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The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration

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THE RISE OF CUSTOMARY BUSINESSES IN INTERNATIONAL FINANCIAL MARKETS: AN INTRODUCTION TO ISLAMIC FINANCE AND THE CHALLENGES OF INTERNATIONAL INTEGRATION

ALI ADNAN IBRAHIM*

INTRODUCTION	663
I. WHAT IS ISLAMIC FINANCE?	664
A. HISTORY OF ISLAMIC FINANCE: ISSUES OF MUSLIMS ' POLITICAL IDENTITY	665
B. ISLAMIC ECONOMICS	667
C. ISLAMIC FINANCE TODAY	668
D. PRODUCT DESIGNING AND EFFICIENCY	670
II. THE ORIGIN AND SOURCES OF ISLAMIC FINANCE	673
A. THEORETICAL FRAMEWORK OF ISLAMIC FINANCE	673
B. FORMATION OF LEGAL AUTHORITY	675
1. <i>The Quran</i>	676
2. <i>The Prophetic Traditions (Sunnah)</i>	678
3. <i>Consensus of Juristic Opinions (Ijma)</i>	679
4. <i>Juristic and Analogical Reasoning (Ijtihad)</i>	680
5. <i>Islamic Law Resembling Common Law</i>	682

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C. SCHOOLS OF ISLAMIC LAW (<i>MADHAHIB</i>): JURISTIC REASONING VERSUS ADOPTION OF SCHOOL	683
III. OTHER FEATURES OF ISLAMIC FINANCE.....	685
A. ISLAMIC AND LEGAL OPINION (<i>FATWA</i>).....	685
B. RULES ON PROPERTY, OWNERSHIP, AND CONTRACTS	689
1. <i>Property and Ownership</i>	689
2. <i>Contract and Its Conditions</i>	690
IV. PROHIBITIVE INJUNCTIONS: <i>RIBA</i> (USURY OR INTEREST ON MONEY LOANS) AND EXCESSIVE UNCERTAINTY AND AMBIGUITY (<i>GHARAR</i>).....	691
A. INTRODUCING INJUNCTIONS ON <i>RIBA</i>	691
1. <i>The Prohibition of Riba: Equitable Considerations and Issue of Time Value</i>	693
2. <i>Riba Today</i>	699
B. EXCESSIVE UNCERTAINTY OR AMBIGUITY (<i>GHARAR</i>)	701
V. FINANCIAL ENGINEERING IN CONTEMPORARY ISLAMIC FINANCE	703
A. ISLAMIC BANKING	704
B. INTERNATIONAL BANKING OPERATIONS	705
C. ISLAMIC INVESTMENT FUNDS AND ISLAMIC INVESTMENT BANKING	705
D. HEDGING AND DERIVATIVES.....	708
E. REAL ESTATE INVESTMENT TRUSTS.....	709
F. CLASSICAL CONTRACT FORMS AND MODERN TRANSACTIONS	709
1. <i>Contract One: Profit-Sharing Dormant Partnership (Mudarabah)</i>	709
2. <i>Contract Two: Profit-Risk Sharing Partnership (Musharakah)</i>	711
3. <i>Contract Three: Cost-Plus Financing (Murabaha)</i>	711
4. <i>Contract Four: Leasing (Ijarah)</i>	712
5. <i>Contract Five: Manufacturing Contract (Istisna)</i>	713
6. <i>Contract Six: Absolute Option (Khiyar Al-Shart)</i>	714
7. <i>Contract Seven: Forward Sale (Salam)</i>	714
8. <i>Contract Eight: Islamic Insurance (Takaful)</i>	715
9. <i>Contract Nine: Agency Contract (Wakalah)</i>	716
10. <i>Contract Ten: Third-Party Guarantee (Damanah)</i> ..	717

11. <i>Contract Eleven: Partial Advance Payment</i>	
(Urbun)	717
12. <i>Contract Twelve: Islamic Bonds or Debt</i>	
<i>Securities (Sukuk)</i>	718
a. History	718
b. The Concept.....	719
c. The <i>Sukuk</i> Standards.....	719
d. The <i>Sukuk</i> Transaction.....	720
e. Convertible <i>Sukuk</i>	721
VI. FUTURE RESEARCH DIRECTIONS.....	722
CONCLUSION	726
APPENDIX	727

INTRODUCTION

This Article demonstrates theoretical foundations of Islamic finance and their correlation with the Islamic finance industry. In this respect, the Article presents an overall survey of the Islamic finance industry, Islamic-law injunctions pertaining to Islamic finance, quasi-regulatory institutions, financial engineering, transaction structures, and evolving practices. The Article also highlights various areas of further research, a comprehensive treatment of which is critical to the continuing growth of Islamic finance in the international financial markets.

Introducing the Islamic financial services (“IFS”) industry, this Article outlines the theoretical framework of Islamic finance and its correlation with Islamic law, and discusses the processes of law-making in Islam, which is significant in understanding the limitations and process of innovative growth in the IFS industry. Part I of the Article briefly traces the modern history of Islamic finance. Parts II and III discuss the sources and functioning of Islamic law and their impact on contemporary Islamic finance. Part IV illustrates the significant prohibitions to be observed by Islamic finance, that is, injunctions to avoid interest-based and excessively speculative transactions. Part V seeks to demonstrate how the theoretical framework of Islamic finance exists today in the IFS industry. With a conclusion to follow, Part VI includes a summary of various

financial services that the IFS industry offers and includes a brief description of contemporary Islamic finance transactions.

I. WHAT IS ISLAMIC FINANCE?

In common parlance, Muslims' financial operations and interest-free banking qualify for defining the expression "Islamic finance." Technically, however, the definition goes beyond the common understanding.¹ It includes the avoidance of interest or usury, which is generally referred to and known as *riba* or "unjustified increase,"² and the avoidance of ambiguity, which is generally referred to and known as *gharar* or excessive "uncertainty, risk [or] speculation."³ Islamic finance also means to earn in a religiously permissible way (*halal*), "and more generally the quest for justice, and other ethical and religious goals."⁴

Among others, two salient features provide a general defining guidance—namely, the philosophy of risk sharing and the promotion of social and economic welfare. The risk sharing philosophy considers the predetermined and fixed interest rate to be unilaterally exploitative on the borrower and, alternatively, suggests a profit and loss sharing arrangement between the creditor and the debtor. The welfare philosophy takes objectives of an enterprise beyond profit maximization.⁵

Although Islamic finance "fell into relative disuse during the colonial period," between the eighteenth century and the mid-twentieth century, Muslims now seek to regain their identity by way of rebuilding their own institutions, including financial institutions.⁶

1. IBRAHIM WARDE, *ISLAMIC FINANCE IN THE GLOBAL ECONOMY* 1-2 (2000) (noting the diversification of Islamic finance from fourteen centuries of practice).

2. *Id.* at 5.

3. *Id.*

4. *Id.*

5. *Id.*

6. Yousf Talal DeLorenzo, *The Religious Foundations of Islamic Finance*, in *ISLAMIC FINANCE: INNOVATION AND GROWTH* 9, 9-10 (Simon Archer & Riffat Ahmed Abdel Karim eds., 2002).

A. HISTORY OF ISLAMIC FINANCE: ISSUES OF MUSLIMS'
POLITICAL IDENTITY

Pakistani scholars led the intellectual debate favoring the feasibility of an Islamic financial system in the 1940s. Certain political and economic developments, such as "the advent of pan-Islamism and the rise in oil prices," facilitated moving theory toward practice.⁷ Early on, Egypt championed this vision in Muslim countries. Saudi Arabia and other countries reinforced it later. The Arab-Israeli conflict fueled the momentum, which saw its climax in the form of the Organization of the Islamic Conference ("OIC") that was established in 1970.⁸ From its inception, the OIC was involved in planning Islamic monetary and financial systems. At its fourth summit held in Pakistan in 1974, the OIC resolved to create the Islamic Development Bank ("IDB").⁹ In 1979, Pakistan began full Islamization of its banking sector, the first country to do so.¹⁰ Furthermore, heightened political slogan in the Arab world gave birth to what we may consider as the partial economic justification

7. WARDE, *supra* note 1, at 74.

8. *Id.*; see SHAHRUKH RAFI KHAN, PROFITS AND LOSS SHARING: AN ISLAMIC EXPERIMENT IN FINANCE AND BANKING 7-12 (1987) (outlining the political and economic background of Islamic finance).

9. WARDE, *supra* note 1, at 75.

The [IDB] is a Multilateral Development Bank serving the Muslim countries. Its present membership stands at [fifty-five] countries. Its purpose is to foster economic development and social progress of member countries and Muslim communities, individually and collectively, in accordance with the principles of [Islamic law]. In order to meet the growing and diverse needs of its member countries, the Bank has established a number of institutions and funds with distinct administrative arrangements and operational rules. These entities and funds, affiliated with the Bank, enable the IDB to mobilize supplementary financial resources in line with [Islamic law] and to focus on those functions and activities, which cannot be covered under its normal financing arrangements. With these affiliated entities and funds, the Bank has evolved over time into a group called the IDB Group. During the span of about three decades of existence, the Bank has made significant strides. The Bank has not only successfully attained a respectable position among the multilateral development financing institutions, but also proved to be a model emulated by other Islamic banks.

Id.; PHILIP MOLYNEUX & MUNAWAR IQBAL, BANKING AND FINANCIAL SYSTEM IN THE ARAB WORLD 156 (2005).

10. WARDE, *supra* note 1, at 77.

for the existence of the IFS industry. Muslim organizations exerted political pressure on the governments of Muslim countries, including those with a known secular manifesto, to encourage Islamic-law-compatible financial products.¹¹ Although Muslim organizations continued to expand throughout the Muslim world, the 1980s showed relatively moderate enthusiasm for Islamic banking. After the 1991 Gulf War, Kuwait was quick to announce the creation of Kuwait Finance House, the country's sole Islamic bank.¹²

The quadrupling petrol price hike during the middle of 1970s—a “petrodollar windfall”—contributed to “Islamic solidarity.”¹³ However, in subsequent years, due to the increasing political tussle among Arab states, the majority of petrodollars were invested in the United States either in the form of defense contracts or deposits in U.S. banks.¹⁴

From the 1990s onwards, Islamic banking and finance grew rapidly. Between 1996 and 1997, Islamic financial institutions grew at an average rate of twenty-five percent and held assets exceeding USD \$200 billion.¹⁵ Currently, the Islamic finance market may exceed USD \$350 billion with a present growth rate of fifteen percent.¹⁶

It appears from the above that the political resurgence has been a constant pressure on the demand for Islamic finance unlike the less constant petrodollar windfall. Since over seventy percent of the IFS

11. *Id.* at 105 (pointing out that Muslim countries amended banking laws to promote Islamic finance).

12. *Id.*

13. *Id.* at 92-93. See generally KHAN, *supra* note 8, at 7 (suggesting that the new wealth of Muslim countries allowed the promotion of Islamic sentiment and pride among its citizens, which had been dormant before the 1970s).

14. WARDE, *supra* note 1, at 92-95.

15. WARDE, *supra* note 1, at 1. But see MOLYNEUX & IQBAL, *supra* note 9, at 148-49 (noting that during the 1990s the growth rate was slower in comparison to the fifteen percent growth rate of the 1980s, but generally considering the 1990s period to be the “most important” because Islamic banking “matured during this time into a viable alternative financial intermediation model”).

16. See Jay Collins, *The Road Ahead for Islamic Finance*, in INTEGRATING ISLAMIC FINANCE INTO THE MAINSTREAM: REGULATION, STANDARDIZATION AND TRANSPARENCY 197, 197 (S. Nazim Ali ed., 2007).

industry is based on consumer financing,¹⁷ the prevailing demand appears to be from the Muslim middle class—and not from the petrodollars reserves.¹⁸ However, some scholars have argued that Islamic finance continues to grow more from the supply side than from the demand side.¹⁹

B. ISLAMIC ECONOMICS

In the wake of nationalized economies in the post-colonized Muslim countries, Islamic finance emerged as a movement to Islamize those economies. The discipline, therefore, was known earlier as Islamic economics. Although the discipline “was initially conceived as an independent Islamic social science, it quickly lost the emphasis on independence and . . . [,] once researchers started using conventional economics tools, their discipline was quickly subsumed by the larger field of economics.”²⁰

Under official patronage by various Muslim countries, the scholars of Islamic economics mainly emphasized, *inter alia*, converting interest-based revenue generation to Islamic modes of financing.²¹

17. Walid Hegazy, *Fatwas and the Fate of Islamic Finance: A Critique of the Practice of Fatwa in Contemporary Islamic Financial Markets*, in ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES 133, 147-48 (S. Nazim Ali ed., 2005).

18. See WARDE, *supra* note 1, at 86 (noting that firms such as Citicorp and Merrill Lynch have established subsidiaries in Islamic countries to provide services and products tailored toward the Islamic middle class).

19. See MAHMOUD A. EL-GAMAL, ISLAMIC FINANCE: LAW, ECONOMICS, AND PRACTICE 190 (2006) (arguing that “jurists who participate actively in Shari’a arbitrage help[] to expand the industry’s customer base through indirect advertisements [such as] conferences and publications . . . as well as religious admonishment that Muslims should avoid conventional finance”).

20. *Id.* at 138. Even though Islamic economics researchers used conventional economic tools “mimicking the (interest based) conventional finance it set out to replace[,] . . . writings in Islamic jurisprudence, Islamic economics, and Islamic finance continued to assert that the conventional interest-based banking and finance is . . . forbidden . . .” *Id.*

21. See generally WORKSHOP ON ISLAMIZATION OF THE FINANCIAL SYSTEM, IIIIE’S BLUEPRINT OF ISLAMIC FINANCIAL SYSTEM INCLUDING STRATEGY FOR THE ELIMINATION OF RIBA: REPORT OF THE IIIIE WORKSHOP ON THE ISLAMIZATION OF FINANCIAL SYSTEM MAY-JUNE 1997, at 104-09 (1999) [hereinafter BLUEPRINT] (pointing out that banks will initially act as intermediaries in the transfer of funds, but will eventually be replaced by new agency-based financial institutions to

Islamic banking thus appeared as an offshoot of Islamic economics. On a small scale, however, Islamic banking started after World War II, at the early days of post-colonization. It started on the basis of theoretical Islamic finance works that were authored in the early nineteenth century in response to the significant Muslim majority who refrained from participating in modern, interest-based commercial banks.²²

C. ISLAMIC FINANCE TODAY

The International Association of Islamic Banks requires every financial institution offering Islamic financial services to have a board of Islamic law scholars directly elected by shareholders.²³ In theory, the *Sharia* (Islamic law) board can review any product proposal for its validation or otherwise. If the board refuses to validate a product proposal because of noncompliance with principles of Islamic finance, financial institutions are left with no option but to abandon the proposal.²⁴ However, some scholars have found instances of "rubber stamping" managerial decisions by the board.²⁵

facilitate the elimination of interest while continuing to process settlements of financial obligations).

22. MOLYNEUX & IQBAL, *supra* note 9, at 147. Credit and cooperative societies remained functional within the colonized Muslim world to offer interest-free financial solutions at a limited scale, but proper Islamic banking institutions started emerging during 1960s. *Id.*

23. WARDE, *supra* note 1, at 226.

[A Shariah Board] is formed of a number of members chosen from among jurists and men of Islamic Jurisprudence and of comparative law who have conviction and firm belief in the idea of Islamic Banks. To ensure freedom of initiating their opinion the following are taken into account: (a) They must not be working as personnel in the bank. That means: They are not subject to the authority of the board of directors. (b) They are appointed by the general assembly as it is the case of the auditors of accounts. (c) The general assembly fixes their remunerations. (d) The Legitimate Control Body has the same means and jurisdictions as the auditors of accounts.

Id. at 226-27 (quoting AHMAD MUHAMMAD ABD AL-AZIZ NAJJAR, ONE HUNDRED QUESTIONS AND ONE HUNDRED ANSWERS CONCERNING ISLAMIC BANKS 20 (1980)).

24. *Id.* at 227.

25. *Id.*

In order to standardize the regulation of the IFS industry, the governments of various Muslim countries and the industry took many initiatives. Malaysia established a National Syariah (*Sharia*) Board to standardize Islamic finance practices and advise the Malaysian Central Bank.²⁶ Pakistan also established a *Sharia* Board within the State Bank of Pakistan to achieve similar objectives, and the United Arab Emirates, Bahrain, and others followed suit. In general, a special regulatory regime governs the IFS industry in Muslim countries and a different regime continues to regulate conventional banking.²⁷ Muslim countries thus have a dual regulatory system catering to both Islamic and conventional banks.²⁸

As for industry-oriented, non-governmental initiatives, advisory bodies were established including the "Institute of Islamic Research . . . at Al-Azhar University (established in Cairo, 1961), the Islamic Jurisprudence Council . . . of the Muslim World League (established in Makka, 1979), the Fiqh Academy . . . of the Organization of Islamic Conference (established in Jeddah, 1984)."²⁹ Although it does not play any formal role of regulating the IFS industry, the practices of the IDB are adopted as industry standards.³⁰ Industry-sponsored bodies include the Accounting and Auditing Organization of Islamic Financial Institutions,³¹ the Islamic Financial

26. *Id.* at 229-30.

27. MOLYNEUX & IQBAL, *supra* note 9, at 162.

28. *Id.* at 162-63.

29. EL-GAMAL, *supra* note 19, at 32.

30. See RODNEY WILSON, ISLAMIC FINANCE 61-63 (1997).

In the long term, the future of the IDB will depend on political developments as much as financial conditions. If the economies of the Muslim world move away from western secularism, the IDB may become even more important. Much will depend on the future in the Gulf region, especially in Saudi Arabia, but certainly during the last decade events seem to have been moving towards greater application of the *Shariah* law as Islamists win more political and economic influence.

Id. at 63.

31. See MOLYNEUX & IQBAL, *supra* note 9, at 149 (explaining that the role of the Accounting and Auditing Organization for Islamic Financial Institutions includes "adapting . . . international standards to suit Islamic financial institutions"); Official Website of Accounting and Auditing Organization for Islamic Financial Institutions [AAOIFI], <http://www.aaofii.com/> (last visited Mar. 6, 2008).

Services Board,³² the International Islamic Financial Market,³³ the Liquidity Management Center,³⁴ and the International Islamic Rating Agency.³⁵

Despite the emergence of the above institutions, no single institution could be regarded as the central point of reference for guidance on the issues of compliance with Islamic law. Therefore, the central role of the *Sharia* Board of each IFS institution continues to drive the bulk of industry innovation. However, opinions from Al-Azhar University, the Islamic Jurisprudence Council of the Muslim World League, and the Fiqh Academy of the Organizational Islamic Conference have been decisive on various controversial transactional issues.³⁶ If an IFS institution has launched a product relying on the opinion of its *Sharia* board or any of the above institutions, competitor IFS institutions invariably adopt the same structure, implicitly confirming the structure's validity and encouraging its broad adoption.³⁷ The industry-oriented, non-governmental institutions and the internal *Sharia* boards of IFS institutions, in effect, collectively act as a quasi-regulatory body.

D. PRODUCT DESIGNING AND EFFICIENCY

The trend of relying on earlier juristic sources has led the IFS industry to borrow classical contract forms that resemble

32. See MOLYNEUX & IQBAL, *supra* note 9, at 150 (noting that the primary role of the Board is to include prudential regulation for the Islamic financial institutions); Official Website of Islamic Financial Services Board, <http://www.ifsb.org> (last visited Feb. 16, 2008).

33. See MOLYNEUX & IQBAL, *supra* note 9, at 149-50 (arguing that International Islamic Financial Market provides much needed market liquidity "due to the absence of a secondary market for Islamic financial instruments"); Official Website of International Islamic Financial Market, <http://www.iifm.net> (last visited Feb. 16, 2008).

34. See MOLYNEUX & IQBAL, *supra* note 9, at 150 (explaining that the Center was established as an arm of the International Islamic Financial Market with a view toward efficiently managing the short term liquidity needs of the IFS institutions).

35. See *id.* at 150-51 (explaining that the Agency supplements the conventional rating industry by rating the Islamic-law compliance of IFS products).

36. EL-GAMAL, *supra* note 19, at 32.

37. See *id.* at 11-13 (describing the process by which Islamic financial institutions create and adopt financial products and services).

conventional financial transactions. The classical contract names are retained to portray the brand name of Islamic finance, as well as to create an independent identity.³⁸ These names are used for the equivalent conventional transactions, which include, for example, using “*ijara*” for “lease,” “*murabaha*” for “cost-plus sale,” and “*takaful*” for “insurance.” To initiate the product-designing or reengineering process, jurists are assisted by lawyers and bankers. The group collectively examines the short-listed conventional products and in the process removes the transactional steps that violate Islamic law and replaces them with those that are in compliance.³⁹ The *Sharia* boards, therefore, play an important role in the development of Islamic finance products. They also indirectly market the product by giving presentations at various conferences where professionals from the IFS industry are in attendance.⁴⁰ When more than one institution offers a product, competition reduces the profits and results in greater innovation.⁴¹

The number of Islamic finance scholars today is small. The same jurists serve on the boards of various IFS institutions, provide expert testimonies before the quasi-regulatory bodies of the IFS industry, and assist in shaping policy opinions and quasi-regulatory frameworks for the IFS industry.⁴²

Scholars have argued that approximating conventional transactions with the help of transaction formats developed and used centuries ago by Muslim jurists may increase the risk of mispricing and inefficiency. Bundling of risks was offered as an alternative, while highlighting the dangers of an approximation strategy.⁴³ In the long

38. *Id.* at 18-19.

39. *Id.* at 11-12.

40. *Id.* at 11.

41. *Id.* at 11-13.

42. *Id.* at 32.

43. *Id.* at 23.

[T]he use of premodern contract forms in Islamic finance essentially reentangles the various risks, for example, by allowing an increase in price due to embedded options, while disallowing sale of those options separately [A]dherence to classical nominate contracts necessarily amplifies the aforementioned tension between efficiency and credibility directions: 1. Classical conditions of nominate objectives. This, in turn, must force the industry to choose one of two contracts may be systematically

term, the suggestion is to revive the substances—and not merely the form—of classical jurisprudence and the economic or best-benefit analyses that the classical jurists developed: the objective of enhancing economic efficiency.⁴⁴ The inefficiency caused by the use of classical contract forms is tolerable only if the spirit and substance of Islamic law is ensured.⁴⁵

Contrary to the aforementioned inefficiency observation on contemporary Islamic finance, a scholar has argued that Islamic finance—which is derived from divine commands—enhances efficiency despite its paternalistic nature.⁴⁶ In support, the scholar describes the standard prisoners' dilemma and maintains that the divine command—"thou shalt not defect"—could yield mutual cooperation among the market participants, instead of mutual defection resulting in inefficiency.⁴⁷

relaxed to enhance efficiency, in which case they would have served no purpose. . . . [The risks of this approach include that] the target audience of Islamic finance may grow progressively more disenchanted by the lip service it pays to classical texts, without adhering to the conditions therein. . . . [Or], 2. Islamic finance may continue to be an inefficient replication of conventional finance, always one step behind developments in the imitated sector.

Id. at 23-25.

44. *Id.* at 26-29 (outlining the established criteria for best benefit analyses, namely: "(1) allowing apparent benefit, (2) preventing apparent loss/harm, (3) preventing means of circumventing the law, and (4) consideration of specific circumstances in time and place").

45. *Id.* at 54-55.

This inefficiency would be tolerable only if we ensure that the spirit of the Law that gave rise to adopted forms is protected. . . . [I]t would be shameful merely to copy or adapt inefficient historical forms and squander the substance of Islamic law. Ideally, contemporary jurists would develop a modern jurisprudence that embodies the substance of premodern law within the context of contemporary legal and regulatory frameworks.

Id.

46. *Id.* at 9 ("[Judge Richard] Posner denounced Adam Smith's support for laws against interest-based borrowing and lending as paternalistic and efficiency reducing.").

47. *Id.* at 9-10.

Within the quasi-religious context of Islamic jurisprudence and finance, there is no doubt that religious injunctions are by definition paternalistic. Indeed, the charge of "paternalism" sounds compassionate when attributed to the Divine and therefore will not be contested. With regard to efficiency

II. THE ORIGIN AND SOURCES OF ISLAMIC FINANCE

A. THEORETICAL FRAMEWORK OF ISLAMIC FINANCE

The Prophet Mohammad was a merchant and a trader; trade and commerce traditions are not new to Islam.⁴⁸ Consistent with the history of Muslims' entrepreneurial business and financial transactions, Muslims today continue to explore commercial opportunities in accordance with the dictates of their beliefs.⁴⁹

reduction, consider the following simple and well-known example, which suggests that paternalistic injunctions against dealings to which parties mutually consent can in fact be efficiency-enhancing.

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

In the standard two-prisoners' dilemma shown [above], each player has a choice to cooperate or defect, with the shown payoffs (the first payoff in each cell is for the row player, and the second is for the column player). For each of the two players, the dominant strategy, regardless of the opponent's choice, is to defect (and get [five] instead of [four], or [one] instead of [zero], depending on opponent's action). Thus, the unique Nash equilibrium (wherein each player plays the best response to the other's selected action) is defection for both players, whereby hereby each player would receive [one].

In this well-known game, it is very clear that the equilibrium outcome of the prisoner's dilemma, to which players will gravitate if left to their own devices, is inefficient. Mutual cooperation would yield [four] for each, instead of [one]. In this case, a paternalistic divine command 'thou shalt not defect' can in fact be efficiency enhancing.

Id.

48. WARDE, *supra* note 1, at 38.

49. See DeLorenzo, *supra* note 6, at 9-10 (outlining the history of the Islamic finance and its continuing evolution to adapt to the changing nature of global business).

Islamic business in history is an exotic and dynamic panorama that ranges from gem merchants in Ceylon, to caravan traders in Mali, to dealers of saffron in Muslim Spain, to sellers of aromatic oils in the deserts of Arabia, to colourful cotton markets in Turkey, to spice markets in India, to the hardwood merchants of Malaysia, to the plantations and industry of Indonesia, to carpetmakers in Kashmir, to the great merchant houses of the Levant, to the oil of the Arabian Peninsula, North Africa, and Brunei. The business practices and ethics in all of these places, and from the moment that Muslims

According to Islam, religious scriptures guide Muslims as to their *inter se* anthropomorphic relationship, dealings with the nature, and the material aspect of the world.⁵⁰ Notwithstanding emphasis on property rights in Islam, Muslims believe that everything belongs to God (*Allah*), a monotheistic being, and humankind is simply a caretaker.⁵¹ Property rights and freedom of trade by mutual consent are central to Islam.⁵²

As caretaker, humankind is strictly accountable for its stewardship of creation in return for benefiting from and exercising authority over the physical universe.⁵³ Humankind must endeavor to abide by approved behavior and refrain from the disapproved. Doing “good” covers all the activities of a believer.⁵⁴ Seeking the permissible (*halal*) and avoiding the forbidden (*haram*) in all the pursuits of life is an overarching duty of a Muslim.⁵⁵ This leads to a jurisprudential examination of the religious scriptures primarily to understand and act according to the permissible (*halal*) framework and to avoid what is forbidden (*haram*). This jurisprudential study took the form of a discipline known as “Islamic jurisprudence” or “Islamic law” (*Sharia*). In general, Islamic law extends to the understanding of a believer’s rights and obligations vis-à-vis God, humankind, and the universe at large.⁵⁶

Since Islamic law treats a person’s wealth and life on equal footing, deprivation of wealth—or enrichment at someone else’s expense through the use of a forbidden means—is viewed with

arrived there, are derived from the same source. Modern Islamic finance and investing came from the same tradition of open but disciplined markets where risk and reward are tempered by clearly articulated religious precepts.

Id. at 13.

50. *Id.* at 11.

51. *Id.*; see WAEL B. HALLAQ, THE ORIGINS AND EVOLUTION OF ISLAMIC LAW 19-20 (2005) (explaining the Muslim belief in God and comparing it to that of Judaism and Christianity).

52. EL-GAMAL, *supra* note 19, at 9.

53. DeLorenzo, *supra* note 6, at 11.

54. THE HOLY QUR’AN: ENGLISH TRANSLATION OF THE MEANINGS AND COMMENTARY 23:51 (1994) [hereinafter QUR’AN] (“O ye messengers! enjoy (All) things good and pure, And work righteousness: For I am well-acquainted With (all) that ye do.”).

55. DeLorenzo, *supra* note 6, at 12-13.

56. *Id.* at 10-11.

strong disapproval.⁵⁷ Economic progress is generally linked to risk, which is essential for all innovations.⁵⁸ Put differently, bona fide, fair, equivocal, and risk-sharing transactions are the hallmark of Islamic finance. Furthermore, in the business dealings, Islamic law enjoins to fulfill contractual obligations and honor commitments.⁵⁹ Unfair dealings and advantages are exploitative and unjust tactics; others include interest charged on money loans, ambiguous contracts, monopolies, and price fixing.⁶⁰ As discussed in Part VI below, it remains to be examined empirically whether the IFS industry is in compliance with the injunctions.

B. FORMATION OF LEGAL AUTHORITY

Being revealed by God, through the Prophet Muhammad, the *Quran* is the first primary source of Islamic law and the principal guide for interpretation.⁶¹ Oral and practice-based Prophetic traditions are the second primary source of Islamic law.⁶² This Article will focus on only some of the sources of Islamic law: the *Quran*, the Prophetic traditions, consensus of juristic opinion, and juristic or analogical reasoning.

In general, the sources in Islamic law may be categorized as revealed and non-revealed.⁶³ The *Quran* is the first revealed source. Being the word of God in its letter and spirit, the *Quran* is communicated through the Prophet Muhammad. “[A]ll that is narrated from the Prophet, his acts, his sayings and whatever he has tacitly approved” (the “Prophetic traditions”) represent the second

57. See *id.* at 17 (quoting the Prophet Mohammad (PBUH): “A persons wealth is as sacred as a person’s blood”).

58. *Id.* at 23.

59. QUR’AN, *supra* note 54, at 5:1 (“O ye who believe! Fulfil (all) obligations.”); see DeLorenzo, *supra* note 6, at 14 (quoting the Prophet Mohammad (PBUH): “Muslims honour their covenants”).

60. DeLorenzo, *supra* note 6, at 15.

61. HALLAQ, *supra* note 51, at 33-34.

62. *Id.* at 49 (“[T]he process that ultimately led to the emergence of Prophetic Sunna as an exclusive substitute for *sunan* was a long one, and passed through a number of stages before its final culmination as the second formal source of the law after the Quran.”).

63. MOHAMMAD HASHIM KAMALI, PRINCIPLES OF ISLAMIC JURISPRUDENCE 1 (3rd ed. 2003).

revealed source⁶⁴ because the *Quran* declared the Prophet's acts, sayings, and tacit approvals to be divinely inspired.⁶⁵ Both revealed sources are considered primary.⁶⁶ In contrast, non-revealed sources were developed by Islamic law scholars, and represent the "methodology and procedural guidelines to ensure correct utilization [sic]" of the revealed sources.⁶⁷ Such sources include consensus of juristic opinion, analogical or juristic reasoning, previously revealed laws, legal opinions from companions of the Prophet ("companions"), equitable considerations, public interest, customs, presumptions of continuity, and blocking the means to evil.⁶⁸ All of the secondary sources derive their authority in the *Quran*, the Prophetic traditions, or both.

1. The Quran

At the beginning, Prophet Muhammad preached "for humility, generosity and belief in God," and the Quranic commandments were revealed subsequently, a period that is viewed as a beginning of "substantive legislation."⁶⁹ As for the Quranic text, it was recorded and confirmed during the lifetime of the Prophet. It is believed to have come down without sustaining any doubt as to the authenticity of its text.⁷⁰ The *Quran* was revealed in the course of twenty-three years from 610 through 632 C.E.⁷¹ Legal injunctions in the *Quran* are

64. *Id.* at 58.

65. QUR'AN, *supra* note 54, at 53:3-4; KAMALI, *supra* note 63, at 18-19, 63, 484 (discussing the differences between manifest revelation (the *Qur'an*) and internal revelation (the Prophetic Tradition)).

66. C.G. WEERAMANTRY, ISLAMIC JURISPRUDENCE: AN INTERNATIONAL PERSPECTIVE 32-39 (1988).

67. KAMALI, *supra* note 63, at 1.

68. *See generally id.* at 228-409 (outlining the methods of interpretation of revealed sources).

69. HALLAQ, *supra* note 51, at 19-21.

70. *See* KAMALI, *supra* note 63, at 78 (noting that none of the *Qur'an* "consists of conceptual transmission, that is, transmission in the words of the narrator himself. Both the concepts and the words of the *Qur'an* have been recorded and transmitted as the Prophet received them").

71. MUHAMMAD KHALID MASUD ET AL., *Muftis, Fatwas, and Islamic Legal Interpretation*, in ISLAMIC LEGAL INTERPRETATION: MUFTIS AND THEIR FATWAS 3, 4 (Muhammad Khalid Masud et al. eds., 1996) ("Muhammed received the first

scattered in its various chapters and are not specific to any particular chapter. Verses containing the injunctions constitute a small portion of what is a compilation of 6,235 verses.⁷² The injunctions include matters related to family law, inheritance, and criminal punishments.

In its narrative style, the *Quran*'s ratiocinative explanations to the injunctions provide guidance for understanding the injunctions in a broader spectrum. By addressing itself to the conscience of an individual, the *Quran* seeks to use its narrative style convincingly. While doing so, it expresses its "purpose, reason, objective, benefit, reward and advantage of its injunctions."⁷³ However, while some of the Quranic expressions are definitive in their application and leave no room for further interpretation, some are open to multiple understandings.⁷⁴ Islamic law has developed a comprehensive set of rules that identify such scope.⁷⁵ The multiplicity of meanings is mainly due to the *Quran*'s variation in grammatical use of language, which profoundly enlarges the scope of investigation on any given topic.⁷⁶ Resolving ambiguity in injunctions from the primary sources requires assistance from other Quranic verses and, if no help is found there, from the Prophetic traditions.⁷⁷ From the array of secondary sources, interpreting, deriving meanings, restricting, and enlarging the scope of an injunction are various forms of juristic efforts that seek to understand the Quranic injunctions in light of the changing social conditions.

revelation, Sura 96 ('The Blood Clot'), in the year 610, and the last revelation, verse 176 of Sura 4 ('Women') shortly before his death in 632.").

72. KAMALI, *supra* note 63, at 17. The legal injunctions in the *Quran* comprise about five hundred verses; however, some have argued that the number is eighty. See ABDUR RAHMAN I. DOI, *SHARI'AH: THE ISLAMIC LAW* 7 (1984) (counting five hundred verses); N.J. COULSON, *A HISTORY OF ISLAMIC LAW* 12 (1964) (counting eight verses).

73. KAMALI, *supra* note 63, at 27.

74. See *id.* at 27-44 (discussing "definitive" and "speculative" approaches to Quranic interpretation).

75. *Id.* at 44-55.

76. See generally *id.* at 117-86 (outlining the means of interpretation of the *Quran* through a close examination of language and grammatical structure).

77. DOI, *supra* note 72, at 7.

2. *The Prophetic Traditions (Sunnah)*

The *Quran* declared the Prophetic traditions to be followed.⁷⁸ The Prophet made a conscious effort to separate the word of God from his own by initially discouraging his companions from recording his life and practices so that there would be no confusion about the text of the *Quran*.⁷⁹ The Prophetic traditions were compiled more comprehensively after his lifetime. Differences in the text and transmission of the Prophetic traditions ensued, laying the foundation for its scientific study. Even though the *Quran* remains the first primary source and supersedes the Prophetic traditions, authenticity in text and transmission elevates injunctions arising out of the Prophetic traditions to the same level as that of the Quranic injunctions. However, no more than ten such Prophetic traditions rise to this level.⁸⁰ As for the status of Prophetic traditions vis-à-vis the Quranic text, they mainly consist of three categories. The Prophetic traditions confirm and reiterate, explain and clarify, or comprise independent rulings that cannot be traced back to the *Quran*.⁸¹ In developing the scientific study of the Prophetic traditions and acceptance of its text in legal reasoning, Islamic law prescribes a number of categories, classifications, and conditions to offer a systematic analysis.⁸² These stipulations help refine the juristic analysis toward finding a solution from this second primary source.

From the many, six collections of the Prophetic traditions are regarded as most authentic—considering both in Sunni and Shiite schools, the total comes to twelve.⁸³ Amongst all of the Sunni school collections, two are considered the most authentic due the strict

78. KAMALI, *supra* note 63, at 63-65.

79. *Id.* at 77-78.

80. *Id.* at 95.

81. *Id.* at 81-87.

82. *See id.* at 58-111 (outlining the main features of the jurisprudential standards for the acceptance of the Prophetic traditions).

83. MOHD. HAMEEDULLAH KHAN, *THE SCHOOLS OF ISLAMIC JURISPRUDENCE: A COMPARATIVE STUDY* 25-27 (1991) (explaining that authenticity of a tradition is determined through a grading system based on the number of persons relating the tradition and the acceptance of the tradition by early companions; this grading system is further tested by classifying the character of the narrator).

standards the collectors employed during their compilation.⁸⁴ The total number of the Traditions in the two most authentic compilations of the Sunni school is about 10,000, which includes a significant number of Traditions that relate to trade, business, and other financial transactions.

3. *Consensus of Juristic Opinions (Ijma)*

In absence of any explicit guidance from the *Quran* and the Prophetic traditions, legal injunctions are derived through a unanimous consensus of juristic opinion (the “Consensus”). The Consensus is not directly revealed and this source of Islamic law is arrived at through rational proof.⁸⁵ In theory, the Consensus can only occur after the Prophet’s lifetime.⁸⁶ Consensus develops from toleration of a plurality of juristic opinions until the diversity of opinion merges to a consensus.⁸⁷ Once established, the Consensus is a binding authority itself—as its reliance on the primary sources is no longer significant—and is not subject to repeal by another Consensus.⁸⁸

The status of the Consensus as a source is established using the primary sources.⁸⁹ There is agreement on the Consensus being a source of Islamic law, but divergent views exist as to what qualifies as Consensus.⁹⁰ According to a classical definition, nothing less than universal consensus of Muslim scholars (and not jurists—which may

84. *Id.* at 26.

85. KAMALI, *supra* note 63, at 228.

86. *See id.* at 231 (explaining that the Prophet was the highest authority during his lifetime, therefore disagreement by others had no impact on his authority, and Consensus was unnecessary).

87. *Id.*

88. *See id.* at 232, 235-36 (clarifying that although this is the majority rule, some scholars believe that creating constituents may repeal the Consensus and enact another).

89. *See id.* at 236-44 (discussing the textual support for Consensus in the *Quran* and the Sunnah, but noting that some scholars argue that this textual evidence does not amount to conclusive proof).

90. *See id.* at 228-60 (outlining the jurisprudential differences on the scope and definition of the Consensus).

be limited in number) would be binding.⁹¹ Some disagree, arguing against restricting Consensus to a consensus of Muslim scholars, and in favor of the consensus of Muslims at large, including laymen and scholars.⁹² However, the majority of scholars have not agreed with such views over the centuries.⁹³ Despite the existence of support for the *majority* of jurists' view—and not the genre of scholars—the popular view favors the consensus of *all* jurists.⁹⁴ Many prominent scholars of Islamic law have recognized universal consensus to be “totally unrealistic.”⁹⁵ Due to the gap between the theory and practice of Consensus, very few instances are available when Consensus was achieved in its classical sense, and those instances are often restricted to the time of the companions of the Prophet and not thereafter.⁹⁶

Some recent scholars of Islamic law assert that Consensus did not receive scholarly attention as much as the science of Prophetic traditions, and consider the lack of such attention to be responsible for the uncertainty as to what constitutes Consensus.⁹⁷ By equating the classical position on Consensus with utopia, scholars have suggested its institutionalization in the form of a legislative body.⁹⁸

4. *Juristic and Analogical Reasoning (Ijtihad)*⁹⁹

One of the essential features of Islamic law is to achieve a harmony between the revealed sources and reason. Juristic and

91. See *id.* at 233 (noting that even a single dissenting scholar would prohibit the formation of Consensus).

92. *Id.*

93. See *id.* (clarifying the belief held by the majority that the Consensus can be exercised by Muslim scholars, as they are representatives of the community).

94. See *id.* at 234 (discussing the qualifications jurists must possess to participate in the Consensus). Specifically, jurists must qualify as upright individuals, be clear of pernicious innovation and heresy, and be qualified to carry out *ijtihad*. *Id.*

95. *Id.* at 229 (noting the existence of occasions where Consensus has been claimed, despite the agreement of only a majority within a particular school or beyond an individual school).

96. *Id.* at 228-29, 259-60.

97. *Id.* at 229.

98. *Id.* at 255-260.

99. Many scholars of Islamic law generally discuss Juristic Reasoning and analogical reasoning separately as two independent sources. However, various scholars do not recognize a difference beyond the nomenclature. *Id.* at 298.

analogical reasoning (“Juristic Reasoning”) is the main instrument for achieving and maintaining the harmony between revealed and non-revealed sources.¹⁰⁰ Juristic Reasoning is, therefore, one of the prime sources of Islamic law.¹⁰¹ The scope of Juristic Reasoning is to infer and extract meaning from the unclear text of revealed sources.¹⁰² It could either be exercised in the form of analogical reasoning (*qiyas*) or in general.

Analogical reasoning seeks to extend an injunction “from an original case . . . to new case, because the latter has the same effective cause as the former.”¹⁰³ Put differently, it applies a textual ruling available for a particular case to a different case for which there is no textual ruling and the effective cause between both the scenarios is the same.¹⁰⁴ One way of exercising Juristic Reasoning is to discover a common effective cause from the primary sources of the *Quran* and the Prophetic traditions, and apply it to a new set of circumstances not expressly regulated by the sources.¹⁰⁵

Encouraging Juristic Reasoning, a Prophetic tradition entitles a jurist to a reward for his effort even though his conclusion is incorrect; for a correct conclusion, a jurist is rewarded twice—once for his efforts and again for reaching the correct conclusion.¹⁰⁶ Arriving at an answer is inherently subjective to a jurist, and may result into multiple opinions by the jurists. This generates a plurality or divergence of opinions in Islamic law.¹⁰⁷

100. *Id.* at 468.

101. *See id.* (explaining that the importance of *ijtihad* lies in the fact that it is a continuous process, and can evolve with the “changing conditions of the Muslim community in its aspirations to attain justice, salvation and truth”).

102. *Id.* at 469.

103. *Id.* at 264.

104. *Id.*

105. This process resembles the common law principle of *stare decisis* or the civil law principle of *ratio legis*. If a judge, distinguishing *ratio decidendi* from an existing case, found that same *ratio* related to both cases, he would analogically apply the decision of the earlier case to the facts of the new case. *Id.* at 299.

106. HALLAQ, *supra* note 52, at 130.

107. *Id.* at 130-32 (discussing the fact that although differences of opinion are common, the opinions are not usually dramatically different).

Exercising Juristic Reasoning remained popular until the ninth century.¹⁰⁸ Thereafter, the number of jurists participating in the exercise gradually fell. Owing to the decline of participation in Juristic Reasoning, some scholars declared jurists extinct and therefore disallowed any further exercise. This period in Islamic history is known as the “closing of the door” of Juristic Reasoning because scholars felt that “all essential questions” had been settled.¹⁰⁹ However, many maintain that the closure never took place, and that the gate of Juristic Reasoning could not have been validly closed.¹¹⁰

A qualified jurist must possess profound scholarship and sharp analytical skills.¹¹¹ According to the classical position, once these conditions exist in someone, he or she is capable of exercising Juristic Reasoning in all the fields where it is needed.¹¹² A modern view, however, is that Juristic Reasoning applies specifically to a “collective effort” of experts in Islamic law and other disciplines.¹¹³ This view is based on the premise that it is not possible for a single person to possess knowledge of many disciplines with equal command and mastery.¹¹⁴

5. *Islamic Law Resembling Common Law*

Defining the Islamic lawmaking process, a notable scholar equated Islamic jurists with common law judges:

Islamic finance thrives mainly in Islamic countries with officially adopted civil laws, but it is driven primarily by a canon-law-like interpretation of Islamic scriptures. However, one can readily see that the canon-like

108. JOSEPH SCHACHT, AN INTRODUCTION TO ISLAMIC LAW 70-71 (1982).

109. *Id.*

110. See generally KAMALI, *supra* note 63, at 468-97 (setting out the history and jurisprudential development of the Juristic Reasoning).

111. See KAMALI, *supra* note 63, at 476-80 (outlining qualifications of a jurist to include, among other requirements, a knowledge of (i) Arabic, (ii) the *Quran* and the Prophetic traditions and their legal content, (iii) the Consensus and analogical deduction, and (iv) the objectives of Islamic law); see also MASUD, *supra* note 71, at 16-17 (summarizing the requisite skill set for a jurist).

112. KAMALI, *supra* note 63, at 480.

113. *Id.* at 496; see EL-GAMAL, *supra* note 19, at 31-32 (stating that collaboration may provide authoritativeness to groups of jurists on modern disciplines).

114. KAMALI, *supra* note 63, at 496.

nature of Islamic jurisprudence is mostly rhetorical. The true nature of Islamic jurisprudence of financial transactions is very similar to Western-style common law. In particular, contemporary developments in Islamic finance owe more to juristic understanding of the canonical texts and previous juristic analyses than they owe to the canon itself.¹¹⁵

C. SCHOOLS OF ISLAMIC LAW (*MADHAHIB*): JURISTIC REASONING VERSUS ADOPTION OF SCHOOL

After the Prophet passed away, two main branches of Muslims emerged during the time of his companions. The Sunni and Shiite branches primarily diverged on political issues, but later each faction developed its own jurisprudence. Since Islamic finance today is flourishing mainly in the countries with Sunni jurisprudence, Shiite Islamic finance practices are converging to Sunni transactional structures.¹¹⁶ Because of this convergence, this Article will only discuss Islamic law and finance as viewed and interpreted by the Sunni schools.

In the early history of Islam, Islamic law and legal studies evolved through scholarly discussion circles led by learned men on various issues.¹¹⁷ By the early part of the eighth century, such learned men had their own circles and students, but the legal doctrine was still

115. EL-GAMAL, *supra* note 19, at 17.

It must be understood that when we claim that Islam has a satisfactory solution for every problem emerging in any situation in all times to come, we do not mean that the Holy Quran and [the Traditions] of the Holy Prophet or the rulings of Islamic scholars provide a specific answer to each and every minute detail of our socioeconomic life. [T]he Holy Quran and the Holy [traditions] of the Prophet have laid down the broad principles in the light of which the scholars of every time have deduced specific answers to the new situations arising in their age. Therefore, in order to reach a definite answer about a new situation, the scholars of [Islamic law] . . . have to analyze every question in light of the principles laid down by the Holy Quran and [the Prophetic traditions] as well as in the light of the standards set by earlier jurists This . . . ongoing process . . . keeps injecting new ideas, concepts and rulings into the heritage of Islamic jurisprudence.

Id. (quoting from a contemporary jurist).

116. *See id.* at 19-20 (noting, for instance, that Iran—a country with majority Shiite population—has imitated the bond (*sukuk*) structure predominantly practiced in regions of Sunni majority).

117. HALLAQ, *supra* note 51, at 153.

incomplete.¹¹⁸ Toward the end of the eighth century, various jurists started developing legal assumptions and methodology and, with the continued association of their respective circles, defended their respective views on Islamic law.¹¹⁹ Students would attend circles in various cities without owing loyalty to any doctrine. However, the students joining a circle to teach would invariably teach what they learned from their own teacher.¹²⁰ Toward the midst of ninth century, various scholars were field specialists and leaders, had personal followings, issued legal opinions, debated legal issues, and formed doctrinal schools that represented a collective entity—as opposed to a personal circle.¹²¹ Each school had its peculiar legal methodology and positive principles, and was named after its founder.¹²²

Fifty years after the Prophet (670 C.E.) until the early eighth century, two main schools emerged: those with a traditional jurisprudential approach and others with rationalist jurisprudential approach.¹²³ The golden age of Islamic law began at this time and lasted until the eleventh century with eight leading schools of Islamic law (including four Shiite schools) emerging during the period.¹²⁴ The next three centuries witnessed juristic elaborations within the established schools until the dark ages of Islamic law which began when Baghdad fell to the Tatars in the thirteenth century.¹²⁵ In 1876, the Ottomans' codification of the *Hanafi* jurisprudence rekindled Islamic law, which was soon followed by various post-colonization juristic revival movements in the twentieth century.¹²⁶

118. *Id.*

119. *Id.*

120. *Id.* at 153-54.

121. *Id.* at 155.

122. *Id.* at 153-59.

123. EL-GAMAL, *supra* note 19, at 30-31.

124. *Id.*

125. *Id.* at 31.

126. *Id.*

Four Sunni schools comprising *Hanafi*,¹²⁷ *Maliki*,¹²⁸ *Shafi'i*,¹²⁹ and *Hanbali*¹³⁰ flourished over the centuries and survive today. The subsequent scholars in each school continued to enrich the school's affiliated doctrine. When the pace of exercising Juristic Reasoning slowed, Muslims, both laymen and scholars, followed the opinions of any of the established schools.¹³¹ Each school has a substantial following in various geographic regions of the Muslim world, and the Muslims in such regions still abide by the school-specific interpretations on issues pertaining to Islamic law.¹³² As for following a particular school, the general rule is that any person who is not capable of performing Juristic Reasoning must follow someone who is capable of doing so.¹³³ Scholars who are not also jurists and laymen should, therefore, refer to the opinions of a jurist.¹³⁴ Within the Sunni schools of Islamic law, the choice is limited to above-mentioned four schools.

III. OTHER FEATURES OF ISLAMIC FINANCE

A. ISLAMIC AND LEGAL OPINION (*FATWA*)¹³⁵

Legal opinion played a central role in the emergence of the modern day IFS industry in 1976 when an Islamic legal opinion was introduced to extend the scope of cost-plus transactions. After that opinion, cost-plus financing became the standard and mainstream

127. Founded by Imam Abu Hanifa An-Nu'man Ibn Thabit in Kufa, Iraq (699-769 C.E.). KHAN, *supra* note 83, at 60-63.

128. Founded by Imam Malik Ibn Anas at Madina in Saudi Arabia (713-795 C.E.). *Id.* at 78-81.

129. Founded by Imam Muhammad Ibn Idris Ash-Shafi'i in Ghazza, Palestine (767-820 C.E.). *Id.* at 94-95.

130. Founded by Imam Abu Abdullah Ahmad Ibn Muhammed Hanbal in Baghdad, Iraq (780-855 C.E.). *Id.* at 110-11.

131. *See id.* at 137-38 (noting that these schools developed their own approach to solve legal problems but share the same fundamental beliefs).

132. *See, e.g., id.* at 78 (explaining how the Maliki school spread into particular regions, first into Egypt and later into other Arab countries).

133. HALLAQ, *supra* note 51, at 147.

134. *Id.*

135. *See EL-GAMAL, supra* note 19, at 32 (describing the concept of *fatwa* as the "elicitation of juristic response to a question, modeled after Roman system of *responsa*").

Islamic banking transaction, practiced now invariably by every Islamic bank.¹³⁶ This legal opinion was based on an opinion of a classical *Maliki* jurist.¹³⁷ A standard practice of seeking a legal opinion ensued in the contemporary IFS industry.¹³⁸

As mentioned, this now rich tradition of providing legal opinions on issues of Islamic law started with the emergence of personal scholarly circles in the eighth century.¹³⁹ The recipients of the legal opinion were common people with questions pertaining to application of Islamic law, politically appointed judges, and political authorities including the *caliph*.¹⁴⁰ The providers of legal opinion, "jurisconsults" or *mufti*, were established scholars, and often leaders of their own schools.¹⁴¹ No distinction between a jurist and a jurisconsult explicitly existed; a jurisconsult was supposed to have the same skill set as that of a jurist.¹⁴² However, in latter periods of some *Sunni* schools, jurisconsults tended to be lesser qualified and would respond to questions only within the framework of his school of Islamic law, by relying upon opinions of the jurists of his school.¹⁴³ This trend continues to date.

Furthermore, a jurisconsult should be an exemplary moral figure, should not practice contrary to the opinion he issues, and should not contradict the doctrines of his own school.¹⁴⁴ Traditionally, the rules applicable to an Islamic judge were equally applicable to jurisconsults, including the necessity to display a dignified demeanor and to avoid emotional expressions and favoritism.¹⁴⁵ Although a

136. *Id.* at 33.

137. *Id.*

138. *Id.*

139. HALLAQ, *supra* note 51, at 153-55.

140. MASUD, *supra* note 71, at 4.

141. HALLAQ, *supra* note 51, at 153-55.

142. Wael B. Hallaq, *Ifta' and Ijtihad in Sunni Legal Theory: A Development Account*, in ISLAMIC LEGAL INTERPRETATION: MUFTIS AND THEIR FATWAS 33, 33-35 (Muhammad Khalid Masud et al. eds., 1996); see HALLAQ, *supra* note 51, at 147 (explaining that jurists and jurisconsults have similar qualifications, educational backgrounds, and requirements for their respective profession).

143. HALLAQ, *supra* note 51, at 17.

144. *Id.*

145. See MASUD, *supra* note 71, at 22 (explaining that muftis or jurisconsults, like judges, are required to treat the parties that come before them equally, regardless of their adversarial nature or personal importance).

jurisconsult is not generally required to set out his “methods of reasoning,”¹⁴⁶ the scope of his work is defined and restricted by the question posed and the jurisconsult should respond accordingly. In other words,

As [jurisconsults] must answer according to what is asked, their field of response is largely determined by the formulation of the question. Since the [jurisconsult] is not an investigator of the facts, these are taken as given. In addition, while the issues involved ought to be ones that have actually arisen and should not be purely hypothetical or imaginary . . . questions are commonly posed in general terms, using the names of fictional individuals . . . or simply ‘a man’ or ‘a woman.’ Such usage of generic descriptions and fictional names distances the query from the particular evidential circumstances of the questioner. Yet in many settings, the [jurisconsult] is confronted personally by the questioner, whose name appears below the text of the question. In this distinctive juxtaposition of the abstract and the actual, questions delimit the [legal opinions] as a genre of legal response.¹⁴⁷

Scholars have noticed anomalies in the current practice of jurisconsults providing Islamic legal opinions to the IFS industry. The IFS industry seeks to be regulated by the opinions of the jurisconsults, who are remunerated by the respective IFS institutions, either for their services as members of the *Sharia* supervisory board, or as independent consultants.¹⁴⁸ A recent analysis criticizes the practice and finds it to be totally inconsistent with the established classical position of Islamic law: a jurisconsult cannot be paid by the person asking the question—other than payment of administrative costs.¹⁴⁹ Remuneration of jurisconsult used to be from the government. A conflict of interest exists in providing opinions in matters where jurisconsults are remunerated, particularly on a *pro rata* basis, and where opinions are linked to the success of the product. The ensuing economic pressure on jurisconsults has resulted in a widespread practice of circumventing tactics by relying upon obscurely minority views in order to push through the contemplated transactional structure. To avoid abuse of Islamic legal opinions,

146. *Id.* at 25.

147. *Id.* at 22-23.

148. Hegazy, *supra* note 17, at 133.

149. *Id.* at 136.

experts have suggested separating the jurisconsult's role of a transaction consultant from his duties as an auditor which require him to ensure conformity with Islamic law.¹⁵⁰ Another notable scholar has classified the trend of choosing permissive minority opinions from the classical jurisprudence as part of "shari'a arbitration": finding the closest approximation to the conventional financial practice and then "reengineering" the product to meet Islamic law, to be sold to an Islamic-finance-based captive market.¹⁵¹

It appears that the financial and transactional teams do not share comprehensive information with jurisconsults, resulting in opinions based on limited information.¹⁵² Although some questions have addressed the integrity of the mechanism for rendering Islamic legal opinions for the IFS industry, other questions remain to be answered. These questions include the following: Is the scope of the opinions determined and if so, how? What is the manner and procedure of opinion-seeking? How much information is provided to and shared with jurisconsults? Whether jurisconsults simply reiterate positions of a particular school or actually engage in Juristic Reasoning?¹⁵³ Finally, How are such opinions reasoned?

Scholars have noted that public access to the processes of obtaining a legal opinion is generally restricted.¹⁵⁴ However, once

150. See *id.* at 139 (comparing the dual role of auditor and consultant to the professional conflicts of interest of accountants and auditors in the infamous Enron scandal).

151. Mahmoud A. El-Gamal, *Limits and Dangers of Shari'a Arbitrage*, in ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES 115, 120 (S. Nazim Ali ed., 2005).

152. See, e.g., EL-GAMAL, *supra* note 19, at 48 (noting that, with respect to the two interlinked contracts used for a sale-repurchase transaction, "in Islamic finance, jurists may be asked to validate each contract separately, without explaining the entire financial structure for which they will be used").

153. Some contemporary jurisconsults have displayed the tendency of not following their own school, but referring directly to the *Quran* and the Prophetic traditions and, in effect, exercising Juristic Reasoning. See, e.g., Hegazy, *supra* note 17, at 146 (explaining the complex and often conflicting pressures on jurisconsults to issue opinions that balance traditional religious beliefs and classical teachings with modern financial transactions).

154. See, e.g., EL-GAMAL, *supra* note 19, at 129 (discussing the structure of Meyer's Shari'a Funds, an Islamic hedge fund, and noting lack of public information about the fund's screening process).

announced publicly, a legal opinion rapidly facilitates replication of the product design process. And, unlike their classical counterparts, Islamic legal opinions today are no longer area-specific and have become transnational with the increasing use of technology.¹⁵⁵

B. RULES ON PROPERTY, OWNERSHIP, AND CONTRACTS

1. Property and Ownership

Classical Islamic law defines property as an object that “must satisfy two conditions: (1) possibility of physical possession and (2) having potential beneficial uses.”¹⁵⁶ According to this definition, many scholars believe that commercial insurance violates Islamic law, for the object of sale is excessively uncertain or ambiguous.¹⁵⁷ Classifications of property include valued or unvalued property (defined as public property or “properties with non permissible uses . . . [such as] wine and pork”), immovable or movable property, and fungible or non-fungible property.¹⁵⁸ Each classification is subject to detailed rules in the various schools of Islam. Such differences of opinion include the eligibility of usufruct for sale or lease, taking possession before reselling, deferred prices, and prepaid forward sale.¹⁵⁹

The classical view of ownership distinguished between total and partial ownership—for example, property plus usufruct or ownership of either.¹⁶⁰ Modern scholarship, however, treats ownership as a “bundle of rights” that is distributable to a number of entities.¹⁶¹ This distinction has lead to devising an Islamic bonds (*sukuk*) structure

155. See MASUD, *supra* note 71, at 31 (explaining that after being reproduced in print, on radio, television and in book-length publications, *fatwas* are now available electronically to an international audience).

156. EL-GAMAL, *supra* note 19, at 36.

157. See, e.g., *id.* (“[I]f the object of an insurance contract were defined as ‘security,’ with its premium viewed as price, the contract may have to be deemed valid. However, many jurists argued, ‘security’ does not qualify as an object of sale, since it does not constitute a tangible good or service.”).

158. *Id.* at 36-39.

159. *Id.* at 36-37.

160. *Id.* at 39.

161. *Id.*

where the title of the transaction property, with its usufruct, is transferred to a special purpose vehicle that deals with all the subleases issued in respect of the property.¹⁶²

Possession of property that gives rise to liability is generally either in the form of a trust or a guaranty arrangement. While in the possession of a trustee, only damage to the property caused by the trustee's negligence or transgression will result in liability for the loss.¹⁶³ In contrast, a guarantor's possession implies liability for any and all damages.¹⁶⁴ Liability and risk issues arising from these distinctions have informed the practice of Islamic banking in dealing with the deposits and cost-plus financing issues, discussed further below.

2. *Contract and Its Conditions*

According to an Islamic legal maxim, the presumption of general permissibility governs until the contrary is established by an injunctive authority.¹⁶⁵ This presumption is equally applicable to the Islamic law of contract that is, and always has been, central to Islamic finance. However, in the case of Islamic contracts, some scholars have regarded permissibility to be based on appropriate precedents, which in effect reverses the presumption.¹⁶⁶

Two basic types of contract exist in Islamic law: compensatory and charitable.¹⁶⁷ Compensatory contracts, in the category of mutual dealings, are entered into by the parties for personal benefit. Charitable contracts lean toward the worship category of injunctions, and parties who enter into such contracts look to God for their reward. For the mutual material benefits to be derived from compensatory contracts, the parties are expected to agree on "value

162. *Id.* at 40.

163. *Id.* at 41.

164. *Id.*

165. See Munawar Iqbal & Tariqullah Khan, *Introduction*, in FINANCIAL ENGINEERING AND ISLAMIC CONTRACTS 1, 2-3 (Munawar Iqbal & Tariqullah Khan eds., 2005) (indicating that the "Doctrine of Universal Permissibility" allows everything that is not clearly prohibited).

166. See EL-GAMAL, *supra* note 19, at 45 (noting the views of Ibn Taymiyya, a leading jurist of the late classical age).

167. Iqbal & Khan, *supra* note 165, at 3.

equivalence” of such benefits and should have access to all relevant information to assess this value. The Islamic law of contract allows parties to freely stipulate any conditions they deem expedient, as long as express prohibitions are observed.¹⁶⁸ Put differently, Islamic law of contract recognizes “party autonomy” in contracts that do not fall into the exceptional category of the prohibited.

Mutual consent is the cardinal point of Islamic law of contract. Supplementing mutual consent, classical jurisprudence enumerates some “cornerstones” of a valid contract, which

pertain to (1) parties of the contract, who must be eligible to conduct the contract, (2) contract language, and (3) object of the contract. A contract was not considered concluded if any of its cornerstones were violated. Conditions of contract conclusion may be grouped into conditions pertaining to (1) contracting parties . . . , (2) contract language . . . , (3) unity of contract session, and (4) permissibility of object for specific contract.

A concluded financial contract was deemed valid if it avoided six main factors: (1) ignorance about object, price, time period, and the like, (2) coercion, (3) conditions contrary to a contract’s nature . . . , (4) unnecessary ambiguity in contract language, (5) encroachment on others’ property rights, and (6) unconventional conditions that benefit one party at the other’s expense.¹⁶⁹

IV. PROHIBITIVE INJUNCTIONS: *RIBA* (USURY OR INTEREST ON MONEY LOANS) AND EXCESSIVE UNCERTAINTY AND AMBIGUITY (*GHARAR*)

A. INTRODUCING INJUNCTIONS ON *RIBA*

Broadly, there are two kinds of injunctions in Islamic law: one pertaining to matters of worship and the other to mutual dealings among people.¹⁷⁰ The general presumption for worship is

168. *Id.* at 3-4.

169. EL-GAMAL, *supra* note 19, at 42.

170. Iqbal & Khan, *supra* note 165, at 2-3.

impermissibility unless enjoined, whereas, in contrast, the default rule of mutual dealing is permissibility unless prohibited.¹⁷¹ While trade by mutual agreement is strongly recommended, taking undue advantage of anyone and depriving him or her of property is strictly prohibited in the *Quran*.¹⁷² Accordingly, in any given mutual dealing, rights of God, transacting parties, and third parties—society at large—are involved and are required to be observed. Rights of God include avoiding transactions that comprise *riba* (interest or usury), excessive uncertainty (*gharar*), gambling (*maysir*), and other activities prohibited by God through His revelation.¹⁷³ Rights of God, moreover, are latently present in every matter of mutual dealing, whereas such rights exist patently in matters of worship.¹⁷⁴ In sum, matters of mutual dealings entail more freedom than restrictions. This might assist in understanding that observing injunctions on mutual dealings by Muslims is also a part of worship with consequences in the Hereafter.

Broadly, Islamic legal injunction for financial transactions can be examined in a “net benefit” analysis, or in view of four types of activities:

(1) [B]eneficial ones that are apparently beneficial, (2) beneficial ones that are not clearly beneficial, (3) harmful ones that are apparently harmful, and (4) harmful ones that are not apparently harmful. No injunctions or prohibitions are needed for the first and third types of activities, whereas injunctions to perform the first type of acts, and prohibitions against the fourth, are necessary. In this regard, the [Quranic] verses . . . clearly explained that drinking and gambling belong to the fourth category: Humans may be lured by the apparent benefits and thus lose sight of the greater harm.

....

171. *Id.*

172. QUR'AN, *supra* note 54, at 4:29 (“O ye who believe! Eat not up your property Among yourselves in vanities: But let there be amongst you Traffic and trade By mutual good-will: Nor kill (or destroy) Yourselves: for verily Allah hath been to you Most merciful!”).

173. Iqbal & Khan, *supra* note 165, at 3.

174. See HUSAYN HAMID HASSAN, AN INTRODUCTION TO THE STUDY OF ISLAMIC LAW 9-10 (1997) (delineating the two major components of Islamic law: dealing with transactions among people and dealing with people’s relationships with God); see also HUSAYN HAMID HASSAN, USUL AL-FIQH (1970).

In the case of wine and gambling, the Qur'anic solution was complete avoidance thereof, since those activities are not essential. In contrast, transfers of credit and risk are at the heart of finance, without which an economic system cannot function. The Islamic legal solution in this case was to impose restrictions on the means of transferring credit and risk, through prohibitions of *riba* [i.e., usury] and *gharar* [i.e., excessive uncertainty and ambiguity] [T]he forbidden *riba* is essentially "trading in credit," and the forbidden *gharar* is "trading in risk," as unbundled commodities.

In other words, Islamic jurisprudence uses those two prohibitions to allow only the appropriate measure of permissibility of transferring credit and risk to achieve economic ends. As many observers and practitioners in financial markets will testify, trading in credit and risk (perfected through derivative securities) is as dangerous as twirling a two-edged sword. Although those vehicles can be used judiciously to reduce risk and enhance welfare, they can easily entice otherwise cautious individuals to engage in ruinous gambling behavior. While financial regulators seek to limit the scope of credit and risk trading to protect systemic failures, Islamic jurisprudence introduces injunctions that aim also to protect individuals from their own greed and myopia.¹⁷⁵

1. The Prohibition of Riba: Equitable Considerations and Issue of Time Value

No single definition of *riba* exists in Islamic law. Scholars extend its scope to an increase in the exchange of two counter-values, but exclude the increased price of a credit sale—and therefore establish the concept of time value for money. Put simply, while some scholars do not accept any increase to be valid, some consider a reasonable return to be justified.¹⁷⁶ Most recently, a scholar has argued that equating the concepts of *riba* and interest is not appropriate because "some forms of interest . . . should not be considered forbidden *riba*."¹⁷⁷ Scholars who do not consider *riba* to

175. EL-GAMAL, *supra* note 19, at 47-48.

176. See Mahmoud A. El-Gamal, "Interest" and the Paradox of Contemporary Islamic Law and Finance, 27 FORDHAM INT'L L.J. 108, 108-11 (2003) (describing the dichotomy between those scholars who view interest as unlawful under Islamic law and those who have more relaxed views on Islamic banking and finance).

177. EL-GAMAL, *supra* note 19, at 51-52.

be equivalent to interest exclude the mark-up credit sales from the prohibition. In other words:

The concept of *Riba* is not confined to money lending only, but extends to exchange of goods as well. *Shariah* recognizes two forms of *Riba*—*Riba al-Nasiah* and *Riba al-Fadl*.

Riba al-Nasiah: *Riba al-Nasiah* deals with *Riba* in money-to-money exchange, provided the exchange is delayed or deferred and additional charge is associated with such deferment. The term *Nasi'ah* . . . means to postpone, defer, or wait, and refers to the time that is allowed to the borrower to repay the loan in return for the “addition” or the “premium.” This kind of *Riba* is the basis of the prohibition of interest as practiced in today's financial transactions. The prohibition of *Riba al-Nasi'ah* essentially implies that the fixing in advance of a positive return on a loan as a reward for waiting is not permitted by the *Shariah*. It makes no difference whether the return is a fixed or variable percentage of the principal, or an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition for the loan.

Riba al-Fadl: *Riba al-Fadl* is more subtle and deals with hand-to-hand or barter exchange. Such prohibition is derived from the sayings of the Prophet (pbuh) who required that commodities are exchanged for cash instead of barter since there may be differences in the quality to ensure that no exploitation takes place due to any mismatch in the quantity and the quality of the exchanges. Otherwise, it may give rise to an unjust increase, i.e., *Riba*. The concept of *Riba al-Fadl* is remarkably similar to the prohibition of increase in lending victuals in the Old Testament (Leviticus 25:37). Whereas the Old Testament prohibits quantitative increases, *Riba al-Fadl* prohibits qualitative increases as well. Considering that in today's markets, exchange takes place through the medium of money, the relevance of *Riba al-Fadl* has diminished, but the essence of the concept remains applicable to similar situations.¹⁷⁸

Riba was gradually prohibited, although only initially discouraged.¹⁷⁹ Charging compound interest was prevalent in pre-

178. ZAMIR IQBAL & ABBAS MIRAKHOR, AN INTRODUCTION TO ISLAMIC FINANCE: THEORY AND PRACTICE 55-56 (2007).

179. QUR'AN, *supra* note 54, at 30:39 (“That which you give in usury For increase through the property Of (other) people, will have No increase with Allah: But that which you give For charity, seeking The Countenance of Allah, (Will increase): it is These who will get A recompense multiplied.”).

Islamic Arabia and was the first to be forbidden.¹⁸⁰ It was common practice to charge interest at a certain maturity date and then compound, or double and multiply, that interest at future maturity dates.¹⁸¹ The final prohibition was more clear and categorical,¹⁸² which came through one of the last verses of the *Quran* and prohibited, in the view of some scholars, compound interest.¹⁸³ It is important to note that the *Quran* does not define the term *riba*. However, we may understand the basic concept of *riba* from the Prophetic traditions, as discussed below. Due to the lack of certainty regarding the definition of *riba*, the Supreme Court of Pakistan remanded a decision of the Shariat Appellate Bench declaring interest in all forms unconstitutional on account of being un-Islamic in order for the Federal Shariat Court to conduct “thorough and elaborate research . . . of financial systems . . . prevalent in the contemporary Muslim countries.”¹⁸⁴

180. *Id.* at 3:130 (“O ye who believe! Devour not Usury, Doubled and multiplied; But fear Allah; that Ye may (really) prosper.”).

181. EL-GAMAL, *supra* note 19, at 50.

182. QUR’AN, *supra* note 54, at 2:275-79.

Those who devour usury Will not stand except As stands one whom The Satan by his touch Hath driven to madness. That is because they say: “Trade is like usury,” But Allah hath permitted trade And forbidden usury. Those who after receiving Admonition from their Lord, Desist, shall be pardoned For the past; their case Is for Allah (to judge); But those who repeat (The offence) are Companions Of the Fire: they will Abide therein (for ever).

Allah will deprive Usury of all blessing, But will give increase For deeds of charity: For He loveth not Any ungrateful Sinner.

Those who believe, And do deeds of righteousness, And establish regular prayers And give [charity], Will have their reward With their Lord: On them shall be no fear, Nor shall they grieve.

O ye who believe! Fear Allah, and give up What remains of your demand For usury, if ye are Indeed believers.

If ye do it not, Take notice of war From Allah and His Messenger: But if ye repent, Ye shall have Your capital sums: Deal not unjustly, And ye shall not Be dealt with unjustly.

Id.

183. EL-GAMAL, *supra* note 19, at 50.

184. *United Bank Ltd. v. M/S Farooq Bros.*, P.L.D. 2002 S.C. 800 (Pak.), ¶18, June 24, 2002, available at http://www.supremecourt.gov.pk/sub_links/judgements/JUDGMENT%20IN%20RIBA%20CASE.zip.

According to the Prophetic traditions, *riba* is generally categorized in two forms: (i) “*riba* of deferment,” accruing over time through deferment of payments (in its worst form it takes the form of compound interest as practiced in the pre-Islamic Arabia); and (ii) “*riba* of increase,” occurring in the form of an increase in exchange of different quantities of good and commodities of same genus or kind.¹⁸⁵ Both forms are discussed in the Prophetic traditions. *Riba* of deferment refers to an increase that generally arises out of the money loans. One authentic Prophetic tradition prohibited *riba* of increase and outlined the general standard: “Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt, like for like, hand to hand, and any increase is *riba*.”¹⁸⁶ To illustrate further:

Indeed, as some Hanafi jurists have noted, the six-commodities Prophetic tradition . . . stipulated two conditions: “hand to hand” and “in equal amounts.” Thus, if one traded an ounce of gold today for a deferred price of one ounce of gold next year, the transaction would still be deemed *riba*, despite the zero interest rate, because of violation of the “hand-to-hand” restriction. Those Hanafi jurists reasoned as follows: An ounce of gold today is clearly worth more than an ounce of gold in one year (recognizing the time value of money). Thus, one would never trade an ounce of gold today for an ounce of gold next year, unless one is getting something else in return (which is not disclosed in the sales contract). Whatever that extra benefit may be, they argued, it constitutes *riba*.¹⁸⁷

The above *Hanafi* view is further explained by a *Maliki* jurist:

It is thus apparent from the law that what is targeted by the prohibition of *riba* is the excessive inequity it entails. In this regard, equity in certain transactions is achieved through equality. Since the attainment of equality in exchange of items of different kinds is difficult, we use their values in monetary terms. Thus, equity may be ensured through proportionality of value for goods that are not measured by weight and volume. Thus, the ratio of exchanged quantities will be determined by the ratio of the values of the different types of goods traded. For example, if a person sells a

185. EL-GAMAL, *supra* note 19, at 49-51.

186. *Id.* at 50-51 (explaining that “Hanafi jurists extended the prohibition to all fungible goods measured by weight or volume, whereas Shafi’i and Maliki jurists restricted it to monetary commodities (gold and silver) and storable foodstuffs”).

187. *Id.* at 52.

horse in exchange for clothes . . . if the value of the horse is fifty, the value of the clothes should be fifty. [If the value of each piece of clothing is five], then the horse should be exchanged for [ten] pieces of clothing.

As for [fungible] goods measured by volume or weight, equity requires equality, since they are relatively homogenous, and thus have similar benefits. Since it is not necessary for a person owning one of those goods to exchange it for goods of the same type, justice in this case is achieved by equating volume or weight, since the benefits are very similar.¹⁸⁸

The concept of equity of and efficiency in exchange is supported by various Prophetic traditions, such as when a man brought some high quality dates for the Prophet from another city. The Prophet inquired if all the dates from that city were the same. The man replied that he exchange two or three volumes of inferior quality dates for ones of higher quality. Disapproving the practice, the Prophet told him not to do that again, and advised him to sell the lower quality dates and buy higher quality dates with the proceeds. Selling the lower quality dates at the best market price and buying the higher quality ones at the most competitive price, ensures overall market and exchange efficiency by pre-committing those who observe *riba* of increase to acquire market information and avoid any disadvantage.¹⁸⁹

As for time value of money, some recent scholars have the following observation:

It is a common misunderstanding and a myth that by prohibiting interest on loans, Islam denies the concept of the time value of money. Islamic scholars have always recognized the time value of money, but maintain that the compensation for such value has its limitations. Recognition of an indirect economic value of time does not necessarily mean acknowledging any right of equivalent material compensation for this value in all cases.

188. *Id.* at 52-53 (footnote omitted).

Of course, lacking the tools of calculus, which were only developed six centuries later, he could not speak of marginal utilities and hence spoke only of 'benefits.' However, the economic idea is still the same: Equity dictates equality of amount when trading fungibles of the same genus, and equality of value when trading nonfungibles or goods of different genera.

Id. at 53 n.17.

189. *Id.* at 53.

According to the *Shariah*, compensation for the value of time in sales contracts is acknowledged, but in the case of lending, increase (interest) is prohibited as a means of material compensation for time.

The Islamic notion of opportunity cost of capital and time value of money can be clearly understood by reviewing the distinction between investment and lending. Time by itself does not give a yield, but can only contribute to the creation of value when an economic activity is undertaken. Given a sum of money, it can be invested in a business venture or it can be lent for a given period of time. In case of investment, the investor will be compensated for any profit and loss earned during that time and Islam fully recognizes this return on the investment as a result of an economic activity. On the other hand, if money is in the form of a loan, it is an act of charity where surplus funds, are effectively being utilized to promote economic development and social well-being.

In response to the contemporary understanding that interest on a loan is a reward for the opportunity cost of the lender, Islamic scholars maintain that interest fixed *ex ante* is certain, while profits or losses are not and to take a *certain* as a compensation for the *uncertain* amounts to indulging in *Riba* and is therefore unlawful. The element of uncertainty diminishes with time and the resultant return on investment is realized, rather than the accruing of return due to passage of time. In short, Islam's stand on the time value of money is simple and clear. Money is a medium of exchange; time facilitates completion of economic activity, and the owner of capital is to be compensated for any return resulting from economic activity. Lending should be a charitable act without any expectation of monetary benefit.¹⁹⁰

190. IQBAL & MIRAKHOR, *supra* note 178, at 61-62 (emphasis in original).

2. *Riba Today*

Modern scholars have attempted to define *riba*:

Focusing on *Riba* in financial transaction, now we can construct a more formal definition of the term. According to the *Shariah*, *Riba* technically refers to the “premium” that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in the duration of loan. At least four characteristics define the prohibited interest rate: (1) it is positive and fixed *ex-ante*; (2) it is tied to the time period and the amount of the loan; (3) its payment is guaranteed regardless of the outcome or the purposes for which the principal was borrowed; and (4) the state apparatus sanctions and enforces its collection.

This definition of the term “*Riba*” is generally accepted by all and is clear, straight-forward, and unambiguous. One would not find any dispute in the literal or the obvious meaning of the term *Riba*, but it is the interpretation and scope of the prohibition and its applicability to practical life which raise several questions for *Shariah* scholars who have dealt with them over a period of time and each time a new situation arises.¹⁹¹

Introducing a “benefit analysis” for examining the classical jurisprudential texts, Professor Mahmoud El-Gamal argues that “balancing economic freedom . . . with risk of abuse” always remained the guiding principle during the classical age of Islamic law.¹⁹² While balancing these matters, the classical jurists would overrule the risk of usury and excessive uncertainty in favor of benefit consideration. For instance, El-Gamal expands his argument that prepaid forward sales were permissible because of the overriding benefit to agriculture and other industries, despite excessive uncertainty for the subject matter.¹⁹³ Buy-back or same-item sale-repurchase was also allowed because the benefits were greater than

191. *Id.* at 56 (observing also that the “Four most commonly asked questions are whether the prohibition is limited to consumer loans only, whether only excessive interest or compounding of interest is prohibited, whether adjustment for inflation or any indexation . . . falls within the definition of *Riba*, and finally whether prohibition of interest denies time value of money”).

192. EL-GAMAL, *supra* note 19, at 48.

193. *Id.*

the risk that such transactions might serve as a vehicle to charge interest.¹⁹⁴

Scholars have noted that understanding *riba* today is more difficult, particularly if relying on the help of financial economics. Despite the works of classical jurists being relatively inconclusive vis-à-vis the complexity of today's financial markets, such works are still helpful in understanding various aspects of *riba*. The scholars went on to observe that "understanding *riba* as prohibiting interest is only partly true, since in the context of credit sales the rules tolerate recognition of the [time value or] opportunity costs of money."¹⁹⁵

In deducing rules on *riba*, the classical jurists derived five rationales as the underlying causes to understand the principles governing *riba*. Collectively, such causes represent "[m]athematical equivalency; [a]voiding commercial exploitation; [m]inimizing commerce in currency and foodstuffs; [l]inking lawfulness of gain to risk-taking; [and] [u]sing money and markets to allocate and moderate risks."¹⁹⁶ Another view about the prohibition of *riba* relates to distributive justice: money should keep circulating within society and not remain limited to a few hands.¹⁹⁷ A more recent view is that the religious prohibition saves individuals from abusing the availability of potentially self-detrimental credit, helps avoid excessive indebtedness on account of individual's irrational behavior, and protects against "paying or receiving unfair compensation for receipt or extension of credit."¹⁹⁸ The more popular view, however, is that interest is exploitative, and therefore prohibited.¹⁹⁹

194. *See id.* (noting also that if the second sale is stipulated in the first agreement it would be clearly prohibited).

195. FRANK E. VOGEL & SAMUEL L. HAYES, III, *ISLAMIC LAW AND FINANCE: RELIGION, RISK AND RETURN* 86 (1998).

196. *Id.* at 78.

197. IMRAN AHSAN KHAN NYAZEE, *THE RULES AND DEFINITION OF RIBA* 7 (2000), available at <http://www.islamic-finance.net>.

198. EL-GAMAL, *supra* note 19, at 54-55 (arguing from the modern psychological and behavioral economic research "that humans exhibit fundamental forms of irrationality in time preference, against which precommitment mechanisms (including those based on religion) can protect them").

199. Iqbal & Khan, *supra* note 165, at 4.

Unfair compensation could be eliminated by pegging the interest rate to the market, and contemporary Islamic finance owes its market interest rate determination (for any particular individual or entity) to conventional finance and its regulatory mechanism. In this regard, benchmarking Islamic finance credit sales interest rates to conventional interest rates has been regarded to be appropriate.²⁰⁰

Since the objectives of commercial lending could be achieved by way of commutative contracts, Islamic law excludes lending from mainstream financial transactions.²⁰¹ Lending is generally considered a charitable act in Islamic law.²⁰² By not claiming repayment as compensation, the lender seeks to give time value of his or her money in charity.²⁰³

As noted, Islamic law aims to eliminate both the exploitation that is inherent in loan interest and other dishonest and unjust gains in all exchange transactions. To summarize the classical definition of *riba*, when the amount has been determined, no increase can be demanded if the payment is not made on time.²⁰⁴ In this way, the definition of *riba* extends beyond compensation for the money lent. Therefore, the need for understanding *riba* in sales is equally important.²⁰⁵

B. EXCESSIVE UNCERTAINTY OR AMBIGUITY (*GHARAR*)

Excessive uncertainty or ambiguity ("uncertainty") generally includes lack of complete information, deceit, risk, and inherent uncertainty as to the subject matter of the contract. Uncertainty about future events and quality of goods may also be included, whether any particular incompleteness is unilateral, bilateral, multilateral, intentional, or otherwise. It is impossible to ensure absolute certainty in any given transaction. It is because of the recognition of this intrinsic limitation that Islamic law tolerates minor uncertainty, but invalidates contracts containing excessive uncertainty.²⁰⁶ Like *riba*,

200. EL-GAMAL, *supra* note 19, at 53-54.

201. *Id.* at 57.

202. *Id.*

203. *Id.* (extending also the same principle to lending of usufruct of property).

204. Iqbal & Khan, *supra* note 165, at 5.

205. VOGEL & HAYES, *supra* note 195, at 74.

206. EL-GAMAL, *supra* note 19, at 58-59 (relating four conditions that invalidate

scholars have argued that the prohibition of uncertainty protects investors from excessive financial exposure “or payment of mispriced premia to eliminate existing risks.”²⁰⁷

Examining conventional insurance and derivatives on the basis of uncertainty, the contemporary jurists prohibited such transactions including naked options. The jurists do not consider security, insurance, and the option to exercise a right to be valid objects of sale; the premia of insurance and the price of options are certain, but the benefit to be derived from them are not, and thus the transaction comprises uncertainty. Analyzing the prohibition, it has been noted that jurists have prohibited only the unbundled sale of a contingency

a contract first listed by Professor Al-Darir).

First, [uncertainty] must be excessive to invalidate a contract. Thus, minor uncertainty about an object of sale (e.g., if its weight is known only up to the nearest ounce) does not affect the contract. Second, the potentially affected contract must be a commutative financial contract (e.g., sales). Thus, giving a gift that is randomly determined (e.g., the catch of a diver) is valid, whereas selling the same item would be deemed invalid based on [uncertainty].

Third, for [uncertainty] to invalidate a contract, it must affect the principal components thereof (e.g., the price or object of sale). Thus, the sale of a pregnant cow was deemed valid, even though the status of the calf may not be known. Indeed, the price of a pregnant cow would be higher than the price of the same cow if it were not pregnant. However, the sale of its unborn calf by itself is not valid based on [uncertainty]. In the first case, the primary object of sale is the cow itself, whereas in the latter case the object of sale is the unborn calf, which may be still-born. Finally, if the commutative contract containing excessive [uncertainty] meets a need that cannot be met otherwise, the contract would not be deemed invalid based on that [uncertainty]. A canonical example is . . . [prepaid forward sale], wherein the object of sale does not exist at contract inception, giving rise to excessive [uncertainty]. However, since that contract allows financing of agricultural and industrial activities that cannot be financed otherwise, it is allowed despite that [uncertainty]. Similarly, while contemporary jurists forbade commercial insurance based on excessive [uncertainty] and availability of noncommutative [Islamic insurance] alternatives, they currently allow [Islamic insurance] companies to deal with conventional reinsurance companies, since [Islamic reinsurance] alternatives are not yet available.

Id.

207. *Id.* at 60-61 (noting empirical findings of contemporary behavioral finance literature to emphasize that “human idiosyncrasies” such as people’s preference of risk-loving behavior over risk-and-loss averse behavior depend on how a “reference point” is presented to them, and also noting that a religious precommitment helps individuals to avoid financial detriments).

or legal right—which is termed to be essentially trading in unbundled credit and unbundled risk—and not the bundled sale of insurance, credit, and options.²⁰⁸

V. FINANCIAL ENGINEERING IN CONTEMPORARY ISLAMIC FINANCE

Forces such as changes in supply and demand or regulatory structure drive financial innovation and financial engineering so that financial institutions can remain profitable.²⁰⁹ Summarizing the Islamic finance contract conditions, scholars have outlined a list of five *a priori* stipulations: (1) compliance with Islamic law in general, (2) conscious and willing agreement of the contract conditions, (3) clarity and awareness that eliminates uncertainties, (4) capability to fulfill all contract conditions at the time of its execution including possession or ownership of the goods or services sought to be transferred, and (5) commitment of the parties not to subterfuge the spirit of Islamic law by applying any legal trick.²¹⁰

The scholars have provided some general guidelines for financial engineering in the today's IFS industry. The guidelines include observing the principles of Islamic law that pertain to applying Juristic Reasoning, and other lawmaking considerations such as taking a lenient view, safeguarding public interest, eliminating hardship, and granting concessions in case of necessity.²¹¹

208. *Id.* at 62.

209. Iqbal & Khan, *supra* note 165, at 2.

210. *Id.* at 10-11 (characterizing this summarization as the five C's of Islamic finance).

211. *Id.* at 11-12.

All these principles emphasize that the guiding principle for *ijtihad* [Juristic Reasoning] is to ensure preservation of the basic objectives of *Shariah* [Islamic Law] Within those overall objectives, these principles provide guidelines for dealing with issues arising from the unfolding complexities of applying the rules of [Islamic law] to new situations. [Taking a lenient view] [*i/stihsan*] refers to departure from a ruling in a particular situation in favour of another ruling which brings about ease. This is done by taking a lenient view of an act which would be considered a "violation" on a stricter interpretation of the action based on earlier *qiyas* [analogical reasoning]. *Masalih mursalah* [Safeguarding public interest] similarly refers to making an exception to the application of a general provision of law for safeguarding

A. ISLAMIC BANKING

As of 2002, ninety-seven Islamic banks were operating throughout the world.²¹² Approximately fifty-eight percent of them are in the Arab world.²¹³ Eighty-three percent of the total assets of the Islamic banks are concentrated in the Arab world.²¹⁴

Early development of Islamic banking was also facilitated by the governments of Muslim countries and the OIC. Unlike their conventional counterparts, Islamic banks have distinguishing features which include the following: offering risk-sharing credit services, putting more emphasis on productivity, comparing conventional emphasis on creditworthiness, offering a wider range of products primarily by adding risk-sharing in portfolios, and showing stable monetary returns. These stable monetary returns are “not possible without the backing of goods and services” that reduce the

public interest. *Raf al-haraj* [elimination of hardship] is another basic principle of Islam which refers to removing difficulties faced by people in general due to change in circumstances. This rule is derived from the *Qur'anic* verse which translates as “God intends for you ease, and He does not want to make things difficult for you” (2:185).

The doctrine of necessity *darurah* allows temporary suspension of normal law in case of dire need. Since this doctrine can often be misused, a word of caution is in order. The doctrine of necessity is meant to be used very sparingly. It is a rule to handle emergencies. Even in emergencies, it does not provide an automatic and unrestricted suspension of the law. First of all, it has to be determined that a situation has arisen where the doctrine can be invoked. While in individual cases it is the individual conscience which will determine this, in the case of public application a ruling must be given by [Islamic Law] scholars, in consultation with the experts in the relevant field. Second, the suspension of the normal law is not absolute. There are limits and conditions to be observed. The *Qur'anic* text (2:173) providing the basis for this doctrine itself lays down two basic conditions: the user must accept the sanctity of the original law (implying a return to it as soon as possible) and, in the meanwhile, use the exception to the minimum possible extent.

Id.

212. MOLYNEUX & IQBAL, *supra* note 9, at 153 tbl.6.1.

213. *See id.* (indicating that the remainder of the Islamic banks are distributed as follows: 18.56% in South and South East Asia, 9.28% in Africa, and 14.43% in the rest of the world).

214. *See id.* at 154 tbl.6.2 (illustrating that the remainder of assets are distributed as follows: 13.05% in South and South East Asia and 3.63% in the rest of the world).

“room for a sudden and mass movement of such funds,”—a phenomenon that results from “interest-based short-term funds” and is generally responsible, destabilizing speculation.²¹⁵

B. INTERNATIONAL BANKING OPERATIONS

While proposing macro-level reforms for Islamic economy, Islamic economists have proposed guidelines for international banking operations. Such scholars have suggested that, in general, taking forward positions in foreign exchange would be permissible. As for international documentary credits, the scholars recommended establishing an international fund, financed by Islamic banks through monthly contributions, and using that fund for the settlements.²¹⁶

C. ISLAMIC INVESTMENT FUNDS AND ISLAMIC INVESTMENT BANKING

The operational rules for domestic and international operations of Islamic banks are different from their conventional counterparts. For instance, the business of Islamic investment funds or banks works within a different structure. These funds are generally either “income funds” or “growth funds,” and are further classified as industry specific lease funds, commodities funds, equity funds, and petroleum funds.²¹⁷

Consistent with Molyneux and Iqbal’s explanation, the pool of funds is managed by a fund promoter who is recognized as an agent in terms of Islamic agency law and is authorized to take all necessary actions for the purposes of agency.²¹⁸ The agent or the fund promoter is entitled to a fixed-fee compensation for services. The fund promoter then appoints a fund manager who is compensated on a

215. *Id.* at 153.

216. BLUEPRINT, *supra* note 21, at 108; see MOLYNEUX & IQBAL, *supra* note 9, at 166 (arguing that the establishment of a coordinating body called the Islamic Financial Services Board will produce and enforce regulatory standards tailored to meet the unique needs of the Islamic banking sector).

217. MOLYNEUX & IQBAL, *supra* note 9, at 158.

218. See *id.* at 157, 173 (identifying a *wak lah*, or agency, as one of the main types of contract in Islamic banking and finance, and stating that *wak lah* satisfies the fundamental principles of the Islamic theory of contracts).

fixed-fee basis or via profit-sharing. Here, Islamic banks and Islamic investment funds have a slightly different structure. Islamic banks participate directly in the profit-risk-sharing arrangement (also known as working-partner or *mudarib*—under a classical contract form known as *mudarabah*, which is discussed below) with the deposit holder, whereas the fundholders themselves bear all the risk of investment.²¹⁹ The profits may be shared, if mutually agreed by the fund promoter and the fund manager. Furthermore, since the fund promoter works strictly in accordance with the terms of the agency granted by the fundholders, the agency agreement must specify the level of Islamic law compliance and the modes necessary to ensure such compliance.²²⁰ Additionally, the fund manager should consult Islamic law opinions or seek guidance from the Islamic law board of the fund.²²¹

As for equity funds, which buy and sell shares of various companies, investment in them is generally considered consistent with the spirit of Islamic law because investment in a company is not *per se* an investment in debt.²²² Scholars have, however, prescribed certain conditions for such investment to be permissible using various tests. First, using the line of business test, the fund must not deal with shares of a company whose primary business is illegitimate according to Islamic law.²²³ Second, using the main-business test, any interest earned by the fund must be “negligible and separable” from the fund’s total income.²²⁴ Also, since the sale of debt is only permissible at face value, the receivable debt in the company’s portfolio must not exceed the “acceptable” proportion. Any interest-based income in excess of ten-percent has been considered

219. *See id.* at 157 (explaining that fund promoters have no share in profits because all of the risk is borne by the fundholders).

220. *Id.* at 157-58.

221. *Id.* at 159.

222. *See id.* at 158 (indicating that equity funds are acceptable under Islamic law because the shareholders, as the owners of the company, are responsible for the company’s deeds).

223. *See id.* (identifying conventional banks, alcohol-based beverages industries, casinos, and pork-based food industry as examples of unlawful businesses according to Islamic Law).

224. *Id.*

unacceptable.²²⁵ Third, using the debt-equity ratio test, the debt-equity ratio of a company should not exceed one-third debt and two-thirds equity.²²⁶ These debt-equity ratio criteria are constantly changing.

This and other screening methodologies have been criticized for being inadequate to ensure compliance with Islamic law.²²⁷ As for the sale-of-debt prohibition in Islamic law and the shares of the companies that have accounts receivable in their portfolio, scholars favor permissibility if, after applying the dominant component test, the ratio of debt receivable is less than fifty percent.²²⁸ Al-Baraka Investment and Development Company²²⁹ initially developed these standards and screening rules which were later “copied and popularized by Dow Jones Islamic Indexes (DJII) and Financial Times’ FTSE Islamic Indexes.”²³⁰

At the early stages of Islamic mutual funds, various screening rules were developed. The most controversial of them were the debt ratios discussed above. During the 1990s, the standardization process was hastened “especially after DJII changed its cutoff debt ratio from thirty-three percent of assets to the thirty-three percent market capitalization.”²³¹ Soon thereafter, this screening method was no longer practical. One of the main reasons was that managers would sell the stock immediately after the ratios changed and crossed the tolerance threshold—giving rise to “buy high, sell low” cycles.²³² This was followed by a race to develop Islamic hedge funds.²³³ The

225. *Id.* at 159.

226. *Id.* But see EL-GAMAL, *supra* note 19, at 126-27 (explaining that early views regarding inclusion of companies with interest income in investment portfolios were strict, but have since become more relaxed, with modern jurists allowing investment in companies whose accounts receivable debt-equity ratio is forty-five percent or more of the total assets).

227. See EL-GAMAL, *supra* note 19, at 125 (criticizing these screens for only incorporating what is impermissible under Islamic law and not including positive injunctions such as, for instance, “helping the poor”).

228. MOLYNEUX & IQBAL, *supra* note 9, at 159.

229. The word *Al-Baraka* literally means religious and divine blessings.

230. EL-GAMAL, *supra* note 19, at 12.

231. *Id.*

232. *Id.*

233. *Id.* at 12-13.

debt-ratio criterion appears to be less strict in Islamic hedge funds. For instance, the Meyer's Shari'a Fund, a pioneer Islamic hedge fund, has developed a new screen that takes into consideration the actual interest income and expense, rather than debt-ratios.²³⁴

D. HEDGING AND DERIVATIVES

Recently, clarifying the saying "Sell not what is not with you," Professor Hashim Kamali has opined that future contracts in fungibles do not fall within the scope of the prohibition and are thus permissible under Islamic law.²³⁵ In an earlier work, Professor Kamali concluded that a blanket prohibition of futures is not supported by Islamic law.²³⁶ He, however, conditioned the permissibility of the futures to effective regulatory control that encourages trading in futures for genuine reasons and restricts speculative risk-taking.²³⁷

Islamic law prohibits interest-bearing debt instruments. However, some Islamic-law-compliant transactions do involve debt such as manufacturing, cost-plus financing, and leasing. But, Islamic finance generally faces a scarcity of financial instruments that are used in conventional finance to contain the market and credit risks involving debt, equity, commodity, and currency transactions. However, certain Islamic finance transactions do resemble transaction structures that, albeit in a limited manner, contain risk exposure—"partial proxies" to conventional derivatives securities.²³⁸ As discussed with other classical contract forms and their modern adaptations, such "derivative-like" transactions²³⁹ include profit sharing partnerships, forward contracts, manufacturing contracts,

234. *Id.* at 129.

235. MOHAMMAD HASHIM KAMALI, *Fiqhi Issues in Commodity Futures*, in FINANCIAL ENGINEERING AND ISLAMIC CONTRACTS 20, 42 (Munawar Iqbal & Tariqullah Khan eds., 2005).

236. See MOHAMMAD HASHIM KAMALI, ISLAMIC COMMERCIAL LAW 206-07 (2003) (categorizing critics' prohibitive judgments on futures and options as speculative and insufficient to justify a prohibition on trading in futures).

237. *Id.* at 207.

238. VOGEL & HAYES, *supra* note 195, at 219.

239. See EL-GAMAL, *supra* note 19, at 81-92 (discussing the term "derivative-like sales" as two permissible types of contracts under Islamic law that allow for sales of nonexistent objects).

absolute option contracts, third-party guarantees, and partial advance payment contracts.

E. REAL ESTATE INVESTMENT TRUSTS

After the bursting of the technology stock bubble, Islamic Real Estate Investment Trusts ("REITs") emerged as an alternative investment strategy. Equity REITs are permissible according to Islamic law, and otherwise lucrative because of the fact that REITs in the United States are required to give most of their net income in dividends.²⁴⁰ The optimal debt-equity ratio for REITs is considered to be between forty and sixty percent. Therefore, the DJII has hindered REITs because, according to the DJII, the permissible debt-equity ratio should be less than thirty-three percent. However, Islamic REITs have not disclosed the methodology that allows them to invest in REITs with higher debt ratios. The methodology might be based on a necessity argument or that REITs represent "a different set of asset class, . . . merit[ing] a different screening benchmark."²⁴¹

F. CLASSICAL CONTRACT FORMS AND MODERN TRANSACTIONS

1. *Contract One: Profit-Sharing Dormant Partnership (Mudarabah)*

Capital owners and investment managers enter into profit-risk sharing arrangements.²⁴² Distribution of profit is in accordance with the pre-agreed proportion, and losses are borne by the capital owner to the extent of the capital invested. The investment manager loses the opportunity cost of his labor. Parties understand that the profit is not guaranteed. Although the investment manager is to follow the contract terms in how he conducts business, the capital owner cannot interfere in the day-to-day business. The investment manager is a fiduciary and expected to conduct the business with utmost honesty. Administrative expenses and those in the usual course of business are

240. See *id.* at 129-30 (explaining that REITs are permissible under Islamic law because they engage in buying, maintaining, and leasing real estate, and derive most of their income from rent).

241. *Id.* at 131.

242. See generally MOLYNEUX & IQBAL, *supra* note 9, at 168-69 (describing the essential elements of the *mudarabah*).

charged to the expense account. Profits cannot be distributed before settling liabilities and restoring equity.

Islamic banks undertake the above classical form from their asset and liability sides. As for the asset side, Islamic banks become the capital owner and use their deposit funds as the capital.²⁴³ Islamic banks are generally authorized by the deposit holders to pool their funds toward capital investment by the Islamic bank. As for the liability side, Islamic banks become the investment manager, with depositors serving as capital owners.²⁴⁴ The depositors authorize the Islamic bank to mix their capital with its own funds—absence of this authorization will invalidate the pooling of funds. Profits are distributed according to an agreed proportion, but losses “must be borne in proportion to the capital provided by each [party].”²⁴⁵ The profits are usually benchmarked to the market interest rate. Losses are rarely reported—or may only be suffered in theory. Many criticize the practical certainty of profit and equate it with prohibited interest.²⁴⁶

This contract form is also used as an Islamic hedge fund and could either be for a specific or general purpose. The interest in the fund can only be traded if the fund mostly invests in “tangible assets, not . . . financial instruments.”²⁴⁷ Similar to conventional hedge funds, Islamic fund managers are compensated for administrative expenses, receive a “carried interest” in the fund profits, and are protected from liability in case of any capital loss, unless they personally invested in the pool of funds.²⁴⁸ This structure gives the fund manager a *de facto* call option on the profits of the fund.²⁴⁹

243. *Id.* at 169.

244. *Id.*

245. *Id.*

246. Hegazy, *supra* note 17, at 148.

247. VOGEL & HAYES, *supra* note 195, at 221.

248. *Id.* at 221-22.

249. *See id.* at 231 (discussing how the manager’s at-risk reputation creates a check upon the manager’s willingness to engage in risky investment strategies).

2. *Contract Two: Profit-Risk Sharing Partnership (Musharakah)*

This contract form resembles Contract One with some differences. In the present contract, both parties provide capital, manage the enterprise, share pre-agreed proportional profit, and share the loss proportionate to their capital investment.²⁵⁰ Islamic banks use a modified version of this contract called a “diminishing partnership.”²⁵¹ The Islamic bank and its beneficiary enter into a partnership to own an asset, with a condition that the bank “will gradually sell [its] share to the beneficiary at an agreed price and in accordance with an agreed schedule.”²⁵² The Islamic bank provides the financing for early acquisition of the property. The pre-agreed payment schedule, through which the Islamic bank sells its share in the asset to the beneficiary, is benchmarked to the prevalent market interest rate. Although charging interest directly on asset-financing would be subject to the *riba* prohibition, Islamic banks in effect receive interest for financing asset-purchase by following this transaction structure.

Another form of a diminishing partnership requires the customer to initially serve as an investment manager, as in Contract One above. After the customer starts buying the assets, it becomes a proportional co-owner and thus partner, and the contract is transformed into a Profit-Risk Sharing Partnership, of Contract Two above.²⁵³ Risk in the property shifts to customer with the transfer of property and, accordingly, the partnership diminishes.²⁵⁴ After buying one hundred percent interest in the asset, the customer becomes the sole proprietor and full owner of the assets.²⁵⁵

3. *Contract Three: Cost-Plus Financing (Murabaha)*

Islamic law permits payment of a premium over cash price on a deferred price. For instance, A is selling a product at a cash price of \$100 and B offers to pay \$105 but with deferred payment. Islamic

250. MOLYNEUX & IQBAL, *supra* note 9, at 169.

251. *Id.*

252. *Id.*

253. Iqbal & Khan, *supra* note 165, at 15.

254. *Id.*

255. *Id.*

banks use this transaction model to provide finance to their customers with a cost-plus marked-up profit.

The customer executes an order to the Islamic bank to buy certain assets, and provides a description of the seller and the cash price. In turn, the Islamic bank enters in two transactions: first with the seller to buy the assets with cash; second, with the customer to sell the assets to the customer at a deferred price, which is scheduled by way of installments or a lump-sum payment and has a built-in marked-up profit component.²⁵⁶ The customer becomes an agent of the bank: "In the contract between the Islamic bank and the supplier, the bank often appoints the person placing the order (the ultimate purchaser) as agent to receive the goods purchased by the bank."²⁵⁷ The marked-up profit is benchmarked to the prevalent market interest rate. Some Islamic banks do not have the asset transferred in their name—mainly to avoid transaction costs—and instead transfer the asset directly to the customer. Often, Islamic banks authorize the customer to act as the bank's agent and transfer the asset in its own name. It is worth mentioning that, despite criticism on the extended use of this transaction, cost-plus financing transactions consist of the bulk of the Islamic banking business, representing over seventy percent of Islamic financial transactions.²⁵⁸

4. *Contract Four: Leasing (Ijarah)*

Islamic law permits leasing of properties and their use against payment of rent. IFS institutions deal in two forms of leases: operational and finance leases. In the case of an operational lease, the usufruct generated by a leased asset, "such as machinery, airplanes, ships or trains, is sold" by the lessor for fixed period.²⁵⁹ The lessor retains the risk in property, but the lessee is responsible for usual maintenance. Being for a short period, the risk of the lessor is high. In case of a finance lease, the period of lease is spread over a longer period of time so that the lessor is able "to amortize the cost of the

256. MOLYNEUX & IQBAL, *supra* note 9, at 169-70.

257. *Id.* at 170.

258. Hegazy, *supra* note 17, at 148.

259. MOLYNEUX & IQBAL, *supra* note 9, at 170.

asset with profit” and retain relatively higher financial security.²⁶⁰ The lessee may purchase the asset at market value after the lease period ends. A finance lease is generally not terminable at the option of the lessee, and requires mutual consent if the lessee would like to sell it during the lease period. Scholars have considered this aspect of the finance lease to be financially infeasible because it makes the lessee worse off than the customers of interest-based financing, where such a stipulation does not exist.²⁶¹ There are also doubts as to whether the non-cancelable nature of the lease is permissible under Islamic law.²⁶² As in Contract Three above, both of the leasing contracts are initiated at the request of the customer or the future lessee. At the conclusion of the contract, the asset is transferred to the lessee at a nominal price, or by way of a gift. Jurists have ruled that such transfer can only be made with a separate contract after termination of the original contract, and “on the basis of an advance promise to effect” the transfer.²⁶³

5. *Contract Five: Manufacturing Contract (Istisna)*

Parties enter into a manufacturing contract of a specified product. The parties also agree on specifications, description, delivery date, pricing, and its modes. It is also permissible to defer the payment of price in such contracts.²⁶⁴ IFS institutions use this contract form for financing a manufacturing contract and enter into two manufacturing contracts. The first contract is between the party initiating a manufacturing request and the bank. This contract includes the price the customer will pay, usually in installments, and the date on which the bank agrees to deliver the product.²⁶⁵ The second contract is in the form of a subcontract between the bank and a manufacturing contractor to manufacture and deliver the product as requested.²⁶⁶ The contractor usually receives advance payment or staggered payments during the contract time. Usually the delivery dates are the

260. *Id.*

261. *Id.* at 170-71.

262. *Id.* at 171.

263. *Id.* at 172.

264. *Id.*

265. *Id.*

266. *Id.*

same in both the contracts, and the original purchaser is authorized to take delivery directly from the contractor.²⁶⁷ The repayment schedule of the manufacturing contract is usually benchmarked at the prevalent market interest rate.

The buyer locks in the price of customized commodities or products and any upward price movement—whether demand-driven or otherwise—of such commodities or products is not likely to have an adverse impact on the buyer. However, the manufacturer cannot sell the commodities/products to anyone else at higher price.²⁶⁸

6. *Contract Six: Absolute Option (Khiyar Al-Shart)*

One party may confirm or cancel a contract in light of an absolute option contained therein. For instance, in the manufacturing contract (Contract Five above), the parties may agree for an absolute option to be exercised by the manufacturer in case all of the buyer's similar manufacturing orders are sourced to the manufacturer.²⁶⁹

7. *Contract Seven: Forward Sale (Salam)*

Parties agree for future delivery for the price paid in advance. Forward sale is not available in every commodity; it is usually restricted to fungibles.²⁷⁰ IFS institutions undertake the forward sale in two ways. First, the IFS institution enters into a forward sale contract, similar to Contract Five above, where the supplier requests future delivery and payment schedule.²⁷¹ Second, the IFS institution buys a commodity by paying in advance and, in an independent

267. *Id.*

268. VOGEL & HAYES, *supra* note 195, at 225.

269. *Id.* at 221.

[P]arties may protect themselves against not only movements in the underlying asset price but also events which may be completely unrelated to the underlying asset. As a (possibly valid) example, an airline company may purchase by . . . [forward contract] one hundred planes for \$5 million each on a date five years in the future, giving the manufacturer an option, which it agrees to exercise only if the airline does not source all of its intervening plane requirements from that manufacturer.

Id.

270. MOLYNEUX & IQBAL, *supra* note 9, at 172-73.

271. *Id.*

contract, sells the commodity to its customer on installments.²⁷² The forward sale contract installments have a built-in profit that is usually benchmarked at the prevalent market interest rate.

By entering into a forward contract and having been paid in full, the forward seller may either already have the commodity or may produce (or grow) it for future delivery.²⁷³ In the event that the seller has proprietary information for price volatility in future, the seller can hedge itself by securing a higher price against future delivery, when it expects adverse price movements in the future.²⁷⁴

8. *Contract Eight: Islamic Insurance (Takaful)*

Risk-taking is part and parcel to the entrepreneurial spirit, and Islamic law recognizes the need for a protection.²⁷⁵ Islamic law also accepts seeking protection against loss from natural calamities. Covering risks that are game-oriented is not permissible within the valid Islamic insurance business.²⁷⁶ Islamic law provides a different structure for protection from entrepreneurial risk and loss from natural disasters. The development of the Islamic insurance industry has followed a non-conventional structure wherein the insurance

272. *Id.*

273. See VOGEL & HAYES, *supra* note 195, at 223-24 (comparing the forward sale contract to the manufacturing contract and noting that one primary difference is that, in the forward sale contract, the seller can use the forward payment for any purpose, while in the manufacturing contract, the seller is required to use the progressive payments solely for the production of the goods).

274. See *id.* at 222-24 (explaining that the seller can consider two factors when determining the sale price—the predicted volatility of the good's price and the expected change of the good's price—and will enter into the contract when the price is expected to decrease or become volatile because this guarantees a floor sale price and averts risk).

275. See MOLYNEUX & IQBAL, *supra* note 9, at 160 (listing three forms of risk: first, the "entrepreneurial risk" that arises in the normal course of business; second, the risk of natural disasters; and third, the unnecessary, self-created risk that arises when people play "games"). The authors suggest that the first two types of risk are inherent in daily life and must be addressed. *Id.*

276. See *id.* (clarifying that "games," which create risks not part of daily life, are unnecessary for the individual because the individual could avoid them by choosing not to play them and are unnecessary for society because they do not contribute to societal wealth). These "games" are equitable to gambling, which Islam prohibits. *Id.*

company participates on a profit-loss sharing basis with a pool of participants (or policy holders) that mutually agree to cover each other in case of loss.²⁷⁷ In this structure the Islamic insurance company does not provide assurance/insurance to the policy holder, but acts on behalf of the policy holders to manage the business. The contributions or premiums are pooled into a fund and invested into Islamic-law compliant investment opportunities. Profits are calculated after paying any claims, and surplus is shared between the company and the policy holders at a predetermined proportion.²⁷⁸ In this regard, the relationship of the company vis-à-vis the policy holders is in the form of Contract One above. It is worth mentioning that no reinsurance, Islamic-law-compliant alternatives are currently available. Therefore, contemporary jurists have allowed Islamic insurance companies to deal with conventional reinsurance companies.²⁷⁹

9. *Contract Nine: Agency Contract (Wakalah)*

This contract entitles the person appointed as an agent to receive a predetermined fee for performing a specified job or task, irrespective of whether the assigned job or task was successfully accomplished. Penalties for breach of trust follow in case of dishonesty or violation of the terms of the contract.²⁸⁰ Islamic banks use this contract form for rendering fund management or investment management services to their customers. The contract is priced with a fixed amount for providing managerial services. After deduction of the managerial fee, the “entire profit or loss is passed back to the fund providers.”²⁸¹

277. *See id.* at 161 (explaining that it is acceptable to protect oneself against suffering, but it is improper to profit from that suffering and, as such, the Islamic insurance industry was developed around the idea of taking care of one another).

278. *Id.*

279. EL-GAMAL, *supra* note 19, at 59. This appears to be a recurrence of the necessity argument that earlier allowed Islamic banks to deal with interest in their effort to compete with the conventional banks. Some scholars have cautioned that a persistent exercise of the doctrine of necessity “may not only contaminate the essence of the system, it may also raise suspicions in the minds of those who have put their trust in the system.” IQBAL & MIRAKHOR, *supra* note 177, at 225.

280. MOLYNEUX & IQBAL, *supra* note 9, at 173.

281. *Id.*

10. Contract Ten: Third-Party Guarantee (Damanah)

Islamic law allows a third party to serve as guarantor to the contracting parties. The guarantor, however, can only charge for its administrative expenses, and not the cost of capital.²⁸² Owing to compensation restrictions, guarantors in contemporary Islamic finance only sponsor entities such as the government or holding companies. The guarantor also holds a lien on the contract assets.²⁸³ Some scholars contend that third-party guarantee models could serve as a put option in view of the fact that various Islamic banks provide third-party guarantees to cost-plus financing (Contract Three above). That is to say, in the event that the purchaser concludes that the cost-plus financing is not as valuable as once thought, it may (theoretically) stop paying and allow the bank to take possession. This may be “a put option with a strike price equal to the value of the remaining installment payments.”²⁸⁴

11. Contract Eleven: Partial Advance Payment (Urbun)

The parties agree to a future performance subject to one party furnishing partial advance payment. In the future, the party that has tendered the partial payment may choose to disregard the contract and, in such case, forfeit the money advanced to the other party. Although it cannot be priced on the conventional options pricing model, the partial advance payment contract may offer a close substitute for conventional financial options. For instance, an airline company intends to buy a fleet of aircrafts at a certain price, which may move upwards in the future, beyond the company's ability to pay. The company would also like to have the option to buy from the open market if doing so would be economical. The company may enter into the partial advance payment contract with the manufacturer, and allow its advance payment to be forfeited if the price turned out to be lower than the company contracted.²⁸⁵

282. VOGEL & HAYES, *supra* note 195, at 221.

283. *Id.*

284. *Id.* at 229 (noting, however, that the bank may place a condition in the guarantee agreement “allowing it to recover from the purchaser any loss . . . suffered”).

285. *Id.* at 227-28.

12. Contract Twelve: Islamic Bonds or Debt Securities (Sukuk)

a. History

Sukuk is a plural form of *saak*, which means title or investment certificate. *Sukuk*, in a contractual form, existed in the seventh century (during the first century of Islam).²⁸⁶ Soldiers and other public officials were paid in cash, as well as in kind.²⁸⁷ “The payment in kind was in the form of . . . ‘commodity coupons’ or ‘grain permits’” (both *sukuk*) that were entitled for the promised quantity of the commodity (usually grains) upon maturity of the coupons or permits, as the case may be.²⁸⁸ Some would sell their coupons or permits for cash, although scholars at that time disputed permissibility of such sale.²⁸⁹

Fourteen centuries later, the practice of *sukuk* was revived in 2001 when the Kingdom of Bahrain issued USD \$250 million with five years of maturity.²⁹⁰ Today, *sukuk* are mushrooming in the international financial markets and their structures are becoming increasingly complex, as newer transactional aspects are being added. Duplication of an existing model becomes more competitive, which gradually diminishes profit margins.²⁹¹

286. Mohamed Rafe Md. Haneef, *Recent Trends and Innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities*, in ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES 29, 30 (S. Nazim Ali ed., 2005).

287. *Id.*

288. *Id.*

289. *Id.*

290. *Id.* at 30-32 (noting that the Kingdom of Bahrain’s issuance was soon followed by Malaysia issuing USD \$600 million *sukuk*, USD \$700 million by the State of Qatar, and USD \$400 million by the IDB). To date, the trend continues to grow, and so do the numbers. For instance, Malaysian companies have issued Islamic debt of USD \$24.97 billion as of 2006. Hasan Jafri & Carolyn Lim, *Malaysia to Sell Islamic Bonds*, WALL ST. J., Sept. 26, 2006, at C4.

291. See EL-GAMAL, *supra* note 19, at 11-13 (discussing the role of financial providers, jurists, and lawyers in the development of IFS products and explaining that when a product is first developed, it has a captive market and is very profitable, but then is easily replicated reducing its profit margin).

b. The Concept

As a general principle,²⁹² direct lending, and charging interest thereupon, is not permissible under Islamic law. Therefore, Islamic finance professionals, scholars, and jurists created equity-disguised debt products, wherein, as discussed below, the bondholder in a leased-based *sukuk* structure, for instance, holds a beneficial interest in an underlying asset and receives rental income as profit—which is usually benchmarked to the prevalent market interest rate or similar competitive pricing methodology. To achieve this, the transaction structure uses classical contract forms such as *Mudarabah*, *Musharakah*, *Murabahah*, *Ijarah*, *Istisna*, and *Salam*, which are described above. *Sukuk*, based on any individual contract form or combinations thereof, are common. *Sukuk* based on combinations are known as hybrid *sukuk*.

Sukuk structures approximate the conventional bond issue, while maintaining their compliance with *Sharia*. Duplication of an existing *sukuk* structure becomes more competitive, which gradually diminishes the profit margins. However, the first entrants with an innovative structure continue to yield high returns. *Sukuk* issued in an international market has usually been in the conventional global bond format in accordance with U.S. Regulation S and Rule 144A.²⁹²

c. The *Sukuk* Standards

The Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”) issued the *Standard for Investment Sukuk* (“Standards”) in 2003.²⁹³ The AAOIFI Standards are generally followed by issuers of *sukuk*. The AAOIFI Standards do not treat *sukuk* to be debts of the issuer, but “fractional or proportional

292. See Haneef, *supra* note 286, at 31 (noting that IDB’s USD \$400 million *sukuk* in 2003 complied with U.S. Regulation S and Rule 144A as did the State of Qatar’s USD \$700 million *sukuk* in 2003, and the Kingdom of Bahrain’s USD \$250 million *sukuk* in 2004).

293. See Michael J. T. McMillen, *Sukuk (Islamic Bonds and Securitization): Toward a Viable Capital (Including Secondary Market)*, in INTEGRATING ISLAMIC FINANCE IN THE MAINSTREAM: REGULATION, STANDARDIZATION AND TRANSPARENCY 145, 148 n.5 (S. Nazim Ali ed., 2007) [hereinafter McMillen, *Islamic Bonds and Securitization*].

interests in underlying assets, usufructs, services, projects, or investment activities.”²⁹⁴ “*Sukuk* may not be issued on a pool of receivables. Further, the underlying business or activity, and the underlying transactional structures (such as the underlying leases), must be *Sharia* compliant (for example, the business or activity cannot engage in prohibited business activities).”²⁹⁵

The AAOIFI’s *Shariah* Board (comprised of twenty renowned international scholars of Islamic law and finance) has recently passed a six-point resolution that clarifies and revises various existing AAOIFI *Shariah* Standards and market practices concerning issuance of various types of *sukuk*.²⁹⁶

d. The *Sukuk* Transaction

The following describes a more prevalent model of the lease-based *sukuk* (*sukul al-ijara*). The model has been used in a number of *sukuk* issues.²⁹⁷ The regular lease-based *sukuk* is in fact lease-ending-with-purchase—that is, purchase of the underlying assets—and resembles the conventional asset securitization. The popular transaction structure is exemplified below. For ease of reference, a graphical representation of the transaction below is provided in the Appendix of this Article.

The actual *sukuk* issuer sets up a special purpose company (“SPC”), which is bankruptcy-remote and distances the real issuer from the subscribers, and SPC acts as the apparent issuer and trustee for the issue;

294. Michael J.T. McMillen, *Contractual Enforceability Issues: Sukuk and Capital Market Development*, 7 CHI. J. INT’L L. 427, 429 (2007) [hereinafter McMillen, *Contractual Enforceability Issues*].

295. *Id.*

296. Before announcing revisions in existing *sukuk* issuance practices and Standards, the AAOIFI’s *Shariah* Board took into consideration recommendations of various stakeholders from the Islamic finance industry. The *Shariah* Board’s recommendations are available at http://www.aaofii.com/aaofii_sb_sukuk_Feb2008_Eng.pdf.

297. See Haneef, *supra* note 286, at 32, 42 (noting that the Kingdom of Bahrain’s USD \$250 million *sukuk*, the Federation of Malaysia’s USD \$600 million *sukuk*, the State of Qatar’s USD \$700 million *sukuk*, and, with more modifications, the IDB’s USD \$400 million *sukuk* all used the leased-based structure).

A seller sells certain assets—for example, real estate, plants and machinery, or infrastructure project concession—to SPC for \$750 million;

SPC leases the assets to a lessee for a five year term. The lessee in most cases is the seller. The lessee also undertakes to buy the assets after the lease period, that is, after maturity of the *sukuk*;

SPC establishes a trust in respect to the assets and issues the lease-based *sukuk* to raise \$750 million with a maturity of five years. Trading at the secondary markets, if any, starts taking place after this point until maturity;

The lessee, as per the term of the lease, starts paying six monthly rentals during the term of the lease, and SPC distributes the rentals among the *sukuk*-holders;

After the five-year lease term, SPC sells the assets to the lessee/original seller pursuant to its undertaking, as mentioned in (iii) above, for \$750 million;

To redeem the *sukuk* upon maturity after five years, SPC distributes \$750 million among the *sukuk* holders;²⁹⁸

SPC is dissolved after it has outlived its purpose, that is, after the expiration of a certain time following the redemption of all the *sukuk*.²⁹⁹

e. Convertible *Sukuk*

Convertible *sukuk* are a recent development. Unlike a latent equity feature in the regular *sukuk*, convertible *sukuk* expressly offer conversion to equity. Convertible *sukuk* have two parts: non-equity and equity. The non-equity part yields a coupon return that is paid from the underlying business activity, such as rent proceeds from the leased assets. The coupon return is redeemable at pre-agreed dates at the face value. The conversion-to-equity feature, on the other hand, allows *sukuk*'s conversion into a share of the designated entity, at a specified date and at a pre-agreed conversion formula.

298. See *id.* at 31-42 (outlining a typical leased-based *sukuk* structure); EL-GAMAL, *supra* note 19, at 107-08.

299. Cf. Haneef, *supra* note 286, at 32 fig.1.A.

In a recent transaction, a Dubai-based port operator issued the largest *sukuk* ever, raising USD \$3.5 billion.³⁰⁰ Being convertible and using the *sukuk-al-musharaka* structure, the *sukuk* were aligned with a takeover bid. The structure allowed conversion of *sukuk* into equity upon an IPO, resembling a pre-IPO convertible bond. A detailed transaction structure is available at the transaction lawyers' website.³⁰¹ There are no standard guidelines available specifically for convertible *sukuk* that are generally followed. AAOIFI's standards guidelines are likely to be available soon to fill this gap.

VI. FUTURE RESEARCH DIRECTIONS

The scholarship on Islamic finance continues to be alarmingly insufficient. Academic critique has not partnered with the growing need for profound analysis. Although accounting and financial analyses have been consistent, they have not been able to greatly assist Islamic finance in innovation and financial engineering. As a result, a trend toward financial reverse-engineering has been growing, with lawyers being the main drivers. So far, it appears the legal practitioners have taken the lead in contributing to the Islamic finance literature.³⁰²

300. DENTONWILDESAPTE, BANK NOTES 1 (2006), available at http://www.dentonwildesapte.com/assets/1/16949_1.pdf.

301. *Id.* at 1-2.

302. It is becoming customary for practitioners, mostly lawyers and some financial experts, to write descriptive overviews of transactions that they have recently handled. Such works include analysis of regulatory and related challenges of Islamic finance; the lawyers' works have started to focus more on transactional structuring and regulatory issues. See, e.g., Ayman H. Abdel-Khaleq & Christopher F. Richardson, *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, 7 CHI J. INT'L L. 409 (2007) (illustrating the legal issues associated with *sukuk* supported by assets located outside the Islamic world through the example of the recent *sukuk* offered by the East Cameron Gas Company, a U.S. oil and gas entity); Kilian Bälz, *Islamic Finance for European Muslims: The Diversity Management of Shari'ah-Compliant Transactions*, 7 CHI J. INT'L L. 551 (2007) (focusing on the lack of Islamic retail financial products in Germany and suggesting regulatory changes that would promote the development of such products); Joseph W. Beach, *The Saudi Arabian Capital Market Law: A Practical Study of the Creation of Law in Developing Markets*, 41 STAN. J. INT'L L. 307 (2005) (describing the goals and provisions of the newly implemented Saudi Arabian Capital Market Law, of which the author was a primary drafter); Andreas Junius, *Islamic Finance: Issues Surrounding Islamic Law as a Choice of Law*

There are issues both at macro and micro levels that need to be immediately addressed: regulatory analysis of Muslim country's markets;³⁰³ comparative corporate governance and developing Islamic finance stock exchange;³⁰⁴ regulatory and quasi-regulatory institutions; comparative tax structures; risk analyses including *Sharia* compliance risk;³⁰⁵ capital flight from Muslim countries;³⁰⁶

Under German Conflict of Laws Principles, 7 CHI J. INT'L L. 537 (2007) (evaluating the decision not to apply *Shariah* law in the British case *Shamil Bank of Bahrain EC v. Beximco Pharm. Ltd.*, and analyzing how German courts would resolve a similar issue); Michael J. T. McMillen, *Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 FORDHAM INT'L L.J. 1184 (2001) (detailing four transactions which the author or his firm structured, two in Saudi Arabia and two in the United States); Michael J. T. McMillen, *Structuring a Securitized Shari'ah-Compliant Real Estate Acquisition Financing: A South Korean Study*, in ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES 79, 81-104 (S. Nazim Ali ed., 2005) (using a transaction in South Korea as a case study to illustrate different financing structures); McMillen, *Islamic Bonds and Securitization*, *supra* note 293, at 145 (discussing the implementation of novel *sukuk* structures in the Bahrain Financial Harbour *Sukuk*, as well as factors that impede growth in Islamic capital markets); McMillen, *Contractual Enforceability Issues*, *supra* note 294, at 427 (discussing the *sukuk* transaction structure and using this structure to demonstrate the potential benefits of expanding the IFS industry and highlighting the current enforceability issues that must be addressed); Umar F. Moghul, *No Pain, No Gain: The State of the Industry in Light of an American Islamic Private Equity Transaction*, 7 CHI J. INT'L L. 469 (2007) (demonstrating the usefulness of the *sharikah* structure through the example of a partnership agreement, designed by the author, which an Islamic bank used to purchase a sizeable minority share in a U.S. company).

303. See Ali Adnan Ibrahim, *Developing Capital Markets in Muslim Countries: Strategies and Policies for Securities Regulation and Corporate Governance*, in ISLAMIC CAPITAL MARKETS: PRODUCTS, REGULATION AND PRACTICES WITH RELEVANCE TO ISLAMIC BANKING AND FINANCE (forthcoming 2008) (discussing the roles of corporate governance, culture, and custom in attracting foreign investment to developing markets and suggesting, among others, that further research should be conducted to analyze the role of customary law in shaping capital market development, in particular corporate governance and securities regulation).

304. See Ali A. Ibrahim, *Convergence of Corporate Governance and Islamic Financial Services Industry: Toward Islamic Financial Services Securities Market*, in INTEGRATING ISLAMIC FINANCE INTO THE MAINSTREAM: REGULATION, STANDARDIZATION AND TRANSPARENCY (2007) (addressing the likely convergence of Islamic financial services industry to the modern corporate governance regimes and arguing that the industry needs to develop a homogeneous securities market).

305. See generally Shaykh Yusuf Talal DeLorenzo, *Shari'ah Compliance Risk*, 7 CHI J. INT'L L. 397 (2007) (defining *Shariah*-compliance risk, discussing the role

Islamic finance consumer advocacy; impact of incentives created by excess liquidity in Middle East; the role and scope of Islamic law supervisory boards, and the corporate governance analysis of their work; the issuance of Islamic legal opinions vis-à-vis the exercise of juristic reasoning; issues pertaining to harmonizing diversified opinions in Islamic law; and choice of law issues.

As discussed above, the growing use of U.S. Regulation S and Rule 144A formats in the debt-based IFS transactions of *sukuk* presents a pronounced effort by the IFS industry to comply with modern corporate governance practices. The industry has done little to address criticism that *Sharia* supervisory boards indulge in conflict-of-interest transactions.³⁰⁷

Various authors have noted that IFS' growth toward the equity market has yet to happen,³⁰⁸ and complete integration of Islamic finance with the international securities markets seems partially dependent on development of Islamic equity products. Whether the equity-based transaction structures invite similar criticism, which its debt-based counterpart has received, can only be analyzed in future. However, structuring a new species of equity transactions that is compatible in the conventional financial markets would inevitably require adherence to the norms of corporate governance in its conventional and Islamic sense.

Empirical evidence is crucial in regards to actual practice of the IFS industry. The analysis should include examination of IFS contracts and their true adherence to Islamic law injunctions, the spirit of risk sharing, and the principles that seek to ensure fairness and to curb exploitative, unjust tactics.

of the Shariah Supervisory Boards, and emphasizing that this system must be understood in order to develop the IFS industry).

306. This issue is introduced recently. See Ibrahim, *supra* note 302.

307. See generally Hegazy, *supra* note 17, at 133-39 (discussing the conflicts created when Shariah supervisory boards act both as auditors and consultants for their institutions and noting that most financial systems now prohibit entities from serving both roles).

308. See Haneef, *supra* note 286, at 60 (concluding that the IFS industry should focus on developing profit-sharing products and expressing hope that such products will be readily available in the future).

In particular, the following questions may be examined: What policies and strategies may be analyzed to improve the regulation of the capital markets in the Muslim countries? Should Muslim countries adopt or import laws and regulations from more developed markets? Is such import already taking place and what are the results of such convergence? Should Muslim countries first learn from the experiences of East Asian markets? What tax structure is needed to help Islamic finance integrate with conventional finance at home and abroad? How different is the Islamic finance risk paradigm and what issues are involved in its examination? Has Islamic finance identified itself as a mechanism for capital flight from Muslim countries? Are Islamic finance consumer advocacy groups important for further growth of the Islamic finance, and what has been their role so far? Has excess liquidity in the Middle East created a negative incentive for long-term products, micro and entrepreneurial finance, and related financial activities that are known to be the essence of Islamic finance? How transparent is the process of product development? How efficient are the Islamic-law supervisory boards in offering a proxy for regulatory authority as quasi-regulators? Would Islamic-law supervisory boards and their mechanisms pass the test of modern corporate governance practices? Do Islamic legal opinions for product development actually go beyond their scope and intrude into the sphere customarily reserved for the exercise of juristic reasoning under Islamic law? If so, what is the impact of such practice? How can harmonization within the diversified realm of Islamic legal opinion and the working of various Islamic schools be achieved? Does a centralized Islamic-law supervisory board within each jurisdiction offer any solution to the diversification problem? How should Islamic countries manage the diversification risk within a larger group of centralized supervisory boards? How will various international jurisdictions respond to a choice of law clause in Islamic finance transactions that seeks to enforce Islamic law? What is the extent of contemporary Islamic finance in representing the promise of its adherence to Islamic law?

The above issues and questions represent some of the most crucial areas. The IFS industry is apparently struggling with these questions. Future research and empirical examination of the above issues and questions will help the industry facilitate integration with the

international financial markets. Analysis of such issues was not the focus of this Article, and should be dealt with separately in another work.

CONCLUSION

This Article demonstrates theoretical foundations of Islamic finance and their correlation with the Islamic finance industry. In this respect, the Article presents an overall survey of the Islamic finance industry, Islamic-law injunctions, quasi-regulatory institutions, financial engineering, transaction structures, and evolving practices. The Article also highlights various areas of further research, a comprehensive treatment of which is critical to the continuing growth of Islamic finance in the international financial markets.

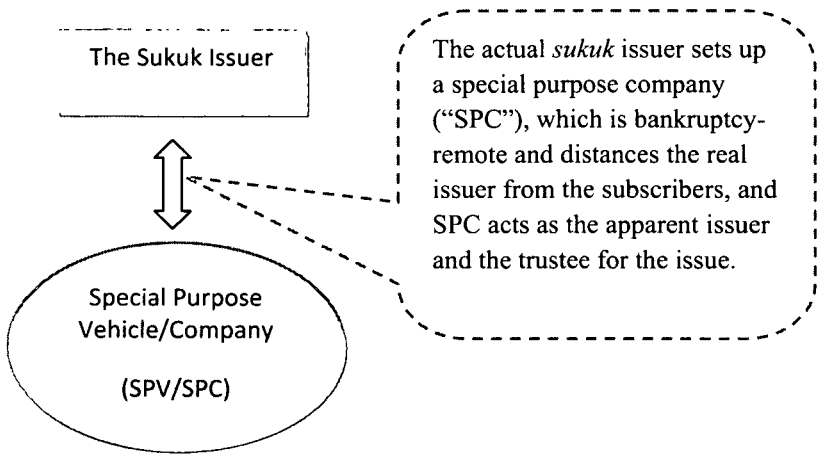
Islamic finance today appears to be competing aggressively with conventional finance. On account of this competition, there is an unprecedented pressure for innovation. The innovation often results in a close approximation of conventional financial transactions. The approximation strategy clearly suggests an intention to streamline Islamic finance products with the conventional financial markets, and to offer a viable alternative. However, this strategy has exposed the Islamic finance industry to the risk of being labeled as an industry that is encouraging tactics that circumvent Islamic law injunctions.³⁰⁹ This raises serious issues of corporate governance in the Islamic finance industry, which may not only thwart its growth within its "captive market," but may also result in reluctant reception in the international financial markets.

Furthermore, Islamic finance offers a great incentive for Muslim countries to develop financial markets and bring them to a level where they are attractive to international participants. With the help of a macro strategy, Islamic finance could also be helpful in promoting small and medium enterprise; micro or entrepreneurial finance or both may lead to economic growth and development in Muslim countries.

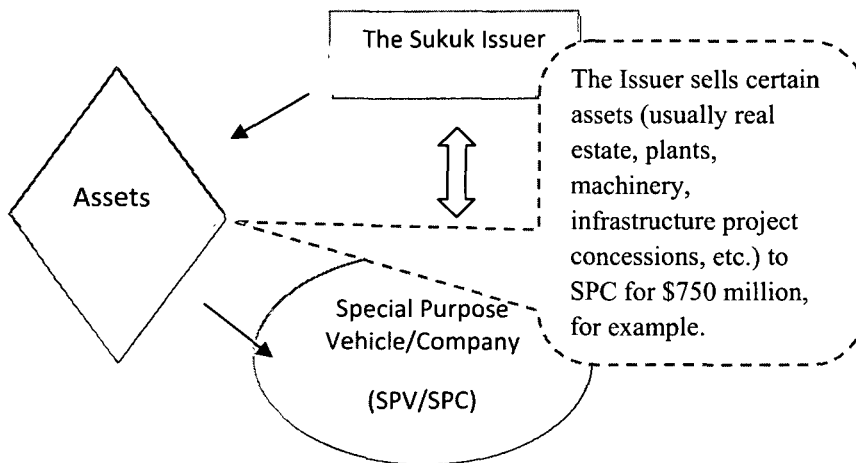
309. Hegazy, *supra* note 17, at 141-48.

APPENDIX

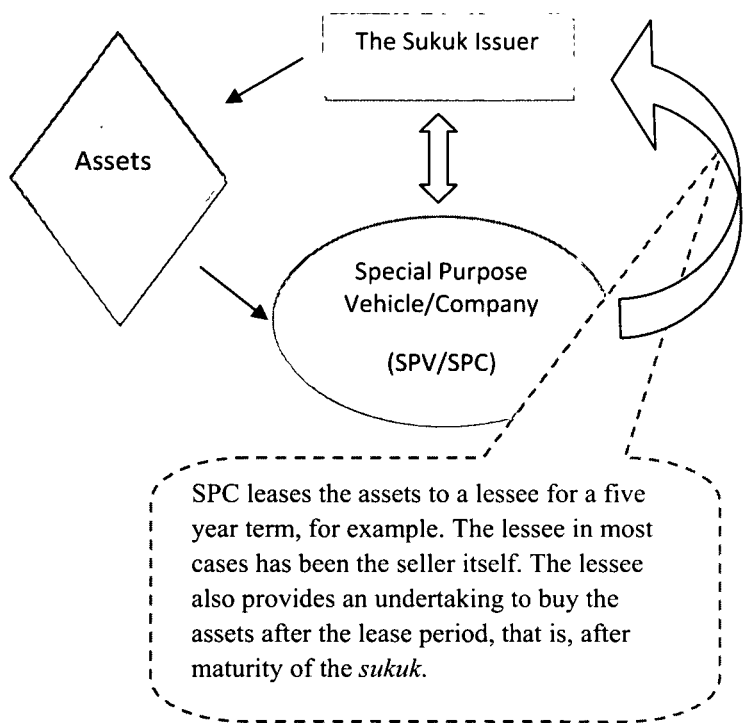
STEP ONE: SETTING-UP SPV/SPC



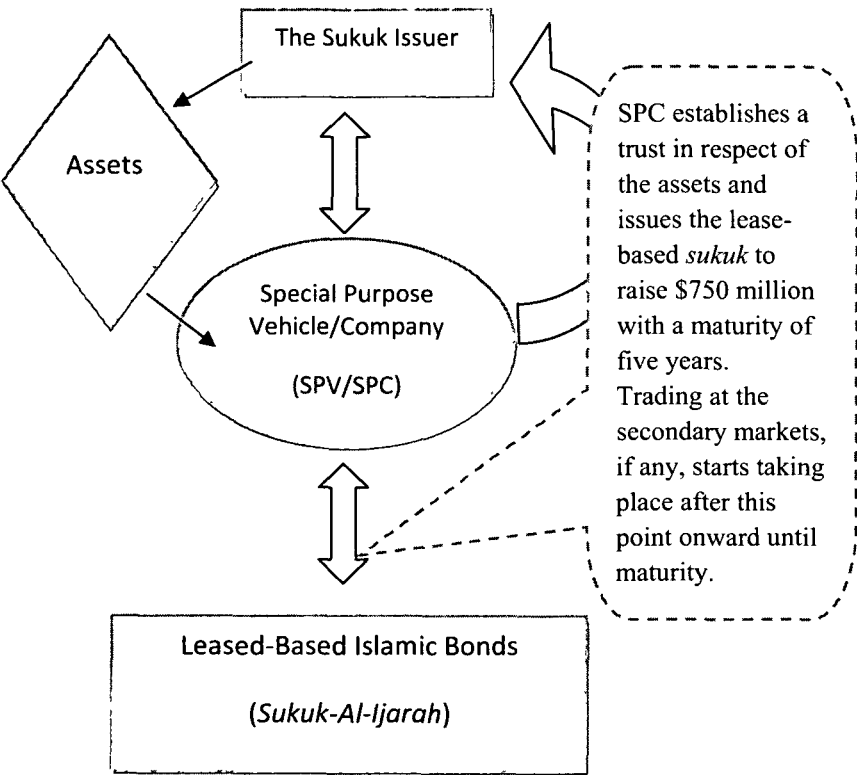
STEP TWO: TRANSFER OF ASSETS TO SPV/SPC



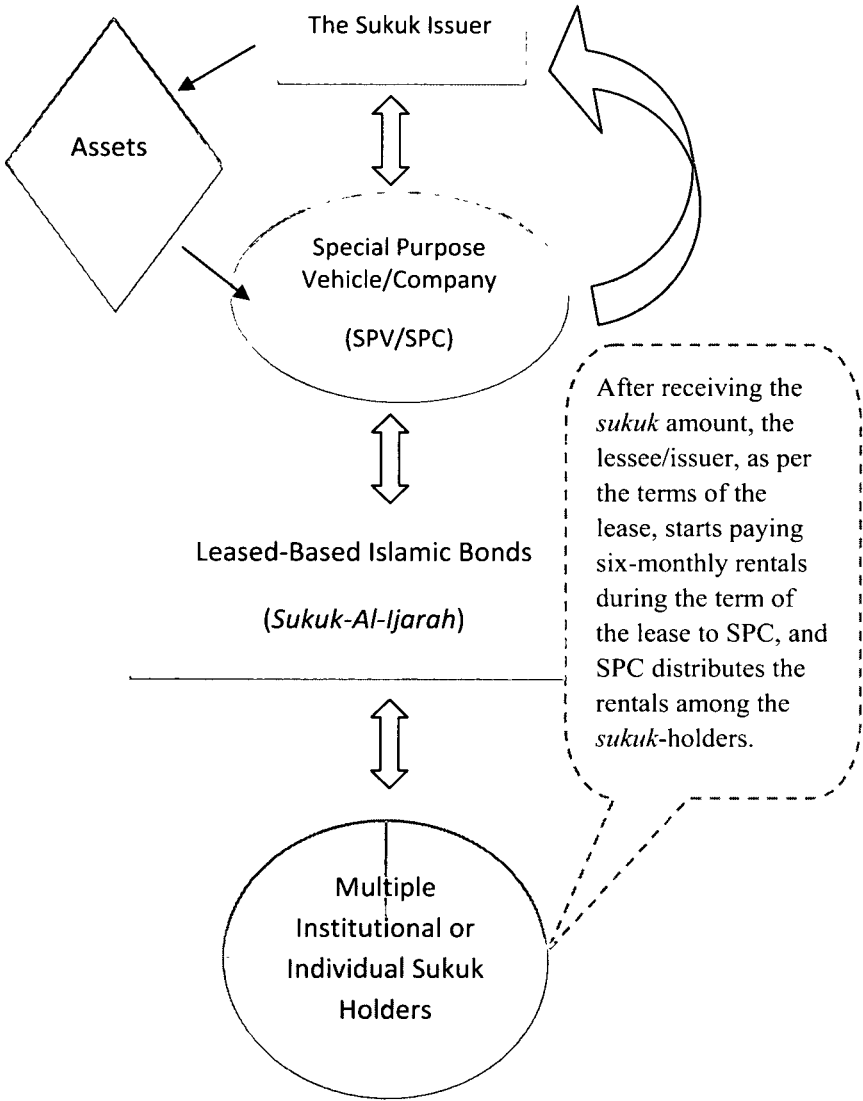
STEP THREE: LEASING ASSETS TO ISSUER



STEP FOUR: ESTABLISHING TRUST AND ISSUANCE OF *SUKUK*



STEP FIVE: PAYMENT OF LEASE RENTALS TO *SUKUK* HOLDERS



STEP SIX: REDEMPTION AND TRANSFER OF ASSETS TO ISSUER

