Riba*,' but God has permitted sale and forbidden *Riba*." The word sale in this verse refers to financing sale because financing sale may be confused with interest lending and a claim then may arise that they are similar. On he other hand, cash-payment sale is very remote from interest lending and has no similarity to it whatsoever. What is obviously similar to interest lending is deferred payment sale at a price that is higher than the cash price. Interestingly, the Qur'an did not degrade this claim or accuse it of irrationality in this Verse.[13] This, implicitly, means that some similarity is acknowledged, yet the Qur'an quickly directs the attention to the permissibility of this kind of sale that is similar to interest lending and the prohibition of the latter. While certain similarity is acknowledged, there are differences that warrant the permissibility of deferred payment sale-based financing and the prohibition of interest- and loan-based financing. This is why the overwhelming majority of scholars argue that the permitted sale in this Verse is deferred payment financing sale. This is also supported by the fact that this permissibility of Verse 2:275 is followed, a few verses later by Verse 2:282, that deals with confirmation and documentation of debts because deferred payment sale creates debts that, similar to the debts of interest lending, require documentation.

Another implication of the Verse 2:275 is that financing (with a return) is permissible and recognized in shariah. While the verse condemns interest-based lending, it approves a kind of sale that fulfills the same objectives including giving a reward for the time value of the sold commodity In other words, the Qur'an establishes a very important rule; sale-based finance arrangements are an acceptable and rewarding usual business activity while *riba* is prohibited. This plainly means that the creation of debts is not a thing that is discouraged or disliked in shariah and avoidance of creating debts is not an objective of the prohibition of *riba*. This conclusion is important because of the confusion that is circulating in Islamic finance conferences, meetings and circles that "Islamic finance is asset-based in contrast to debt-based finance." The fact, as practiced in contemporary Islamic financial institutions and instruments, is: Islamic finance is a debt-based sale financing much more that it is venture capital (Musharakah) financing and these practices rely on the Verse 2:275. These practices create sale-established debts in contrast to interest-lending debts.

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[13] Interestingly, such degrading style is used in the Qur'an in many other occasions whenever the unbelievers offer a weak or irrational argument. For instance, in many verses of arguing with opponents the Qur'an uses phrases like: " . . . will they not understand?" " . . . you may understand," " . . . do you not understand?" " . . . in order that you may rationalize" "… have you no rationale?" ". . . if only you have reason," "… don't you reason," " . . . so that they may have mind to rationalize with!"

Therefore, we need to rephrase that confused assertion, as this paper argues to make it read as follows: Islamic financing is asset based because it deals with real goods and services by means of contracts that create either debts or asset ownership.

There are a few apparent and multi-facet similarities between deferred-payment sale at a higher than the cash price and interest lending when the loan is used to finance the execution of a cash sale of an asset. First, in both cases, the purchaser gets the asset or goods at the time of the contract and pays later. Second, the amount she will end up paying may be about the same in both transactions, i.e., the deferment-related increase in the price may be equal to the amount of interest paid on the loan. Third, the seller gets compensated for the time span between the contract and the maturity of the debt and the lender gets also compensated for a similar time span. Finally, a debt is created in the amount of the deferred price that is higher than the cash price or in the amount of the loan plus its interest.

On the other hand, the major difference between interest financing and sale-based financing is that interest financing is done in a loan contract that stipulates that a debt may be assigned increments while sale-based financing recognizes that only goods and services may have different prices depending on the dates of payment and delivery. In reality a debt, because of its own nature, cannot produce any increment. This is the ideological basis for the prohibition. The implications of this difference are great. First, accepting the unreal premise that debt may have increment requires the creation of another unreal assumption about the valuation of the increment, or the rate of interest, itself. Second, once debts have increment, it must be acceptable to reschedule them with increment and there must be discounting with a reduction. These operations do not create value; they only transfer wealth from one to another. Third, In addition, trading debts may become a huge operation in the society, as it is in the West today, this is a purely speculative business with a zero sum as it only transfers wealth from one to another; it does not create added value and it consumes a large quantity of the human and material resources that are taken away from the production or real goods and services. The shariah does not find in these transactions a methodology that promotes increasing the quantity of goods and services and the welfare of the economy. These speculative financial transactions do not increase the number or productivity of workers on production lines, of inventories on shelves, of goods and services reaching consumers; they only enrich some individuals and impoverish others. Fourth, lending-based finance does not allow the application of moral and social screening without additional cost and legalities (as a result of adding conditions that restrict the use of funds at the borrower's end and creating monitoring procedures to enforce them) while moral and social screen is intrinsic to sale finance. Finally, the size of finance in the economy becomes detached from the real market in

the case of loan-based financing, and it would expand on its own in isolation from real production and exchange.

Salam is another sale financing contract. It is a sale of deferred-delivery goods for a presently-paid price or a sale on description of goods that do not exist at the time of contract. Its objective is to finance producers who will then be able to acquire the inputs they need and pay their current expenses. Obviously this kind of sale financing must require a clear consensual agreement on the full specifications of the goods sold, determined date and place of delivery, and the amount of the price. *Salam* creates an in-kind indebtedness which carries not only a financial risk but also a commercial risk of price variations. In order to avoid price speculation, the shariah does not allow selling owned goods before taking full possession of them.

Because of the nature of its indebtedness, a successful use of the *salam* financing contract requires certain market conditions such as stable or predictable commodity prices, adequate risk mitigation tools, and an efficient and active commodity market that enables the creditor to liquidate her positions soon upon delivery.

The last major sale-based financing contract is *istisna'*. It is a sale financing of fully described, specified, constructed, or manufactured goods against a price that may be paid at any time. It is a contract that can be used to finance producers or consumers depending on the consensual date of payment, and the seller does not have to be the actual producer. *Istisna'* [manufacturing-sale] is similar to *salam* in that both contracts are on sale of goods that are not available at the time of the contract, they require future delivery. The only important difference is that *istisna'* does not require advance payment of the price.

3. Lease Contracts

As a matter of definition, lease, or ijarah, financing is a sale of a usufruct for a given price that is payable at any agreed upon date. The object of ijarah is a usufruct (a right to use an asset and take its benefits and then return it to its owner at the end of the agreed period) of long living assets that are not consumable during the contract period. In Islamic lease financing, as it is in leasing as defined in other laws, the lessor is responsible for delivering the asset in usable conditions and maintaining its usability throughout the lease period. The lessee is responsible for the rent and for returning the asset to lessor at the end of the lease. Since the asset is entrusted to the lessee, she will be responsible for damages only in cases of abuse or negligence but not for normal wear and tear. It should be noted that while lease financing keeps the ownership of the asset in the name of lessor, leasing is a debt-creating contract as the

periodical rentals become a debt on the lessee, and this debt can be mitigated by all and any kinds of collaterals and securities.

In many countries, tax systems and accounting standards distinguish between operational and financial leases. This distinction is basically related to who may get the benefit of deducting amortization allowances from taxable income and how to represent, accounting wise, the parts of periodical payments that are assigned to paying for the principal of the leased asset. The shariah does not assign much concern to differences between these two kinds lease contracts as long as they both legally maintain the title of the leased asset in the hand of the lessor. This means that same conditions and legalities apply to both financial and operational leases.

Furthermore, a lease contract may be combined with an offer to sell the asset to the lessee gradually. Gradual sale necessitates a gradual reduction of rentals to make them consistent with the changing distribution of ownership. the shariah and Accounting Standards issued by the Auditing and Accounting Organization of Islamic Financial Institutions (AAOIFI)[14] recognize different versions of financial lease and accepts this idea that a gradual transfer of ownership may take place along with the parts of the periodical payments assigned to buying the leased asset even without a title change upon each payment.[15] Other considerations especially those related to taxes do not raise any Shari'ah red flag.

The leased asset can also be sold, used as collateral, and traded in an exchange market as long as the lease agreement remains untouched and the rights of lessee protected. The new owner becomes entitled to the rentals from the day of transfer of ownership. A lease financing can also be contracted for an asset that is fully described, but not yet in existence.

Additionally, the rent may be structured in any consensual manner that fulfills the financing objectives of the parties. It can be paid as one lump sum in advance in order to finance the lessor or at the end of the lease to finance the lessee. It can be spread over a number of years that does not have to coincide with the period of the lease, and rentals can be increasing or decreasing at a fixed or moving rate or at a rate that is tied to an external factor that becomes known before the beginning of each new rental period.

The characteristics of the lease contract make it amenable to different formulations that serve the multiple financing objectives of the lessee and the lessor. This

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[14] A voluntary non-binding professional organization of the industry based in Bahrain. It maintains high respect among Islamic banks and financial institutions.

[15] The Accounting and Auditing Organization for Islamic Financial Institutions, Shari'a Standards, 2003. Standard No. 9.

flexibility provides ample room for creativity in Islamic security which allows the issuance of different kinds of Sukuk over the last few years.

Finally, according to shariah, an owned usufruct is an independent property that stands on its own and can be subject to any and all kinds of transactions that apply to any property. The implication is that usufructs can be represented in securities and floated in an exchange market. Hence, they can create a new form of investment tools. This makes the shariah basis for different kinds of *sukuk* (Islamic bonds) that represent usufructs only.

4. Characteristics of Classical Financing Contracts

There are six main characteristics of classical Islamic financing that are presented briefly below:

First, Islamic financing is usually described as asset-based financing because it is based on owning goods and assets. This is apparent in sharing-based financing as the ownership of funds provider is carried over to the new properties purchased with her funds. It is also obvious in lease financing since the lessor deserves rent because she owns the leased property. In sale-based contracts this characteristic takes a little different form: sale financing requires that a seller owns a commodity, an asset or a property and has full possession of it and then she sells it at a higher and deferred price. Therefore, sale financing is also asset of goods based because it begins with assets although it ends up creating debts.

Second, the investment asset must be of the kind that may grow or create an increment either by its own nature or by the effect of real market forces. All such properties can be assets that may entitle the financier to receive a return, including goods that may be sold, physical assets that may be used in a special manner to produce goods and services, and intangible assets such as patents and trade marks that may be applied to a production or marketing process. On the other hand, debts and cash in demand deposits are assets that do not provide such an entitlement.

Third, owning productive assets or goods and services, while a necessary condition in Islamic finance, is not alone sufficient. It must be coupled with another condition to make the financing Islamic. This condition is that we look at actual, real life, genuine return. In other words, the return of the financier is determined in actual market. Accordingly, return on sharing-based financing is determined in the market of the goods and services produced and sold and in the market of the inputs of the firm, return to lease financing is determined in the usufruct market and return to sale financing is determined in the market of future prices of goods and services.

Fourth, contractual justice, fairness, and balance characterize classical Islamic finance contracts. These characteristics are expressed in several ways: free negotiation, consensual agreement, distribution of profits per agreement and losses per capital shares, and prohibition of misrepresentation, ambiguity (gharar) and excessive pricing (ghabn).

Fifth, Islamic financing includes intrinsic moral and social commitment and screening. Determining what to finance is an important issue in Islamic finance because it is channeled through producing, owning, selling, or leasing, all which makes the finance provider involved directly in the production and sale of whatever she finances. Hence, the moral and social screen is integrated in the process of shariah compatible financing itself and is not an imposed addition. The shariah prohibits the production and trade of commodities and services that are condemned on either moral grounds or on the basis of their social and environmental harm and according to Islamic finance, you cannot finance them because you cannot produce or own them!

Finally, Islamic finance contracts are flexible and amenable to create hybrids. This is discussed below.

Interesting to note is that, after revisiting all the classical Islamic finance contracts, they are not specifically Islamic! In the sense that these are normal contracts peoples of all faiths, colours, races, places, times, and ages have been using and practicing all along. There is nothing in the basic features of these contracts that is uniquely or extraordinarily Islamic. They are the same financing contracts that existed before Islam and that everybody uses and practices. These contracts are known in the West and known in the East and known every where in the present days and in the past days. They are simply business as usual. The important difference between Islamic finance and debt based finance, that is dominant in the West today, is that Islamic finance does not accept to be based on unreal assumptions or illusions: that money, given as debt, increases in the properties of others while in reality it does not grow; that a market may exist to trade debts while in reality this market is fabricated and that a rate of increase (or a price of time) may exist for a loan while this is a pure illusion! Islamic financing contracts may be considered naively simplistic but they are formidably real and down to earth with all its crude truth.

B. Hybrid Islamic financing contracts

The classical Islamic finance contracts have been described in the Jurists' writing over centuries. They are the product of simple tow-party relationships. Today financing is provided by intermediary institutions that collect resources from those who have surpluses and pour them into business and industry. Thus, on the basis of

the characteristics or salient features of the classical Islamic financial contracts, contemporary Islamic banks, in cooperation with shariah scholars, have developed a host of hybrid financing contracts that suits their role as mediators and the industry of financial intermediation.

Financial intermediation is a relatively new industry that has been developed in Western countries over the past three centuries. When a merchant sells at a deferred price or a lessor leases an asset, she is providing financing to the purchaser or the lessee. By contrast a financial intermediator is a corporation that specializes in getting the savings of those who have them and channelling them to businesses that need them for investment. In other words, financial intermediation is a specialty of those who recruit deposits and provide funding while merchants and producers deal with the daily decisions of a production line and buying and selling of goods and services.

Today's Islamic banking specializes in financial intermediation that requires suitable or appropriate tools that serve its specialty without transgressing the shariah limits. This is the role of Islamic financial engineering whose products are the Islamic hybrid financial contracts. In other words, the hybrid Islamic finance contracts constitute the empirical and practical backbone of Islamic banking and finance in the world today, an industry that started in the mid 1970s and has been growing at an average of over 14 percent annually over the last three decades.

There are eight major hybrid Islamic financing contracts that are practiced in Islamic banks today: *murabahah* to the purchase orderer, installment sale, *mudarabah* investment deposit, three-party *istisna'*, leasing to the purchase orderer, compound *salam*, Buy Back, and *tawarruq*.

Murabahah to the purchase orderer is a sale in which the price is equal to the known cost plus a known profit or mark up. This cost and profit are fully disclosed to the person who made a purchase order. *Murabahah* to the purchase orderer is a combination of a request to buy with a promise to re-buy, a cash-buy by the Islamic bank, and a deferred payment sale contract to the client. It begins with an order to buy from a customer to the bank with a promise that she will buy the same from the bank. The order defines the commodity, quantity, cost, and supplier. Once the bank approves financing, the two parties agree on the bank's profit margin. A power of attorney or delegation of authority is then issued by bank to the customer. As an agent of the bank, the customer contracts a cash purchase with the supplier and takes physical delivery; after delivery a second purchase contract between the bank and its customer is concluded in which the goods are sold to the customer at cost and the agreed profit. The price is deferred and the date of payment is scheduled. It looks long, but all these steps are prepared and signed together with a condition that the execution of the second purchase contract is effected only after delivery.

Murabahah is a hybrid contract of sale financing characterized by the following:

1. The bank owns the commodity even for a short period of time. This is what legitimizes, from a shariah point of view, the bank's profit.
2. The bank bears liability in regard to this ownership for the duration of ownership; this makes it concerned about the truthfulness of the transaction as it becomes a real purchaser/owner, not only a mere financier.
3. The transaction has an order to purchase, a promise to buy, an agency contract, and two sale contracts.
4. It is necessary that there ought to be real goods circulating from one hand to another.
5. Size of financing cannot exceed the exact amount of cost plus profit.
6. Rescheduling of payment for an increment and discounting are not permissible, so there will not be accumulation or creation of layers of debts.
7. For the bank, the transaction begins with cash out and ends with money in.
8. *Murabahah* creates a debt on the customer similar to the loan debt in conventional banks.
9. The *Murabahah* debt is subject to collaterals, guarantees, mortgages, and other default risk mitigation measures.
10. It is simple, easy to understand, and neat.

Murabahah is the most popular mode of financing in Islamic banks today. In certain Islamic banks, it occupies 80–90 percent of their total financing.

Installment sale is exactly a *murabahah* in which the price is paid in installments. A large majority of Islamic banks do not distinguish between *murabahah* and installment sale. Malaysia and Brunei are the exception. The central bank of Malaysia defines it as an independent Islamic finance contract and called by the abbreviation of its Arabic name BBA (*Bay Bithaman Ajil*). It is used very often in combination with Buy-back arrangement to provide personal finance.

Mudarabah investment deposit is a *mudarabah* financing contract between an Islamic bank and a depositor. The bank invests the deposit in its financing business, and the profit will be divided between the fund owner and the bank, being the manager, according to an agreed on ratio. *Mudarabah* deposit contract adds three conditions to the simple *mudarabah* that is known in classical literature. It mixes funds from all depositors together, it mixes funds of depositors with funds of the manager, and it provides certain procedures of early withdrawal.

Mudarabah investment deposit is the Islamic alternative of the time deposit in conventional banks. It does not give a pre-fixed rate of return. Therefore, depositors

choose between Islamic banks on the basis of past performance. In this regards, they are closer to investment in open mutual funds; a key difference, though, is *mudarabah* deposits are usually set for an agreed period of time.

Islamic banks usually offer *mudarabah* deposits for different maturities, including three months, six months, a year, and three years, with different ratios of profit distribution. They also offer a variety of facilities of withdrawal similar to passbook and small saving accounts. Usually, two broad categories of *mudarabah* deposits are normally offered: general *mudarabah* and restricted *mudarabah*. While general *Mudarabah* deposits are used by the bank in any and all their financing business at the bank's discretion, restricted *mudarabah* are invested in special projects that are designated and selected by the customer and are usually offered through the private banking department for large deposits only.

Three-party *istisna'*, sometimes called Financing *istisna'*,is an *istisna'* contract between a bank and a purchaser or customer put together with a second *istisna'* contract between the bank and a contractor or manufacturer that is identified by the customer. It is essentially a project financing tool whereby a corporation wants to build a project or purchase machinery and equipment. The project is put together by the corporation in a detailed blueprint. The plans are submitted to an Islamic bank for financing, and two independent *istisna'* contracts are put together in one document among three parties: the bank, the contactor, and the customer. The customer has an agency agreement that delegates to the customer authority of acceptance of delivery in regard to the contract between the bank and the contractor. Obviously, all specifications of the project, price of each *istisna'* contract (which includes the cash price between the bank and contractor and deferred or installment price between the customer and the bank), dates of payment of each contract, dates of delivery of each stage, and the mark up are stipulated in the contract.

Financial *istisna'* contracts are often used for large projects, with a syndication of a group of Islamic banks or Islamic and conventional banks together. Financial *istisna'* is also used as an alternative of lending to the government.[16] Also, the Islamic Development Bank (an inter-governmental Islamic bank with 57 member Muslim countries) uses this financing hybrid contract in its developmental project financing.

While the indebtedness created in simple *istisna'* financing is in kind, i.e., in the form of manufactured goods to be delivered or projects to be built, the debt created by the

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[16] In the early 1990s, when the Saudi Government supported its budget by domestic borrowing from private banks, Al Rajhi Banking Corp for Investment (a Saudi Arabian Islamic bank) financed, on a three-party *istisna'* basis, the construction of public schools as an alternative to buying treasury bonds.

financing *istisna'* is in monetary terms because the in-kind debt of one contract is offset by that of the other. This makes financing *istisna'* less risky and more easy to handle than simple *istisna'* or *salam* contracts.

Leasing to the purchase orderer is a financing contract consisting of a cash purchase of equipment by proxy through the purchase orderer and a lease to the same. It begins like a *murabahah* to the purchase orderer but ends as an operational or financial lease. Furthermore, if the contracted products or goods are to be manufactured or built, it may begin as an order to make an *istisna'* contract with the supplier or contractor and end as a lease-to-own contract.

Leasing to the purchase orderer is a form of financing that is similar to "Build and Transfer," with a few minor differences that are necessitated by the shariah requirement of defining the real ownership at each stage of construction. The lease contract component may be signed at any time regardless of whether the leased property is already in existence or not, or in the possession of the lessor or not, as long as the postulate that no rentals are earned for any period during which the property is not made available for the lessee to derive its usufruct is maintained. Additionally, the lessor must be the owner of any rental-generating property, wholly or partially. In other words, property cannot be sold and rented at the same time.

Lease to the purchase orderer may end by giving the property as a gift to the lessee (when installments include cost plus rentals), when the lessee opts to buy the asset at a predetermined price, by extending the lease to a new period, or by giving the property back to the lessor.

Lease to the purchase orderer is practiced by Islamic banks in house and car financing as an alternative to the conventional mortgage or lease. Accordingly, each of the equal installments consists of an ever-declining rental of the share of property that the lessee does not own and ever increasing amounts to buy segments of the bank's property. Payment may be accelerated by virtue of a lessor's open offer to sell to the lessee her share of the property. Delinquent payments do not reduce the rent of following period.

In compound *salam*, Islamic banks attempt to avoid the in-kind debt of the classical *salam* financing. They conclude a reversed *salam* contract with another customer in which the Islamic bank will be the seller of the same goods it is buying in a previous *salam*. But since the reverse *salam* financing would bring back funds financed (as *salam* requires payment at the time of contract), the banks do not like to counter a *salam* by another *salam*. Instead, Islamic banks counter a *salam* financing by a *murabahah* with another customer of same goods and quantity as the *Salam* financing contract. This way, they can use their resources in financing producers against in kind

debt of goods to be delivered in the future, through *Salam* and financing consumers through *Murabahah* on future delivery and future payment of the same goods.

The components of a compound *salam* are as follows: (1) a *salam* financing with a producer (say a farmer) for future delivery and immediate payment to the farmer; (2) a *murabahah* sale to a grain whole-seller for same goods, quantity, specifications, and delivery date against future payment (i.e., financing the whole-seller)[17] and (3) an agency agreement to delegate the whole-seller to take delivery directly from the farmer.

Finally, although the in-kind debt of one contract is offset by that of the other, each contract, on its own, can afford having any and all kinds of collaterals and guarantees. The Islamic bank can also take collateral for the final monetary debt of the final purchaser.

Buy back is essentially practiced by Islamic banks in Malaysian and Brunei for providing personal financing. It is a cash buy of goods owned by a customer and deferred sale of the same goods at a higher price to the same customer. A version of this contract is done as buy lease-to-own back.

While the shariah counsellors of most Islamic banks do not approve of this hybrid financing contract because it is merely a lending for interest hidden under a different name, some scholars argue that it may be the lesser of an evil when compared with interest lending. Therefore, they accept it in case of need for cash to pay off an interest-based loan.[18]

Tawarruq is a financing hybrid that aims at providing cash or personal finance to a customer. Similar to "buy back," it adds certain goods or assets between the provision of cash to the customer and the customer repayment of a larger sum in the future. *Tawarruq* consists of a *murabahah* to the purchase orderer plus another agency contract in which the customer authorizes the bank, on behalf of the customer, to sell the same goods purchased on *Murabahah* for cash and hand the money to the customer. *Tawarruq* is exercised on local goods, such as cars or common stocks, or on international commodities in the international exchange markets. In the latter case,

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[17] For some shariah scholars who argue against deferment of both payment and delivery, this contract takes the form of a binding promise to conclude a contract in the future;

[18] One Islamic bank in the Gulf area practiced 'buy and lease-to-own back' financing since 1999. The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) approves of this financing hybrid provided the lease contract is separate and independent from the purchase contract and none is made dependent on the other. Accounting and Auditing Organization for Islamic Financial Institutions, Shari'a Standards, 2003. Standard 9 § 3/2, p. 140.

a number of spot commodity contracts will be used depending on the amount of financing.

Tawarruq increases the cost of financing by adding broker commissions to buy and sell. It unlinks Islamic financing from the real exchange and production market because, although commodities are purchased and sold, they are not intended in the transaction, and they go back to the market without giving a signal to producers to replace them. *Tawarruq* also inflates the spot market with unreal transactions.[19]

While *tawarruq* is not practiced in Malaysia, it is common in several Islamic and conventional banks in the Gulf region, especially in the context of Islamic transactions departments in conventional banks in Saudi Arabia. However, the majority of Islamic banks and their shariah counselors consider *tawarruq* as pure interest lending hidden under a different name and do not include it within the Islamic hybrid financing contracts. Yet, a few shariah scholars, especially in Saudi Arabia, approve of it on the ground that it is a series of sales whereby each one of them is permissible. *Tawarruq* has been practiced since 1999 by Islamic banks and Islamic department of conventional banks in Saudi Arabia. The shariah scholars' counsel of the Muslim World League, a Saudi Arabian organization, issued an opinion in late 2003 suggesting that the *tawarruq* financing, as practiced by banks is merely an interest transaction that is not permitted in shariah. At the same time, it upheld a previous opinion that permits the same if it is practiced individually and consists of two separate contracts of buy deferred and sell cash provided it is not organized by a third party like a banker.

C. Categories of Islamic Financial Contracts

Financial contracts are sorted into three categories: full-disclosure contracts, called *amanah* contracts; trust-based contracts, called *amanah*-hand contracts; and negotiation contracts, called *musawamah* contracts. *Amanah* contracts require full honest disclosure of cost and profit. The most common example is *murabahah* financing because it is a financing sale on the basis of cost-plus and the amount of profit may be a lump sum or a ratio of cost. In this contract, any incidence that reduces the cost of the financier, such as a commission obtained on the contract, must be reflected in an equal reduction in the amount charged to the beneficiary.

[19] It happened in Saudi Arabia in the year 2005 that one bank heavily used the stocks of a power company for its *tawarruq* transactions. The result was a great volatility in the price of that stock to an extent that required central bank intervention to force the bank to stop using stocks in its *tawarruq*.

Amanah-hand contracts include all financing transactions that imply agency or authorization to take action. This is best seen in a fund management contract. Managers are required to use the funds and make investment decisions to the best interest of the funds' owners. Consequently, they will be charged for any fraud, neglect, or abuse of the funds, but they cannot be charged for a loss that results from changing market conditions.

Musawamah contracts are those whose conditions are discussed, negotiated, and consented to by the parties. This can include agreeing on a rate of mark-up in *murabahah* or on a ratio of profit distribution in *musharakah* and *mudarabah*.

This categorization is not exclusive as a contract may be based on consensual negotiation and at the same time on full and honest disclosure. Additionally, it may be a *musawamah* contract and an *Amanah*-hand contract at the same time.

IV. Sukuk and Islamic securities

Although securitization means transforming assets into financial assets that can be subscribed to in an exchange market, it began by representing assets in tradable documents. The classical shariah literature cites innumerable incidences where such documentation and exchange take place. To begin with, the Qur'an itself mentions documentation of debts in a written form. Documentation is a representation of ownership or entitlement.[20]

Accordingly, assets that can be securitized include physical properties (whether fixed assets or merchandise inventory), intangible rights (such as publication or patent rights), usufructs, and debts (both monetary and in kind). Of course, money may also be included. From the shariah point of view, principles that govern tradability and negotiability of securities are those that relate to sale (*bay'*), money exchange (*sarf*), and transfer (*hawalah*).[21]

Shariah, like other legal systems, permits the sale of fixed assets, goods in inventory, rights, usufructs, and any bundles or packages of them. As a precaution against interest, the shariah requires that when money is exchanged for money of the same currency, it must be done at face value; it also prohibits margin and future *sarf*. In other words, the exchange of money must fulfill two conditions: the full payment of exchanged quantities of both currencies and delivery executed at the time of contract. Also, to avoid interest, transfers of debts must be performed with no regard of

[20] Qur'an at 2:282.

[21] *Bay'* contract is used for physical and intangible properties, rights, and usufructs (*ijarah* is the specific term used for usufruct but it is defined as a sale of usufruct), *sarf* contract is used for exchange of a currency for other currencies, and *hawalah* contract is used for transfer of debt from one person to another.

maturity. This means that debts are exchangeable at face value. This is a clear denial of any time value of debt on the ground that debts do not change, increase, or decrease as a result of passage of time.

Additionally, because real life is usually complex, the "rule of majority" is approved in shariah and in other legal systems too. The rule of majority states that "when things are mixed, packaged, or bundled together rulings that apply to majority apply to all." Accordingly, when money and debts are mingled with other assets, the rules of sale apply if the majority is physical properties-cum-rights-cum-usufructs. The rules of sale mean that prices are negotiable, determined by consent on the basis of the market forces and can be spot or deferred, and the delivery of sold objects may also be immediate or at a future maturity. Conversely, if the total of money and debts makes a majority, the rule of face value then applies.

Finally, since securitization is a mere representation of assets in financial forms, the shariah applies the rules, that are appropriate to an asset, to the security that represents that asset. In other words, a very important principle of Islamic securitization is that a security is only a veil; what matters is what the security symbolizes. Consequently, while all properties can be documented, the shariah's acceptable securitization belongs only to physical properties, intangible rights, usufructs, and a bundle or package whose majority consists of any combination of these assets. But if a security represents a sum of money, a debt or a bundle in which the total of cash and debts makes a majority, the face value rule becomes applicable. The latter implies inability to submit this kind of instrument to market pricing and therefore, this kind of security cannot be traded in the exchange market.

A. What Can Be Securitized from The shariah Point of View?

A useful exercise includes implementing the above stipulations for securities and seeing how different kinds of assets can be securitized from an Islamic point of view and, at the same time, pointing out those assets that are not recognized for securitization.

Obviously, physical goods, or inventories, can be securitized while they are in the warehouses of companies. Fixed assets can also be securitized, as well as economic rights such as patents, trade marks, franchise rights, exploration rights, and rights to a physical future flow (e.g., right to a 5 percent of oil production of a given oil well, or 15 percent of electricity generated by a given generator or power plant). Usufructs, i.e., the right to use a fixed asset for a given period of time, can also be securitized. Services can also be securitized by issuing IOUs that represent a number of units of a well-defined service such as kilowatts of electricity, minutes of phone service, or hours of Internet connection. Finally, we can also securitize a package or bundle

consisting of any combination of the above mentioned properties, even if they have with them any amount of debts and money, provided that the total of these two items does not make a majority of the package. The best example of packages is common stocks.[22] The resulting securities can be sold in the market for any price, discounted or surcharged; they are negotiable and tradable at full scale.

On the other hand, money-based debts (such as CDs, treasury and corporate bonds, and units in a *murabahah* fund),[23] cash assets, gold, silver,[24] and rights to a future cash flow, are all kinds of assets that the shariah requires that their trade or exchange must be at face value by means of either *sarf* or *hawalah* contracts. These assets cannot be traded at a market price, and they are ruled out from negotiability on the basis of the prohibition of *riba*. In addition, there are a few other assets that are also ruled out from tradability according to the shariah principle of realism, validity, and on moral standards. These include indices that do not represent ownership of any real thing and options.[25]

B. Kinds of Islamic Securities

Islamic instruments and securities can be structured as output or gross-revenue sharing securities, net profit bundle of assets equity securities, net-profit sharing *mudarabah* securities fixed-income leased-assets deeds, floating-prices usufructs, or services securities.[26] Most of these securities already exist in the capital markets of several Muslim counties like Malaysia, Indonesia, Saudi Arabia, Bahrain, Kuwait, United Arab Emirates and Qatar.

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[22] Although common stocks are defined in finance as a right to a future flow of income, the shariah definition coincides with the Western legal definition of a common stock as a partial ownership of a company. This ownership covers all the company and its assets and liabilities.

[23] Units in a *murabahah* fund represent the assets of the fund that consist of only *murabahah*-generated debts and cash.

[24] Gold and silver used to be money at the time of Revelation, and the Sayings of the Prophet mention them. They will remain treated as money out of respect of the text of the law giver.

[25] Options are recognized as financial rights by the OIC Fiqh Academy but they are not permissible to trade on the ground that they are simply created for the purpose of trading and they do not exist on their own in the market, this is yet another application of the principle of realism.

[26] The example of these bonds is a bond that gives a time-sharing right of one week a year in a vacation apartment or hotel room for twenty years that begins, say, on January 1, 2010. This kind of bond presently exists in Saudi Arabia for hotels and suites around the Grand Mosque in Makkah and the Prophet’s Mosque in Madinah.

The term *sukuk* is an Arabic word (singular *sak*) that means documents. It is used loosely in contemporary Islamic finance literature to mean any Islamic security. It is also used as a specific name for *ijarah* (lease) based securities.[27]

There are three kinds of *ijarah sukuk*. First, there are *sukuk* that represent assets leased for a long term (5–20 years); they provide fixed income. Second, there are also *sukuk* that represent usufruct units of real estate properties such as hotel rooms and suites; they provide capital gain/loss in addition to the use of the usufruct they represent. And, third, there are hybrid *sukuk* that represent bundles of leased properties and *murabahah* debts; they also pay a fixed return.

Mudarabah certificates are another kind of Islamic securities. They are based on the *Mudarabah* contract and have been issued and traded at a small scale in Pakistan since the mid 1980s. *Mudarabah* certificates are similar to common stocks except that they do not give voting rights to their owners. At the same time they differ from preferred stocks because they neither have a guaranteed minimum return nor a priority at liquidation.

The beginning of the twenty-first century is witnessing a new phase of Islamic finance with the rise in *sukuk* issuance. In its meeting in the summer of 2000, the OIC Fiqh Academy studied the idea of *Ijarah* securities and issued a famous resolution approving the principle of securitizing leased assets. it also suggested the name *sukuk* for them. Since then *sukuk* have been issued by corporations and governments in the Middle East and South and Southeast Asia. Interestingly, over the last three years, 2002–05, some international bodies like the Islamic Development Bank in Jeddah, the World Bank, and some regional governments in Germany joined this trend by issuing Islamic *sukuk* to attract Muslim investors. It is estimated that *sukuk* issuance is going on at a growth rate that exceeds 20 percent annually, and in the mid 2006, about it reached about US$ 20–25 billion. The secondary market of Sukuk is not yet developed as none of their issues is circulated or traded because of the high demand in a market that is still far from being satisfied.

V. Conclusion

During the past two centuries or more, most of the Muslim countries lived under European rule for varying periods. Consequently, civil, business, and penal laws in the greatest majority of the Muslim countries are derived from the Western codes, and very often these codes were implanted without any changes to accommodate domestic socio-cultural environment. Some of these laws have been amended over

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27 The word *sukuk* is the plural of *suk*. It is an Arabic of Persian origin word صك that is the origin of the English word check. It means a document, title, or deed.

the last half a century of independence, yet there is still a lot to be amended too. As a result, business is as usual both from the point of view of the status quo of local business laws; it is also business as usual from the point of view of the Islamic law, the shariah, because the Islamic finance contracts are a reflection of the business finances as practiced in reality by all communities.

Yet, doing business with Islamic banks and other financial institutions raises an issue of legality, especially in dispute resolution. Islamic banks normally insist in all contracts that the shariah should be the law of reference for dispute solving, but since the shariah is not exactly coded in most of the cases there is always a need for defining the meaning of such a clause in legal documents. This requires careful attention to determining specific rules of arbitration and an arbitration body. Fortunately, a group of Islamic banks felt this need. In April 2005 they established an International Islamic Board of Arbitration for Financial Disputes whose offices are in Dubai, UAE. It is yet to set up its rules and procedures. But for now Islamic finance is, in both its essence and practical application, no more than business as usual.