UNIVERSITAT DE BARCELONA

Viability of Derivatives in Radical Islam

A Comparative Assessment of the Technical and Shariah-Compliant Characteristics of the Main Islamic Financial Instruments: Contracts & Defaults in the Prospect of Revivalism

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Abstract

This work examines the prospective viability of derivatives and financial contracts more generally under a strict application of *Shariah* law. The author adopts a cross-disciplinary approach in order to convey the idea that some of the most popular contracts and arrangements in Islamic finance law are deficient from a structural and *Shariah*-compliance perspective. The thesis argues that the investor protection issues arising from this conclusion are sufficiently serious to undermine the viability of these instruments not only in a radical but also in a more conservative environment.

This conclusion is arrived at after an in-depth analysis of the fundamental *Shariah* principles, relevant to finance, placing them in a historical, jurisprudential and political context. The work endeavours to guide the reader through the many turns of Islamic law, breaking down established concepts and questioning their application in modern Islamic law.

For example, the author unpacks the notion of *wa'd* (promise), arguing that its extensive use in Islamic contracts renders much of the resulting complex transactions deficient from a structural perspective. Furthermore, this work highlights technical and *Shariah*-related weaknesses in essential contract forms, with a particular focus on *murabaha*.

Importantly, the author approaches the research question from the viewpoint of contracts – comparing constructs of Islamic Contract Law to those of its Common Law counterpart, without ignoring relevant influences and inspirations coming from the civil law tradition. The purpose of this comparison is to establish that some of the most popular financial arrangements, such as *sukuk*, are deficient in their investor protection provisions. What is more, the author underlines that due to the hybrid characteristics of the *sukuk* instrument and the lack of tailor-made regulation, investors are inadequately provisioned for the event of issuer's default.

Starting with the idea that the *sukuk* instrument is structured on the basis of and resembles a number of conventional instruments, the thesis examines the possibility for a sukuk investor to obtain redress under US and UK law, as well as the comparable provisions in Malaysia and France.

Alongside this, the author delves into the beginnings, inspirations, main strands and important political leaders of Islamic Revivalism. The aim of this inquiry is to arrive to a convincing explanation about the political and economic developments in established and aspired to Islamic States. To this end, this work offers a case study of Iran and ISIS, including an analysis of the Iranian Islamic finance system and a hypothesis about the possible approach of a jihadi-salafist government to the financial framework of their aspired to State.

As a last point, the work considers how FinTech fits within the objectives of *Shariah* law and more specifically, its risk-management and social justice strategies.

The thesis offers conclusions which draw on the extensive research and map out a possible view of the future of financial instruments in a radical Islamic environment.

Resum

Aquest treball examina la viabilitat potencial de derivats i contractes financers més generalment sota una estricta aplicació de la llei de Sharia. L'autor adopta un enfocament interdisciplinari per tal de transmetre la idea que alguns dels contractes i arranjaments més populars en la legislació financera islàmica són deficients des d'una perspectiva estructural i de compliment de la xaria. La tesi argumenta que els problemes de protecció dels inversors derivats d'aquesta conclusió són prou greus per minar la viabilitat d'aquests instruments no només en un entorn radical, sinó també en un entorn més conservador.

Aquesta conclusió s'arriba després d'una anàlisi en profunditat dels principis fonamentals de la Sharia, rellevants per al finançament, situant-los en un context històric, jurisprudencial i polític. L'obra s'esforça a guiar el lector per les múltiples voltes del dret islàmic, desglossant conceptes establerts i posant en dubte la seva aplicació en el dret islàmic modern.

Per exemple, l'autor desaconsella la noció de wa'd (promesa), argumentant que el seu ús extensiu en contractes islàmics fa que gran part de les transaccions complexes resultants siguin deficients des d'una perspectiva estructural. A més, aquest treball posa de manifest les debilitats tècniques i relacionades amb la Sharia en les formes de contracte essencials, amb una particular atenció a la murabaha.

És important destacar que l'autor aborda la qüestió de la investigació des del punt de vista dels contractes: comparant construccions de la llei de contractes islàmica amb les de la seva contrapartida de dret comú, sense obviar les influències i inspiracions rellevants que provenen de la tradició del dret civil. L'objectiu d'aquesta comparació és establir que algunes de les disposicions financeres més populars, com sukuk, són deficitàries en les seves disposicions de protecció dels inversors. A més, l'autor subratlla que, a causa de les característiques híbrides de l'instrument sukuk i la manca de regulació a mida, els inversors no es disposen de manera adequada en cas d'impagament de l'emissor.

A partir de la idea que l'instrument sukuk està estructurat a partir i s'assembla a diversos instruments convencionals, la tesi examina la possibilitat que un inversor sukuk obtingui redreçament segons la legislació nord-americana i del Regne Unit, així com les disposicions comparables a Malàisia i França. .

Paral·lelament, l'autor aprofundeix en els inicis, les inspiracions, les principals línies i importants líders polítics del revivalisme islàmic. L'objectiu d'aquesta investigació és arribar a una explicació convincent sobre els desenvolupaments polítics i econòmics dels Estats islàmics establerts i aspirants. Amb aquesta finalitat, aquest treball ofereix un estudi de cas d'Iran i ISIS, incloent-hi una anàlisi del sistema financer islàmic iranià i una hipòtesi sobre el possible enfocament d'un govern jihadi-salafista al marc financer dels seus aspirants a l'Estat.

Com a últim punt, el treball planteja com FinTech s'encaixa dins dels objectius de la llei de Sharia i, més concretament, de les seves estratègies de gestió de riscos i de justícia social.

La tesi ofereix conclusions que s'extreuen en les àmplies investigacions i mostren una possible visió del futur dels instruments financers en un entorn islàmic radical.

Resumen

Este trabajo examina la viabilidad prospectiva de derivados y contratos financieros de manera más general bajo una estricta aplicación de la ley Shariah. El autor adopta un enfoque interdisciplinario para transmitir la idea de que algunos de los contratos y arreglos más populares en la ley de finanzas islámica son deficientes desde una perspectiva estructural y de cumplimiento de la Shariah. La tesis argumenta que los problemas de protección de los inversores derivados de esta conclusión son lo suficientemente graves como para socavar la viabilidad de estos instrumentos no solo en un entorno radical sino también en un entorno más conservador.

Se llega a esta conclusión después de un análisis en profundidad de los principios fundamentales de la Shariah, relevantes para las finanzas, colocándolos en un contexto histórico, jurisprudencial y político. El trabajo intenta guiar al lector a través de los muchos giros de la ley islámica, desglosando los conceptos establecidos y cuestionando su aplicación en la ley islámica moderna.

Por ejemplo, el autor desempaqueta la noción de wa'd (promesa), argumentando que su uso extensivo en los contratos islámicos hace que muchas de las transacciones complejas resultantes sean deficientes desde una perspectiva estructural. Además, este trabajo resalta las debilidades técnicas y relacionadas con la Shariah en las formas de contrato esenciales, con un enfoque particular en murabaha.

Es importante destacar que el autor aborda la cuestión de la investigación desde el punto de vista de los contratos, comparando las construcciones del derecho contractual islámico con las de su contraparte del derecho consuetudinario, sin ignorar las influencias e inspiraciones relevantes que provienen de la tradición del derecho civil. El propósito de esta comparación es establecer que algunos de los arreglos financieros más populares, como el sukuk, son deficientes en sus disposiciones de protección al inversionista. Además, el autor subraya que debido a las características híbridas del instrumento sukuk y la falta de una regulación a medida, los inversores no cuentan con una provisión adecuada para el caso de incumplimiento del emisor.

Comenzando con la idea de que el instrumento sukuk está estructurado en base a una serie de instrumentos convencionales y se asemeja a él, la tesis examina la posibilidad de que un inversor sukuk obtenga una reparación bajo las leyes de EE. UU. Y el Reino Unido, así como las disposiciones comparables en Malasia y Francia .

Junto a esto, el autor profundiza en los comienzos, inspiraciones, líneas principales e importantes líderes políticos del revivalismo islámico. El objetivo de esta investigación es llegar a una explicación convincente sobre los desarrollos políticos y económicos en los Estados islámicos establecidos y aspirantes. Con este fin, este trabajo ofrece un estudio de caso de Irán e ISIS, que incluye un análisis del sistema financiero islámico iraní y una hipótesis sobre el posible enfoque de un gobierno yihadista-salafista al marco financiero de sus aspirantes al Estado.

Como último punto, el trabajo considera cómo FinTech se ajusta a los objetivos de la ley islámica y, más específicamente, a sus estrategias de gestión de riesgos y justicia social.

La tesis ofrece conclusiones que se basan en la extensa investigación y trazan una posible visión del futuro de los instrumentos financieros en un entorno islámico radical.

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Most-Used Arabic Terms:

Bay ’al-istisna’ (manufacturing contract)

Bay ’al-mu’ajjal (instant sale of an asset in return for a payment of money (made in full or by instalments) at a future date)

Bay ’al-salam (deferred delivery sale)

Bay’ bithaman ’ajil (deferred payment sale)

Fatwas (legal opinions)

Fiqh (scholarly interpretation of Islamic law)

Gharar (risk and uncertainty)

Ijab (offer)

Hadith (report)

Hajj (piligrimage)

Haram (forbidden)

Ijarah (leasing contract)

Ijarah waiqtina Islamic hire purchase

Ijtihad (legal reasoning)

Islam (voluntary submission of God)

Istisna’ (an agreement to sell a non-existent asset, which is to be manufactured or built according to the buyer’s specifications and is to be delivered on a specified future date at a predetermined selling price)

Jihad (to strive)

Kabul (Qabul) (acceptance)

Madhab (school of jurisprudence)

Maysir (gambling)

Mudarabah (profit and loss-sharing agreement)

Mudarib (entrepreneur)

Murabahah (mark-up sale)

Musharakah (joint partnership)

Qimar (gambling, speculation)

Qiyas (analogical reasoning)

Qur'an (recitation)

Rabb al-mal (capital provider)

Riba (usury)

Salam (future delivery)

Shariah (the path to the watering place)

Shia (a group or supportive party of people, the party of Ali)

Shirk (idolatry)

Sukuk (Islamic bonds)

Sukuk ijarah (lease-back Islamic debt instrument)

Sunnah (the trodden path)

Sunni (people of the tradition of Muhammad)

Tahawwut (hedging)

Takaful (Islamic insurance)

Taqlid (following a decision without examining its reasoning)

Tawarruq (monetization)

Tawhid (the oneness of God)

Ulama (Islamic scholar)

Ummah (the community)

Wa'd (unilateral promise)

Wadiah (safe custody)

Zakat (almsgiving)

Wakala (agency agreement)

Abbreviations:

AAOIFI Accounting and Auditing Organisation for Islamic Financial Institutions

ABS Asset-backed securities

BCBS Basel Committee on Banking Supervision

EBA European Banking Authority

ECB European Central Bank

ESMA European Securities and Markets Authority

CRD Capital Requirements Directive

CRR Capital Requirements Regulation

EMIR European Market Infrastructure Regulation

EU European Union

GCC Gulf Cooperation Council

IFSB Islamic Financial Services Board

IOSCO International Organization of Securities Commissions

ISIS Islamic State of Iraq and Syria

LIBOR London Interbank Offered Rate

LME London Metal Exchange

MENA Middle East and North Africa

MII Mudarabah Interbank Investment

MiFID II Markets in Financial Instruments Directive II

OIC Organisation of Islamic States

OTC over-the-counter

SPV special purpose vehicle

UAE United Arab Emirates

UK United Kingdom

US United States

Chapter 1: Methodology

Research can be compartmentalised into, *inter alia*, conceptual and empirical. Between the two kinds, this author will predominantly rely on the former as the nature of conceptual research arguably lends itself better to academic research of the sort undertaken here. More precisely, the investigation of Islamic financial instruments must be located within the more general framework of Islamic jurisprudence. Tracing the links between Islamic Finance and Islamic Jurisprudence and defending one or another argument related to this symbiosis, will require processing abstract notions and theories. The predominantly legal research will also delve into economics and philosophy which justifies the employ of conceptual research. Thus, the author will attempt to review and reformulate existing notions related to the main subject of the work by making them more applicable to the main argument of the thesis.[1] More importantly however, the writer will introduce ideas of her own which will be presented in an abstract way. There will be no original empirical research in this work but the author will occasionally rely on and analyse data collected by other people.

Furthermore, this author will favour the deductive approach in her research as opposed to the inductive one as the former will allow her to arrive at conclusions logically following the analysed material. The writer intends to keep an open mind as to the direction of her conclusions as to not influence the integrity of the research. Matching the desired outcome to specifically

[1] Prof (Dr) Khushal Vibhute and Filipos Aynalem 'Legal Research Methods' (2009) Prepared under the Sponsorship of the Justice and Legal System Research Institute, available: https://chilot.files.wordpress.com/2011/06/legal-research-methods.pdf accessed 21 April 2017.

selected data, which is something akin to the inductive approach, will not be appropriate for this research; rather, the author would endeavour to sketch the context and then draw conclusions about the correlation between the general framework and the research problem at hand.

In terms of what type of theoretical sources will be approached, these will be mainly secondary (analyses of the *Qur'an* and the *Sunnah*) but the author will also rely on primary sources such as the *Qur'an* itself as well as relevant judgments and legislation.

The secondary research will rely on articles, books and text books written in the field of Islamic finance, Islamic jurisprudence and conventional finance, more specifically derivatives. Furthermore, the author will consult textbooks on the English common law, most notably on Property and Contract law. The author will make use of legal research data bases such as Jstor, Research Gate, SSRN as well as universities' own research databases of working papers. The research will also require regular work in a library as well as careful planning.

The data collected from the above research will allow for the writing up of a concise and in depth overview of derivatives in conventional finance and their Islamic alternatives. Furthermore, some research will be undertaken into Islamic jurisprudence with an emphasis on Islamic philosophical and religious thought as well as political theory, with the aim of providing the contextual background to Islamic financial legal thought. However, the main objective will be to remain focused on answering the questions and the research will at all times be conducted with this in mind.

In addition and apart from research and analysis, the author will use comparison as one of her main tools. For example, the Western "conventional" financial system will be compared to the *Shariah* law one, the approach to Islamic finance and Islamic revivalism, adopted by the *Sunni* will be compared to this adopted by the *Shia* and so on. On a more practical note, the author suggests to compare states where different versions of *Shariah* law or *Shariah* compliant instruments have been employed for business purposes (such as Malaysia and Iran, for instance) in order to evidence the possibilities of divergence in their practices.

With respect to the first research question, it is envisioned that the research will bring outcomes which are largely in line with the existing literature, although fresh insights as to the comparability of the two systems are also expected. It is also hoped that the result will be a more structured and streamlined comparative report on the two systems. This will set the context for answering the second research question which should fill existing gaps in the literature. This author believes that her work will contribute to this field of research by bringing fresh insights into the larger area of Comparative (Conventional vs. Islamic) Finance Law. These insights will relate to whether conventional financiers and financial institutions should be able to continue investing in the *Shariah* compliant market in case of radicalisation and whether they would be able to continue offering the same investment opportunities to Muslim customers who adhere to a radical version of Islam. This may have a huge potential impact on these institutions' profitability considering the rate of growth of the Middle East financial market, the number of Muslims living in European countries or in the US (which has increased in the last years) and the available purchasing power of Middle Eastern investors.

Lastly, there will be no interview or qualitative data research; however, some statistics of the performance of the *Shariah* compliant instruments will be sought and applied into the work in order to be able to support the thesis' conclusions.

Chapter 2: Introduction

> *If we are to look at the Islamic financial system, it is natural that we look at the core of Islam itself. Unlike many other religious systems, we see Islam as a deen, or as a complete way of life. Beyond basic religious beliefs and practices, Islam shows us how to best conduct ourselves in everyday matters. This code of best conduct is called the Shariah, and it is the basis of the Islamic financial system. But the Shariah has been put there not as a set of rituals to make life difficult. It serves several important purposes. Firstly, the Shariah is a means for us to approach and seek the pleasure of the Creator. Secondly, a positive side effect of complying with Shariah is that it brings about human success and harmony -- allowing man to attain excellence. It is through the strong adherence of the Shariah that the Muslims of earlier generations achieved their magnificence and global success. Thus, the Islamic financial system, being a part of this Shariah system, ought to be treated in the same light. Just as the Shariah is a means to an end, so too is the Islamic financial system. The implementation of an Islamic financial system is not the end goal. It is, in fact, a means and a tool of competitive advantage for the Ummah's success, including economic success.*[2]

[2] Tan Sri Nor Mohamed Yakcop, 'Reflections on the Islamic Financial System', quoted by Abdul Malik Ishak J in *Tahan Steel Corp Sdn Bhd v Bank Islam Malaysia Bhd* [2004] 6 MLJ 1.

This quote, taken from a speech delivered by a former Minister of Finance of Malaysia, not only encapsulates the unique nature of the Islamic financial system and its policy objectives but also hints to themes and notions of the Islamic Revivalism. Thus, it foreshadows political themes important to the current discussion.

2.1. The research topic and its relevance

The topic of this thesis will be the viability of derivatives in radical Islam. According to statistics, by 2018 'The Islamic finance industry comprised 1,389 full-fledged Islamic financial institutions and windows. Islamic banking accounted for 71%, or US$ 1.7 trillion, of the industry's total assets in 2017.'[3] Given the importance of the Gulf region specifically and the Middle East more generally to international commerce, this arguably necessitates analysis of the type to be carried out in this thesis. To begin with, in a "radical" scenario the existing banks and other financial institutions are likely to feel a squeeze in the type and number of financial instruments available to them. The hypothesis of this author is that this will probably affect interactions in the international capital market and international trade. This topic is of further interest because it necessarily will involve comparison between the respective frameworks of conventional and the Islamic finance. The author intends to carry out this comparison in depth, by unpacking Islamic finance and examining fully each of its constitutive elements.

There is a good supply of literature on Islamic jurisprudence in general, including analysis of the *Qur'an* and the *Sunnah*, and on Islamic financial law. The general consensus of this scholarship is that financial instruments used by *Shariah* compliant institutions must be *Shariah* compliant, that there are a number of instruments that achieve this purpose and that this results in a system which is far more resilient to financial distress than the conventional financial system. The debate, as far as it exists, focuses on whether the *Shariah* compliant equivalents to Western financial instruments are substantially true to Islam and not just dressed up to seemingly comply

[3] IFDI 2018, 'Islamic Finance Development Report 2018 Building Momentum', (2018), https://repository.salaamgateway.com/images/iep/galleries/documents/20181125124744259232831.pdf accessed 15th September 2019, 5.

with *Shariah* law, while remaining Western in spirit. The author will attempt to contribute to this debate to the best of her abilities.

2.2. Main themes of the work

To date, there is no comprehensive text book on Islamic finance, which delves into its working, questioning the validity of its constructs from a technical and comparative perspective. Specifically, this research will examine the connection between Islamic finance and Islamic contract law, and their interdependency upon which the novel financial instruments have been constructed. This thesis will develop an argument that existing deficiencies in the modern Islamic finance instruments may render them vulnerable to revision or removal from the instrumentarium of Islamic finance. This would be of a particularly relevant concern in a framework of tighter religious rule.

A large part of this work will be dedicated to the concept of promise in Islamic contract law.[4] By comparing it with the corresponding concept in the common law, and by examining the approach to it of the Islamic Schools of thought, the author will argue that the premise has been overused or even abused in the pursuit of *Shariah* compliant financial structures, more specifically in the case of *murabahah* and *tawarruq*.[5]

The second important focus of this thesis will be the discussion on *sukuk*, which will span over three of the thesis' chapters.[6] *Sukuk* will be discussed from the point of view of its similarities with the corresponding conventional concepts, such as bonds and shares,[7] from the perspective of its religious compliance[8] and from the point of view of its alleged investor protection deficiencies.[9] To this end, the author will argue that the *sukuk* instrument manifests weaknesses from both *Shariah*-compliant and structural perspective.

[4] Chapter 7.
[5] Chapter 7.
[6] Chapters 8, 9 &10.
[7] Chapter 8.
[8] Chapter 9.
[9] Chapter 10.

Indeed investor protection will be given a strong focus in this work, due to the belief of the author that matters of investor protection will be at the heart of a decision to continue or not with the development of Islamic finance. What is more, the thesis will explore the possibility to address *sukuk* defaults under the premises of English contract law in order to prove that on a closer examination of this particular aspect of *sukuk*, the instrument fails to measure up.[10]

The third important focus of the thesis will be analysis of Islamic revivalism, which serves as the political and philosophical underpinning of modern radical movements.[11] The author will trace the beginnings of this ideology as far back as the early years of Islam and will outline the justifications behind the denominational divide between *Sunni* and *Shia*.[12] In addition, this work will present an in-depth analysis of the revolutionary movements during the 20th century, including the Iranian revolution, looking for and finding the rationale for the events that took place in this period.[13]

The chapter on revivalism will include analysis of salafism as the philosophical foundation of jihadist movements and a case study on Iran and its system of Islamic finance.[14] Lastly, the thesis will provide an examination of the ideology of the Islamic State of Iraq and Syria (ISIS), followed by a hypothesis on the possible deployment of Islamic finance instruments by the organisation.[15] The work will conclude with a chapter on FinTech and the way financial technologies may assist Islamic finance in a more or less conservative political environment.[16] The conclusion of the thesis will review the main themes and lines of inquiry while at the same time delivering a definitive answer to the research question.[17]

From a purely technical perspective, however, how viable Islamic finance would be in environments of radicalization (or in a full-on radical framework), hinges on two pillars. First, the objectives of the conventional financial framework are enforced not only through the law of contract but also, and to a much greater effect, through regulation of conduct (what is known as micro prudential regulation). In distinction, Islamic finance is not only entirely structured on

[10] Chapter 8; See also Chapter 10.
[11] Chapters 4 & 11.
[12] Chapter 4.
[13] Chapter 11.
[14] Chapter 11.
[15] Chapter 11.
[16] Chapter 12.
[17] Chapter 13.

contracts but is enforced through them. The legitimacy and efficiency of these contracts, including in a cross-border context, is therefore instrumental to the success of the framework. The second pillar is the compliance of the relevant financial instruments with *Shariah* law.

As this work will argue below, Islamic finance law amalgamated by bringing into its corpus much of the legal tradition of the Common law, while borrowing sparingly from the Civil law (most specifically, French Civil law) tradition. It however surrendered the borrowed concepts to the fundamental values of *Shariah*.

2.3. Provenance of Islamic finance

The deep connection of Islamic finance to conventional contractual forms and concepts was preserved partly as a remnant of the continuous and notable presence of Western imperialism in a number of Muslim countries. Furthermore, the flexibility and dynamism of the Common law in itself and its impact on the global trade framework, including its regulation, were instrumental in the shaping of the Islamic finance framework.

In addition, the wave of nationalism and national revival witnessed in many Muslim countries, for example, in Egypt, Persia, Iraq and India, ignited the local intellectual elite to provide a working and culturally sensitive answer to the old, Western model of governance. This revivalist movement transcended, *inter alia*, into the making of these countries' financial systems. Given the above considerations, however, and despite the desire to make a clean break with the occupiers' legal tradition, practical realities demanded that crosspollination takes place. This remains particularly relevant to the modern development of Islamic finance.

2.4. Research questions

This research is intended to deliver an answer to two principle questions. The first is to identify which conventional derivatives are translatable to the Islamic financial market as it now is and the second, to create a hypothesis as to whether the current Islamic finance framework will survive a transition to radical Islamisation. The second question is based on the premise that Islamisation or radicalisation of a State apparatus will likely change the governance dynamic, including in the sphere of financial law.

The purpose of this study is therefore to establish which conventional financial instruments or their Islamic alternatives will survive such a transition to radicalisation (if any) and what can be done so that Islamic Finance survive hardening of the political course. As has been noted, "[P]resumably the more politically radicalized the Islamists become, the less likely they will be to make common cause with the Islamic financiers'. [18] However, even in the context of a non-extremist but aspiring to piety Islam, problems may arise as many of the currently used instruments have been branded by critics Islamic in substance but not in spirit. This author's argument is that whichever change we witness – "soft" or "hard" radicalism, this may bring a squeeze in the number and nature of the financial instruments available in the Islamic financial market.

2.5. Contributions of the author

The extensive research conducted by this author indicated that to date there is no comprehensive book on Islamic finance, which examines the connection between the religious underpinning of the discipline with those principles of conventional finance it borrowed from, while looking at the effect radical ideologies may have on the existing framework. In the process of this research, the author analysed the Islamic notions of social justice, progress and wellbeing, comparing them to the respective Western concepts and more specifically, to those informed by and deeply rooted in the capitalist ideology.

Influenced by the author's belief that to understand the uniqueness of Islamic finance a researcher must unpack all fundamental elements of the framework, the work included an analysis of the concepts of property and ownership and their respective development in the Islamic and Anglo-Saxon jurisprudential traditions. To this end, the contribution of this author was not only in identifying key concepts relevant to the development of Islamic finance law, but also in

[18] Robert Springborg ed., *Development Models in Muslim Contexts: Chinese, 'Islamic' and Neo-liberal Alternatives*, (Edinburgh University Press 2009), 130.

highlighting that the lack of development of the trust instrument in Islamic finance law is rooted in the *Shariah* law premise that *Allah* is the absolute owner of all that exist (including property) to which people are beneficiaries. This suggests that while carefully carried out changes in the current regime are needed, they are unlikely to be introduced if the governmental power is vested in a revivalist regime.

Furthermore, the author offered a strong argument that ownership in Islam gives rise to responsibilities rather than rights. Since the Islamic concept of ownership is informed by ideals of social justice and morality, this could explain Islamic finance's generally relaxed attitude to the regulation of contractual default; this is a state of affairs governed by the pronouncements of the *Qur'an*, rather than the secular regulator.

In addition to contributing in this regard, this book delved into the basics of the Islamic contract and analysed them, particularly their provisions for default, from the perspective of the common law. To this end, the author has unpacked the Islamic contract and analysed the essential principles and concepts on which it has been based, and compared those to their analogical common law counterparts. More specifically, after analysing in-depth the notion of *wa'd* (promise), (which stays at the foundation of most *Shariah*-complaint Islamic financial instruments) the author has built an original argument that *wa'd* is being abused by the framework to help structure ostensibly compliant with *Shariah* instruments.

The comparative analysis between Islamic law and the common law was deemed appropriate because much of the principles of Islamic contract law mimic their conventional counterparts, more specifically those originating in the Anglo-Saxon tradition. To the extent some borrowing has taken place from the French civil law, this too has been addressed, albeit in passing. Furthermore, all Islamic financial instruments and specifically the *sukuk*, the discussion on which took up a large part of this work, function on the basis of Islamic contracts. The viability of these contracts and their remedies should, therefore, be crucial for the viability of the financial instruments proper.

After having done the above research, this work proved that the products currently utilised in Islamic finance are deficient because they do not provide for adequate protection in cases of default on the obligations of the issuer. A specific contribution of the discussion was the argument that the wide-spread understanding that asset-based *sukuk* is potentially riskier than the asset-backed one, is misguided. This finding supports concerns of the potential of the *sukuk* instrument to cause investor protection and micro-prudential issue.

The second contribution of this research is with respect to the link between radicalism and the viability of Islamic financial instruments. To the author's knowledge, to date there is no research which while examining the causation of the current predicament would make a clear link between Islamic radical ideology and finance. To this end, the author presented two case studies that constitute contribution. The first one is a complete guide to the Islamic finance framework of Iran and the second is examination and hypothesis of the possible use of Islamic finance instruments by ISIS. Importantly, the author delved into the fundamental principles of ISIS' ideology and linked them to their strategies of governance, as observed to date. Furthermore, the thesis outlined the most pertinent similarities and differences between the revolutionary tactics of *Shia* and jihadi-salafists. Based on the case studies above and the analysis of their respective religious and political convictions, the author built an argument that should an extremist government of a jihadi-salafists/ISIS provenance take over governance, the respective state is likely to develop in two possible directions. Either it would preserve a minimum range of Islamic finance instruments to serve its basic needs of finding, most notably through commodity trading, or it will develop a unique framework of *Shariah*-compliant financial instruments, which it will gradually push to expand outside its jurisdiction.

The conclusion that a technocratic, right-wing government, such a future ISIS government is expected to be, would preserve some form of the framework was supported by statistics on the Islamic finance sector's performance in most countries of interest, most notably, Malaysia, Saudi Arabia, UAE, Kuwait, Bahrain and Indonesia. The collected data suggested that despite its shortcomings, the Islamic finance sector has a definitive positive impact on countries' economies.

Ultimately, despite all initial analysis pointed towards a conclusion that a more radical system would impact on the Islamic finance framework, rendering it obsolete, the examination of the existing data pointed the author towards a conclusion that the establishment of a radical political order will not quite have this effect. Rather, some tightening is to be expected on the way towards taking power and perhaps during the early years of radically-bent governance. This is further supported by findings that an Islamic State would not allow any form of conventional financial instruments on its capital market (as demonstrated by the example of Iran).[19]

With the above in mind, this research concluded that the real danger to the viability of the currently used Islamic finance instruments comprises in their structural deficiencies rather than the attitudes of those in power. However, the author suggested that a continuous weakness of the regime may prompt a governmental decision in direction of a radical overhaul of the entire financial framework, due to pragmatic rather than religious considerations. Being able to come to this tentative conclusion comprises the main contribution of this work.

Chapter 3: Mapping out the context of Islamic Finance

3.1. Main points to consider: overview of the Islamic Finance concept

The terms ‘Islamic banking" and "Islamic finance" are not identical ("Islamic finance" being the more comprehensive one) but they are often used interchangeably, because banks carry out much of the derivative trading (and other forms of Islamic finance) in Muslim countries. Due to this importance of the Islamic banking sector, it will be given substantial attention in this work. For example, the author will often build on comparisons between the conventional and *Shariah* compliant financial framework, while making regular references to Islamic banking. It is important to appreciate, however, that it is not banks that are the center of this analysis. Rather, and very much in line with the way they are perceived in Islamic finance, banks will be discussed here in their capacity of (inevitable) intermediaries between a *Shariah* compliant financial framework and the Muslim community.

[19] IFN, ‘The Iranian Capital Market in 2016; Deepening the Current Instruments’ (December 2015) https://www.islamicfinancenews.com/the-iranian-capital-market-in-2016-deepening-the-current-instruments.html accessed 15th September 2019.

To understand the role Islamic banks perform in the larger narrative of Islamic finance, a brief introduction will be given to the main concepts operating in Islamic financial law, starting with the phenomenon of Islamic banking.

The creation of the Islamic banking system in the 1970s was the result of a drive to provide Muslims with an alternative to conventional banking. Soon after its humble beginnings, it started gaining prominence among Muslim retail and business customers.[20] The popularity of Islamic banking increased in the years after the latest global financial crisis, following the apparent resilience to financial shocks demonstrated by Islamic banks.[21] This attracted the attention of experts which came to the conclusion that while Islamic banks are indeed lagging behind their conventional counterparts in terms of profitability, they are more conducive to stability than them. The general consensus was that this is largely due to Islamic banking's approach to interest payment and their choice of product portfolio.[22] For example, it was noted that during the latest crisis, Islamic banks fared better than the conventional ones (also) because they excluded the very risky collaterized debt obligations (which were blamed for the crisis).[23]

The rulebook of Islamic Banks contains a number of religion-based restrictions because, as the name "Islamic" suggests, they must operate in consistency with the religious duties imposed on them by the Islamic (*Shariah*) law.

Shariah law is a religious law; however, its guidance goes beyond the spiritual aspects of Muslims' life. *Shariah* permeates the entire spectrum of life of the Muslim community – the secular as well as spiritual dimensions, transforming it according to the Islamic ethical and moral principles.[24] The latter are based on the *Qur'an*. They contain the goals, which the Muslim community should aspire to. Due to their comprehensive reach, these principles govern, in addition to other areas of life, the field of Islamic finance and business, including the connections between business and society, such as taxes and corporate responsibility. Furthermore, *Shariah*

[20] Filippo di Mauro et al., 'Islamic Finance in Europe' (2013) European Central Bank Occasional Paper Series NO 146 / JUNE 2013, 12-13.
[21] Muhammad Bilal Khalid and Muhammad Hanif, 'Comparative Risk Return analysis of Conventional and Islamic Banks in Pakistan' (2014) http://ssrn.com/abstract=2419326 orhttp://dx.doi.org/10.2139/ssrn.2419326 accessed 18th August 2018.
[22] Filippo di Mauro et al., (n 20), 10.
[23] Claudio Borio, 'The Financial Turmoil of 2007: A Preliminary Assessment and Some Policy Considerations' (2008) BIS Working Paper no. 251, https://www.bis.org/publ/work251.pdf accessed 20th August 2017.
[24] Filippo di Mauro et al., (n 20), 12.

law approaches the area of finance not only from a technical perspective, bringing to it a lot of prohibitions and clarifying what should and should not be done, but also from the point of view of maintaining and improving social justice and fairness in the Muslim world. This suggests that what takes place in the areas governed by Islamic finance law is intended to have a strong bearing on other aspects of Muslims' lives. Ultimately, the prohibitions in themselves (such as the prohibition on interest) are not an end in itself; they exist to clear the road to a fairer (meaning interest-free) economic system[25] and to a more community-friendly society. The objectives of *Shariah* law, and more so, that they are pursued in earnest, distinguishes the Islamic financial system from the practices of conventional finance.

It must be admitted however, that despite the conceptual differences between the conventional financial model and the Islamic one, the latest decades were a process of increased cross-fertilization between the two financial models. For example, there has been an increase of investment (over $100 billion in the first decade of this century) in the Islamic market which led to a rising number of Islamic (*Shariah* compliant) financial instruments.[26] This tendency has continued over the second decade although the size of investment fluctuated in line with the price of oil and was influenced by other factors, including the difficulty to differentiate a *Shariah* compliant fund from its conventional counterpart.[27] Despite the above, Islamic finance and more specifically, Islamic banking is gradually increasing its market share, displaying a rate of growth of more than 73% over the course of the first decade of the 21st century.[28]

The desire of conventional financiers to trade with and invest in the Muslim market is understandable, given the natural resources of these countries and the untapped market. For Islamic financiers on the other hand, cooperation with Western investors seems desirable because of the possibility to obtain low cost funds;[29] at the same time, for them this flow of investment has not been without problems. In addition to what will constitute much of the debate in this work – namely, the difficulty reconciling the Western and *Shariah* approach to business, the main challenge for the free in-flow of foreign capital has proven to be management of risk in a *Shariah*

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[25] Bashar H Malkawi, 'Financial derivatives between Western legal tradition and Islamic finance: a comparative approach' (2011) JIBLR 276, 276.
[26] Ibid, 280.
[27] The European, 'Market trends in Islamic finance: an expert analysis' (2nd September 2016) https://the-european.eu/story-10847/market-trends-in-islamic-finance-an-expert-analysis.html accessed 2nd May 2019.
[28] Muhammad Hanif, *Islamic Banking*, (Createspace 2011).
[29] F E Vogel and S L Hayes, *Islamic law and Finance. Religion, Risk, and Return* (Brill Leiden 2006), 219.

compliant environment. The short answer to this is that despite the overall stability of the Islamic market, financial risk is not managed very well in this framework, including risk linked to the return of the investment, the liquidity of the respective entity and the purposes to which the capital will be applied.[30]

Furthermore, while many similarities between the two financial models do exist, they differ on a few but important points. While conventional finance operates on the basis of interest, *Shariah*-compliant financial institutions must use a profit and loss sharing model where the positive or negative returns of the investment are distributed between the debtor and the creditor (respectively, the customer and the bank or more generally, the borrower and the lender).[31] In addition to that Islamic finance demonstrates a much lower risk tolerance compared to its conventional counterpart, which changes much of the existing structures and the way they operate.

3.2. Fiqh and how it relates to Shariah Law

While *Shariah* deals with the divine revelations (*wahy*) of the *Qur'an* and *hadith*, *Fiqh* (true understanding) governs both legal reasoning (*ijtihad*) *per se* and the issued (or contemplated) legal verdicts (*fatwa*). This is to say that in addition to being a specific method of reaching a legal outcome, *Fiqh* forms the body of law developed by the legal schools (*madhhabs*) and legal scholars through legal reasoning (*ijtihad* or *qiyas*) and the issuing of legal verdicts (*fatwa*). The concept of *ijtihad* refers to the physical or mental effort, expended in the delivering of a judgment. Furthermore, it refers to *independent reasoning* of the jurist or of his thorough mental exertion in finding a solution to a legal question. *Qiyas* (which Islamic jurisprudence derived from Jewish law)[32] on the other hand is the *analogical reasoning*, applied by jurists in order to deduct legal principles from the *Qur'an* and the *Sunnah*. *Ijtihad* and *qiyas* are followed by a consensus among leading Islamic scholars who contemplate the issues at hand. While the concept

[30] Malkawi (n 25), 280.
[31] Malkawi (n 25), 280.
[32] Schacht J, *An Introduction to Islamic Law* (Oxford University Press, 1982), 21.

of consensus appears to have been influenced by Roman law,[33] it was organically needed in the Muslim framework to facilitate the acceptance of new legal principles into the body of Islamic law.

As the legal code of Muslims, the rules of *Shariah* are intended to be followed by Muslims without anyone disputing them. In distinction, although *Fiqh* is directly derived from the *Qur'an*, its very purpose is that a consensus should be reached; therefore, it embraces questioning and reasoning on matters of interest, within the confines of the parameters established by *Shariah*. Importantly, the point of *Fiqh* is not to supersede *Shariah*, which it can never do. Rather, it complements it by filling the gaps and addressing the issues that have not been discussed in the *Qur'an*.

This granularity of *Fiqh* compliments the generality of *Shariah*, which takes a broad view on what is permitted and what is forbidden to Muslims. Note that while *Shariah* law is immutable and addresses the big picture of life, *Fiqh* focuses on the detail, taking care of narrow and tackling practical and specific problems within the Islamic legal framework. Furthermore, because *Fiqh* reflects life as it is at the moment of reasoning, it can change over time.

Despite the differences between *Shariah* and *Fiqh*, both have the objective of protecting the interest of society. The final goal of these two bodies of law is taking care of the collective interest, which inevitably, changes with the times. Interesnigly, the interaction between *Shariah* and *Fiqh* illustrates that the need to remain flexible in the pursuance of the religious objectives has gradually been internalized in Islam. To this end, the impact of *Fiqh* is to contribute to a respectful and true to Islam transformation of the existing legal framework. Note that *Fiqh* cannot and does not endeavor to change the Islamic legal principles; rather, it offers a discussion and solutions, which would better support Muslims when their circumstances change.

To this end, it is notable that *Shariah*'s main focus was always to ensure the common good. Although largely immutable, precisely because of its attachment to the good of the collective, *Shariah* has undergone only small changes over time. These changes have been prompted by developments in society and the life of the community. *Shariah* has reflected these developments

[33] Ibid, 20.

by carefully adapting, with the assistance of scholars, the interpretation of legal rules to the transformations of life. This demonstrates that *Shariah* Law and *Fiqh* are organically connected.

An example highlighting how this process works in practice could be drawn from Islamic Contract Law, in the specific case when the contractual relationship has broken apart. Note that in the case of contractual breakdown, around half of international private contractual disputes are decided through arbitration.[34] In addition, private contracts between Muslims or those including a Muslim party that take place in a Muslim State will almost always include resort to arbitration, in case of a breach, because this is *Shariah*'s preferred method of adjudication.

How arbitration is carried out, however, depends on the particular scholars and school. Some suggest that arbitration should be done through conciliation (*sulh*),[35] and others that it should be binding on the parties.[36] Unlike in the West, conciliation comprises a part of the arbitration process in Islamic society. Its inclusion is rooted in cultural specificities, such as Muslims' tendency to approach conflict as something 'negative, threatening and destructive to the normative order [which] needs to be settled quickly or be avoided.'[37] A Muslim arbitrator has, in addition to his other duties, for instance, the duty to clarify the facts and establish the truth, a duty of conciliation, coupled with an obligation to apply the relevant *Shariah* law principles.[38] Traditionally, only if it could be established that the dispute could not be resolved through conciliation, is the arbitrator allowed to proceed with arbitration.[39]

The Islamic system of dispute resolution resonates with the understanding that the community (the tribe, the clan, the extended family) should take precedence over the individual – which is a point where the Western and Eastern perspectives on conflict clash.[40] To this end, consider that:

[34] Across all sectors, the survey showed that respondents refer as many disputes to arbitration (47%) as they do to litigation (47%), data, Gerry Lagerberg and Loukas Mistelis, 'Corporate choices in International Arbitration Industry perspectives' (2013) PwC, International Arbitration survey, https://www.pwc.es/es/publicaciones/gestion-empresarial/assets/corporate-choices-international-arbitration.pdf, 7.
[35] Aida Othman, '"And Amicable Settlement Is Best": Ṣulḥ and Dispute Resolution in Islamic Law' (2007) 21(1) Arab Law Quarterly 64, 73-74.
[36] Ibid.
[37] Aseel Al-Ramahi, 'Sulh: A Crucial Part of Islamic Arbitration' (2008) LSE Law, Society and Economy Working Papers 12/2008, 18.
[38] Ibid, 17.
[39] George Sayen, 'Arbitration, Conciliation, and the Islamic Legal Tradition in Saudi Arabia'(2014) 9(2) U. Pa. J. Int'l Bus. L 211, 224.
[40] Aseel Al-Ramahi (n 37), 18.

conflict resolution in the Middle East aims to restore order. Even though a dispute might begin between two individuals or two families, it soon involves the entire community or clan. The initiation and implementation of any intervention is based on the social norms and customs of the society. These social codes operate as a pressuring tool to reach and implement an agreement between two parties. Bargaining moves are conducted on the basis of preserving the social values, norms and customs. Future relationships are very crucial elements in settling disputes in the Arab-Islamic context. Priority is given to people and relationships over task and structures.[41]

Furthermore, the drive to preserve the established order is a very Islamic thing to do. As Schacht notices,[42] order is of extreme importance to Muslims, who have transmitted the idea of *sunna* (precedent or normative custom) across centuries of Islam.[43] Furthermore, the emphasis on decency and moral conduct as well as complying with the community's expectations could explain behaviours in the field of financial regulation, most notably the (lack of) Islamic law arrangements on defaults.[44]

Another reason why Muslims are not willing to accept the binding force of arbitration is that, contrary to the expectations of a Western party, Muslims are not comfortable with the notion of "final ruling" in a dispute.[45] As highlighted above, while they do not readily accept this, they place great value on negotiation and conciliation.[46] To add to this, Muslims are suspicious of the arbitration rules of the International Chamber of Commerce (ICC) and are unhappy (to the degree of resenting them) of its extremely high fees.[47] Furthermore, Western arbitration is historically seen with a suspicion caused by a number of rulings, which were perceived as imperialistic and unfair by the Muslim parties.[48]

Having said that, the *status quo* is that over two thirds of the Organisation of Islamic States (OIC) have already become parties to the New York Arbitration Convention,[49] which indicates that

[41] Aseel Al-Ramahi (n 37), 19.
[42] J Schacht, *An Introduction to Islamic Law* (Oxford University Press, 1982).
[43] Ibid.
[44] Discussed at length in Chapter 10.
[45] 'The decision of the hakam [conciliator], which was final, was not an enforceable judgement but rather a statement of right on a disputed point.' See Aseel Al-Ramahi (n 37), 5.
[46] See in general, Aseel Al-Ramahi (n 37).
[47] Occasionally Muslim parties do arbitrate in the international sphere; see *Dallah v Pakistan* [2010] UKSC 46.
[48] See *Petroleum Dev., (Trucial Coast) Ltd v. Sheikh Abu Dhabi* 1 Int'l & Comp. L.Q. 247 (1952), discussed in Charles N. Brower and Jeremy K. Sharpe, 'International Arbitration and the Islamic World: The Third Phase' (2003) 97(3) The American Journal of International Law 643, 644-645.
[49] United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 10 June 1958).

should parties to a dispute be referred to arbitration (which should happen, if appropriate), the respective States should accept, recognise and enforce the decision of the arbitrator as if it was a domestic judgment.[50]

Last but not least, while Muslim counterparties may have agreed to include an arbitration clause in their contract, they have likely not done this willingly. This dynamic may create some difficulties when adjudication is called for. Perhaps to accommodate for a wider range of needs and type of contracting parties, and as an expression of openness, flexibility and its embracement of evolution, *Shariah* accepts both types of arbitration despite the fact that the natural choice here would seem to be to accept only arbitration by conciliation.[51]

Such flexibility, to the degree it has been demonstrated in recent times, is important in practical terms. Due to its natural resources, the Middle East is attractive for commerce, being a place where foreign investors would be interested to invest. It is also a significant source of investment funds. This applies to traditional investments and investments done through the means of FinTech, such as via robo advisors, peer-to-peer lending or crowdfunding. Historically speaking, the increased commercial activity in the region has given rise to disputes that have been resolved largely through arbitration. As mentioned, this method of dispute resolution has so far been equally attractive to both sides – foreign investors and local entrepreneurs. It is expected that this trend will continue in the future and it will affect retail investors in FinTechs and/or the various FinTechs operating within the Islamic market sphere. Knowing that whatever your preferences for dispute resolutions are, they will be catered for within the Islamic market sphere, is a huge boost for commerce. This illustrates the important point that the Islamic legal framework has the necessary devices to accommodate the market and they could be exercised at any juncture of the legal framework.

3.3. What are the objectives of Shariah law and how it governs the Islamic Finance framework?

[50] New York Convention Arts II(3), III & V. See Brower and Sharpe (n 48), 647-648.
[51] See in general, George Sayen, 'Arbitration, Conciliation, and the Islamic Legal Tradition in Saudi Arabia'(2014) 9(2) U. Pa. J. Int'l Bus. L 211.

As discussed, the term Islamic Finance refers to the whole framework of financial activities carried out according to the prescriptions of *Shariah* Law (the Divine Law). *Shariah* law provides instruction to Muslims in all areas of their life –personal and social – including the process of carrying out financial transactions. In addition, the term refers to the *per se* legal framework adopted in Islamic countries. As to what the term means, the word "*Shariah*" translates to "a way to the watering-place" and the "path … to seek felicity and salvation'.[52]

Shariah law places extreme importance on the protection of the five pillars of Islam (*al-arkan al-khamsah*), which are faith in God, manners of worshiping Him, charity to the poor, fasting, prayers and the *hajj* (piligrimage). These five pillars and their objectives should always be taken in consideration while applying *Shariah* law in practice, including in financial dealings.

Fundamentally, *Shariah* law's prescriptions and proscriptions are derived from the *Qur'an* and its abstract ethical and moral principles. In addition to the *Qur'an*, *Shariah* law relies strongly on the *Sunnah*; the body of literature, which contains Muslims' accumulated lifestyle wisdom, based on the example set by the Prophet Muhammad. The message of these two sources is manifested in the body of Islamic jurisprudence, known as *Fiqh*, containing rulings and judgments produced by the various Islamic legal schools (*madhhabs*) and by renowned Islamic judges and jurists. The area of *Fiqh* dealing with financial transactions is called *fiqh-ul-muamulaat*.[53]

Shariah law is strongly focused on community wellbeing as it views it as being paramount to the wellbeing of the individual. One of the aims of *Shariah* finance law is to help believers who have suffered financial misfortune and/or have been put at a financial disadvantage in respect of their financial state. Note that in *Shariah*'s view, creating benefit for someone is considered secondary to the principle of alleviation of hardship. Still, in the assessment of harm and benefit, *Shariah* law approaches the matter by electing (or favouring while balancing between different objectives) the lesser loss and the greater benefit.[54] In reality, the application of these principles leads to a very strong bias towards what is good for the larger community rather than for the individual financial actor. Notably, in the context of a financial transaction, the larger

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[52] Mohammad Hashim Kamali, *Shari'ah Law: An Introduction*, (Oneworld Publications, 2008), 2.
[53] Islamic Finance Advisory Board: Permission & Prohibition under Islamic Law (2016). http://islamicfinanceboard.com/permission-prohibition-islamic-law/ accessed 30th January 2019.
[54] Institute of Islamic Banking and Insurance, 'Shari'ah Rulings and Finance' (n.d.), http://www.islamic-banking.com/shariah-rulings-finance.aspx accessed 30th September 2018.

community's interests are deemed strongly aligned with those of the financial institution party to the transaction. This approach allows *Shariah* law to attain some of its financial services objectives by simultaneously driving towards macro and micro financial stability (the stability of the financial system as a whole and that of the financial institution forming a part of it).

However, there is another dimension to Islamic Finance's communitarian spirit, which is reflected in the way the principle of relieving hardship operates. *Shariah* compliant financiers are called upon under this principle to consider favorably transactions that will alleviate one's financial debts and poverty rather than transactions the only purpose of which is to make the actor richer. It is suggested that this conservative take on entrepreneurship, along with the requirement to bank without imposing or paying interest, may be responsible for the relatively low profitability of Islamic banks.

Understanding the above fundamentals, goes some way towards explaining the context in which the prohibitions imposed by *Shariah* law, namely the ban on interest,[55] excessive risk taking,[56] speculation and gambling,[57] unearned income[58] and trading in forbidden products and industries, operate.[59] It is arguable that despite their apparent strictness and even rigidness, its adherence to these prohibitions helped the *Shariah* compliant banking system to exit the last financial crisis relatively unscathed.

As a last point, it should be recalled that although Islamic Finance anchors itself in a 14 centuries old religion, as a model of financing it is still in its early years.[60] Nevertheless, considering the authority of *Shariah* law in the Muslim world, including among the Muslim population living in the West, the potential for development of this area is substantial. Being so young, however, could be both an advantage, as it leaves Islamic Finance open to fresh ideas and structures, and a disadvantage, as it makes it less sophisticated, varied or flexible than conventional finance. Given the competition between the two systems, it could be that the latest trends in conventional finance

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[55] Hans Visser, *Islamic Finance: Principles and Practice*, (2nd edn. Edward Elgar 2013).
[56] Ibid.
[57] Islamic Finance Advisory Board: Permission & Prohibition under Islamic Law (2016), http://islamicfinanceboard.com/permission-prohibition-islamic-law/ accessed 30th September 2018).
[58] Ibid.
[59] F Jamaldeen, Seven Prohibited Industries in Islamic Financial Investments (2017), http://www.dummies.com/personal-finance/islamic-finance/seven-prohibited-industries-in-islamic-financial-investments/ accessed 30th September 2018.
[60] Islamic Banker, 'An Early Experiment: Islamic Banking' (2018), https://islamicbanker.com/education/early-experiment-islamic-banking accessed 30th September 2018.

(for example, FinTech, which has become ubiquitous in the last few years) may serve Islamic financiers as a means to close the competitiveness gap between conventional and *Shariah* compliant finance. For example, adopting the different iterations of FinTech could help broaden the scope of *Shariah* compliant offerings to Muslims around the world, including by reaching out to underrepresented pools of customers. In addition, careful application of FinTech may assist Islamic finance with persistently challenging areas such as that of risk management and issues, such as the (i)liquidity of Islamic credit institutions.

Given the benefits of financial technologies, the logic of the market would suggest that FinTech will be increasingly adopted by Islamic finance companies and particularly by those operating in secular environments. To this end, one important consideration should be FinTech's neutrality with respect to *Shariah* compliance. While its use in the *Shariah* finance framework should be encouraged, this should be done with greater than the ordinary degree of due diligence. This and other considerations related to FinTech justified the inclusion of the topic in the last Chapter of this work.

Chapter 4: Between the "normal" and the "radical" in Islam

One of the main themes of this work relates to the viability of the Islamic finance system (more generally) in conditions of radicalism. The following chapter will explore the philosophical underpinning of the doctrine of revivalism, as well as its historical development, in order to provide a backdrop for the discussion on financial instruments. The topic of revivalism will be revisited at the end of the work (Chapter Eleven), where the author will provide a more practical and case study based perspective on the issue.

Before beginning our journey in the realm of Islamic revivalism, an explanation is due as regard to the distinction between the expressions "radical Islam" and "radical Islamism", the former referring to one of the philosophical underlays of Islam and its jurisprudential consequences, and the latter to a political movement pursuing the establishment of Islamic government.

The word "radical" is used in everyday parlance with a reference to something being at the extreme end of a political or religious belief. Despite an ongoing global tendency towards secularization, religions remain intrinsically linked to politics and state governance, although not in the same overt way as was the case in the past. In distinction to the secularization trend, some countries in the Middle East and North Africa have preserved the role played by religion, whether this is by designing the entire legal framework according to *Shariah* law[61] or by adopting a mixed model where *Shariah* governs only the area of family law.[62]

However, the specific state governance framework notwithstanding, observing *Shariah* law remains a fundamental duty of every Muslim, including Muslims working in government. To understand how this would impact on and shape governmental policies one should consider the three basic principles in a *Shariah* compliant political system. These principles require that 'the political system should be consistent with the teachings of Islam; …the masses should be obedient to the political authority of the rulers; and … the political system should function on the basis of mutual consultation of the participants.'[63] The above suggests that in their governance practices, the political leaders of Islamic countries must give serious consideration to the provisions of *Shariah* law; that these practices must be coordinated with the will of the people; and that the people, once having chosen their leaders, must follow them in a spirit of constructivism and obedience.

To this end, it would matter that, whether it is actions against an established tradition by adopting fringe versions of the religion or taking the traditional practices and beliefs to a new level, radicalism has a strong potential for change. It is this potential for change that could be activated through a possible radical interpretation of the traditional Islamic teachings which will be examined below. The frame of reference will remain that of financial contracts.

Importantly, this analysis is not intended as the passing of a judgment, one way or another, on the political and/or military actions that are, can be or have been taken in the pursuit of certain beliefs. Rather, this work is an attempt to deliver some answers as to whether the type of novel

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[61] Such as in Egypt, Mauritania, Sudan, Afghanistan, Iran, Iraq, the Maldives, Pakistan, Qatar, Saudi Arabia, Yemen, and certain regions in Indonesia, Nigeria, and the United Arab Emirates.

[62] Such as Malaysia.

[63] Ashlea Hellmann, 'The Convergence of International Human Rights and Sharia Law. Can International Ideals and Muslim Religious Law Coexist?' (n.d.) http://webcache.googleusercontent.com/search?q=cache:FAJKIwrhn0UJ:www.nysba.org/Sections/International/Awards/2016_Pergam_Writing_Competition/submissions/Hellmann_Ashlea.html+&cd=1&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 13th May 2019. See also, Dr. Khalid Zaheer, 'Humans Rights Law and Islamic Shari'ah: Areas of Compatibility and Conflict' (2019) http://www.khalidzaheer.com/essays/kzaheer/social%20issues/human_rights.html accessed 2nd May 2019.

structures approved to use on the Islamic market could meaningfully change as a result of a profound political change. In other words, this chapter is intended to help discern whether the current Islamic financial order is vulnerable to disruption and if yes, where this disruption may come from.

By way of conclusion to this prologue, it should be admitted that the word "radical" conveys but a mere sentiment. After all, we all have different beliefs; what is radical for one person may seem completely normal for the other and *vice versa*. However, because the finance world works with certainty and clear definitions (we are talking about money, after all), the following section will endeavor to flesh out "radical" in the context of finance in a more definitive way.

4.1. The notions of renewal, condemnation and striving

Somewhere between "classical" and "radical" Islam, there is a relevant to this discussion strand of Islam known as Islamic revivalism. As has been compellingly argued, 'Islamic revivalism is viewed as a revolutionary force whose aim is to topple the established order in the Muslim world, be that authoritarian or democratic.'[64]

Before everything however, Islamic revival (*tajdid*) is a philosophical concept prompted by a desire to return to the original values and the fundamentals of the Islamic religion. In this aspect of Islam, the turn to religion has been interpreted as an attempt to bridge the ideological gaps left open by failing secular governments. The main failures of such governments arguably manifested in erosion of nations' cultural and spiritual heritage, which on the individual level was expressed as an ever increasing need to understand, affirm and impose one's identity. Nevertheless and even within the frames of one denomination, this process of acknowledging one's connection to religion was not straightforward, due to the existence of disparate groups formed by people with different levels of education and life experiences, including experiences (or lack of them) with foreign cultures. Outside the closed group of a denomination, the 'profound and explosive'[65]

[64] Nasser Momayezi, 'Islamic Revivalism and the Quest for Political Power' (1997) 17(2) UNB https://journals.lib.unb.ca/index.php/JCS/article/view/11753/12527 accessed 25th July 2019.
[65] Ibid.

differences grew much bigger, fanned by different and often conflicting interpretations of the common faith.

The coming to terms with the realization that a number of sacrifices must be made in order to affirm one common identity across all differences (at least within one's denomination) has fueled Islamic revivalism over the centuries.

Tajdid has appeared numerous times throughout the development of Islam, fundamentally prompted by the understanding among Muslims that the ideal of Islam – a fully developed Islamic State – has not been achieved in reality.

The narrative of Islamic revivalism recognises the concept of *mujaddid* (the person who leads the renewal). While there is no agreement on the *mujaddid* for every century, there is no doubt among Islamic thinkers that the reformation and renewal of Islamic faith should remain a relevant concept. Critically, in the quest of preserving Islam pure, reformation and renewal were clearly distinguished by the revivalists from the infusion of Islam with non-Islamic elements. Admittedly however, Islamic revivalism even in its most pure, true Islamic form was not a uniform school of thought. Even the sources of the movement were not identical because of the many denominational, cultural, national and even racial iterations of Islam.[66]

While this sentiment that the true Islamic state has not yet been arrived at is arguably true at this point in time (barring the example of Iran), the revival ideology is also linked to the understanding among some scholars that the main political ideologies of the modern world have failed and it is time for the modern world to adopt the values of Islamisation rather than for Islam to modernize itself.[67]

Over the centuries, Islamic revivalism has developed into three main strands. The first and most conservative strand has sought to preserve the main concepts of pre-modern Islamic revivalism. Adoption of this approach should leave little room for Islamic finance as we now know it, for the majority of the currently used Islamic financial instruments are unlikely to withstand the scrutiny

[66] Nasser Momayezi, (n 64).
[67] Yvonne Yazbeck Haddad, John Obert Voll and John L. Esposito, *The Contemporary Islamic Revival: A Critical Survey and Bibliography* (Greenwood Press, London), 24. See, https://books.google.es/books?id=9wsH2c7mYm8C&pg=PA24&dq=islam+revival+tajdid&hl=en&sa=X&ei=xtyRVP_sHISWyATOhlHABA&redir_esc=y#v=onepage&q=islam%20revival%20tajdid&f=false accessed 16 January 2019.

of a conservative revivalist. This was not so much the case with the second category of revivalism, which sought to infuse older concepts with modernity and make them relevant to the changing times. It is arguable that the current state of Islamic finance represents, willingly or not, this exact tendency. The third revivalist strand was the most radical – giving rise to new concepts, reflecting the changing conditions of our modernity.[68] It is this third strand that could prove to be the most useful when bridging the gap between traditional Islamic finance and its modern iterations, for instance, *Shariah* compliant FinTech.

The second important theme in the narrative of Islamic revivalism (the first being the purification of Islam from evil), historically present in Islamic ideology, is the call to judge contemporary societies. This follows logically the theme of purification as practices and beliefs not in accordance with a pure form of Islam would be subjected at the least to harsh criticism.

The identification of entities or individuals as failing to measure up to the standards of a pure Islam is designated by conservative revivalists as nonbelieving (*kafir*) and the process of judgment, passed on to them, as *takfir*. The practice of *takfir* has historically been preferred only by the more militant strands of revivalism. Its first adherents were the Kharijites from the first century of Islam. After the Kharijites, groups using the label "infidel" for fellow Muslims who, in their view, were failing to properly adhere to Islam were also called Kharijites by their opponents.[69] The adoption of this word as a concept (a judgment perhaps?) reflects the controversy of *takfir* but more so, a perception, quite common among most Muslims, that one should not judge another Muslim's piety, for judging this is God's domain.

Another relevant idiosyncrasy of Islam is that it thrives on continuity. The link to the past is strong in Islam and ideas which have circulated from the beginning of this religion are still discussed and often acted upon today. This debate includes political theorists, politicians and militants and the clash between a more extreme and moderate ideology often transcends the theoretical and enters real life. It suffices to recall the influential writings of Sayyid Qutb (discussed later in this work), which brought him accusations of being a Kharijite as well as a (perceived) critique from the then head of the Muslim Brotherhood that Muslims must be

[68] Ibid.
[69] Yvonne Yazbeck Haddad (n 67), 25.

‘preachers, not judges’.[70] Another notable example of the tendency of radical words to transcend into extremism in life is the assassination of the Egyptian president Anwar al-Sadat, carried out in 1981 by the extremist Jihad group. Note that in connection to the assassination, the group claimed that “[r]ulers of this age are in apostasy from Islam”.[71]

This logically leads to the third important theme in Islamic revivalism, that of *jihad* (holy war). The concept has entered everyday parlance, indicating indiscriminate warfare against whoever is perceived as an enemy of Islam.[72] The theoretical foundation of extremist *jihad* could be found in the work Ma’alim (Milestones) by Sayyid Qutb, published in 1966, and the medieval work Zad al-Ma’ad (Provisions of the Hereafter), compiled by Ibn Qayyim Jawziyyah’s and his teacher Ibn Tymiyyah (1263-1328).[73] However, in its essence *jihad* is a much broader notion.

Haddad et al. argue correctly, that *jihad* contains much more than a call for a military action. It includes a broader effort, exerted by its followers, to adhere, affirm and support the divine message.[74] To this end, the holy war could be inner and spiritual, as well as military.

Inner *jihad*, as most concepts of Islam, has differing interpretations. For example, Suzanne Haneef translates “*jihad*” as “striving” and further argues that its connotation to “holy war” has been implied by the misuse of the word by the Western media and by some well-meaning but ignorant Muslims.[75] She perceives inner *jihad* as the constant inner struggle to self-improve and self-purify.[76] However, for others yet, inner *jihad* is manifested through ‘waging al-jihad against corrupt and impious Muslim rulers/governments’.[77]

It is without dispute that with its drive towards the purity of the past and its values, *jihad* has been instrumental in the struggle for national identity and sovereignty of the Muslim peoples against European colonialism, which has infused the last two hundred years. In this narrative, *jihad* had been a term not solely preserved for religious application – but also adopted by secular

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[70] Hassan al-Hudaybi, *Preachers, not Judges*, (1969).
[71] Yvonne Yazbeck Haddad (n 67), 25.
[72] Fawaz A Gerges, *Journey Of The Jihadist: Inside Muslim Militancy*, (Houghton MifflinHarcourt 2007), pp.I, 4-5.
[73] Simon Reece Gray, *The National, Regional & Global Phases of Jihadism*, (2012) Thesis with the University of Waikato, 28.
[74] Yvonne Yazbeck Haddad (n 67), 26.
[75] Suzanne Haneef, *What Everyone Should Know About Islam and Muslims* (Kazi Publications, 14th edition 1995).
[76] Ibid.
[77] Simon Reece Gray (n 73), 69.

nationalistic movements and renamed irredentist *jihad* ('waging al-jihad to redeem Muslim land from non-Muslim rulers/forces').[78]

Curiously, although the issue of national identity was one of the driving forces behind revivalism, Islam has been and has remained conflicted on the issue of the nation-state. In fact, not all Islamic thinkers agree that a nation-state is beneficial to Islam, many arguing that the concept has been introduced by the former colonialists so they can break and weaken the *Ummah* (the global Muslim community).[79] While post the 1970s this question of pan-Islam has shifted away from the mainstream narrative, partly because the *Qur'an*, *Hadiths* and *Sunnah* do not specifically determine what an Islamic State should be like,[80] the discussion on it is still ongoing, particularly in some radical corners. Importantly, such notions became also a crucial part of ISIS' ideology. What is more, a comparison between ISIS' idea of society and the early iterations of the Muslim Brotherhood demonstrates disturbing similarities, particularly in the way the Brotherhood aspired to change society and its institutions, in accordance with *Shariah* law. Further to the parallel, in its early days the Brotherhood too envisioned the establishment of the Islamic Caliphate.[81]

The third type of *jihad* (militant *jihad*) will not be specifically considered in this analysis although it is arguable that the shadow of a more radical reading of the Islamic teachings influences, in one direction or another, the narrative of the mainstream theorists. Crucially, it must be acknowledged that as much as the *Qur'an* is immutable, the interpretations of Islam are fluid and very much dependent on the specific geo-political circumstances. As a reflection, and given that *Shariah* teaches the masses to be obedient to the political authority of the rulers,[82] it can be expected that changes in Islamic political life or even in the political course, as long as it has been introduced by recognised political leaders, will likely be accepted across the Muslim polity's spectrum. Such changes can differ in their impact and ambit; but even the least profound of them could in theory reshape the current financial services framework. To this end, the first

[78] Simon Reece Gray (n 73), 69.
[79] International Crisis Group, "Understanding Islamism", op. cit., pp.6-7.
[80] Simon Reece Gray (n 73), 70.
[81] Dilip Hiro, *War Without End: The Rise Of Islamist Terrorism And Global Response*, (Routledge 2002), p.63.
[82] Ashlea Hellmann, 'The Convergence of International Human Rights and Sharia Law. Can International Ideals and Muslim Religious Law Coexist?' (n.d.) http://webcache.googleusercontent.com/search?q=cache:FAJKIwrhn0UJ:www.nysba.org/Sections/International/Awards/2016_Pergam_Writing_Competition/submissions/Hellmann_Ashlea.html+&cd=1&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 13th May 2019.

strand of revivalism with its drive to preserve the tradition of pre-modern Islamic revivalism contains the greatest danger to the *status quo* and as such deserves the closest attention.

4.2. Sunni's concept of political power

The *ahl as-sunna* (the 'people of the custom'), also known as S*unni,* comprise one of the two main branches of Islam. The *Sunni* branch has the majority adherents compared to any other denomination of Islam, including that of the *Shi'a*. [83] In translation 'the word Sunn, in Arabic, comes from a word, which means "one who follows the traditions of the Prophet". The *Sunni* recognise the six *Hadiths* (the spoken word of Mohammad) and the four schools of Islamic law, and are seen by some as the most orthodox branch of Islam.[84]

Central to the denominational clash, the *Sunni* believe that the first four caliphs of the early Islam are the rightful heirs of Prophet Muhammad. *Sunni* and particularly radical *Sunni* regard the period of all four caliphs as the golden age of Islam.[85] Furthermore, while the *Shi'a* (translated from Arabic the word means 'a group or supportive party of people', 'Shia't-Ali, or "the Party of Ali"'[86]) hold the belief that the Prophet had been specifically chosen to receive the revelations because of the qualities of his person, his family and his tribe, in the traditional *Sunni* narrative, leadership should be vested in those most capable of performing the duty. Namely, a leader of the Caliphate could be anyone hailing from the Quraysh tribe, including the Umayyad clan, as long as the person has proven himself to be worthy for the role.[87] Furthermore, the *Sunni* have adopted an understanding that the earthly organisation of life, including the leadership of Islam, is a manifestation of political reality, rather than being determined by a divine order or inspiration. The pragmatic approach to leadership, adopted by *Sunni*, led them to accept caliphs that were

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[83] Joseph Schacht, *An Introduction to Islamic Law* (OUP 1982), 16-17.
[84] Learn Religions, 'Key Differences Between Shia and Sunni Muslims' (2019) https://www.learnreligions.com/difference-between-shia-and-sunni-muslims-2003755 accessed 11th August 2019.
[85] Emmanuel Sivan, 'Sunni Radicalism in the Middle East and the Iranian Revolution' (1989) 21(1) International Journal of Middle East Studies 1, 5.
[86] Learn Religions, 'Key Differences Between Shia and Sunni Muslims' (2019) https://www.learnreligions.com/difference-between-shia-and-sunni-muslims-2003755 accessed 11th August 2019.
[87] Encyclopedia Britanica, 'Quraysh people' (2019) https://www.britannica.com/topic/Quraysh accessed 4th June 2019.

'unexceptional and even foreign'[88] in order to have 'proper exercise of religion and the maintenance of order'.[89] In the pursuance of order (as opposed to political chaos), *Sunni* jurists 'devised a theory of election that was flexible enough to permit that allegiance be given to the de facto caliph, whatever his origins.'[90] This theory notwithstanding, the majority of *Sunni* jurists still insist that caliphs must hail from Muhammad's tribe, the Quraysh.

The relative flexibility of the *Sunni* branch led to a more accepting approach to views and customs taking place in the *Sunni* society, even if such views had no roots in the *Qur'an* or were displayed by peripheral groups.[91] Note, however, that *Sunni* radicals do not accept the rule of the Umayyad dynasty as truly Islamic, largely because of its secular nature. This sentiment is shared by many ordinary Muslims, which explains why the period of this dynasty is often referred to in literature as the Arab Kingdom.[92]

The *Sunni* determined their fundamental concept of governmental power in the period between 11-14th century.[93] Note, however, that the *Sunni* concept of "state", as we now understand it, was created much later. As mentioned previously, the *Qur'an* and *Hadiths* do not contain a specific reference to the way the Islamic State should function. For example, the *Qur'an* uses the word *dawlah* (previously 'meaning to rotate, alternate, take turns, or occur periodically, dawlah, in a modern context, refers to the concept of state'[94]) in the context of "property", "fortune" or "domain".[95] Other notions, such as "*imamate*" (initially referring to 'leading the course of prayer in the mosque'[96]) and "*caliphate*" (initially meaning "succession" and now understood to be 'the normative model of the Islamic state') were the terms which have historically been used by *Sunni* thinkers to denote the Islamic government.[97]

88 Encyclopedia Britannica, 'Sunni' (n.d.) https://www.britannica.com/topic/Sunni accessed 11th August 2019.
89 Ibid.
90 Encyclopedia Britannica (n 88).
91 Encyclopedia Britannica (n 88).
92 Asma Afsaruddin, 'Umayyad dynasty' (2019) Enciclopedia Britannica, https://www.britannica.com/topic/Umayyad-dynasty-Islamic-history accessed 16th August 2019.
93 See, Leonid R Sykiainen, 'The Islamic Concept of Caliphate: Basic Principles and a Contemporary Interpretation' (2017) National Research University Higher School of Economics, Working Papers, SERIES: LAW WP BRP 72/LAW/2017 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2918685 accessed 11th August 2019.
94 Azhar Niaz, 'Dawlah' (2012), Islamicus, http://islamicus.org/dawlah/ accessed 11th August 2019.
95 *Qur'an*, 59:7; Sykainen (n 93), 3.
96 Sykainen (n 93), 3.
97 Sykainen (n 93), 3.

To this end, the notion of "caliphate" is intrinsically linked to the question of what would be the structure of a more conservative or more radical model of state government. The deliberate fluidity of the construct suggests that the Prophet has envisioned a concept of state, which was sufficiently flexible to serve Muslims across different political realities.

To this end however, it is crucial to understand that "caliphate" is understood not only as a governmental structure but also as the manifestation of Islamic political (state) power. It is the latter, which is of a greater importance for two main reasons. Firstly, as mentioned above, the *Qur'an* (this is supported by the majority of Islamic thinkers) does not determine a specific caliphate structure or even manifestation. Secondly, in the *Sunni* tradition, caliphate is necessary to create order out of chaos for even a despotic leadership is better than no leadership at all.[98]

The concept of Muslim State sovereignty is of further relevance to the topic. According to the prevailing doctrine, all supreme (including political) power in the Islamic State belongs to *Allah*. Because of that, *Allah* is the holder of the Caliphate's sovereignty. The belief that all political power existing in the earthly domain is merely delegated by *Allah* to the *Ummah* (the community), explains the importance of *Shariah* law for the governmental structures as well as why the populace is expected to obey its political leaders.

Furthermore, the actual government of an Islamic State (or the Islamic State) constitutes of a division of sovereignty between *Shariah* and the *Ummah*. As per the doctrine of Muslim State sovereignty, the community's sovereignty is not absolute but it is subjected to the supremacy of *Shariah*. The main and inalienable right of the community is to choose a leader, a caliph, to whom it would delegate (but not concede) its exclusive rights. A very important trait of this organisation of power is that the legislative authority of the *Ummah* spreads as far as the areas not legislated about by the *Shariah* in the form of pronouncements in the *Qur'an* and the *Sunnah*. This suggests that a conservative reading of the *Qur'an* by the leaders of the community may further narrow the legislative reach of the *Ummah*, something that was observed during the active period of the Islamic State of Iraq and Syria (ISIS) (roughly 2014-2018).

[98] This trait of the *Sunni* doctrine could explain, at least partially, the more flexible approach of *Sunni* Islam to Islamic finance and more specifically, the aspects of it, which most mimic Western finance, discussed later in the work.

Foreshadowing the discussion that will take place in the next chapters, it is arguable that the Islamic perspective on governance would help clarify the provenance and importance of some of the main principles discussed in this work, for instance, the prohibition of *riba*,[99] which rendered suspect the purity of the novel Islamic finance instruments. Furthermore, since the *riba* ban was put in place with the main purpose to protect the poor and disenfranchised from being taken advantage of, it understandably holds a strong appeal with the larger Muslim community. The same would apply to radical thinkers, who, in their majority embrace leftist, populist positions, which are in part informed by the very Islamic idea that community's wellbeing is paramount. As a general rule, radical Islamic writers lean heavily towards these precepts in Islam that preach protection of the poor against the rich, social fairness and justice, charity and respect to the fellow Muslim, particularly to those financially weaker. Non-coincidentally, these are the principles which would underline a more hard-liner approach to finance in revivalist-led governance.

As for some ecumenical *Shia* thinkers and particularly, Ayatollah Khomeini, they have acknowledged to a great extent the 12 years of the caliphs Abu Bakr and Umar. It is true, however, that this was done for political reasons, such as extending the *Shia* related rule over a longer historical period. Particularly in the case of Ayatollah Khomeini, this approach to the interpretation of Islamic history was adopted largely because it supported the Islamic Revolution, which ideally, in the narrative of Islamic revolutionaries, should spread along the entire Muslim world. To quote Ayatollah Khomeini, "The Iranian people's revolution is only a point in the start of the revolution of the great world of Islam."[100] As argued by an analyst of the Tony Blair Institute for Global Change, '[t]hese words of Ayatollah Ruhollah Khomeini… marked the beginning of a project: to inspire and enable an Islamist revival across the Muslim world.'[101] In the pursuance of this ideal, Khomeini tried to inspire *Sunni* Muslims to see the brotherhood among them and *Shia* Muslims as reaching beyond denominations and nationalism, although this was a difficult task, considering the deep historical divide lying in between.[102]

[99] Discussed in Chapter 5.

[100] Ayatollah Ruhollah Khomeini, speech to the people during the Imposed War, Tehran, Iran, 22 March 1989, http://www.irna.ir/fa/News/81494977, in Kasra Aarabi, 'The Fundamentals of Iran's Islamic Revolution' (2019) Tony Blair Institute for Global Change, https://institute.global/insight/co-existence/fundamentals-irans-islamic-revolution accessed 16th August 2019.

[101] Kasra Aarabi (n 100), ibid.

[102] Sivan (n 85), 7-8.

4.3. The crossroad between denominations

The *Sunni* and *Shia* denomination division appeared soon after the death of the Prophet in 632 CE. At first the division was political and caused by a historical incident where Ali's house's (656-660 CE) right to caliphate (Ali was the Prophet's cousin and brother in law) was usurped by the supporters of the three caliphs and his grandson and his followers were killed in the process. The *Shia* denomination arose from among the supporters of Ali, whereas the *Sunni* became those accepting that the claim of the three caliphs was righteous, despite the morally dubious acts (even according to *Sunni* Muslims) of usurpation and Husayn's murder.

Furthermore, while some important *Shia* thinkers, such as Ayatollah Khomeini, displayed a more permissive and even accepting view of the first two caliphs, Abu Bakr and Umar, the third caliph Uthman (644-656) was an enemy of Ali and as such was not acknowledged by the *Shia* supporters. This lack of acknowledgment was traditionally expressed by cursing the name of the caliph and the Companions of the Prophet, and treating the caliphate of the Umayyad dynasty as not truly Islamic. The *Sunni*, in distinction, accept all four caliphs as orthodox and true rulers and particularly Uthman is seen as a true caliph by *Sunni* radicals.[103]

An additional form of self-identification for the *Shia* is their commemoration of the assassination of Husayn, known as Ashura, where people engage in mourning processions, during which men whip or harm their torsos to blood in order to empathise with Husyan's suffering. This uniting and emotive celebration has been used on numerous occasions to support revolutionary causes, more specifically against the "White Revolution" and the Shah's reformatory ideas. The obvious importance of Ashura for *Shia* stands in stark contrast with its relative unimportance for *Sunni* – so much so that in some *Sunni* territories such as Egypt, Ashura is celebrated as a happy event marking the overturning of the *Shia* dynasty.

The *Shia*'s attachment to the idea that only true descendants of Ali are legitimate to rule a *Shia* country makes it clear that radicalism can easily translate this into a total disregard to currently established norms, including in commerce. This scenario played out during the revolution

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[103] Sivan (n 85), 6.

overturning the Iranian Shah. In comparison, the *Sunni* have traditionally viewed an existing regime of a Muslim government as legitimate, as long as it demonstrates respect to Islam. Interestingly, particularly in light of the events of the recent decade, *Sunni* thinkers are far more willing to accept order instead of chaos, even if this order is achieved at the price of certain compromises. As a consequence, *Sunni* political theory does not easily lend itself to revolution and the role of the *ulama* (knowledge), the learned interpreter of Islam or rather an expert in Islamic religious sciences,[104] is not as elevated in *Sunni* as it is in *Shia* Islam.

Even this claim should however be qualified by reference to the distinction between the two denominations. The revered status of *ulama* in *Shia* allows them certain financial independence, achieved through donations and contributions by the believers.[105] This, on the other hand, has historically given the *ulama* the freedom to oppose governmental power because not only would they be protected by the masses in times of social unrest, they did not depend financially on any subsidies from the State. At the same time, the *ulama* were able to promote radical changes in the political government, particularly against powers that have been seen as illegitimate or failing Islam. In comparison, the *ulama* in the *Sunni* framework, while still perceived heirs of the Prophet, are endowed with a lesser political importance. However, they still possess authority, which 'actually relativizes the usual claim that there is no clergy in *Sunni* Islam.'[106]

In this context, it is notable that Khomeini, who was fronting the Islamic Revolution in Iran, treated the centuries long division between *Sunni* and *Shia* as harmful for Islam. His policies and writings therefore attempted to provide for some reconciliation between the two denominations, some unification, which would allow for the ideas of the Revolution to permeate the lands of the *Sunni*. However, as the below account will demonstrate, such unification never took place. What is more, the ideas of the *Shia* radicals remained for the most part effective within countries with *Shia* majority, with a negligent impact on predominantly *Sunni* inhibited states.

Despite the fact that many parallels could be found in the way Islam was treated in *Sunni* and *Shia* countries, the two denominations did not seem to share their approaches, experiences and

[104] Martino Diez, 'Ulama, the Heirs of the Prophets' (2018) https://www.oasiscenter.eu/en/ulama-who-they-are accessed 4th June 2019.
[105] Sivan (n 85), 10.
[106] Martino Diez, 'Ulama, the Heirs of the Prophets' (2018) https://www.oasiscenter.eu/en/ulama-who-they-are accessed 10th August 2019.

values. With the notable exception of the *Sunni* thinker Sayyid Qutb Ibrahim Husayn Shadhili, whose importance was already touched upon in this narrative, *Sunni* traditionalists and *Shia* have remained on their separate paths to interpretation of Islam.[107] Still, it could be argued that as regard their most extreme theorists, there seems to be an overlap of ideas, particularly those relating to the diagnosis of the main problem facing the Islamic world and the method of its correction.

For instance, both *Shia* and *Sunni* revolutionaries and radicals have identified the main danger to Islam to be the persistent Westernisation of Islamic countries, a Westoxication as Emmanuel Sivan puts it.[108] This, in their view, permeates the consciousness of the masses or even attacks people's minds at a subconscious level, making them susceptive to Western values such as democracy, liberalism, economic development, socialism and nationalism, to name a few.[109] Importantly, the idea that by adopting a Westernised way of life, including innovation, Muslims become captivated by the illusion of the "good life" is particularly pervasive among such thinkers. It suffices to recall that the concept of *jahiliyyah* (ignorance), adopted by revivalists and particularly espoused by Qutb, is used with regards to modern secular life with particular negativism.

Also common among the *Shia* and radical *Sunni* is the approach taken to finding a cure for the *jahiliyyah*. The cure is seen as winning back the masses, in particular the younger generations and the approach to that does not exclude overthrowing of governments or other forms of violence.[110]

In Sivan's view, *Sunni* and *Shia* differ on four major philosophical points: jurisprudence (largely in family law), historic vision, political theory and eschatological myths. Sivan, however, acknowledges that as far as jurisprudence is considered, the *Sunni* and the *Shia* have the most in common. The similarities are such that some ecumenical *Sunni* scholars hold the *Shia* school of thought as the 5th School of Islam, along with the four *Sunni* schools by Azhar University in Cairo and under the name of *maddhab Ja'fari*.

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[107] Emmanuel Sivan, 'Sunni Radicalism in the Middle East and the Iranian Revolution' (1989) 21(1) International Journal of Middle East Studies 1, 1.
[108] Ibid, 2.
[109] Sivan (n 85), 2.
[110] Sivan (n 85), 2.

The *Shia's Ja'fari* School was named after Jafar al-Sadiq (d. 748), who was the 6th imam and a descendant of Muhammad through the appropriate line. The *Ja'fari* School draws from the *Qur'an*, the *Sunnah*, consensus (based on Prophet's or an infallible imam's opinions) and human reason.[111] The latter concept is important for this School because it entitles *Shia* jurists to infer categorical judgments based on pure and practical reason, even for matters that have not been covered in the main sources of Islamic law. Note that for the *Ja'fari* School, '[w]hatever is judged necessary by reason is also judged necessary by revelation.'[112] The importance of this approach to the practical realities of the Iranian Revolution is significant.

To this end, it is interesting that those ecumenical *Sunni* scholars who support the closeness between the two denominations and particularly the most radical of them, value *Shia* jurisprudence including the normative law relating to the Islamic Revolution. The same attitude of acceptance is noticed among radical *Shia* scholars (for example, Ayatollah Khomeini and Muhammad Husayn Fadlallah). The latter in particular perceived all 5 Schools of Islam to be truly Islamic.

Another point of conversion between *Shia* and radical *Sunni* thinkers is the concept of *ijtihad* (independent legal reasoning). However, while *Shia* have supported *ijtihad* through their history, *Sunni* radicals have (significantly) resumed applying it in their practice only recently. In addition to that, throughout the centuries *ijtihad* was partially approved of by the neo-Hanbali School,[113] despite this being the most conservative among the *Sunni* Schools of thought (for example, the School was advocating for a literal interpretation of textual sources). This is unsurprising, given the link between the Hanbali School and Wahhabism, the latter seen as fundamental for the development of the doctrine of *jihadi*-salafism.

It could be suggested that the permissive approach to *ijtihad* demonstrated by *Shia*, *Sunni* radicals and the Hanbali School was instrumental to their strategies of revivalism. In addition, it gave the respective denomination or School greater freedom to govern matters of importance to them. For

[111] Oxford Islamic Studies Online, 'Jafari: Shii Legal Thought and Jurisprudence' (2019) http://www.oxfordislamicstudies.com/article/opr/t125/e1153 accessed 9th July 2019.
[112] Ibid. European Parliament: Understanding the branches of Islam: Shia Islam (2016).
[113] Originally founded in Bagdad in the 9th century, and named after Ahmad ibn Hanbal.

example, the neo-Hanbali School, despite its conservatism, has proved to be the most liberal among the four *Sunni* Schools as far as commercial matters are concerned.[114]

This peculiarity is arguably due to the School's openness to accept as a source of the law (in addition to the *Qur'an*, the *Hadith* and the *fatwas* of Muhammad 's Companions, sayings of a single Companion) traditions with weaker chains of transmission or lacking the name of a transmitter in the chain, and reasoning by analogy (*qiyas*) when absolutely necessary. By doing so, the School arguably left some room for interpretation that could be used appropriately by its scholars, particularly in matters of commerce. Notably, by rejecting *taqlid* (blind adherence to the opinions of other scholars), [115] the neo-Hanbali School has formed its own original body of jurisprudence and preserves the academic independence of its scholars. Note however, that the approval of legal reasoning (*ijtihad*) in the Hanbali School's tradition is subject to a careful study of the *Qur'an* and the *Hadith*.

The majority of the adherents of this School are found in Saudi Arabia and Qatar, as well as Palestine, Syria and Iraq.[116] As will be seen further below, Saudi Arabia and to an extent Qatar are leading in terms of global share of Islamic finance banking assets and perform very well in terms of GDP. The closer look at the ideological underpinning of their policies explains why such success has been achieved, regardless of the fact that both countries owe the bulk of their revenues to their huge oil reserves.

As a final point, it should be acknowledged that while the *Sunni* for the most part accept *Shia* normative law, they are less acceptant on the matter of sources of law. For instance, while *Sunni* acknowledge six basic compilations of *Hadith*, *Shia* accept others, in addition to these principal six; *Shia* also accepts *Hadith* coming from different traditions.[117]

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[114] Oxford Islamic Studies Online, 'Hanbali School of Law' (2019) http://www.oxfordislamicstudies.com/article/opr/t125/e799 accessed 9th July 2019.
[115] Ibid.
[116] Oxford Islamic Studies Online (n 114).
[117] Sivan (n 85), 3.

Chapter 5: Principles of Islamic Finance

As discussed, *Shariah* governs the entirety of Muslim's life – professional, social and familial. By extension, *Shariah* also governs one's business dealings. The framework of Islamic finance was introduced to give *Shariah*'s principles practical application in the area of finance. For various reasons, which will be explored later in this work, the resulting structures were intended to work as well within a *Shariah*-compliant financial environment as they would in a conventional finance one. This peculiarity of the subject matter invites us to look closely at the relevant *Shariah* principles and examine how, as a result of their application, Islamic Finance compares to conventional finance.

To understand the functioning of Islamic Finance, one needs to first grasp the approach to business in *Shariah* governed societies. In very simple terms, business is an umbrella term for a commercial activity comprising of exchange of and/or transactions with respect to things that are owned by different people. Because of the fundamental link between ownership and business, before moving further into the matter of Islamic Finance one must first consider how ownership is perceived in Islam and compare this to the interpretation of the concept in Western jurisdictions.

5.1. Ownership in Islam and the Western legal tradition

Even in the conventional legal framework, "ownership" is loaded with some potentially problematic statements and assumptions. This remains the case although the technical definition of ownership does not differ across Western jurisdictions (ownership being perceived "as a set of relationships, granting to a person or to a group control over a specific resource *vis à vis* other persons")[118].[119] However, underneath the surface, the old debate led by Western philosophers on

[118] Michele Graziadei, 'The structure of property ownership and the common law/civil law divide', (2017), https://iris.unito.it/bitstream/2318/1661636/1/Graziadei%20property%20Law%2004-chapter%204.docx, accessed 25th April 2019, 3.
[119] Ibid, 2.

whether the right to property is a natural or a posited right, or whether it has been granted to people by God, or whether it is nothing more but a useful social construct, continues.[120]

Comparison with *Shariah*'s understanding of the construct complicates things further. For example, while ownership is acceptable for Muslims, it is not valued as highly as it would be under the Western and more specifically, Anglo-Saxon tradition.[121] The Western understanding is that property and ownership are sacrosanct and this is notwithstanding the debate referred to above, which is mostly theoretical and provides a background to property law rather than a framework for its operation. In distinction, *Shariah* law actively links ownership with responsibilities and the concept is informed by ideals of social justice.[122]

The differences between the Islamic and conventional approach to ownership tend to decrease once the area of finance is considered. With respect to the ownership of a specific derivative, the conventional approach (influenced by the Anglo-Saxon system)[123] is that the product i.e. the underlying asset plus the derivatives from it, consists of a bundle of contractual rights,[124] where, in addition, the ownership of the underlying asset is separated from the ownership of the derivative from it. This flexibility of ownership allows relative freedom of the way the derivative is used and for what purposes.[125]

The concept of "bundle of rights" is instrumental not just to derivatives, but also to the common law of property; furthermore, it is not foreign to Islam. On the contrary, the notion is a well-established - so much so that it has given rise to arguments that the common law has originated in

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[120] See more generally, John Locke, *Two Treatises of Government*, (CreateSpace Independent Publishing Platform 2017); See also, Alison Clarke & Paul Kohler, *Property Law* (CUP 2007).

[121] Let's recall that even the Western philosophical thought harbours doubts on whether we should use the terms "ownership" and "property", arguing that these concepts are inaccurate and do not reflect the real rights with respect to a resource. See Stanford Encyclopedia of Philosophy, 'Property and Ownership' (First published Mon Sep 6, 2004) https://plato.stanford.edu/entries/property/ accessed 25th April 2017.

[122] Mervin K Lewis, 'Ethical principles in Islamic business and banking transactions', Chapter 3 in Mohamed Ariff and Munawar Iqbal (eds.), *The Foundations of Islamic Banking: Theory, Practice and Education,* (Edward Elgar 2011).

[123] Jane B Baron, 'Rescuing the Bundle-of-Rights Metaphor in Property Law' (2014) 82(1) University of Cincinnati Law Review 57, https://pdfs.semanticscholar.org/99ad/5d68d2c729a29226cc93eaac10bf79af9ebb.pdf 6th February 2018, 58-59.

[124] Jeremy Josse, *Dinosaur Derivatives and Other Trades*, (Wiley 2015), 68.

[125] Ownership matters, 'Use of derivatives in the market for corporate control' (n.d.) http://www.ownershipmatters.com.au/research-news/issues/use-of-derivatives-in-the-market-for-corporate-control/ accessed 10th May 2018.

Shariah.[126] This notwithstanding, the below discussion will highlight that although *Shariah* law and common law use similar or even at times the same terminology, in most cases the similarities between the them are only superficial. The differences between them, however, run very deep and on a conceptual level. This should be well understood now so that when the two structures are later compared, one has a clear idea of how each respective foundation has informed all future developments.

5.1.1. Comparative discussion on property in the Islamic and Western legal tradition

The Anglo-Saxon legal system treats property as "the legally recognised relationships we have with each other with respect to things."[127] On a more sophisticated level, the term "property" could refer to:

- The nature of the right one has (a property right as opposed to a personal right)
- The nature of the relationship (for example, "bailment" is a property relationship)
- The thing in itself[128]

Out of the three different iterations of "property", the last one is the most controversial in the understanding of English law. For example, Cunningham, Stoebuck and Whitman argue that to call a tangible object a "property" of someone and "owned" by them is a non-lawyerly talk, because it 'confuses "property" with the various subjects of "property"'.[129] In addition, Hohfeld suggests that "property" is best defined on a case by case basis, after examining the arising relationships of opposites, such as:

> right, privilege, power and immunity and their corresponding opposites of no-right, duty, disability and liability
>
> and correlatives, such as:

[126] Washim Ahmed, 'Concept of Property' (2016) University of Toronto, The Third Annual Conference on Islamic Economics and Islamic Finance, 2.
[127] Alison Clarke & Paul Kohler, *Property Law* (CUP 2007), 3.
[128] Ibid, 17.
[129] Cunningham, Stoebuck and Whitman, *The Law of Property* (West Group, 2000 3rd edition).

> right, privilege, power and immunity and their corresponding opposites of duty, no-right, liability and disability respectively.[130]

The civil law approaches the matter in a different, arguably less complicated way, which can be seen from the below excerpt, describing the approach under French law:

> *In the civil law … the notion of ownership is confounded with the thing itself. The right is in the land, considered as establishing a direct link between the person and the thing. It is referred to as a real right, the consequences of which are that it is enforceable against all persons, and it accords among other benefits a droit de suite and a droit de préférence to the holder. To determine whether a right is proprietary the civilian lawyer considers whether it is a direct right in the thing. The English realty/personalty distinction is … made, not as in the civil law, on whether the right creates a direct link (jus in re) or not (jus in personam and jus ad rem), but on the basis of whether it is enforceable against the whole world (jus in rem or realty) or not (jus in personam or personalty).*[131]

Furthermore, the French Civil Code defines ownership as 'the right to enjoy and dispose of things in the most absolute manner'.[132]

In contrast to the common law and civil law systems, *Shariah* law does not offer a unanimous definition of what constitutes property; rather, whether or not a thing will be construed to be a property (of someone) will depend on the approach taken by the jurist analysing the case. In the interest of legal certainty, it may be appropriate to keep in mind the below analysis of the *Sunni* approach to property,[133] which provides a compendium of the definitions of each school, that could be applied to the thing in question either in conjunction or separately.

As a representative of the *Sunni* Schools, the Hanafi School holds that property could only be "things" – something that exists in reality. However, just existing in reality would not make a thing property – it needs to adorn a number of attributes, such as:

[130] W N Hohfeld, 'Fundamental Legal Conceptions as Applied in Judicial Reasoning' (1913) 23 Yale Law Journal 16.
[131] See Barbara Pierre 'Classification of property and conceptions of ownership', (1997) 28(2) Revue générale de droit 235, 251. See also, Yaëll Emerich, 'Conceptualising Property Law: Integrating Common Law and Civil Law Traditions' (Edward Elgar Publishing 2018), 109-110.
[132] Code Civil, art.544. (Translated by Georges ROUHETTE, Professor of Law, with the assistance of Dr Anne ROUHETTE-BERTON, Assistant Professor of English). See also, a discussion on the French and Islamic law respective positions on ownership by Saba Habachy, 'Property, Right, and Contract in Muslim Law' (1962) 62(3) Columbia Law Review 450, 455-456.
[133] To which *Shia* largely subscribes.

- It has to be desirable
- It has to be durable – meaning it must be possible to store it for future use
- It has to be of benefit to people
- It has to abide by the laws of scarcity and expenditure.[134]

The Shafie School, on the other hand, focuses predominantly on whether the thing supposed to be property has *exchangeable* value and this value is such that it *benefits* people.[135] In comparison, the Anglo-Saxon theory of property does not require that specific *exchangeable* value should be assigned to a "property" in order for it to be treated as one. However, the disconnect between the common law and the Shafie School is not complete because Anglo-Saxon property law separates the idea of "property" as a "thing" from that of "property" as "wealth", which is an interesting distinction, having bearings on financial law (the law of trust funds).[136]

The Hanbali School places the emphasis on whether the thing is something that the Muslim can *legally benefit* from (whereas "legally" is understood as "compliant with *Shariah* law"). There is only one exception to this requirement - where the benefit in question is made use of due to extreme need or necessity (for example, hunger or extreme poverty).[137] By extension, this means that criminal conduct negates property rights (for example, by negating inheritance if it has been obtained by murder),[138] which is in line with the forfeiture rule in English common law and the so-called "slayer rule", if we are looking at the US legal tradition.[139] It has to be emphasised nevertheless, that the "legally benefit" requirement of the Hanbali School goes beyond the forfeiture rule because, unlike the common law, it considers the entirety of obligations arising under *Shariah* law.

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[134] Ahmed Washim, 'Concept of Property' (2016) University of Toronto, The Third Annual Conference on Islamic Economics and Islamic Finance, 8.
[135] Ibid, 9.
[136] Bernard Rudden, 'Things as Thing and Things as Wealth' (1994) 14 Oxford Journal of Legal Studies 81 and R C Nolan, 'Property in a Fund' (2004) 120 Law Quarterly Review 108.
[137] Washim (n 134), 10.
[138] Al-Islam, 'Inheritance' (n.d.) https://www.al-islam.org/five-schools-islamic-law-sheikh-muhammad-jawad-mughniyya/9-inheritance accessed 23rd October 2017.
[139] Rosie Kelly, 'How murder affects inheritance rules' (2019) Anglia Research, https://www.angliaresearch.co.uk/articles/how-homicide-affects-the-rules-of-inheritance/ accessed 25th November 2017. See the UK case *Estate of Crippen* [1911] P 108. For a US perspective, see *Mutual Life v. Armstrong*, (1886) 117 U.S. 591 (6 S.Ct. 877, 29 L.Ed. 997).

Finally, the Maliki School characterizes "property" as a thing that could be owned with the corresponding right to exclude others from enjoying it.[140] This understanding of "property" seems to be half- aligned with the Anglo-Saxon one where it holds that "property" is the right to enjoy something to the exclusion of others.[141]

In addition to the above, we must also consider that, according to Islam, all property is held on trust for *Allah*. In this sense, human owners are deemed vice-regents and beneficiaries of the property. It could be argued that any property right enjoyed by a person should be deemed imperfect, because, according to *Shariah*, the absolute right to any property belongs to *Allah*.[142]

To some extent, the Islamic law's approach may be said to resemble the dual ownership concept in the common law, where land is deemed property of the Crown. For example, in the UK all land is traditionally considered property of the British Crown, despite that a freehold property is held by its owners for an undetermined period and they have the right to dispose of it as they see fit, subject to existing covenants or other restrictions related to the applicable bundle of rights.[143] The way this concept works in practice is that should the owner of a certain freehold property dies without an heir, the ownership of her land reverts to the Crown under the *bona vacantia* concept.[144] However, the point of this principle is merely to create a system of efficient property distribution whereas no land would stay without husbandry and use. While it was possible for this concept to be introduced in England because of the status of the British monarchy, it has likely been preserved till the present day because of the land scarcity issue, of which the British Isles suffer. In other words, the British common law concept is strictly related to real property and is based on necessity as well as on the premise that land should be used efficiently. It is not or it is no longer based on the notion that someone has a higher claim to ownership.[145] It transpires that

[140] Al-Shatibi and Washim Ahmed, 'Concept of Property' (2016) University of Toronto, The Third Annual Conference on Islamic Economics and Islamic Finance, 10.
[141] Thomas W Merrill, 'Property and the Right to Exclude' (1998) 77(4) Nebraska Law Review 730; see also, Jonathan Klick and Gideon Parchomovsky, 'The Value of the Right to Exclude: An Empirical Assessment' (2017) Faculty Scholarship, 1637, http://scholarship.law.upenn.edu/faculty_scholarship/1637 accessed 23rd August 2019.
[142] Qur'an 7:125; See Saba Habachy, 'Property, Right, and Contract in Muslim Law' (1962) 62(3) Columbia Law Review 450, 452.
[143] Land Registry, 'Freehold Land & Property Title Information' (n.d.) http://www.land-registry-documents.co.uk/information/freehold-title-estate/ accessed 23rd August 2019.
[144] Citizens Advice, 'Who can inherit if there is no will – the rules of intestacy' (2019) https://www.citizensadvice.org.uk/family/death-and-wills/who-can-inherit-if-there-is-no-will-the-rules-of-intestacy/ accessed 13th January 2019.
[145] Of course, "ownership" is still interpreted in line with the Anglo-Saxon understanding.

while *prima facie* similar in their treatment of ownership of land, at least as far as outcomes are concerned, the common law and *Shariah* law differ deeply on a conceptual level.

For instance, the Anglo-Saxon concept is fundamentally different from the dual ownership concept in Islam, which is not motivated by considerations of efficiency or scarcity of land but is firmly rooted in religious principles. The idea of the absolute ownership by *Allah* is manifested in the *Qur'an* where it is stated: "To *Allah* belongs the dominion of the heavens and the earth and all that is therein".[146] This premise is further strengthened by the requirement that all property must be dealt with in a manner which is compliant with *Shariah* law.[147]

Further with respect to the comparison between the two jurisdictions, even if one rejects the efficiency argument, while it could be argued theoretically that monarchy has a divine origin[148] and that monarchs take property in trust for God, therefore loosely aligning the Anglo-Saxon and the *Shariah* law approaches, Islam not only holds that the absolute owner is not a human being or institution but property does not change its beneficial owner which in all cases remains with a human being.[149] This position is clearly evident in the Islamic law on inheritance. [150] Another distinction arises with respect to the so-called "forced heirship". For example, a Muslim is only allowed to give away one third of her property. The rest she must leave to her heirs. In comparison, the concept of "forced heirship" does not exist in most common law jurisdictions, such as England and Wales, Australia and the US, where one can freely dispose of his or her property during one's life time.[151]

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[146] Quran, https://www.quranwow.com/#/ch/1/t1/ar-allah/t2/en-itania/a1/alafasy-64/a2/itania-64/v/1 accessed 26th January 2017, [5: 120].

[147] Lutfi Abdul Razak and Muhammad Nabil Saupi, 'The concept and application of ḍamān al-milkiyyah (ownership risk): Islamic law of contract perspective' (2017) SRA International Journal of Islamic Finance, (Emerald Publishing Limited).

[148] As it has been in the past, see generally John Locke.

[149] Siti Mariam Malinumbay S. Salasal, 'The Concept of Land Ownership: Islamic Perspective' (1998) 2(2) Buletin Geoinformasi 285, 285.

[150] Ibid, 287. The two systems are nevertheless aligned in some respects. For example, in Islam, similarly to other jurisdictions, upon the death of the beneficial owner, the estate goes to his or her heirs. Like the common law, *Shariah* inheritance law has the objective to deliver the property of the deceased to at least one of their lawful heirs. It facilitates the process of transition of property in many ways. In case that no close relatives exist, the inheritance rights fall on distant relatives and only failing that or if there should be any bars to inheritance, the estate goes to the public treasury (bait al-mal) (and to the Government, which is also the current case in the UK). Notably, in this the *Shariah* law on inheritance very much resembles its US common law counterpart, particularly in the process of bait al-mal, known in the US as "escheat."

[151] See, Abid Hussain, 'Islamic Laws of Inheritance' (n.d.) http://www.islam101.com/sociology/inheritance.htm accessed 01 April 2019. See also, Mohamad Asmadi bin Abdullah, 'The Entitlement of the Bayt Al-Mal to a Muslim

The above supports an argument that Islamic property law is a lot more focused on the community benefit than on the individual's right to dispose with their property. This feature of *Shariah* law signals that property relations in Islam are subjected, before everything, to considerations of faith and no so much to the personal choices of self. Foreshadowing the discussion on risk management in Islamic finance, it seems that the practices of restricting individual conduct within the religious and moral principles of the Muslim faith, has informed the more relaxed regulatory regime applicable to Islamic financial contracts.

Furthermore, technically speaking, the usage of the term "beneficial owner" in *Shariah* does not overlap with the usage of the respective common law term. In the latter, "beneficial owner" not only means the person who benefits from the property but the term is used specifically in the context of the trust instrument (whereby on the instructions of the settlor, the property is held on trust by a trustee for the benefit of the beneficiary).[152] In comparison, in Islam, the beneficial owner is the *de facto* owner. There is no trust held on behalf of another human being and there are no other parties such as a trustee or a settlor. While *Shariah* nevertheless utilises the concept of trust because the thing which constitutes property is at all times and circumstances held on trust for Allah, this is not done in a way, which can facilitate trust instruments in financial law.

5.1.2. Derivatives and the "bundle of rights" concept

Further to the above, both Islamic law and the common law accept that "property" could be subjected to the bundling of the rights related to it. To this end, a typical "bundle" contains:

Praepositus' Estates; an Analysis of the Right of a Muslim to Bequeath Without Obtaining a Consent from the Bayt Al- Mal' (2012) 4(1)International Journal of Social Sciences and Humanity Studies 1309; Expatica, 'The implications of UK inheritance tax, law and UK wills for foreigners' (2019) https://www.expatica.com/uk/finance/taxes/the-implications-of-uk-inheritance-tax-law-and-uk-wills-for-foreigners-1040799/#Unclaimed accessed 1st April 2019; Maggie Lourdes, 'Probate Laws on the Next of Kin' (n.d.) https://info.legalzoom.com/probate-laws-next-kin-22269.html accessed 1st April 2019; Elissa Romanin et al., 'Australia International Estate Planning Guide Individual Tax and Private Client Committee' (2019), https://webcache.googleusercontent.com/search?q=cache:N4bjps1iyxsJ:https://www.ibanet.org/Document/Default.aspx%3FDocumentUid%3D8525FF1E-938F-43DA-BD7C-AFDB6025B324+&cd=3&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 1st April 2019; Michael Galligan, 'Forced heirship' in the United States of America, with particular reference to New York State' (2016) Trusts & Trustees 22(1):103-118; Apart from Louisiana where certain exceptions apply; Julie Garber, 'What Is Forced Heirship?' (2018) https://www.thebalance.com/forced-heirship-3505530 accessed 1st April 2019.

[152] Siti Mariam Malinumbay S. Salasal (n 149), 287.

- the right to use the good
- the right to earn income from the good
- the right to transfer the good to others
- the right to enforce property rights[153]

Needless to say, the "bundle of rights" concept injected a lot of flexibility and sophistication in English property law. *Shariah* law recognises a similar concept. However, the resemblance between the two "bundle of rights" theories remains only skin deep– and there is a notable distinction in how the two systems approach the issue.

As it has already been established, the common law does not differentiate between the concepts of "property" and "ownership". Rather, it recognizes that there always are (certain, specific) property rights which exist in relation to a thing. For Islamic law, however, "property" and "ownership" are separate concepts.

Furthermore, while the common law characterizes "property" as a relationship with respect to a thing, *Shariah* law puts a specific focus on property *being* a "thing". This distinction is very important because it can explain, among other things, why derivatives were so easy to grasp and apply in the West while remaining largely unattractive for Muslims. In addition, this explains the attachment of Muslims to tangible as opposed to derivative assets. This explanation would hold even if the relevant *Shariah* rules on asset-based trade are suspended for the moment.

Derivatives are, of course, contracts and the rights arising from them are, before everything, contractual rights. In this capacity, derivatives of an asset form an extra layer of rights superimposed over the asset-applicable bundle of (property) rights; however, these rights have no proprietary character. Despite this inferiority, derivatives rights with their fragmented character and dependency on an underlying asset resemble the bundle of rights, as understood in the common law of property. Furthermore, they could arguably form and interact within their own derivative bundle much in the way property rights interact together. At least they could be perceived to be doing so, by common law versed investors for whom, the further fragmentation

[153] Daniel B Klein and John Robinson, 'Property: A Bundle of Rights? Prologue to the Symposium' (2011) 8(3) Econ Journal Watch 193.

of rights caused by derivatives was easy to internalize and therefore, non-frightening. What is more, since fragmentation of rights was already established in the Anglo-Saxon legal system, derivatives appeared logically conceived. Perhaps as a result, the system failed to spot just how risky these instruments were.

Even if the *Shariah* specific prohibitions on risk, interest and speculation are not factored in, it is evident that *Shariah* law approaches derivatives in a way that differs fundamentally from that of its conventional counterpart. As discussed above, bundling of rights does not work in Islamic law the way it does in the common law. This is because property in *Shariah* is contained in the "thing" and is not expressed through a "right". Such an approach is consistent with the *Shariah* tendency to restrict individual choice and the range of individual action with respect to one's property. As was seen above, a Muslim property owner has a non - absolute property right over the property, could not dispose of it on his death in full agreement with his wishes (unless his or her wishes were in line with the *Shariah* rule on inheritance) and as far as the *in vivo* use of this property is concerned, is under the various strict obligations imposed by *Shariah* law.

On another view, Islamic law diverges from the common law and the Western legal tradition more generally in the way it perceives beneficial ownership. The premise that all property is held on trust for Allah notwithstanding, it has been argued that the right of ownership as 'the right of complete and absolute disposal' in Islamic law is 'more absolute than it is in modern systems of law.'[154] This has led, for example, to a system which has historically not recognised expropriation for public utility and foreclosure for unpaid debts. Both have been introduced into the Islamic legal framework since the second half of the last century;[155] however, the sense of unjustness attached to foreclosure or expropriation is likely to have remained part of the cultural make-up of Muslims.

Furthermore, as far as contracts are concerned, for a Muslim party they are based on mutual promises, which Muslims are expected to honour and not to hedge, opt out from, gamble with and generally use as an investment rather than an obligation.

As to the process of bundling, in the *Shariah* context it refers to bundling and fragmentation of *transactions* so that they remain *Shariah* complaint (as opposed to bundling and fragmentation of

[154] S Habachy, 'Property, Right, and Contract in Muslim Law' (1962) 62(3) Columbia Law Review 450, 456.
[155] Ibid, 456-457.

contractual *rights* which is conceptually unacceptable). This will be seen in the *murabaha* instrument, discussed later, [156] where the bundling and fragmentation are employed in the creation of a construct, consistent with *Shariah* law. This preliminary analysis already allows us to suggest that derivatives could be problematic for the Islamic financial environment because of their reliance on concepts, which are foreign to the Muslim investor. On a separate note however, and far more importantly to the current discussion, derivatives are suspect in Islam because of their inherent inconsistence with Islamic values.

5.2. Application of the social justice theory in Islamic finance

One of the most prominent features of the philosophy of Islam is its embracement of the notion of social justice, applicable across all areas of *Shariah* law, including that of finance. This has given rise to unique legal principles, setting Islamic law apart from conventional legal systems.[157] The Islamic profit and loss sharing model, the introduction of which was motivated by a desire to prevent exploitation of the poor, along with the objective that it is better to relieve hardship than create wealth are fitting examples of this characteristic. Furthermore, while it could be argued that the objective of *Shariah* finance to protect the underprivileged classes from being cheated out of material security resembles the Western welfare framework, at least as a result, there is a subtle distinction between the two systems, worth mentioning here.

The purpose and aim of *Shariah* finance Law is to create a financial system whereby the difference between the stronger and the weaker party is diminished in the interest of achieving greater social justice and equality. Notably, *Shariah* does not view protection of the poor as a handout to a helpless recipient (although it places great value on charity)[158] but as empowerment for them to participate in the process of creation of material wealth. To this end, when one argues that the Islamic finance framework offers greater protection for the marginalized compared to the

[156] See Chapter 7.
[157] Russell Powell, 'Social Justice and Islamic Jurisprudence', (2018) 16(3) Seatle Journal for Social Justice 1, 21.
[158] Russell Powell, 'Zakat Drawing Insights for Legal Theory and Economic Policy from Islamic Jurisprudence' (2010) 7 PITT. TAX REV. 43, 43-44.

Western counterpart,[159] what is meant is greater protection to them with respect to and in the course of their financial dealings. To this end, the Islamic finance framework is inclusive, placing less value on sophistication than it does on participation. In their ideal version, the principles of Islamic Finance become the necessary foundation upon which a socially friendly superstructure could be erected. However, the operation of this superstructure requires positive action such as mutual contributions to the commercial network and continuous abiding by its founding principles by financial actors.

5.2.1. Key relevant concepts in conventional banking

The relevant to finance prohibitions imposed by *Shariah* would be better understood in a side by side comparison with the relevant principles of conventional finance. For reason that the operation of Islamic finance and Islamic banking overlap almost entirely, the section on conventional finance will consider the pertinent to the discussion practices of conventional (secular) banks.

Banks across the world, whatever their provenance, enjoy a preferential treatment by national and supranational regulators. This is justified because these institutions contribute to the global economic development by providing funds for investments and by being central to (at least until recently) the payment system. [160] In addition, banks are deemed very important for systemic stability because of their role in the process of creation of money.[161] Last but not least, banks, and more so central banks, are valuable because they offer facilities such as physical storage of money. These features are instrumental to the degree of customer trust, enjoyed by conventional legacy banks (the term excludes newly founded FinTech based banks and firms offering *quasi*-banking services). The crucial role trust plays for financial stability is highlighted by Claudio Borio, who argues that:

[159] Raja Palaniappa, 'A Brief History of Derivatives' (2017) https://originmarkets.com/origin-hosts-issuer-roundtable-in-parallel-with-the-25th-annual-euromoney-global-borrowers-conference-3/ accessed 1st April 2019.
[160] Kassim Hussein, 'Bank-level stability factors and consumer confidence – A comparative study of Islamic and conventional banks' product mix' (2010) 15 *Journal of Financial Services Marketing* 259.
[161] Ibid.

a precondition for the system to work at all is trust that the object functioning as money will be generally accepted and that payments will be executed. But a well functioning system also requires trust that it will deliver price and financial stability. Ensuring trust is difficult and calls for strong institutions – an appropriate "institutional technology".[162]

In distinction, while Islamic banks are important to their states' economy too (this importance varies greatly in each respective national case), they are not as trusted by their ordinary Muslim customers as their conventional counterparts are in their native environment. This trend is particularly notable in countries where an underdeveloped banking sector is combined with a high-degree of religiousness of the population, such as post-war Iraq, for example.[163] The reasons for that are found in the nature of modern banking.

Conventional banks are, among other things, businesses facilitating finance ("loaning of money") to clients. A typical conventional bank would make available three generic types of loans: short-term, medium to long-term loans and overdrafts (including credit cards).[164] In a more granular definition, banks serve as intermediaries between those who need to deposit their capital safely and those who need to borrow capital to fund their ventures or personal expenses.[165]

While lucrative, giving out loans is risky because of the possibility of debtors defaulting on the loan contract. Technically speaking, loan contracts are a type of credit with a schedule, containing terms agreed by the counterparties and a time schedule of repayment. Defaulting in this context means that the debtor or a third party acting as his guarantor has fallen behind on the regular payments to pay out the loan or has become insolvent and therefore unable to repay the debt. The credit risk contained in such transactions is a substantial part of the risk package of the banking business;[166] to this end, it cannot be ignored that the issue of non-performing loans was

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[162] Claudio Borio, 'On money, debt, trust and central banking' (2019) BIS Working Papers No 763 January 2019, https://www.bis.org/publ/work763.pdf accessed 27th August 2019, 1.

[163] Robert Looney, 'Banking on Baghdad: Financial Change in Postwar Iraq' (2004) 3(5) Strategic Insights. See also, Robert Looney, 'Postwar Iraq's Financial System: Building From Scratch' (2005) 12(1) Middle-East Policy Council, https://www.mepc.org/journal/postwar-iraqs-financial-system-building-scratch accessed 27th August 2019.

[164] Muhammad Hanif, 'Differences and Similarities in Islamic and Conventional Banking' (2014) http://ssrn.com/abstract=1712184http://ssrn.com/abstract=1712184 accessed 5th July 2019, 12.

[165] Kehinde A John, 'The Impact of Bank Fraud on Financial Institutions in Nigeria', <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2190089>accessed on 5th July 2019, 1.

[166] Céline Baud and Eve Chiapello, 'Disciplining the neoliberal bank:

and still remains one of the main causes for concern in the course of banking business. In fact, the greater the volume of non-performing loans, the higher is the possibility that the bank will fail.[167] Because of such considerations, the viability of banks has been measured on the basis of their loan credit performance.[168]

Furthermore, a typical conventional bank will carry out its banking business by both borrowing and lending money, and profiting in a different way from either of these practices. For example, banks accumulate assets (equity and loans) in order to make profit and then they use this profit to accumulate more assets in a (hopefully for them) never-ending spiral. In fact, so that the process of being profitable is carried out at its most effective, banks borrow money (accumulating debt) to purchase more assets or to make potentially profitable investments (known as "leveraging").[169] Simply put, conventional banks finance their investments by utilizing the interplay of debt and equity. When properly used, this activity is trusted to increase the bank's profitability.[170] Furthermore, subject to the rules of prudential regulation being adhered to, there are no impediments, moral or otherwise, for conventional banks to engage in this process.

A big part of successfully profiting from banking business is the ability of bankers to take a calculated transactional risk. Typically the bank encounters the greatest risk when it invests money and when it lends it. How good the debt/equity balancing exercise is or rather, how precise the bank's investment prognosis is, will make the bank stable or not. Out of control borrowing practices can lead to instability of the bank which can be rectified either by taking internal measures or by the bank becoming insolvent and subject to the existing insolvency regulation.[171] To this end, it should be recalled that in a capitalist system, businesses reward themselves for the undertaken risk by preserving most of the profit for themselves. Equally, should the enterprise fail to achieve commercial success, the losses are borne by the entrepreneur.

Credit risk regulation and the financialization of loan management', Working Paper – February 2014 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2417396>accessed on 5th July 2019, 9.

[167] R DeYoung and G Whalen, 'Banking industry consolidation: Efficiency issues', Office of the Comptroller of the Currency, Working paper No. 110 (1994).

[168] Ibid.

[169] Kaouther Toumi, Jean Laurent Viviani and Lotfi Belkacem, 'A Comparison of Leverage and Profitability of Islamic and Conventional Banks' (2011) available <http://ssrn.com/abstract=1836871> accessed 24th November 2017, 2.

[170] Kaouther Toumi, Jean Laurent Viviani and Lotfi Belkacem, 'A Comparison of Leverage and Profitability of Islamic and Conventional Banks', http://ssrn.com/abstract=1836871 accessed on 21th July 2018, 2.

[171] In the EU, the BRRD and Delegated Regulation (EU) 2019/348.

For this reason, when banks invest (typically with borrowed capital), they bear the risk that (should the risk fail to deliver), they may have to repay the debt by selling some of their other assets (or alternatively, they risk to become distressed). However, should a bank is sufficiently big to endanger the financial stability of its creditors, it can prompt contagion among other banks leading to systemic destabilisation.[172]

Scenarios of failing banks are fortunately rare. However, conventional regulators are appreciative of the ill effects of excessive credit risk and have attempted through the years to counteract it through legislation. This tendency has become more visible in the period following the 2008 financial crisis. A strict approach to minimum capital requirements which would help the bank recover from non-performing loans, was adopted in the United States (the so-called Dodd-Frank Act[173]), the European Union (the CRD/CRR packages[174]) and elsewhere in the conventional finance world. Such regulation was more or less loosely based on the Basel Accords and their rationale, namely that it was in the interest of bank solvency for banks to reserve a specific pre-determined cushion of capital on which they could fall upon at times of financial distress.[175]

Most of the scenarios described above are distinct from the case of Islamic banks, not only because they are expected to act in a *Shariah*-compliant way but also because *Shariah* law is situated on the left side of the political spectrum, while capitalism occupies the right. Crucially, even though secular banks exist in non-capitalistic countries, the institution of the modern bank is a product of and thrives best in conditions of capitalism. It makes sense therefore to spend a moment on what capitalism means in real terms and how this compares with Islam.

[172] Lawrence J. White, T'he Basics of 'Too Big to Fail'' (March 2014), NYU Working Paper No. 2451/33564, https://ssrn.com/abstract=2769232 accessed 23rg August 2019.
[173] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L No 111-203, s 201ff, 124 Stat 1375 (2010) (codified at 12 USC s 5381ff) (hereinafter Dodd-Frank Act or DFA), Wall Street Transparency and Accountability Act of 2010.
[174] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance OJ L 176, 27.6.2013, p. 338–436 & Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance OJ L 176, 27.6.2013, p. 1–337.
[175] Baud and Chiapello (n 166), 10.

Unlike Islam, capitalism is individualistic. While it, similarly to Islam, praises individual effort and initiative, and rewards entrepreneurship, it stops short of letting the community assume responsibility for entrepreneurial risk. This is an important distinction because business ventures typically contain substantial financial risk. Capitalism is based on the belief that, subject to the relevant legislation being abided by, it is the entrepreneur who should bear the risk and reap the fruits of his business endeavors.

To recall, entrepreneurship is one of the four factors of production, according to capitalist economic theory; the other being land, labor and capital. While entrepreneurs are expected to provide capital and/or labour for their enterprise, they do so with the expectation of a reward. With respect to capital, the reward for investing it in a certain venture is obtained by the respective individual entrepreneur as (in the form of) interest.[176]

Similarly, when conventional banks work with capital (i.e. with money), investing or loaning it to customers, they expect to be compensated for their efforts. In this sense, interest is nothing more than a well-deserved reward for having fulfilled the expectations arising from the particular enterprise. It is logical therefore that capital or rather, money, became the center piece of banking operations and its main source of income. To this end, money is treated as a commodity, making the investor more money. In comparison, Islam fundamentally disagrees with assigning time value to money and treating it as a commodity, although examples from the practice of Islamic banking and derivative trading suggest that there is a substantial disconnect between reality and theory. This trend has been noted in Islamic finance academic writing.[177]

The simplest way to accumulate income for banks is to accept deposits from their prospective customers and to use these deposits in order to finance loans to other customers.[178] Banks reward the investment of the depositors by giving them a small percentage of interest on top of their

[176] Muhammad Hanif, 'Differences and Similarities in Islamic and Conventional Banking' <http://ssrn.com/abstract=1712184http://ssrn.com/abstract=1712184>accessed on 13th August 2017, 3.
[177] See, for example, Abu Umar Faruq Ahmad and M. Kabir Hassan, 'The Time Value of Money Concept in Islamic Finance' (2009) 23(1) The American Journal of Islamic Social Sciences 66; Monzer Kahf, 'Time Value of Money and Discounting in Islamic Perspective: Re-visited' (1994) 3(2)Review of Islamic Economics 31; M. Fahim Khan, 'Investment Decision Making, Time Value of Money and Discounting in an Islamic Economy' (2017) 30(1) JKAU: Islamic Econ 83.
[178] Hanif (n 176).

deposit and reward themselves for giving out loans by charging borrowers a much higher percentage. Under conditions of capitalism such practices are deemed normal and banks are expected to give out loans, whether personal or business, to customers they have identified as a low credit risk.

However, while lucrative, taking deposits and giving out loans is deemed insufficiently profitable for modern banks. Because of that, the capital which banks have been entrusted with is typically put to more efficient use by the bank pursuing other sources of revenue, including trade, transfers, guarantees or safety of wealth. Generally speaking, these activities are common across all kind of banks, conventional and non-conventional. Where banks differ is not on the type of services they provide but on how they treat the issue of risk and sharing of reward.

For some type of banks, i.e. conventional ones, risk is a tool for making revenue. Banks are not only exposed to risk but they actively seek to participate in risky business ventures because of the reward attached to it. Banks' performance could be affected by exposure to financial risk, interest rate risk, liquidity risk, foreign exchange risk and credit risk,[179] each of which is properly managed in order to increase the possibility of profit and minimize the vulnerability to loss.[180] Such risk-management techniques encompass the source of funds and how they are used. As is known, when depositors in conventional banks deposit money in their vaults, they transfer the risk to the respective bank which guarantees to them a pre-agreed return. In comparison, following the profit and loss sharing principle, deposit guarantee is inadmissible under *Shariah* law.[181] The said deposits are then used by conventional banks to loan money to borrowers. In such a case, the conventional banking model posits that borrowers must pay interest regardless of how high or low the returns obtained by them are. It could be argued that this approach is again in contrast to the Islamic profit and loss sharing principle.

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[179] Fauziah Hanim Tafri, Rashidah Abdul Rehman and Normah Binti Omar, 'Empirical evidence on the risk management tools practised in Islamic and conventional banks' (2011) Research Gate, https://www.researchgate.net/publication/227430222_Empirical_evidence_on_the_risk_management_tools_practised_in_Islamic_and_conventional_banks accessed 23rd August 2019.

[180] M. S. Nazir, A.Daniel & M. M. Nawaz, 'Risk Management Practises: A Comparison of Conventional and Islamic Banks in Pakistan' (2012), 68 American Journal of Scientific Research 114. See also, Mahfod Aldoseri and Andrew C Worthington, 'Risk Management in Islamic Banking: An Emerging Market Imperative' (2016), in Sabri Boubaker, Bonnie G. Buchanan, and Duc Khuong Nguyen (Eds.) *Risk Management in Emerging Markets: Issues, Framework and Modeling*, (Emerald 2016).

[181] But see the discussion on Iran in Chapter 11.

In most cases, conventional banks transfer the risk accumulated by them as a result of such transactions by way of securitization or through the assistance of credit default swaps.[182] By and large, this model of financing is based on debt. Debt-based financing is, however, looked upon with a suspicion in *Shariah* law for reasons that it entrenches inequality.[183]

While the "risk-courting" attitude of conventional credit institutions is in total contrast to the approach to risk in *Shariah* compliant banking institutions, both conventional and Islamic banks aim to manage the risks they are exposed to. However, secular banks do that by transferring the risk to other parties while Islamic credit institutions manage it by way of risk sharing.[184]

This is the case even though the conventional model of banking requires that banks bear the financial consequences of the actions of its managers. In other words, under normal circumstances banks would bear the financial risk as corporations and would not share it with its customers.[185] In the Western model, this shouldering of risk by banks justifies their entitlement to receive a reward if and when their enterprises bring positive returns. To this end, the reward is interpreted as being derived from as well as justified by the risk taken. The bank distributes a small percentage of this reward to its depositors as interest on the deposited money and retains the rest. [186]

This is in contrast with *Shariah* compliant banks, which (as will be discussed throughout this work) have adopted a risk-sharing model on which the relationship between banks and their customers is based.

It is arguable that following the global financial crisis, during which many conventional credit institutions were severely affected and some even ruined, conventional banks started operating in

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[182] Note the use of credit default swaps with respect to the underwhelming performance of European bank stocks in 2016, discussed in Chapter 9.

[183] Ezry Fahmy et al., 'Islamic Finance: Debt versus Equity Financing in the Light of Maqasid al-Shari'ah' (2009) MPRA Paper No. 20722, 5. Of course, this does not mean that debt-based contracts are not used in Islamic finance; they are but their usage is subject to compliance with various *Shariah* norms. See the discussion on the *murabaha* contract or the *sukuk* instrument, Chapters: 7, 8 & 9.

[184] Maher Hasan and Jemma Dridi, 'The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study' (2010) IMF Working Paper.

[185] Of course, this is only *prima facie*. A strong argument could be made that in practical terms conventional banks share the risk of their business conduct with other stakeholders, including customers. The appreciation of this, lead to a variety of post-crisis legislation, including on bank resolution.

[186]Hanif (n 176), 11.

a more heavily regulated environment, resulting in their effectively sharing a greater part of the assumed risks with their customers – and indeed with the rest of the tax payers.[187] For example, in case a bank falls in distress, its national central bank will first attempt to help it by injecting it with capital. [188] Note also that banks have a way of protecting themselves against risk by taking on (or more often by requiring that their customers take on) an insurance policy protecting the bank in case that the risk came to pass. However, even if it is the bank who takes on the insurance policy, its price is usually passed on to the end consumer. An example of that is the long-standing tradition of UK banks to impose obligatory insurance on customer loans. While consumer protection regulation is occasionally able to protect and compensate consumers from such practices,[189] housing loans across jurisdictions retain a requirement for payment-protection insurance,[190] despite some signs that in some European countries the regime is becoming more consumer-friendly.[191]

In addition, conventional banks protect themselves from the risk of illiquidity by employing various tools, such as giving out short term loans, issuing bonds against receivables, leasing company bonds, or by lending in short notices (money at call), investing in government bonds and making equity investments, to name some of the most typical.[192]

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[187] See literature on banks being too big to fail; see, also Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (BRRD).

[188] Hanif (n 176), 16.

[189] Hilary Osborne, 'PPI exposé: how the banks drove staff to mis-sell the insurance' (2012) The Guardian, https://www.theguardian.com/money/2012/nov/08/ppi-expose-banks-drove-staff-mis-sell-insurance accessed 27th August 2019.

[190] Consumer Financial Protection Bureau, 'What is mortgage insurance and how does it work?' (2017) The US Government, https://www.consumerfinance.gov/ask-cfpb/what-is-mortgage-insurance-and-how-does-it-work-en-1953/ accessed 27th August 2019. For a UK perspective, see Council of Mortgage Lenders, 'Insurance Requirements' (2019) https://www.cml.org.uk/consumers/about-mortgages/insurance/ accessed 27th August 2019. For a glimpse at the requirements in Spain, see Strong Abogados, 'Mortgages in Spain' (n.d.) https://www.strongabogados.com/mortgage.php accessed 27th August 2019. Banks cannot force the hiring of products such as insurance, pension plans or cards that condition the price or the granting of the loan, unless they adhere to the criteria of the Bank of Spain.

[191] See The New Mortgage Act in Spain, which states that "Banks cannot force the hiring of products such as insurance, pension plans or cards that condition the price or the granting of the loan, unless they adhere to the criteria of the Bank of Spain." See Costaluzlawyers, 'The New Mortgage Act in Spain' (2019) https://www.costaluzlawyers.es/2019/02/25/the-new-mortgage-act-in-spain/ accessed 27th August 2019.

[192] Julia Hoyle and Geoffrey Whitehead, *Elements of Banking: Made Simple* (Hainemann Professional Publishing 1987), 129.

Furthermore, regulation protects banks by requiring them to maintain a reserve (which also earns interest), divided between the respective national central bank and investments in government bonds. Of course, *Shariah*-compliant banks also employ many of the above risk-management devices and are, just as conventional banks, subject to the requirements of the Basel III framework.

The above, however, supports an argument that conventional banks are well insulated from the risk of their investment policies while they stand to profit most from the capital entrusted to them by their investors and depositors. This begs a question as to why banks are allowed to retain their privileged position, despite the obvious disparity in the relationship with their customers. The simplified answer is that banks, particularly large ones, serve important social roles, in addition to doing banking business, such as, *inter alia*, storing value and coordinating the market.[193] Foreshadowing the discussion on FinTech, it should be noted that the proliferation of FinTech and specifically, the entrance of Blockchain and cryptocurrencies into modern banking and financial services, as well as the overexpansion of BigTechs, has made the future of traditional banks uncertain. Regardless of which institutions will take over the role of coordinator of markets and guardian of value in the future, this is likely to be someone other than legacy banks.

This pessimistic prognosis notwithstanding, allowing banks to proliferate and develop in the West contributed to the establishment of a sophisticated and multilayered financial market, where novel investment strategies (and instruments) have provided the foundation for further economic growth. To this end, approaching banks as mere service providers, the performance of which is measured solely on the basis of risk and reward distribution, would be misguided; and it could not provide sufficient insight when comparing the conventional system to the Islamic one.

5.2.2. Shariah law's prohibitions in focus

This section will present an analysis of the main prohibitions imposed by *Shariah* law on the Islamic finance framework: *Riba* (interest), *Qimar* (games of chance), *Gharar* (uncertainty) and

[193] For a quick summary of the main arguments pro and against banks, see Chaya Benyamin, 'Are Banks a Force of Good or Evil?' (2018) The Perspective, https://www.theperspective.com/debates/businessandtechnology/banks-force-good-evil/ 23rd August 2019.

Maysir (speculation). It will touch upon the remaining relevant proscriptions and will compare the Islamic framework to the conventional as appropriate.

5.2.2.1. Riba: prohibition of interest

Riba means excessive interest or usury. While it is widely known that imposing *riba* is forbidden in Islam, [194] what may be less well known is that both Christianity and Judaism have also and for centuries imposed a ban on usury.[195] On its part, Islamic finance recognises different versions of *riba*: for instance *riba al-fadl*, where one would obtain profit, that is both excessive and unlawful or a form of *gharar* - *riba al-nasi'a*, where one would gain 'an unlawful advantage by speculating on uncontrollable risk'. [196] Note in this connection that, according to some scholars, the *riba* concept does not fully overlap with the Western notion of interest and should therefore not be analysed within the same lines,[197] while some even suggest that the prohibition is either outdated[198] or it is misunderstood.[199]

The theoretical debate aside, in practice the *riba* principle means that Islamic financiers and lenders are prohibited from charging interest on investments and loans. The rule is in force because charging interest on money is regarded in Islam as an 'unjustifiable increase of capital'. To appreciate the extent of the prohibition, note that *riba* bans usury but also loaning of money with even *some* interest. This stands in contrast with the approach in Christianity and Judaism which forbid excessive interest, as well as with conventional lending, to which interest is instrumental.

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[194] Qur'an, Meaning of the Glorious Quran, translated by M. M. Pickthall, 2: 275-278.

[195] Jean-Françis Seznec, 'Ethics, Islamic Banking and the Global Financial Market' (1999) 23-SPG Fletcher World Aff 161. 165; see also the Bible in Ezekiel 18:8 and Deuteronomy 23:19 which discusses these prohibitions as applicable to both Christians and Jews. See also Daniel Klein, 'The Islamic and Jewish Laws of Usury: A Bridge to Commercial growth and Peace in the Middle East' (1995) 23 Denv J Int'l L. & Pol'y 535, 541-544.

[196] Malkawi (n 25), fn 39.

[197] Hans Visser, Islamic Finance: Principles and Practice (Edward Elgar 2009), 32.

[198] Muhammad Zahid Abdul Aziz, 'The Negative Impact of Riba Banking on the Performance of Islamic Banking in Dual Banking System' (2012) https://www.academia.edu/3294279/The_Negative_Impact_of_Riba_Banking_on_the_Performance_of_Islamic_Banking_in_a_Dual_System accessed 6th May 2019.

[199] Feisal Khan, *Islamic Banking in Pakistan: Shariah-Compliant Finance and the Quest to Make Pakistan More Islamic*, (Routledge 2015), 54.

This prohibition, as well as others which will be discussed later, should not be perceived as an Islamic ban on entrepreneurship. Quite the contrary: Islam promotes entrepreneurship and places great value on investing one's effort, labour and initiative in a project. It cannot be denied nevertheless that *Shariah* law positions entrepreneurship within certain, well-determined parameters. For example, as touched upon already, money in Islam could only be used for the purposes of buying and selling of goods and services. In theory, equating money with commodity is strictly forbidden, as is storing money in the bank with the intention of gaining interest on them.[200]

This approach to money has been the focal point of many a debate. Furthermore, the proposition that money should not be perceived as a commodity has been qualified over time. In addition, there has been uncertainty as to whether money possesses time or quantity value.

How this concept is applied in reality, is seen in the case of Islamic loans. Despite the prohibition on *riba*, Islamic finance currently allows the imposition of small amount of money, additional to the principal amount, in Islamic loans. This is not considered interest and is subject to many conditions being satisfied. Furthermore, it is intended to serve as a compensation that money loses its value over time and appreciation that the money loaned are directed away from another, perhaps more profitable investment.[201]

5.2.2.2. The riba ban in the banking business

The consistent imposition of the *riba* ban, including in banking, results in a lending model where lenders are necessarily invested in the success of the business venture they finance, leading to a more lenient treatment of borrowers and to a greater scrutiny of the viability of the proposed investment. Furthermore, as a result of the operation of the *riba* ban, the risk inherent in and the profit derived from a business venture is not solely imposed on or enjoyed by the borrowing party but is shared by the lender.[202] While this method of lending brings some specific challenges in addition to the ones banks have traditionally had to tackle, to date this remains the way Islamic lending operates. Although the debate on *riba* is currently ongoing, as it has been for centuries,

[200] Malkawi (n 25), 281.
[201] Malkawi (n 25), 281-282.
[202] Hans Visser (n 85), 27.

leading to sometimes more relaxed but more often more stringent approach to the prohibition, the current trend in Islamic finance is to regard all *riba* as non-permissible.[203]

As this author has argued elsewhere,[204] the prohibition on *riba* may in certain circumstances affect trading and investing. For example, consider the stance of the Institute of Islamic Banking and Insurance, which is that 'any guaranteed increase in return tied to the maturity and the amount of principal, regardless of the performance of the investment, would be considered *riba* and is strictly prohibited'.[205] From a conventional finance point of view, the extent of this definition is significant because it would cover most bonds and loans, and perhaps other instruments too.

As will be seen below, this paper will offer an argument that many of the currently traded Islamic derivatives should be considered conventional instruments, dressed-up in a *Shariah*-compliant way. If this is indeed the case, it would not be unreasonable to expect that any tightening of the regime in a *Shariah* compliant jurisdiction would bring about a total prohibition on derivatives, perhaps with a few exceptions. However, although this seems like a logical outcome, the research undertaken in this work suggests that political radicalization does not necessarily translate into a radicalized financial market (although some correlation between the two has been observed).[206] Indeed, whether this will be the case will depend a great deal on how strict the respective *Shariah* regime has become, as well as on other, more pragmatic considerations. Whatever path is chosen, the *Qur'an*'s pronouncements on *riba* will be a starting point for any policy discussion. This necessitates an analysis of the *Qur'an*'s approach to usury, provided below.

[203] Muhammad Mazhar Iqbal, 'A Broader Definition of Riba' (n.d.) http://www.pide.org.pk/pdf/psde%2018AGM/A%20Broader%20Definition%20Of%20Riba.pdf accessed 23rd August 2019.
[204] Maria Todorof, 'Shariah-compliant FinTech in the banking industry' (2018) ERA Forum (2018) 19:1–17 https://doi.org/10.1007/s12027-018-0505-8, 5.
[205] Institute of Islamic Banking and Insurance: Shari'ah Rulings and Finance (n.d.). http://www.islamicbanking.com/shariah-rulings-finance.aspx accessed 5th January 2018. For examples how this may play out in practice, see the discussion on *sukuk* in Chapters 9 & 10.
[206] See the discussion on Iran's banking practices in Chapter 11: [11.6.2.].

5.2.2.3. Doctrinal considerations: the Quran's view on riba

The *Qur'an*'s position on *riba* is aligned with the social justice tendencies of the Islamic faith. The idea is clear and simple; there is no confusion in the mind of Muslims as to why the prohibition exists. As an example, one majorly negative consequence of *riba*, on which scholars across all Islamic schools agree, is *riba*'s potential to corrupt the moral of society by normalizing the misappropriation of somebody else's property. The discussion on ownership in the preceding sections highlighted that Muslims treat ownership as sacrosanct, to the point that they have traditionally rejected expropriation for policy reasons or foreclosure due to unpaid debts.[207] In this undisputed view, *riba* is *zulm* (fundamentally unjust) and destructive, it demeans people and it diminishes one's personality. In a different, more technical narrative, *riba* is feared to lead to negative growth and financial instability.[208] This exhaustive but true to the Islamic credo take on *riba* is based on the *Qur'an* which states:

> *"Those who swallow usury cannot rise up … That is because they say: Trade is just like usury; whereas Allah permits trading and forbids usury. He unto whom an admonition from his Lord comes and (he) refrains (in obedience thereto), he will keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returns (to usury) - Such are rightful owners of the Fire. They will abide therein. … Allah has blighted usury and made almsgiving fruitful. Allah loves not the impious and guilty. Lo! Those who believe and do good works and establish worship and pay the poor-due their reward is with their Lord and there shall no fear come upon them neither shall they grieve. O you who believe! Observe your duty to Allah and give up what remains due to you) from usury, if you are (in truth) believers. And if you do not then be warned of war (against you) from Allah and His messenger. And if you repent, then you have your principal (without interest). Wrong not and you shall not be wronged. And if the debtor is in straitened circumstances, then (let there be) postponement to (the time of) ease; and that you remit the debt as alms giving would be better for you if you did not know".*[209]

[207] See Chapter 5.

[208] Mohammad Nejatullah Siddiqi, 'Riba, Bank Interest and the rationale of its prohibition', Islamic Development Bank, Islamic Research and Training Institute, Visiting Scholars' Research Series No.2 (2004), 41.

[209] Qur'an, *Meaning of the Glorious Quran*, translated by M. M. Pickthall, 2: 275-280.

The *Qur'an* views *riba* as condemned by *Allah* and therefore unacceptable for the faithful. The verse focuses repeatedly on the benefits of giving any extra wealth accumulated during trade back to the poor and on refraining from usury. The practical implications of *riba* are perceived negatively because of the tendency of multiplication, inherent in interest.[210] It is because the extra wealth is created by multiplication rather than effort, that *riba* is deemed sinful by the *Qur'an*, which suggests that the extra part should be given away to charity rather than used for oneself.[211]

While scholars tend to agree that *riba* loosely refers to what in the West is perceived as "interest", the term can also be translated as "growth". This translation is arguably more appropriate since it sheds some extra light onto the religious reservations to the concept. In the context of loans for instance, although the concept of *riba* indeed represents the interest paid under the contract, it also refers to all late payment penalizations.[212] This makes *riba* the sum of all that the consumer pays over and above the principal. The words "over and above" are key because in the case of interest the words "over and above" are seen to mean "excessive".

The imposition of such an excessive payment obligation is viewed by the *Qur'an* very unfavourably because it breeds societal corruption (*fasad*). Relevantly, in Islam *fasad* conceptualizes a plethora of evil occurrences, going far beyond usury. It encapsulates the acts of 'dividing people into classes and discriminating between them',[213] bloodshed,[214] the 'destruction of crops and people',[215] 'giving people less than full measure and wronging them in their goods',[216] the arrogance founded on extreme wealth,[217] 'severing the ties of kinship'[218] and sexual perversion.[219] In other words, *fasad* encompasses dehumanization, waste, racism and elitism, the breaking of the family unit, the lack of modesty and humility, and the adoption of unconventional intimate choices.

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[210] Ibid, 3:130.
[211] Qur'an (n 209), Chapter 30, *al- Rum*, 30:39.
[212] Ibrahim Zaki el-ddin Badawi, *Nazariyat al-Riba'l Muharram* , Cairo: Al-Majlis al-A'la li Ri 'ayet al-Funun wa'l-Aadab wa'l 'Ulum al-Ijtima'iyah, (1964), 26-41.
[213] Qur'an (n 209), 28: 4; Siddiqi (n 208), 42.
[214] Qur'an (n 209), 2:30.
[215] Qur'an (n 209), 2: 205.
[216] Qur'an (n 209), 11: 85; 26: 183; Siddiqi (n 208), 42.
[217] Qur'an (n 209), 28:77.
[218] Qur'an (n 209), 47:22.
[219] Qur'an (n 209), 29: 28-30.

The *fasad* complex network of morally reprehensible conducts, which seem disparate at first glance but are very much interconnected on a deeper view, is a comprehensive concept. Much like *Shariah* itself, it covers the whole spectrum of the moral negatives penetrating society's life. This understanding of the interconnectedness of conduct and the measuring up of a society's value by looking at its conduct is a fundamental feature of the Islamic moral thought.[220] In turn, Islam has created an ideal concept of what and how society should be. If this ideal is imagined to be a structure, to be created by the parties to the Islamic social contract, the prohibitions of *Shariah* are intended to be the parts creating this construct. In this narrative, each piece, regardless of its size, is crucial to the completeness of the picture.

Because of this, and of the understanding that humans are fallible and the human mind deficient, *Shariah* has given Muslims a step by step guide to what is permitted and what is clearly not, as well as what may be allowed, subject to certain conditions being satisfied. From a modern perspective, this practical approach to the interaction of the spiritual with the earthly is intended to serve both as a code of conduct (morality) and a rulebook (law), thus assisting the practical navigation of Islam.

For example, as highlighted above, the *Qur'an* draws a link between the act of imposing *riba* and the concept of unlawful appropriation of another's property. Because of this, in Islam '[I]nterest on money is regarded as representing an unjustified creation of instantaneous property rights: unjustified, because interest is a property right claimed outside the legitimate framework of recognized property rights; instantaneous, because as soon as the contract for lending upon interest is concluded, a right to the borrower's property is created for the lender'.[221]

To make the above concept understandable to believers, the *Qur'an* singles out the usury practising money lenders. Such people were condemned for 'taking usury when they were forbidden it, and of their devouring people's wealth by false pretenses'.[222]

In addition to misappropriation of other people's property, the *Qur'an* underlines *riba*'s ability to promote false economics. This transpires in *riba*'s divergence from traditional trade based on

[220] Discussed in Chapter 4: [4.1.].
[221] Mohsin S Khan, and Abbas Mirakhor (editors) *Theoretical Studies in Islamic Banking and Finance*, Houston, Texas: The Institute for Research and Islamic Studies, (1987), 4.
[222] Qur'an (n 209), 4: 161, sura al-Nisa'.

buying and selling of goods and services. A big practical flow of *riba* is that instead of relying on real, certain and predictable transactions, it corrupts money and turns it into a commodity while as a result, promotes lending with charging interest.[223] In the *Qur'an*'s view, trading and charging interest are two distinct notions and the latter has no connection to the real economy.

In this narrative, the *Qur'an* prohibits *riba* not only because it is unjust and morally unsafe but because it perceives it as ultimately leading to the financial demise (*mahq*) of society through the diminishing of the individual and communal wealth.[224] Before all however, this inevitable downward spiral applies to moral values rather than material assets, and to the inability of usurers to contribute meaningfully to the wellbeing of society. The importance of the topic of *riba* merits that Islam's view on it is once again juxtapositioned to the approach to interest adopted in conventional finance.

5.2.2.4. Conventional lending: pricing of risk in different scenarios

The concept of charging interest is related to the practice of money lending. Due to interest being most commonly charged by conventional banks than by other conventional credit providers, the following section will discuss the example of banks, without however excluding other financial services providers from its conclusions.

When a bank lends money, it assumes the risk that the debtor will default on their loan. In this transaction, it is the bank (B) that provides its customer (C) with capital, which is then used by C to finance his own enterprise. The money provided by B as a loan (L) is treated in the transaction as a factor of production. Since B risks its capital, it must be rewarded. In this context, the additional money paid to B by C in the form of interest is the reward for the risk undertaken by B. From a capitalist point of view,[225] the transaction is not unfair because C uses L to generate value for himself, which, if successful, he will not share with B.

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223 Siddiqi (n 208), 43-44.
224 Qur'an (n 209), 2: 276.
225 Farooq Aziz et al., 'Justification of Reward of Capital in the Capitalist Economic System' (2013) 16(6) IOSR Journal Of Humanities And Social Science 83; For a more general overview of the principles of capitalism, see Bruce R. Scott, 'The Political Economy of Capitalism' (2006), Harvard Business School Working Paper No 07-037.

The loan transaction between B and C could be represented as trading on the basis of risk and profit probabilities, where the interests of the parties could be aligned or in conflict. In circumstances of stability, a lender may favour having a defaulting debtor because this would generate a better return on his investment. This may prompt a relaxed attitude to lending where more loans are distributed to customers and the price of capital is relatively low. It is arguable that in this scenario the interest of the lender and the debtor are in conflict because, due to interest accruing, the defaulting debtor will likely pay more until he returns his debt, than he would if he paid his debt on time. Examples of this playing out would be a credit card debt or a restructured loan debt. Furthermore, in situation of stability, interest rates are likely to be low, which while beneficial for debtors has proven to lower the overall profit of lenders.[226] This may once again influence banks to prefer defaulting debtors, subject to eventually receiving back the loaned money plus the accrued interest and the penalty for late payments.

In contrast, in circumstances of financial crisis, the bank will be less inclined to lend capital and the price of capital will rise. In this scenario, both debtor and creditor will have interest that the debt is returned on time, despite the great profitability for banks, because of the uncertainty and fluctuations of rates, often accompanying financial crises.[227] It is arguable that in such circumstances the interests of the bank and the customer are aligned because both parties could be negatively affected by rates fluctuations. Furthermore, empirical data suggests that the volume of activity attained by the banking sector would be affected by changes in the interest rate, not necessarily bringing greater profits to the bank.[228]

Whatever scenario takes place, it is clear that interest remains a fundamental feature of conventional banking.[229] For this reason, it has been institutionalised and highly regulated by

[226] Carlos Pérez Montes and Alejandro Ferrer Pérez, 'The impact of the interest rate level on bank profitability and balance sheet structure' 35 Revista de Estabilidat Financiera, Banco de Espana & DG Financial Stability, Regulation and Resolution 123, 125. See also R Dobbs, S Lund, T Koller and A Shwayde, 'QE and ultra-low interest rates: Distributional effects and risks', (2013) Report by McKinsey Global Institute, November 2013 and S&P Global, 'Negative Interest Rates' (2016) S&P Global Market Intelligence Report.
[227] Fabio Canova, 'The Sources of Financial Crisis: Pre-and-Post Fed Evidence' (1991) 32(3) International Economic Review 689, 689.
[228] Carlos Pérez Montes and Alejandro Ferrer Pérez, 'The impact of the interest rate level on bank profitability and balance sheet structure' 35 Revista de Estabilidat Financiera, Banco de Espana & DG Financial Stability, Regulation and Resolution 123, 148.
[229] Muhammad Hanif, 'Differences and Similarities in Islamic and Conventional Banking' (2014) Available at SSRN: <http://ssrn.com/abstract=1712184http://ssrn.com/abstract=1712184> accessed 21st November 2017, 3.

authorities, making it a relatively stable source of income. Although conventional and Islamic banks are similar in many ways as they are business ventures and should be profitable in order to exist, they differ fundamentally on the matter of risk and reward, represented through interest. To the extent an Islamic bank will undertake a risk, it will share the reward derived from the transaction with its customer. More to the point, such a reward could never be fixed in advance, because Islamic retail loans must not contain a pre-determined profit. In comparison, conventional banks loan out money on the basis of fixed interest rate on loans. Not having certainty in this respect would be considered unacceptable for a Western customer because this would interfere with him managing his long-term financial strategies.

5.2.2.5. The views of Islamic scholars: arguments in favour and against the ban

Those financial institutions which aspire to comply with *Shariah* would not be able to carry out its business in the same (the conventional) way, due to the various prohibitions found in Islamic finance law and more specifically, the prohibition on interest. This presents Islamic banks with a difficult choice because they are too, like conventional banks, in the business of creating wealth. Importantly, value generation is in itself compliant with *Shariah* because in the *Shariah* narrative, the more value is being generated, the greater the wealth of the community. Furthermore, Islam places a big emphasis on the balanced development of all aspects of an individual's life and expects that all such aspect would co-exist in harmony. [230] The spiritual and the material are not, in the Islamic view, in contradiction; rather, the material is necessary to achieve a state of all-round wellbeing for the population.

The above considerations however do not justify imposition of interest in financial transactions *per se*, because Islamic scholars believe that value may be generated even without application of interest. More importantly than that, *Shariah* law strives to solidify the status of the real economy in Muslim-populated countries. In connection with this, Siddiqi argues that a debt based

[230] Mohammad Nejatullah Siddiqi, 'Riba, Bank Interest and the rationale of its prohibition', Islamic Development Bank, Islamic Research and Training Institute, Visiting Scholars' Research Series
No.2 (2004), 30.

economy, such as the Western one, operates in the following ways: by exchanging goods for money, goods for debt, goods for goods, debt for money, debt for debt and money for money.[231]

The first three forms of exchange are *Shariah*-neutral because they take place in the real economy. This includes even transactions, in which goods are exchanged for debt because Islam accepts debt, as long as the transaction is transparent, straightforward and linked to a tangible asset. As regard barters (exchange of goods for goods), *Shariah* advises the monetization of the transaction.[232] In case this is not the approach elected by the contractual parties, to ensure compliance with *Shariah* they have to abide by the rule that the exchanged goods must be equal in value and their exchange should be simultaneous. Failure to do the former may result in *riba* in excess (*riba'l-fadl*). Not abiding by the latter may render the parties liable of *riba* in delay (*riba'l-nasi'a*).[233]

Considering that exchanging goods for money, debt or in a barter transaction is a part of the operation of the real economy, it becomes even more important that commercial transactions are not contaminated by interest, speculation or gambling, fraud, hoarding, hazard, coercion, exploitation of need or lack of transparency. Any of the above practices is considered by *Shariah* law to be detrimental to the real market. This is so much the case that *Shariah* law provides quite specific instructions on what is not permitted – for example, the list includes *najsh* (raising prices by making false bids) and *jahl mufdi ila al-niza* (lack of information leading to dispute).[234]

The last three forms, discussed by Siddiqi: debt exchanged for money or other debt and money exchanged for money are prevalent on the financial markets. *Shariah* scholars accept that due to

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[231] Ibid, 31-32.

[232] There are conflicting opinions on the matter. See, for example , A K M Meera & M Larbani, 'Seigniorage of fiat money and the Maqasid al-Shari'ah: The compatibility of the gold dinar with the Maqasid' (2006) 22(1) Humanomics 84, who argue that 'barter trade is inferior to one with money because it poses some problems during exchange. Some of those problems are double coincidence of wants, unidentified medium of exchange and limited diversification of production. … in barter economy efficiency is lower because of scattered medium of exchange function of money and, therefore, the standards of living would be lower than what would be in case of monetary exchange.' In Alam Asadov, 'Money in Islam: A Social Contract Perspective' (2017) https://www.researchgate.net/publication/319813210_MONEY_IN_ISLAM_A_SOCIAL_CONTRACT_PERSPECTIVE accessed 5th JUly 2019, 4.

[233] Siddiqi (n 208), 32. See also, Valentino Cattelan ed., *Islamic Finance in Europe: Towards a Plural Financial System* (Edward Elgar 2013), 43.

[234] Mohammad Nejatullah Siddiqi, *Role of State in the Economy: An Islamic Perspective*, (The Islamic Foundation 1996), 104-05.

its detachment from the real economy, financial markets tend to create inequality between the transacting parties. This is caused by, among other things, informational asymmetries. [235] This finding makes it even more important, according to *Shariah* finance theorists, to apply rigorous screening of all transactions with respect to the prohibited practices enumerated above.

Furthermore, despite certainty and transparency being high on the list of Islamic finance values, both being promoted constantly in theory and in practice, it is the matter of *riba* – the prohibition of interest – which receives most attention during the discussion about the future of Islamic banking.

A bit surprising perhaps, but there have been arguments that the *riba* prohibition needs to be relaxed in the interest of the development of the industry and the wellbeing of the community. For example, such critics of the current regime have pointed out that savers would benefit from obtaining interest on their savings and this would serve as an incentive for them to deposit their money in the bank.[236] In addition, the practice of banks giving out loans without charging interest for it contradicts established banking practices in an increasingly interconnected world. It puts such banks at a grave disadvantage, possibly leading to their collapse. One collapsed bank is a considerable problem in itself but it is unlikely that the collapse will remain confined to a single credit institution. Rather, the market will experience a set of contagion-based banking failures which may seriously undermine systemic stability.

A more technical argument in favour of interest suggests that because the price of capital fluctuates, due to a number of factors, linking capital with interest would indicate its price in a reliable way. More importantly however, interest is known to promote equilibrium between the supply and demand of capital and to facilitate its efficient allocation. In doing so, it could serve as an important project management tool.[237]

In addition to the above arguments, scholars have noted that the prohibition on *riba* has been caused by misinterpretation of the Prophet's words. For example, Cizakca argues that Prophet Mohammed received divine guidance[238] to make Makah the global trade hub. This made it

[235] Siddiqi (n 208), 33.
[236] Siddiqi (n 208), 33.
[237] Siddiqi (n 208), 57.
[238] Qur'an (n 209), 2: 198.

necessary to promote monetary trade and move away from barter, which was seen as a form of *riba*.[239] This interpretation has been subjected to a lot of scrutiny and caused statements that Islamic economists have 'misunderstood the concept and it opened door to various wrong interpretations about Riba.'[240]

Nevertheless, scholars have continued arguing that including some form of interest in the Islamic finance framework would be efficient and will not contradict *Shariah* law. For example, Faridi suggests that Islam does not prohibit interest in its current (allegedly non-exploitative) condition because the prohibition was imposed to counteract the exploitative and unjust trading system in pre-Muslim Arabia, which came to be replaced by the new, more progressive Islamic structure.[241] Siddiqi speaks within the same lines, reminding that while the purpose of the *riba* ban was to avoid the exploitation of the individual, we can no longer talk of exploitation, due to, in particular, the existing extensive consumer protection legislation and more generally, the rule of law. Furthermore, it has been added that ordinary savers could only benefit if they receive additional income, paid by banks, on their savings. This would suggest, according to these scholars, that in the current conditions, usury does not exist and if it does, it is not a part of the regulated system.[242] This is a bold statement, which could be easily challenged by reference to credit and store cards, popular in the conventional economy - the often extortionate interest rates of such cards disadvantage their customers significantly.

The argument that interest is a tool of exploitation has been further explored with the conclusion that 'it contradicts facts because nowadays ultimate borrowers are businessmen and ultimate lenders are salaried individuals, the former being financially better off than the latter.'[243] Iqbal continues on to claim that the other prominent reason for the prohibition of interest, namely, that 'interest-based external financing leads to unfair distribution of profits [a]lthough …not wrong,

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[239] Murat Cizakca, 'The Islamic Gold Dinar - Myths and Reality' (2011) 3(1) ISRA International Journal of Islamic Finance 49, https://www.academia.edu/3241886/Islamic_Gold_Dinar_Myth_and_Reality accessed 5th July 2019, 50.

[240] Umar Vadillo, 'Answers to the Questions of the Federal Shariah Court of Pakistan' (2013) https://umarvadillo.wordpress.com/2013/10/19/answers-to-the-questions-of-the-federal-shariah-court-of-pakistan/ accessed 27th August 2019; See also, Alam Asadov, 'Money in Islam: A Social Contract Perspective' (2017)https://www.researchgate.net/publication/319813210_MONEY_IN_ISLAM_A_SOCIAL_CONTRACT_PERSPECTIVE accessed 5th July 2019.

[241] Fazlur Rahman Faridi, 'Riba and Interest', in Islamic Studies (Islamabad), March, (1964), 1-43 and 7-8, 37-41.

[242] Siddiqi (n 208), 58.

[243] Muhammad Mazhar Iqbal, 'Prohibition of Interest and Economic Rationality', (2010) 24(3) Arab Law Quarterly 293, 293.

…is not very appealing in positive economics.'[244] Iqbal, nevertheless, suggests that one economically sound justification for preserving the prohibition would be that 'the risk of an investment is least when financed exclusively by equity'.[245] Thus, while not devising a direct link to religious theory, Iqbal makes an argument that compliance with *Shariah* law will be beneficial to systemic stability.

Furthermore, Siddiqi qualifies his conclusions on *riba* by stating that as far as consumption loans are concerned, there should be no *riba* because it would be amoral to impose it on customers taking up such loans to assist their daily lives. However, he is of the opinion that if the loan is a commercial one, which would suggest that the borrower intends to profit through it, the imposition of *riba* should be permitted. Lastly, Siddiqi says: '[I]t is not the riba prohibited in Islam as it is only a predetermined rate of profit that the bank agrees to pay as an agent of the depositor who entrusted to it the task of profitable employment of the deposited capital'.[246] By this, he arguably suggests that from a religious point of view, the practice of profit and loss sharing is superior to that of imposing interest, regardless of the type of loan.

5.2.2.6. Al-Qimar: Shariah law's approach to games of chance

Another important prohibition operating on the Islamic market is the ban on *qimar* (or "*al-qimar"*, meaning "betting and waging/ gambling"). This prohibition on games of chance is based on the understanding that such activities necessarily comprise of a winner and a loser. [247] *Shariah* law places a prohibition on *qimar* in the course of investments where investors are hoping that an excessively risky venture will have a lucky outcome. This is forbidden because it is perceived as gambling.[248] The same prohibition applies *vis-à-vis* endeavors to profit excessively or abnormally by price manipulation through syndicating, spreading rumours or engaging in other underhand

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[244] Ibid.
[245] A Iqbal, 'Liquidity risk management: a comparative study between conventional and Islamic banks of Pakistan' (2012) 12(5) Glob. Bus. Manag. Res. Int. J. 57.
[246] Siddiqi (n 208), 58.
[247] Qur'an (n 209), 5:90; Investopedia, ' Gharar' (2017), https://www.investopedia.com/terms/g/gharar.asp accessed 5th January 2018.
[248] M U Chapra, *Towards a Just Monetary System*, (The Islamic Foundation 1985).

practices.[249] Consequently, 'unusual, illogical, manipulated, and unethical speculation in the stock market, which refers to trading in the stock market purely for short-term gains, resulting in an uncertainty in the market and sure losses, or longer term positioning of the share for others' would also be covered by this prohibition.[250] Importantly, *qimar* can be proven by looking at the intentions or conduct of investors, meaning that it is disconnected from the actual financial reward.[251] However, the prohibition does not ban investment decisions, which shun uncertainty or excessive risk and are taken after a 'fundamental analysis with the intention of getting a normal profit from the market.'[252]

The *qimar* prohibition may become relevant in the context of some conventional financial instruments (for example, futures), because of the high degree of risk they contain. From this perspective, because futures are speculative in nature, they should be explicitly forbidden by *Shariah* law.[253] Note however, that according to some theorists, despite the inherent risk contained in them, some derivative contracts (not just futures but also forwards) could be deemed *Shariah*-compliant as long as measures have been taken to offset their riskiness. An example of such measures would be the introduction in the respective contract of terms and conditions that are consistent with *Shariah* law.

5.2.2.7. Denouncing maysir: proscription on gambling

The concept of "*maysir*" prohibits 'risk-taking that involves unlawful appropriation and the gain of one party at the expense of the other'.[254] The prohibition is based on the *Qur'an*, where it is stated:

> *"O ye who believe!*

[249] Sahih al-Bukhari, Book 3, Volume 34 (Sales and Trade), Hadith 367 http://www.sahih-bukhari.com/ accessed 15th April.

[250] Md. Mahmudul Alam and Chowdhury Shahed Akbar, 'Rationality of the Capital Market: Capitalistic System vs. Islamic System' (2015) 5(3-4) International Journal of Behavioural Accounting and Finance 279, 288.

[251] Sahih al-Bukhari, Book 1, Volume 1 (Revelation), Hadith One, http://www.sahih-bukhari.com/ accessed 15th April 2017 in Md. Mahmudul Alam and Chowdhury Shahed Akbar, ibid.

[252] Md. Mahmudul Alam and Chowdhury Shahed Akbar (n 250).

[253] See the discussion on futures in Chapter 6: [6.3.4.2.].

[254] Marilyn Siew-Ai Ong and Chun-Phuoc Jeong, Commodity Futures Trading: Its Permissibility According to Sunni Traditionalists Ijtihad and Ijtihad Maqasidi' (2012) 13(2) International Journal of Business and Society 93, 101.

Eat not up your property

Amongst yourselves in vanities

But let there be amongst you

Traffic and trade

By mutual goodwill:"[255]

The verse refers to unlawful appropriation of another's property by either *riba* or *maysir*. Similar to *qimar*, m*aysir* means gambling, including games of chance, which are in their totality prohibited by *Shariah* law because they generate randomly obtained or luck based income. *Shariah* favors profit obtained after a careful consideration of whether the transaction will necessitate taking of risks and if yes, what the degree of such risks would be. Note that, similar to the prohibition on *qimar*, the prohibition of *maysir* is a strict one; the offending conduct is prohibited by default. This means that gambling will be prohibited solely because one engages in it, even if it does not bring financial rewards.

The *maysir* prohibition is justified by the consideration that the unearned income in the gambling context is achieved through immoral inducement and on the basis of *qimar*: when receiving or endeavoring to receive *maysir*, the agent hopes to profit by chance (by either gambling or speculating), which is unacceptable under *Shariah* Law.[256]

5.2.2.8. Gharar: the approach to risk and uncertainty in Islamic law

Gharar means excessive risk and uncertainty. *Shariah* law prohibits taking of excessive risk, deceiving of one's transacting counterparties and engaging in deals wrought with uncertainty. Once again, this differs fundamentally from the approach of conventional (Western) finance which has adopted a business model based on risk. In contrast, the prohibition of *gharar* is imposed in Islam to ensure that transacting parties will not be deceived due to inherent

[255] Al-Qur'an, Sūrah Al-An-Nisaā' (n 209), 4:29.
[256] Sherif Ayoub, *Derivatives in Islamic Finance: Examining the Market Risk Management Framework*, (Edinburgh University Press 2014), 189.

uncertainty, such as unclear contract terms or uncertain quality of the product in which the parties deal.[257] To this end, uncertainty is treated very broadly and is taken to encompass price, object, time and particularly the subject matter of the contract with respect to which contractual certainty must not be compromised because of excessive risk, inherent uncertainty or insufficient information.[258] Nevertheless, it must be acknowledged that measuring the degree of risk (i.e. is the risk excessive) or the uncertain outcome of a financial transactions could be difficult in practice.

The prohibition on *gharar* covers all instances of commodities that cannot be delivered to the buyer, commodities that are not tangible at the time of contracting and those that are illegal or are not a result of one's efforts or labour. Any commodity or goods fulfilling this requirement cannot become a subject of the contract and therefore cannot be sold to a contracting party. A good example of this would be animal or fish that have yet to be hunted or fished. Under this analogy, derivatives should be, strictly speaking, forbidden or at least objected against under the *gharar* prohibition, because the profit derived from them depends too much on external factors that are to be guessed by the business person (in this number, currency fluctuations or increases and decreased of the value of instruments on the stock market). However, note that any goods that are tangible, legal and productive do not contradict the *gharar* principle and they could be subjected to securitization.

A small number of theorists hold, however, that there could be an exception to this prohibition if forecasting is made using the trader's own intelligence rather than relying on luck.[259] This more relaxed approach corresponds with the view that *gharar* should not be interpreted too strictly or else the Islamic market risks contraction rather than enjoying the expansion it has been through recently.[260] Furthermore, not all denominations treat the prohibition in the same way. For

[257] Todorof (n 204), 6.
[258] Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice* (CUP 2008), 59. See also Haider Ala Hamoudi, 'The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law' (2008) 56 Am. J. Comp. L. 423, 444.
[259] Malkawi (n 25), fn 46.
[260] Sajjad M. Jasimuddin, 'The Stock Exchange and Islamic Finance: Some Thoughts for a Reconsideration' (2001) Vol.14 (2) The Islamic Q. 105, 108.

example, Iranian (*Shia*) jurists have adopted a more relaxed stance on *gharar*, the justifications for which will be explored more fully in Chapter 11.[261]

5.2.2.9. Products or industries which are prohibited to trade with/in under Shariah law

Shariah law prohibits trading in some products. Among them are alcohol, pork (and all meat not slaughtered in accordance with *Shariah* law), tobacco, illegal drugs and activities, weapons, particularly those that cause collateral damage, as well as products of the entertainment industry (including adult entertainment, erotic art, some types of non-Islamic music and films and gambling).[262]

Chapter 6: Risk management techniques in modern finance: derivatives

6.1. Shariah law's risk management tools

Managing of risk is a very important part of conventional as well as *Shariah* finance. The following section will offer an argument that the Islamic financial tradition manages risk by employing the prohibitions on *riba* and *gharar* in conjunction and in pursuance of the fundamental values of Islam.

The ban on *gharar* implies that excessive risk is proscribed in *Shariah* compliant transactions. The prohibition targets ordinary investors pursuing a transaction that could be deemed excessively risky and the party (usually a bank) willing to fund the investment.

[261] Chapter 11: [11.6.2.7.].

[262] F Jamaldeen, 'Seven Prohibited Industries in Islamic Financial Investments (2017), http://www. dummies.com/personal-finance/islamic-finance/seven-prohibited-industries-in-islamic-financialinvestments/ (accessed 5 January 2018).

It is suggested that by shunning risk, Islamic finance law achieves two distinct goals. First, it avoids a system where the poor would be getting poorer due to the negative impact of a spiraling debt. This proposition is based on the assumption that a retail investor may incur debt if he makes unsound or risky investment decisions. On a macro prudential note, controlling risk restrains financial speculation, which could potentially lead to micro prudential failures and systemic instability.

It must be acknowledged that Islamic finance does not rely solely on *riba* and *gharar* to achieve its objectives. Rather, it aspires to create a holistic framework where each principle supports and interlinks with the next. For example, in the context of banking, not only does *Shariah* law prohibit *riba*, it also forbids trade in intangible financial goods; the intention is that the effect of these bans would contribute to a more stable economy.[263] Furthermore, in addition to interest, *Shariah* law does not permit speculation (*maysir*) or any form of financial uncertainty or *risk* (*gharar*),[264] because it perceives them as based in immorality, caused by deception and illusion (including self-illusion).[265]

While this interconnectedness is truly enforced, it is feasible that some of the prohibitions, most notably on *maysir* and *gharar*, may potentially undermine development of a sophisticated business framework. As an example, the prohibition of *gharar* is due to *Shariah* law's fixation with contractual certainty regarding quantity, quality and delivery date under the contract and particularly with the idea of clarity of the subject matter of the contract. This sets it apart from modern conventional finance which thrives on speculation and risk[266] or from Western contract law which places a considerable value on the concept of *caveat emptor* (buyer beware) in distinction to the Islamic idea that fairness of contractual relations should be upheld before everything.

The restrictive effect of the prohibition on *gharar* could be better appreciated if one considers how it, together with the proscription on *maysir*, prevents Islamic Finance from resorting to practices resembling conventional insurance. The shunning of conventional insurance is justified by reference to a separate prohibition (taking money up front for something that is not certain to

[263] Visser (note 85), 27.
[264] Visser (note 85), 25.
[265] Visser (note 85), 25.
[266] Visser (note 85), 25.

take place in the future). The uncertainty here is double – it refers to one's inability to foresee future happenings and particularly to the insurer's lack of strict guarantees that the injured party will be made whole if an undesired financial outcome comes to pass. This understanding of conventional insurance is justified by data on how often conventional insurers pay in such circumstances, pointing that their approach to reimbursement is too restrictive for the Islamic understanding.[267]

Furthermore, note that *Shariah* law does not accept not sharing in the risk as part of issuing of insurance policies. Even more importantly, Islamic law prohibits paying in advance in order to protect from or reduce financial risk. [268] The *Shariah* law answer to this is an Islamic insurance concept (*takaful* (solidarity)), whereby 'a group of participants agree amongst themselves to support one another jointly against a defined loss. … the participants contribute a sum of money as wholly or partially *tabarru* (donation) into a common fund, which will be used mutually to assist the members who suffer a defined loss or damage.'[269]

The above perhaps helped highlight that *Shariah* theorists see a strong link between economic development, financial stability and the Islamic moral principles. Furthermore, this illustrates that when considering the way Islamic finance law functions and develops in practice, one must not only take account of the religious and philosophical foundations of this framework but also of the way they are perceived and applied by people in their day to day life.

We have so far determined that the restrictive regulatory framework established in Muslim countries is justified by and founded on *Shariah* law; therefore, it has a religious origin. A separate point should be made however, on the practical effect of having in place an Islamic orientated financial services regulatory model. While the propensity of Islamic finance to promote systemic stability remains largely outside the topic of this work, it should be mentioned that empirical data from the 2007-2008 crisis period suggests that at the relevant time the

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[267] Misab Pt, 'Takaful (Islamic Insurance); Comparative Study on Conventional Insurance and Islamic Insurance' (2015) academia.edu, https://www.academia.edu/12178808/TAKAFUL_ISLAMIC_INSURANCE_COMPARATIVE_STUDY_ON_CONVENTIONAL_INSURANCE_AND_ISLAMIC_INSURANCE accessed 23rd August 2019. See also, IAIS, 'Issues Paper on Conduct of Business in Inclusive Insurance' (November 2015) https://www.iaisweb.org/file/57850/issues-paper-on-conduct-of-business-in-inclusive-insurance accessed 23rd August 2019, Principle 22.

[268] Visser (note 85), 26.

[269] Azman Mohd Noor, 'A Shariah Compliance Review on Investment Linked Takaful in Malaysia' (2009) 17(1) Islamic Economic Studies 1, 1.

performance of banks operating under the *Shariah* model was good.[270] Relevantly, this outcome has been linked to *Shariah*'s distaste for interest based lending, which led to curtailing in the Islamic financial market of the risks associated with lending. The immediate effect of doing so was that Islamic banks became more resilient to the threat of insolvency. [271] The argument that the *Shariah* finance model is resilient is further supported by the supposition that the Islamic profit and loss sharing model insulates the business (the borrower) from a substantial part of the associated commercial risks, while passing some of them onto the lender.

Furthermore, their good performance during the financial crisis was credited mostly to Islamic banks' unusually high capital-assets and liquidity ratio. While the latest years have made us witnesses to a certain degree of "conventionalization" for Islamic banks, measured for example by looking at the share of fee-based to total income,[272] the Islamic credit institutions have largely remained compliant with their religious obligations. This has been reflected in their higher liquidity – i.e. in their capital - assets ratio, which is in favour of capital. While this result was achieved through their adhering to the relevant *Shariah* duties, it was also the outcome of operating in an unsophisticated market where the possibilities to invest without charging or obtaining interest are few.[273]

Nevertheless, Islamic banks' good performance in the period of 2007-2008 could give force to arguments in favour of maintaining or developing a strict(er) *Shariah*-based regulatory framework. Such restrictive behaviour could affect strongly the Islamic market for derivatives, particularly because conventional derivatives are widely perceived as unsuitable for *Shariah* compliant markets. Why is that the case?

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[270] Mohammed Ebrahim Hussien et al., The Performance of Islamic Banks during the 2008 Global Financial Crisis: Evidence from the Gulf Cooperation Council Countries --- Journal of Islamic Accounting and Business Research (2019) https://www.researchgate.net/publication/319182400_The_Performance_of_Islamic_Banks_during_the_2008_Global_Financial_Crisis_Evidence_from_the_Gulf_Cooperation_Council_Countries_---_Journal_of_Islamic_Accounting_and_Business_Research accessed 15th September 2019, 10-17. See also, International Monetary Fund, 'IMF Survey: Islamic Banks: More Resilient to Crisis?' (2010) https://www.imf.org/en/News/Articles/2015/09/28/04/53/sores100410a accessed 23rd August 2019.

[271] Visser (note 85), 28.

[272] Thorsten Beck, Asli Demirguc-Kunt and Ouarda Merrouche, 'Islamic vs. Conventional Banking: Business Model, Efficiency and Stability', World Bank Policy Research Working Paper 5446 (2010).

[273] Visser (note 85), 29.

Simply put, derivatives are suspect in the *Shariah* finance rulebook because they are risky and closely linked to interest. Both features are prohibited by *Shariah* law. This gives a negative connotation to derivatives and acts as a deterrent for Islamic credit institutions, which become as a result, less likely to enter into them. This is unsurprising, even without considering *Shariah* law's implications, because derivatives are perceived one of the main contributors to the 2007-2008 financial crisis. From the point of view of Islamic banks, caution would give them lesser exposure to shocks and greater overall resilience, compared to their conventional counterparts. It is, therefore, conceivable that prudential considerations are likely to persuade some of the financial players and investors to remain conservative. Whether this trend could expand and bring in stricter prohibitions is a matter to be considered in some detail later in this work.[274]

The rest of Chapter Six will contribute to the discussion by briefly reviewing the main types of conventional derivatives: forwards, futures, options and swaps. This will be followed by a review of the principles of ethical finance and the most essential conventional financial concepts.

The discussion on how risk fits in within Islamic Finance jurisprudence and the comparison with conventional finance has highlighted that attitude to risk is one of the two major points of distinction for conventional and Islamic finance. The second point on which they diverge is the way income is earned. Conventional finance is risk friendly, unlike the *Shariah* compliant one. This is not to say that taking of risk is prohibited *per se* by *Shariah*. Rather, *Shariah* proscribes excessive risk. Furthermore, *Shariah* finance – similarly to conventional finance - sees risk as an attribute to financial transactions, which should be properly managed so that the possibility of losses and by extension, of financial crises, is minimized.

To this end, it should be noted that while conventional finance has traditionally thrived on risk, managing of risk has become an important part of modern, post-crisis Western financial regulation. So much so that considerations of how risk is assessed, weighted and handled underlined most of the post 2007 financial regulation, for example the MiFID II,[275] EMIR[276] or

[274] More specifically, in Chapters 11 & 13.
[275] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.
[276] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories Text with EEA relevance In force, OJ L 201, 27.7.2012, p. 1–59.

the CRD package.[277] Managing of risk through regulation is a strategy that contrasts with the regulatory approach prior to the 2007-2008 crisis, namely reliance on derivatives as a risk management tool. The perception that derivatives can miraculously "cure" situations of high risk, bringing them to a state of normality, proved to be rather persistent because even despite the shocks of the last decade, derivatives are still widely used for risk management purposes in the West.[278]

This quality of derivatives did not work out quite as planned in the 2007-2008 period, however, as has been widely argued during the last decade. Most notably, what commentators have strongly suggested was that among other things it was derivatives which contributed meaningfully to the 2007-2008 collapse of the Western financial markets.[279]

True as this may be, not all derivatives have been created equal and not all of them are by default extremely risky. As just one example, the US Financial Crisis Inquiry Commission pinpointed synthetic securities as adding to the losses that shook markets and financial institutions in 2008.[280] Furthermore, the report by the Commission highlighted the risky subprime securitization and the over-the-counter, unregulated derivatives as magnifying the crisis,[281] which it stated was instigated, among other things by 'a combination of excessive borrowing [and] risky investment'.[282] The following section will give a brief technical introduction to derivatives and the linked to it process of securitisation. Upon doing so, the Chapter will deal with the way derivatives fit within the Islamic finance framework.

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[277] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC;
Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance In force OJ L 176, 27.6.2013, p. 1–337.

[278] Kimberly Amadeo, 'Derivatives, With Their Risks and Rewards' (2019) https://www.thebalance.com/what-are-derivatives-3305833 accessed 25th March 2019.

[279] See, for example the report by the US Financial Crisis Inquiry Commission, 'The Financial Crisis Inquiry Report' (January 2011) https://cybercemetery.unt.edu/archive/fcic/20110310173545/http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_full.pdf accessed 3rd April 2018.

[280] Ibid, xvi.

[281] US Financial Crisis Inquiry Commission (n 181), xviii.

[282] US Financial Crisis Inquiry Commission (n 181), xix. Note the discussion on the regulatory deficiencies of the *sukuk* instrument, developed in Chapter 10.

6.2. The derivative instrument and securitization as risk management techniques

6.2.1. Conventional framework

Derivatives are, before everything, contracts to buy and sell, concluded between two or more parties.[283] Generally speaking, derivatives are used for a variety of purposes, chief among them hedging of risk and speculation. As their name suggests, the value of these financial instruments is *derived* from the underlying asset,[284] which could be a single asset, such as security or a set of assets, such as index.[285] Very often the following instruments are used as underlying assets: bonds, commodities, currencies, interest rates, market indexes and stocks.[286] The most commonly used derivatives are futures contracts, forward contracts, options and swaps.

Securitization is a process creating structured fixed income products, pooling various types of contractual debt and selling them as bonds, pass-through securities or collateralized mortgage obligation (CMOs) to investors. Article 2 of the Securitisation Regulation, defines the process as constituting of

> *'a transaction or scheme, whereby the credit risk associated with an exposure, or a pool of exposures, is tranched, having both of the following characteristics: payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme'.*[287]

Another definition describes this legal structure as having the 'following essential generic features:

> *(1) formation of contractual rights over a pool of cashflow generating financial assets;*
>
> *(2) with the optimisation (repackaging, tranching) of the economic benefits (cash flows) and risks generated by this pool;*

[283] Jean Folger, 'What is a derivative?'(2018) Investopedia, https://www.investopedia.com/ask/answers/12/derivative.asp accessed 5th April 2018.
[284]Ibid.
[285] Jean Folger (n 283).
[286] Jean Folger, (n 283).
[287] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012, OJ L 347, 28.12.2017, p. 35–80, Article 2.

(3) with the subsequent transfer of the repackaged benefits and risks to third parties (referred to as investors);

(4) issuing debt, customarily in the form of transferable securities;

(5) where the said debt is backed by the underlying assets; and

(6) where the value of the debt depends on the value and/or the performance of the underlying assets.'[288]

It transpires that, much like derivatives, securitisation can be used for risk and benefit transfer, as well as for value optimization. To this end, note that a security is defined as an instrument

> *primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, [financial instrument]…plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders.*[289]

Depending on the type of risk transfer, securitisation could be defined as traditional or synthetic.[290] The former type involves an SSPE (the securitisation special purpose entity) and issuance of securities and the latter does not necessitate either of these two conditions.

In the process of traditional securitisation the legal title of the asset is effectively transferred to the issuer of the securities, the SSPE. The outcome of this is that the originator's balance sheet no longer contains the underlying assets and the cash flows generated by these assets transfer to the SSPE. In distinction, the case of synthetic securitisation allows that 'the ownership of the securitised exposures remains with the originator (that is, the exposures remain on the balance sheet) and the credit risk is transferred with the use of credit derivatives or financial guarantees.'[291] In other words, in this type of transactions, the originator credit institution will preserve the legal title to or ownership of the reference assets. Since the underlying asset will not

[288] Kirill Glukhovskoy and Joseph Tanega, 'CDOs under siege: Part 1: compliance under the IAS and Basel II', (2006) 21(11) JIBLR 652, 653.

[289] US Securities and Exchange Commission, 'Asset-Backed Securities', Final Rule, p.39, Federal Register, 70(5) (Jan 7, 2005) p.1515, http://www.sec.gov accessed on 06th May2019.

[290] T. Frankel, 'The Law of Cross-Border Securitization: Lex Juris' (2003) 12 Duke J Comp Int'l L 475 http://childedlaw.org accessed on 6th April 2017.

[291] Angelos Delivorias, 'Synthetic securitisation: A closer look', European Parliament Briefing (June 2016). Note the connection to asset-based *sukuk*, discussed in Chapters 8 & 10.

be transferred during synthetic securitisation, entering into derivatives is *prima facie* beneficial to the originator.[292] For originators, the main positive feature of securitization is that it assists in credit risk management. Through securitization, assets that were previously risky and illiquid become less risky and more liquid financial instruments.[293] The conversion of illiquid assets into securities is done to facilitate transactions with them, including their sale.[294]

In summary, through securitization originators gain more available capital which could be invested in business while diminishing their credit risk. This feature makes securitization very attractive to issuers, a tendency which has seen a particular peak in the years just preceding the latest financial crisis.[295] These findings do not indicate that the process of converting risk into securities is devoid of risk. For example, the transfer of risk may bring a false sense of security and prompt as a result excessively risky business ventures. The unpredictability of such financial tactics could lead to further hedging and commensurate increase of risk. In addition to that, the mere engagement in over securitization creates an inherent fear that the sensible degree of risk has been reached and surpassed; this, in itself, brings along justified fears of financial crisis,[296] which can be alleviated only by further hedging.[297]

Furthermore, the resulting product may be fraught with errors, which can have a negative effect on market participants and eventually, on the health of the market itself. To this end, note that the Barclays Capital Research report argues among other things that: 'soaring defaults are due to weak underwriting rather than weaker housing or a sudden risk in monthly payments due to the structure of certain mortgages.'[298]

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[292] P Jeffrey, ed., *A Practitioner's Guide to Securitisation* (City & Financial Publishing, 2006), 5-6.

[293] Mohamed Saad Lahlou and Joseph Tanega, 'Islamic Securitization: Part I—Accommodating the Disingenuous Narrative', (2007) 6 JIBLR 295, <http://ssrn.com/abstract=1148360>accessed on 9th September 2017, 296; See also Basel Committee on Basel Committee on Banking Supervision 'International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Comprehensive Version' (Basel II) (2006) in *Credit Risk—Securitisation Framework*, s. IV A, http://www.bis.org, 120.

[294] See T Frankel, *Securitization: Structured Financing, Financial Asset Pools, and Asset-Backed Securities* (1991 & Supp. 2002), 3.

[295] Bank for International Settlements (BIS), 'BIS Quarterly Review' (2006), 20 http://www.bis.org accessed on 7th June 2017.

[296] See G. Tett, 'The Unease Bubbling in Today's Brave new Financial World' (2007) January 19, Financial Times, http://www.ft.com/cms/s/0/92f7ee6a-a765-11db-83e4-0000779e2340.html#axzz35B60DpZv accessed on 13th June 2004, 20, which bases its conclusions on

[297] Lahlou and Tanega (n 293), 296.

[298] In Tett (n 296).

Despite the risks, securitisation has maintained its compelling qualities to date, demonstrated by its growth in the conventional market, which increased in the years after the crisis. This signifies that the benefits provided by this process far outweigh the inherent challenges (or so it is hoped).[299] In this connection, one should not forget that conventional finance theory espouses the belief that the market is capable of self-regulating and even self-healing, meaning that in the face of volatility, it is expected to naturally increase risk control and improve liquidity.[300] Of course, such an optimistic prognosis of the market is more rarely seen in the years after the global crisis.

6.2.2. Islamic Securitisation

The tendency to favour securitisation in the years preceding the global financial crash has also been observed in the Islamic market, [301] which however showed much greater resilience in the face of the crisis, despite (or perhaps because of) the increased resort to securitization.
In terms of the structure of the process and its checks and balances, while it is governed closely by *Shariah* law,[302] it also remains subject to the applicable principles of international financial regulation. As securitization was introduced in Islamic markets as a result of the Western influence and the ever increasing commercial interactions with conventional financial partners, it inevitably bears strong linkage to the original.

Furthermore, even though the Islamic market develops in ways that are unique and true to the values of *Shariah*, it has been appreciated that interaction with the Western principles and rules is unavoidable. The consensus is that to the extent that trade with the West is desired and carried out by Muslim countries, Islamic Finance must abide by the obligations posited by conventional

[299] P J Davies, 'Snags Lie Ahead for Securitisation' (2007) January 18, Financial Times, 37.
[300] See, M MacKenzie, A Gangahar and S Scholtes, 'The Avenging Goddess Volatility Vents Her Anger' (2007) March, Financial Times, 43.
[301] Standard and Poor 'Islamic Finance is Securitization's New Frontier' (2006) http://www.securitization.net accessed on 7th April 2017.
[302] H A Hamoudi, ''Muhammad's Social Justice or Muslim Cant: Langdellianism and the Failures of Islamic Finance' (2006) 40 Cornell International Law Journal, 19–25, http://ssrn.com, accessed 5th April 2017.

regulation,[303] while however remaining true to *Shariah* values and its national and cultural idiosyncrasy.[304] So far in the context of securitisation and derivatives trading, this has not proven to be easily achieved, [305] for reasons that will be explored further in this work. What happened in reality, instead of the ideal fusion conceived by theorists, is a mixture of obligations, performed in the context of the international standards set by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB).[306] To introduce some context, AAOIFI is a standard setting body, which oversees whether the existing Islamic Finance instruments comply with the conventional rules.

While the obligations referred to above are governed by the principles of *Shariah* law, they allow the employment of the traditionally accepted as well as some novel Islamic financial instruments.[307]

6.2.3. Derivatives: a historical view

Perhaps surprisingly, trading with derivatives is not a new idea. For example, instruments such as rate swaps, currency derivatives and structured products were quite commonly used in ancient times although understandably, they were not quite as sophisticated as their modern equivalent. There is evidence that futures contracts were used in Mesopotamia during the second millennium BC[308] and that even prior to that, between 4500 and 4000 BC, the people of Sumer used financial tools resembling futures in their business practices.[309] These developments continued through Ancient Greece (recorded forward contracts and derivatives trading), the Champagne fairs in

[303]See C Jordan, 'The Conundrum of Corporate Governance' (2005) 30 Brooklyn J Int'l L 983, 990, referring to K. Pistor, 'Patterns of legal Change: Shareholder and Creditor Rights in Transition Economies' (2002) European Bank for Reconstruction and Development, Working Paper No. 49 http://papers.ssrn.com accessed on 5th November 2017.
[304] See P Legrand, 'The Impossibility of Legal Transplants' (1997) 4 Maastricht J. Euro. & Comp. L. 111.
[305] Mohamed Saah Lahlou and Joseph Tanega, 'Islamic Securitisation: Part II—A Proposal for International Standards, Legal Guidelines and Structures' (2007) 22(7) JIBLR 1, 18.
[306] AAOIFI, 'Islamic Finance Standard-Setting Bodies AAOIFI and IFSB Join Forces' (2017) http://aaoifi.com/announcement/islamic-finance-standard-setting-bodies-aaoifi-and-ifsb-join-forces-to-strengthen-the-development-and-resilience-of-the-islamic-financial-services-industry/?lang=en accessed 7th May 2019.
[307]Lahlou and Tanega (n 195), 297.
[308] See the famous Dojima Rice Exchange known as the first modern futures market: Mark D. West, 'Private Ordering at the World's First Futures Exchange' (2000) 98(8) Michigan Law Review, Symposium: Empirical Research in CommercialTransactions 2574.
[309] Raja Palaniappa, 'A Brief History of Derivatives' (2017) https://originmarkets.com/origin-hosts-issuer-roundtable-in-parallel-with-the-25th-annual-euromoney-global-borrowers-conference-3/ accessed 1st April 2019.

Medieval Europe (international clearinghouses for credit), on the 1515 Antwerp's Bourse, where forward contracts were traded and during 18th century Japan, where the first secondary market for derivatives was founded and a clearing house was put into operation.[310] In the 19th century notable was the contribution of the Chicago Board of Trade, which introduced various standardised agreements and regulations pertaining to the use of these instruments. The activities outlined above suggest that the idea of a derivative was easy to form because of their convenience and high degree of practical usefulness. For this and other reasons various versions of these instruments were utilized across cultures, geographical locations and times. This utility aspect of derivatives is an important reason why they should remain a part of modern finance, including Islamic finance.

It is arguable that derivatives proliferated so much in the last decades because of the invention of the computer and the Internet. This is why the early years of modern derivatives are often located in the recent past and more specifically, the early 1970s. Coincidently, this is also the time when Islamic Finance and Islamic banking came into being. It is likely that these two developments occurred not by chance but as a result of a specific set of circumstances operating at the material time. For example, the revival of derivatives was arguably caused by the increased volatility of the financial markets in the West.[311] Importantly, the 70s were also a time of change for the Middle East. [312] This was the time when the much discussed Islamic Revival became most prominent, its ideologists seeking to create *Shariah*-based legal structures, including in finance. [313] The Islamic finance framework was therefore born out of the post-colonial sentiments of the Middle Eastern nation States and a desire to deliver a *Shariah*-compliant answer to the Western financial system, which would function in the Muslim world.[314]

For these reasons, little by little and over the course of the last few decades, derivatives, which have meanwhile become a fixture of conventional finance, would find their way, in one form or another, into the *Shariah* compliant financial markets. This gradual absorption of Western financial practices took place not because or rather, not only because the proponents of *Shariah*

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[310] Ibid.
[311] Ernst Juerg Weber, 'A Short History of Derivative Security Markets' (2008) SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1141689 accessed 25th April 2019.
[312] Chedli Mallat, *The Renewal of Islamic Law: Muhammad Baqer as-Sadr, Najaf, and the Shi'i International* (CUP 1993).
[313] Ibid.
[314] Chedli Mallat (n 312).

finance wanted to emulate the example of the West. Rather, it happened because of the perceived benefits associated with derivatives and perhaps above all, because of their ability to hedge risk.

6.3. Derivatives in conventional and Islamic finance: function, strategies and technical characteristics

6.3.1. Overview

While the ability of derivatives to protect against risk will be the main focus of this section, their use goes beyond being a risk-hedging device. For example, if properly used, they could add extra sophistication and inject new energy into the market: the economic functions provided by them are, in addition to risk management: assisting in price discovery[315] and improving transactional (market) efficiency. In summary, it is widely accepted that derivatives are used to:

- protect against price movements (not just increases but also decreases of price)
- increase exposure to price movements for speculative purposes
- assist with markets penetration
- assist with the movement of more illiquid assets.[316]

Each of these features (or aspirations) of derivatives trading could be potentially beneficial in its own right. However, arguably the most important quality of these instruments is their risk controlling function.

[315] Derivatives can assist in determining the price of the underlying asset. For example, the spot price of a future may provide information about the price of the underlying commodity. See, Corporate Finance Institute, 'Derivatives' (2019) https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/derivatives/ accessed 1st April 2019.

[316] James Chen, 'Derivatives' (2019) Investopedia, https://www.investopedia.com/terms/d/derivative.asp#advantages-of-derivatives accessed 23rd August 2019.

6.3.2. Shariah issues with derivatives' risk-management strategies

The starting point in the analysis of the risk management aspect of derivatives must be the consideration that risk management serves to protect existing profits and not to create new profits. Profits are protected by hedging against the risk of loss. To this end, "hedging risk" means employing a strategy to protect from the risk of loss. In this context, a "hedge" means a risk reducing investment.[317]

Hedging is however not a foolproof strategy for success. While the expectations are that the hedge and the underlying asset will move in different directions, external events may cause them to align, thus causing losses to the hedging party. Such external events could be man-made or force majeure. An example of the former was the global financial crisis of 2007-2008. Floods, nation-wide or industry-wide strikes, or war would fit the description of the latter. [318]

To exemplify that the Islamic Finance challenges related to derivatives are likely to start from the point of the definition, let us consider a more technical description of what hedging comprises of: 'the act of taking an offsetting position in a related security, which helps to mitigate against adverse price movements.'[319] Although risk hedging is in itself permitted under *Shariah* (because the reduction of risk protects the economy and individual people's wealth),[320] this particular definition could be *Shariah* problematic because of its strong connotation to insurance. This connection becomes evident if one decides to insert the words "to insure" in the place of "which helps to mitigate". Perhaps the way to avoid such an interpretation of the definition is to read the words "to mitigate" as meaning "to limit the damage" and not as "to bet against the risk to lose". This is, in any case, a potentially loaded definition and one that demonstrates the challenges which conventional derivatives can present in a *Shariah* finance context.

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317 Nathan Reiff, 'Hedge' (2018) Investopedia, https://www.investopedia.com/terms/h/hedge.asp accessed 4th April 2019.
318 Ibid.
319 Steven Nickolas, 'How can derivatives be used for risk management? (2018) Investopedia, https://www.investopedia.com/ask/answers/052615/how-can-derivatives-be-used-risk-management.asp accessed 10th May 2018.
320 Azlin Alisa Ahmad, Mustafa `Afifi Ab. Halim and Nadhirah Nordin, 'The Viability Hedging Instruments in Current Application' (2014) 8 International Business Management 327, 327, https://www.medwelljournals.com/abstract/?doi=ibm.2014.327.335 accessed 12th April 2019.

Another issue would be that hedging can act as a risk-reward. This means that if the risk of some adverse event happening comes to pass, hedging against this risk brings financial reward to the party (minus the price of the hedge). As such, this protection comes at a cost which, just like an insurance policy, consists in the premium or the fixed fee payable, depending on the particular product. It makes sense that greater risk will need greater (more expensive) hedging, which may result in surpassing the point of cost-effectiveness. Cost-efficient yet successful hedging appears to require, therefore, balancing between providing for too little and too much protection. Furthermore, hedging requires attention and alertness; and eyes on the prize, whereas "the prize" is the ultimate transactional benefit targeted by the hedging party(ies). Notably, the ultimate benefit from a transaction does not always coincide with a financial reward. As an example clarifying this concept, consider a big corporation, which has issued bonds in order to finance an enterprise. In this scenario, hedging the bonds would be seen favorably by future investors, even if, on the whole, the hedge may end up being too expensive or not profitable enough.

Note that from an Islamic Finance point of view, the above is unsustainable and should not be allowed. First, *Shariah* law does not allow a party to a commercial transaction to be rewarded for taking a risk, particularly when the context is speculative, which is often the case with derivative trading. Secondly, hedging for the sake of lulling future investors into a false sense of security will be fraudulent, which is unacceptable in Islam. Another option would be that the hedge compensates for incompetent or speculative investment on behalf of the bank. In this scenario, hedging is not treated as risk-reward but as a micro prudential device. However, it is suggested that even in this context hedging will not be acceptable under *Shariah*, because of the prohibition on speculation and gambling. It appears that while Islamic Finance does make some use of hedging, it subjects it to a number of conditions and allows its operation in a very restricted way. This applies above all to the use of hedging as a risk-controlling device.

6.3.3. Conventional finance, derivatives and risk management: further exploration

Conventional finance uses derivatives in order to hedge risk in three main areas:

- To ward off foreign-exchange or foreign currencies risks – the risk that the currency rate underlying the contract will change thus causing financial losses: this is often used in cross-border trade.
- To hedge interest-rate risk: this could be used in the context of loans, particularly for business investment.
- To hedge commodity or product input: this is often used in the agricultural business, transportation or any other business that rely on the supply of raw materials.[321]

It could be argued that risk is a *functional* characteristic of the derivative instrument. That not only are derivatives employed to protect the contracting parties from various risks but without making risk a (*the*) fundamental element of their operation, they will not be useful to the market. Although there are other uses for derivatives, such as price discovery and market penetration, their main value is in managing of risk. Risk is both the environment where derivatives operate and their justification for being on the market.

(A bracket should be open here to recall instances when derivatives are used for the purpose of side-stepping some rule such as, for instance, the disclosure regime in the context of takeovers. In such examples, shareholders with a large shareholding avoid the obligation to disclose their holdings by entering into a swap transaction with respect to the "excessive" shares, whereby they acquire the interest in the swap and the "excessive" percentage of shares are formally held by a third party. This type of transactions, as well as the above mentioned occasions when derivatives are used for market penetration or to move hard-to-trade assets, prove the versatility of derivatives and are obviously an exception to how important risk is to the derivative instrument.) However, it is hardly surprising that the overwhelming majority of derivatives are used for hedging. Given the prominent prohibition on excessive risk, imposed on *Shariah* compliant finance, this aspect of conventional derivatives will be explored further during the discussion on their Islamic finance equivalents.

It would be useful to remember that while the nature of derivatives is inherently risky, this in itself does not define them as speculative or excessively risky instruments. To this end, a

[321] David Harper, 'How Companies Use Derivatives to Hedge Risk' (2018) Investopedia, https://www.investopedia.com/articles/stocks/04/122204.asp accessed 10th May 2018.

distinction should be made between risk and excessive risk or even speculation. Obviously, what is deemed excessive depends a lot on the interpretation of "excessive" and the respective risk appetite, bringing some vagueness into the area. The bottom line is, that controlling derivatives in the Islamic (and also in the conventional markets) may become an easier task if regulators focus on regulating the environment within which these instruments operate – providing transparent and well-regulated structures, capable of controlling and absorbing the volatility of derivatives, rather than plainly discarding them as may be the case in some instances.[322] This opinion is shared by some contemporary Islamic writers who suggest that in order to protect the public interest (*maslaha al-amm*) and the Islamic *Shariah* goals (*maqasid 'al-Shari'ah*) 'new local policies and regulatory frameworks for the futures industry [should] be set up by governments and futures industry regulators, with the assistance of academic researchers, to combat the negative effects of financial globalisation on [derivatives]… trading.'[323]

Let us now recall that the International Monetary Fund characterized derivatives back in 1998 as 'specific financial risks [that] can be traded in financial markets in their own right'.[324] Depending on the viewpoint, if derivatives are indeed tantamount to risk, fighting (market) risk with (more) risk makes for either a very sophisticated market structure or for a combustive power, undermining financial stability. In reality, derivatives have performed both purposes[325] and this underlines the importance of having them strictly and efficiently regulated.

Considering the above arguments and the not too sophisticated stage of the Islamic market, the cautious attitude of *Shariah* financiers towards derivatives is easily understood, even without taking note of the *Shariah* based objections to derivatives. Such cautiousness is justified and it indeed should remain in place until such time that the Islamic financial markets become fully capable to absorb the risk emanating from derivatives.

[322] For a fascinating discussion on the topic see, Richard L Sandor, *Good Derivatives A Story of Financial and Environmental Innovation*, Audible Studios on Brilliance Audio; Unabridged edition (July 26, 2016).
[323] Marilyn Siew-Ai Ong and Chun-Phuoc Jeong, Commodity Futures Trading: Its Permissibility According to Sunni Traditionalists Ijtihad and Ijtihad Maqasidi' (2012) 13(2) International Journal of Business and Society 93, 93.
[324] International Monetary Fund, 'Financial Derivatives' (2011) https://www.imf.org/external/np/sta/fd/index.htm accessed 23rd August 2019.
[325] As an example see the latest financial crisis.

Nevertheless, while it is arguable that the first two applications of these instruments[326] (protecting against price movements (not just increases but also decreases of price) and increasing exposure to price movements for speculative purposes) should in theory remain outside Muslims' market practices, because they draw on insurance against bad financial luck and speculation respectively, the second two objectives of derivative trading should be considered positively. Assisting with markets penetration and helping with the movement of more illiquid assets, which derivatives can do, is not in obvious conflict with Islamic principles. In addition, employing derivatives for these purposes could potentially be beneficial for Islamic banks which, while characterized with high liquidity, have a tendency to stagnate combined with a low appetite for investment.[327] Furthermore, there may be circumstances where derivatives could be used to manage the risk related to price movements, however in a *Shariah* compliant way. Whether this would be taken to be the case or not would depend on the approach of the interpretative authority. The different outcomes following a moderate or radical interpretation of *Shariah* norms can be relevant, particularly because it is here – at the protection against price movements – where the real benefit of derivatives lays.

6.3.4. The most commonly used derivative contracts in focus

6.3.4.1. Forwards: use in the conventional and their interpretation in the Islamic finance

Forward contracts ("deferred" contracts) are contracts for exchange of goods and money at a future date where the price of the goods is agreed upon at the time of signing of the contract. For example, on 20th November 2016 party A and party B enter into a contract whereby party A promises to deliver to party B on 30th November 2016 10kg apples at a price of Euro 1, 50 per kilo. Party B agrees to purchase the lot at the quoted price and to pay for it on 30th November 2016. As we can see, there are a number of promises to this contract which must be honored at a

[326] As per the above analysis.
[327] A Iqbal, 'Liquidity risk management: a comparative study between conventional and Islamic banks of Pakistan' (2012) 12(5) Glob. Bus. Manag. Res. Int. J. 57; See also, J Muhammad and I Manarvi, 'Performance comparison of Islamic and conventional banks in Pakistan' (2011) 11(1) Glob. J. Manag. Bus. Res. 7 and H.A.Loghod, 'Do Islamic banks perform Better than Conventional banks: Evidence from Gulf Council Countries' (2006) API-Working Paper Series, Arab Planning Institute—Kuwait, Information Center.

future date in order for the contract to be performed as initially intended. These promises refer to the kind of product, the quantity of the product, the price per kilogram product and the day of delivery (we could also add to the contract a promise that the apples will be of a certain quality or any other promise, for that matter). In total, there is the promise that the product will indeed be delivered under the agreed conditions and on the agreed date and that the buyer will indeed pay on the agreed day and the agreed amount.

For the sake of clarity, the above example concerns apples; however, forward contracts are mostly used with currency and particularly when one party wants to purchase an item (could be even real property) abroad or under circumstances where the exchange rate of a currency matters for the price of the item. For instance, one may enter into a forward contract that on this or that date they will purchase this or that object for this and that amount of money – and the money will be exchanged at the exchange rate which was in force at the time of signing of the contract. This could be very useful when purchasing property or goods abroad and the transfer of funds must be done on a particular date in the future. The benefit of this transaction is that it can help avoid losing money if the local currency of the purchaser is unstable and is likely to drop in the coming months. In this case we should note that although forward contracts by definition entail a lot of uncertainty because almost the entire transaction takes place in the future (barring a small deposit put down at the time of signing), they provide a substantial peace of mind with respect to the amount paid – and this is a significant point.

From the prism of Islamic Finance, however, as both the goods and the payment for them are to be exchanged at a future date, this transaction entails the risk that either the goods or the payment for them will not be delivered. The above arrangement is by default problematic from a *Shariah* point of view because in addition to the risk of loss, Islamic law does not permit trading in what one does not yet own, because this is considered to be speculation (*maisir*). To recall, *maisir* is forbidden under Islamic Law. Furthermore, *Shariah* law rejects ambiguity in contracts and in principle, not having certainty about the delivery of any of the contracted products, should trigger the prohibition on *gharar* (uncertainty) under *Shariah* law. Islamic law, perhaps under pressure to keep up with the competition from conventional finance, nevertheless accepts such contracts, as long as it can be inferred that the parties intend to honour their commitments and this inference is supported by part upfront payment. Among the instruments used to structure such transactions are *murabaha*, *bai muajjal*, *bai salam*, *bai istisna*, *arbun* and *wa'd*.

What is more, some more liberal interpretations suggest that forward contracts should be considered nothing more than a commitment to conclude a contract (*wa'd*) and not a contract *per se* with the actual contract taking place at the time of the actual exchange. Whether such an interpretation will be adopted will depend very much on the willingness of the interpreting body to align a conventional instrument with the principles of *Shariah* law.

6.3.4.2. Futures in a comparative perspective

Futures contracts are derivatives that are potentially unacceptable under Islamic law as they run contrary to the assumption that financial transactions must bring benefits to the real economy. Furthermore, they run contrary to the rule that risk should be shared between the transacting parties. In futures contracts one party necessarily loses and the other wins. The most important point is however, that in futures no real exchange takes place; rather, the transaction entails payment of the difference between what was agreed to be paid at the time of maturity and the market price of the goods at that exact moment. Let us consider the following example. On 20th November 2016, party A would agree to sell to party B on 30th November 2016 10 specific shares at a price of $10 per share. If on 30th November the price of these shares is lower than $10 per piece, for example $9 per share, the seller wins. He would have made a gain of $10 dollars from this trade, based on the difference between the agreed price and the price on 30th November. Equally, if the price of these shares is $11 per share, the winning party is the buyer who will have made a gain of $10 from this trade, because on the day when the contract matures, each share is one dollar more expensive than the price per share agreed upon under the futures contract.

However, consider the following more granular explanation:

> *Since the futures price will generally change daily, the difference in the prior agreed-upon price and the daily futures price is settled daily also. Money is drawn out of one party's margin account and put it into the other so that each party has the appropriate daily loss or profit. If the margin account goes below a certain*

value, then a margin call is made and the account owner must replenish the margin account. This process is known as marking to market. Thus on the delivery date, the amount exchanged is not the specified price on the contract but the spot value (since any gain or loss has already been previously settled by marking to market).[328]

Futures, therefore, entail many of the features that are forbidden in Islamic finance such as speculation, no real exchange, no shared risk and certain loss which is more often than not allocated to the financially weaker party. This explains why futures are not or should not be used in *Shariah* compliant environments.

6.3.4.3. Structuring options in conventional finance and the perspective of Shariah law

'Traders buy options to speculate or to hedge current holdings, as well as generate income through option writing.'[329] Broadly speaking, there are two types of options – call options and put options. In call options, the stock subject to the contract is owned by the writer of the option. In put options, the stock in question is owned by the buyer of the option.[330] Call and put options could be stand-alone or combined, the latter taking the art of hedging a notch higher, because it allows hedging against both eventualities, thus setting the player behind with the premium only.[331] Embedded options are another kind of options that differ from the stand-alone type. In this case, the option is incorporated (embedded) into the main product, giving the buyer or seller the chance to cancel without consequences other than paying the premium (which is usually included in the price of the product).[332]

Call options are financial derivatives whereby the parties contract for the right (but not the obligation) to buy (to exercise a call option) or sell (to exercise a put option) with respect to a

[328] Marilyn Siew-Ai Ong and Chun-Phuoc Jeong, Commodity Futures Trading: Its Permissibility According to Sunni Traditionalists Ijtihad and Ijtihad Maqasidi' (2012) 13(2) International Journal of Business and Society 93, 94 f.n. 2.
[329] James Chen, 'Option Definition' (2019) https://www.investopedia.com/terms/o/option.asp accessed 3rd April 2019.
[330] Islamic Markets, 'Option Contract In Islamic Finance' (2019) https://islamicmarkets.com/education/option-contract-in-islamic-finance accessed 24th March 2019.
[331] Ibid.
[332] Islamic markets (n 330).

certain amount or the entirety of an underlying financial asset at a specified price (strike price) for a given period of time or on a specific date.[333] There is a difference among jurisdictions regarding the exact time an option falls to be exercised. For example, in Europe this would be only on the expiration date (exercise date) of the option whereas in the US options can be exercised for the duration of the time from the signing of the contract until the expiration date of the option.[334] If we apply the apples example to options, it would look as follows.

On 20th November 2016, party A, who is a producer of apples, situated in the European Union, contracts with party B to sell them 10kg of his lot of apples at $1 per kilogram apples and the expiration date of the option is 30th November 2016. As the contract is subject to European Union law, party B could only exercise this option on the date of expiry, i.e. on 30th November. Unfortunately, the price of apples meanwhile falls to $0.90 per kilogram which makes it financially profitable for party B *not* to exercise the right to buy. The point of the contract, from the perspective of the buyer is to secure a price which seems reasonable at the time of contracting while keeping the possibility open to back out of the deal should a better price exist on the market at the time of expiry. From the point of view of the seller this is not ideal, which is why many options work with a down payment put down by the buyer at the time of contracting. This down payment, called premium, is non-returnable in case the contract does not go through and it serves as a compensation for the seller. The premium is the price the buyer pays to have the option to buy the product or not. Of course, the example with apples is simplistic. Let us see how this would work in practice if the option is written for shares.

In such a case, the motivation for the buyer would be that the strike price of the share would be less than what the same share would cost on the market on the option's expiry date. If this will be the case, the seller will have to sell the shares at the agreed price and the buyer will make a profit. From the point of view of the seller (the writer of the option), the best case scenario is that on the expiration date the price of the shares should stay the same or be lower than its price at the time of signing. In such a scenario, the seller profits from the premium, while selling the shares at the normal market price.

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[333]Chen (n 329).
[334] Chen (n 329).

However, even if the option writer has some guaranteed profit (the premium), he is still in a less favorable position compared to the buyer because volatility of the market may lead to the price of the shares to soar up. The risk of that could be offset through a covered call, the so-called short-term hedge. Covered call is a short term investment strategy, typically employed by investors willing to keep an asset for a long time. Importantly, the investor in the example does not expect big fluctuations in the price of the asset; therefore, in order to generate income from it, he writes call options which will give him the opportunity to profit from the premium on each such option. As we saw above, should an option expire at a point when the market price of the stock is higher than the strike price, the buyer will buy, and the seller must sell – the typical size of an option is 100 shares per contract written. While perfectly acceptable for the conventional market environment, covered calls may be problematic in Islamic finance because they combine insurance with no real asset backing the transaction (the actual transaction is driven by differences in prices, much like futures rather than by the performance of the asset).

Another way in which options can be used to insure against losses is through the use of a put option. Simply said, a put option is a "stay put/do not do anything" option. Put options give the buyer the right to sell, without being obligated to, at the strike price.[335] This is how this works in practice.

A put option writer would write a put option if he believes that the price of a certain stock will stay the same as or exceed the strike price at the time the option expires. If on the expiration date this prediction comes to pass, the put option writer keeps the premium, which is his only gain from the transaction. This happens because the buyer would not want to make use of the right to sell because he can sell it at a higher price on the market. For example, if on 20th November 2016 a holder of 100 N26 shares worth $10 each believes that on 30th November 2016 these same shares will cost $10 each or more, he will happily write a put option. This will allow them to keep the (now more expensive or at least same price) shares while also keeping the premium.[336]

In contrast, a put option holder will buy the option (by paying the premium to the option writer), which would allow them to sell the stock at the strike price if he believes that the price of the

[335] Chen (n 329).
[336] Haroun Rahimi, 'Option Contract in Islamic Finance' (2017) https://ssrn.com/abstract=2758359 or http://dx.doi.org/10.2139/ssrn.2758359 accessed 4th April 2019.

underlying stock will fall at the expiration date. If this comes to pass, the option writer is under obligation to purchase the stock at the strike price. The gain for the option buyer constitutes of the difference between the market price and the strike price minus the premium paid, multiplied by the number of options (usually 100 shares per contract). Usually option writers set a strike price at which they have previously decided to purchase the stock in question, thus avoiding (big) losses in case that the strike price exceeds the market price of the stock. However, it is clear that the position of the parties is misbalanced with more risk absorbed by the option writer, at least where put options are concerned. It is doubtful therefore that put options will not present a challenge under Islamic finance and the stricter the approach, the greater the likelihood that this derivative will not be allowed.

According to Andreas A Jobst Islamic finance law allows options only if they:

> *"are employed to address genuine hedging demand on asset performance associated with direct ownership interest;*
>
> *disavow mutual deferment without actual asset transfer; and*
>
> *eschew avertable uncertainty (gharar) as prohibited sinful activity (haram) in a bid to create an equitable system of distributive justice in consideration of public interest (maslahah)."* [337]

What this indicates is that options are, in principle, accepted under *Shariah* law, subject to certain conditions being satisfied. However, while the above is still valid, there are many other things that need to be considered, many of them outside the realm of economics and within the realm of the current Islamic legal constructs. Before moving further into this analysis, however, one must consider that the main purposes of options in the conventional financial markets are three:

- *To protect against risk, i.e. against adverse changes in price.*
- *To allow for arbitrage, i.e. to benefit from the different prices of the product in different markets.*

[337] Andreas A Jobst, 'Derivatives in Islamic Finance' (2008) IMF http://www.eurekahedge.com/NewsAndEvents/News/728/Derivatives_in_Islamic_Finance accessed 26th December 2016.

- *To speculate, i.e. to undertake exposure to risk with the hope of profiting from this.*

It is immediately clear that at least the last purpose of options is inherently suspect under Islamic finance rules as *Shariah* law prohibits *maisir* (speculation and gambling). The link to speculation indicates that the profit from an option does not depend on the protection of the value of the underlying asset but on the increase of this value.[338] As to the rest of the features of options, these are also problematic in this author's view. In support of this opinion, consider the following:

> *The Islamic Figh Academy of the Organization of Islamic Cooperation (IFA-OIC), which is an ISB stated, "Since the subject of [option] contracts is neither sum of money, nor a utility, nor a financial right which may be waived, then the contract is not permissible in Shari'ah". The majority's opinion is grounded on three different reasons: 1) nature and the use of options are such that amounts to maysir (gambling); 2) options are used for excessive speculations; and 3) the premium paid is impermissible.*[339]

Furthermore, it has been suggested that the gambling nature of options takes them close to the so called zero-sum game which necessitates that the gain of one party is made up for through the loss of the counterparty.[340] Lastly, it has been argued by Usmani[341] that 'the premium which is paid for the option is not permissible because it consists of a promise and charging a fee for a promise is impermissible'.[342]

It could be added that options deal with the performance of the value of the underlying asset rather than the performance of the asset itself. This takes them away from the real economy and while this is fine in conventional finance, it is not so under *Shariah* law. In order to overcome the challenges inherent in options while preserving the benefits of this derivative, a number of

[338] I Iqbal, D S Kunhibava & A P D A W Dusuki, 'Application of Options in Islamic Finance' (2012) International Shariah Research Academy ISRA, (ISRA Research Paper (No. 46)), 10–17 https://islamicbanker.com/publications/application-of-options-inislamic-Finance accessed 16th April 2019.

[339] Islamic Markets (n 330).

[340] Iqbal, Kunhibava, & Dusuki (n 338).

[341] M T Usmani, 'What Shariah Experts Say Futures, Options and Swaps' (1996)1(1) International Journal of Islamic Financial Services, http://www.nzibo.com/IB2/FOS.pdf accessed 16th April 2019, 2.

[342] Mohamed Bengana and Mohamed Yassine Khouildi, 'Options: From Conventional and Islamic perspectives Analyses on the Islamic solutions' (2018) MPRA Paper No. 84499, https://mpra.ub.uni-muenchen.de/84499/ accessed 13th April 2019.

alternatives have been put in operation. They, on the surface at least, meet the requirements of Islamic finance. These alternative forms of options will be discussed in Chapter Seven.[343]

6.3.4.4. Shariah-incompliant and Shariah-approved conventional swaps

Swaps are over-the-counter (OTC) contracts, subdivision of options. They are one of the first derivative products that were introduced in Western practice. Swap is defined as a contractual agreement between two parties, which contract for the simultaneous delivery of periodic payments in exchange of two different cash flows streams.[344] The payments are known as the legs or sides of the swap. Payment is determined based on hypothetical values of underlying assets called notionals. The swap agreement can be done by exchanging an asset or liability in the same or different currencies or a floating interest rate stream with another of fixed rate or *vice versa*.

We distinguish between four types of swaps: interest rate swap (IRS), asset swap (AS), equity swap (ES) and commodity swap (CS). The first two are widely used on the conventional market for hedging and speculative purposes. The commodity swap is attractive to the Middle Eastern market although in order to be used there, it is dressed up as a *Shariah* acceptable concept.

The importance of swaps for the development of trade and for the economy is evident in the following quote:

> *Exclusively, the currency swap product was offered in the United States market as early as 1970s and was followed with the interest rate swap in 1981.*[345] *These swap products were very well received by the public to the extent that the total swap transactions increased to more than USD700 billion in 1989 and the total outstanding swap touched approximately USD4.6 trillion at the end of 1992.*[346] *According to the Bank of International Settlements, the swap transactions in the global swaps market had reached more than USD415.2 trillion at the end of 2006, which appeared to be 8.5 times more than the rate of Gross National Product of*

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[343] Chapter 7: [7.4.].
[344] Asyraf Wajdi Dusuki, 'Shariah Parameters on Islamic Foreign Exchange Swap as Hedging Mechanism in Islamic Finance' (2009), 4.
[345] John Marshal and Kenneth Kapner, *The Swaps Handbook*, (New York Institute of Finance, 1990), p.xvii.
[346] Satyajit Das, *Swaps and Financial Derivatives: The Global Reference to Products, Pricing, Applications, and Markets,* (2nd ed. ,The Law Book Company, 1994), 3.

the world for the year 2006 and was more than other transactions in derivative market.[347]

The narrative goes that if properly used, swaps could protect companies, banks and other important commercial actors against interest rate and currency rate fluctuations. This function of swaps arguably enables them to serve as stabilizing factor for the market, thus contributing to financial stability. As mentioned at the overview on derivatives, these instruments are favoured by economists for their ability to manage financial risk. Risk management techniques have traditionally included other measures in addition to the use of derivatives, such as diversification and concentration; however, hedging was widely believed to be superior to the other two methods.[348] This was the prevailing opinion, at least up until the crisis of 2007-2008.

Nevertheless, the expectations of the market still are that swaps could be used to hedge from financial risks,[349] reduce the cost of financing,[350] to allow for larger scale operations,[351] facilitate access to new markets[352] and maximize profits through speculation.[353]

6.3.4.5. Interest Rate Swaps

Interest rate swaps consist of an exchange of two interest rates, one fixed and the other floating, paid on a notional principal, for a determined period. The exchange of rates takes place along with an exchange of the respective cash flow and liabilities.[354] In most cases, the underlying asset for such swaps is the notional principle amount of the bond or loan. The swap does not affect the ownership of the underlying asset (although this is also possible). The swap constitutes

[347] Asyraf Wajdi Dusuki, (n 344), 3.
[348] B N Wardrep and J F Buck, 'The Efficacy of Hedging with Financial Futures: An Historical Perspective' (1982) 2(2) Journal of Futures Markets.
[349] Marshall and Kapner (n 345), 268.
[350] Marshall and Kapner (n 345), 267.
[351] Asyraf Wajdi Dusuki (n 344), 5.
[352] Raj Vantakesh and Vijaya Vantakesh, Interest Rate and Currency Swaps: The Market Products and Application, (Probus Publishing, 1994), 19-20.
[353] Asyraf Wajdi Dusuki (n 344), 6.
[354] John C. Hull , 'Mechanics of Interest Rate Swap' Chapter 7.1., p. 156 in John C Hull, *Options, Futures, and Other Derivatives* (10th ed. Pearson 2018). See also, James Chen, 'Swap' (2018) Investopedia https://www.investopedia.com/terms/s/swap.asp accessed 5th April 2019.

of two legs (two cash flows) – one fixed and another variable. The interest rate used for the transaction could be an interbank exchange rate (a benchmark interest rate), a floating currency exchange rate, or index price.[355] This type of swap is a particularly good tool to hedge mortgages or corporate loan exposures against increase in interest rates.[356] This explains why they are not so popular amongst retail investors and are not found on exchanges.

An example of interest swap would be when two banks exchange (swap) the interest rates over equal sized investments that they respectively own. In this case, if bank A receives a rate based on LIBOR plus 3%, it is tied to a floating rate (because LIBOR fluctuates) and bank B receives 5% fixed rate each month, they may decide to swap their rates each believing that the swap would be beneficial for them.

As an example, interest rate swaps could protect against fluctuations of the interest rate when a party (party A) has undertaken a loan on a variable rate. In this case, if the party anticipates that the rates will rise, it will be better served by undertaking an interest swap with someone (party B) who anticipates that the interest rates will remain the same or will decrease. In exchange for party B undertaking this swap (i.e. undertaking to pay the loan provider the variable rate instead of party A), party A will pay party B a fixed rate on the same amount. The financial outcome of the swap will depend on the accuracy of the parties' predictions, the premium paid to party B and also, on the percentage paid to the intermediary (usually a bank) arranging the transaction. As with most other derivatives, more notably futures, there is always a winner and a loser in this transaction. In addition, although interest rate swaps could and often are used to protect the underlying asset, they could and often are used for speculation. Consider the following explanation, which covers both uses of IRSs:

> *Counterparties enter swap transactions to hedge existing cashflows from adverse interest rate movements in the market and / or speculate on interest rate movements. For example a party paying variable / floating interest on a loan may wish to swap to a fixed rate of interest, in the belief that interest rates are going to rise. Similarly a party may simply wish to enter a swap transaction to speculate and bet on interest rates moving one way or another.*[357]

[355] Ibid.
[356] Nicholas Burgess, 'How to Price Swaps in Your Head - An Interest Rate Swap & Asset Swap Primer' (April 9, 2017),https://ssrn.com/abstract=2815495 or http://dx.doi.org/10.2139/ssrn.2815495 accessed 5th April 2019, 1.
[357] Ibid, 9.

Prima facie, speculating and betting makes swaps attractive to the risk tolerant investor. In the case of interest swaps however, as they are mostly used by large corporate entities, the question does not boil down to how resilient one is towards financial risks (although it matters when an institution makes bad financial choices repeatedly). Rather, speculating and betting with swaps has a draw for the informed investor and for the one who is confident that their judgment of where the rates will go – up or down – will turn out to be the correct one. Predictions are not always accurate in reality however, which is ironically (partly) why interest swaps preserve their attraction for their specific audience.

6.3.4.6. Credit Default Swaps

Asset swaps are used to generate asset financing. This derivative makes it possible for investors to borrow funds in order to purchase an asset. In most cases, asset swaps are used for the purchase of bonds.[358] Alternatively, asset swaps could be used as a bond rich-cheap analysis tool.[359] Other types of swaps include commodity swaps, currency swaps, debt swaps and total return swaps. A particularly controversial swap is the credit default swap (CDS) whereby one party agrees to pay the principle and interest of a defaulted loan to the CDS buyer. This swap works on the premise that a lender is concerned that a borrower may default on a loan. In this transaction, the lender buys a CDS from a third party investor. The swap serves as an insurance policy or a guarantee that the seller of the CDS will reimburse the lender in the case the borrower defaults. The reimbursement concerns the principal and all interest payments from the point of default up to the maturity date of the security. The buyer of the CDS pays for having this guarantee by an ongoing premium payment which maintains the contract. CDSs are controversial because they transfer the credit exposure of fixed income products to one or more third parties. CDS's riskiness could lead to excessive leverage because it arguably promotes high risk appetite

[358] Nicholas Burgess (n 356), 9.
[359] Burgess (n 356), 1.

and irresponsible investing behaviour. This feature of CDSs arguably caused them to contribute to the latest financial crisis.[360]

Generally speaking swaps serve as a tool to exchange value or risk. In the latter case, how risk is managed may become instrumental to their acceptance by *Shariah* compliant markets. Currently, their application in Islamic Finance has been made possible by the use of *tawarruq*,[361] *wa'd* or commodity *murabahah* (for instance, *murabaha* based currency swaps, *murabaha* profit rate swaps or Islamic total return swaps). Such *Shariah* compliant, swap-like deals are nowadays governed by the Hedging (*Tahawwut*) Master Agreement issued by the International Swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM).

As regard whether swaps and *quasi* swaps would be welcomed in a stricter environment, this may not necessarily be the case, particularly in the example of the interest rate swap. Note that the *Qur'an* takes a lenient stance towards defaulting debtors, particularly when the default is due to hardship.[362] To this end, it states that 'If the debtor is in a difficulty, grant him time till it is easy for him to repay; but if you waive the sum by way of charity it will be better for you, if you understand it.'[363]

Chapter 7: Shariah's response to forwards, futures, options and swaps: quasi (Islamic) derivatives

Chapter Seven will be dedicated to the most popular *quasi*-derivatives used in the Islamic world. The writer will discuss each financial instrument individually, paying special attention to their respective appropriateness, according to different scholars. As Islamic Contract Law (ICL) is an

[360] Chen (n 329). Justin Kuepper, 'Credit Default Swap (CDS) Definition' (2019) https://www.investopedia.com/terms/c/creditdefaultswap.asp accessed 16th September 2019.

[361] Islamic Finance also enforces a connection between financial transactions and goods. This often leads to circularity when it comes to loans. An Islamic loan contract is called a *tawarruq* (this is an instrument most common in Kuwait, Saudi Arabia, Oman, The United Arab Emirates, Bahrain and Qatar, collectively known as the Gulf Cooperation States). In a *tawarruq*, an Islamic Bank will purchase some specified goods on behalf of its client, who will then usually pay for them in installments. The Client will however sell the goods on to a third party, but receive immediate payment in full for them. See, Visser (n 85), 30.

[362] The Quran, *The Qur'an in English Translation* (MidEast Web for Coexistence 20004), <http://www.mideastweb.org/mew-quran.pdf> accessed on 12th June 2017, 2:280.

[363] Ibid.

integral part of the law of Islamic Finance, relevant parts of it will be discussed below at some length.

7.1. Complex transactions: Islamic forwards

Having discussed the interplay between *Shariah* law and *Fiqh*,[364] we will now analyse the effect of the prohibitions on Islamic Contract Law. It is a trite statement that the main prohibitions make it challenging to utilise most conventional derivative contracts in a *Shariah* compliant setting. Generally speaking, with very small exceptions (applicable to agricultural and manufactured goods) forwards and futures are prohibited in Islamic finance, based on the degree of uncertainty permeating these instruments. As is well known, uncertainty is treated as troublesome by *Shariah* finance law. Furthermore, *Shariah* law disallows the sale of goods which the seller is not yet in possession of,[365] which is by default the case of derivatives. Because the future delivery of such goods (and with that the performance of the contract) is uncertain, forwards and futures are generally unaccepted in Islamic business practices.[366]

However, as is the case with other instruments, there are some ways to avoid the above prohibition, for example, by entering into a prepaid purchase agreement (*'bai'salam'*), which allows purchasing of the subject of the contract by paying for the goods upfront and receiving them at maturity,[367] or by structuring the transaction with the help of separate contracts, best exemplified by the *wa'd*/*murabaha* contract. Note that the rules of Islamic contract law require that complex (more than one transaction) deals should be structured in two separate contracts, which is precisely the way the *wa'd*/*murabaha* arrangement is structured.[368]

As already noted, forward contracts are not permitted by *Shariah*, unless it can be inferred that the parties intend to honour their commitments and this inference is supported by part upfront payment.[369] However, Islamic Contract Law works with a number of Islamic forwards, which

[364] Chapter 3:[3.2.].
[365] J Schacht, *An Introduction to Islamic Law* (Oxford University Press, 1982), 135.
[366] Visser (note 85), 26.
[367] Visser (note 85), 26.
[368] Visser (note 85), 26. However, refer to the discussion on *wa'd murabaha* (later in this Chapter) for an argument that this arrangement is deficient in terms of *Shariah* compliance.
[369] See Chapter 6: [6.3.4.1.].

perform to a greater or smaller degree the purpose of their conventional counterpart. Some of these instruments are construed as a single transaction and some of them are more complex. Examples of the former are the forwards *bai'salam'* and *istisna* which are generally accepted by most scholars.[370] The *salam* contract is suitable for fungible commodity transactions and has traditionally been used to finance agricultural goods as well as textiles.[371] There the seller is paid in advance to deliver goods at a date in the future but he does not have possession of these goods at the time of contracting.[372] The *salam* price is the spot price and the seller is morally obligated to carry out the delivery.[373] There are some exceptions in the rule of advance payment. According to some authorities, a small window of time could be given to the purchaser. For example, AAOIFI allows this extension to be of two to three days.[374]

In the *istisna* contract, the buyer contracts for the forward purchase of something that has to be manufactured or customised by the other party to certain specifications.[375] Importantly, the seller in *istisna* cannot conclude another contract which would offset the risks attached to the original contract; in other words, he is not allowed to hedge the risk, arising from the contract.[376]

The more interesting to this discussion forwards are contracts which need more than one transaction in order to remain compliant with *Shariah* law. This section will stop specifically on *murabaha* contract; however, in order to give the whole context, the discussion must start from the concept of promise, as it is understood in Islam.

7.2. Interpretation of wa'd (unilateral promise) in Islamic Contract Law

The Islamic contract (*akad)* is very similar to a bilateral contract under the common law in that it is concluded between two (or more parties) and it hinges on the declaration of offer and

[370] Adlin Izyana Jaafar, HamizahMohd Khusairi & Aishath Muneeza, 'Introduction to Salam or Forward Sale' Wahed, (November 2018) https://journal.wahedinvest.com/introduction-to-salam-or-forward-sale/ accessed 8th May 2019.
[371] Angelo M Venardos, 'Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System (Heritage Trust Group, 2010), 294.
[372] Not to be confused with shorting: see, Michael Mahlknecht, 'Islamic Shorting: Trend or Hype?' (2008) http://www.eurekahedge.com/Research/News/649/Islamic_Shorting_Trend_or_Hype accessed 13th May 2019.
[373]Investopedia, 'Spot price' (n.d.) http://www.investopedia.com/terms/s/spotprice.asp accessed on 18th June 2017.
[374] AAOIFI, 'The guidelines and conditions for combining several contracts into one single transaction', (2007), 165.
[375]Malkawi (n 25), 283.
[376]F E Vogel and S L Hayes, *Islamic law and Finance. Religion, Risk, and Return* (Brill Leiden 2006), 224-225.

acceptance made at the same time.[377] *Wa'd* is, at least, a morally binding promise, the breaking of which attracts social reprimand and even opprobrium. At the beginning, *wa'd* did not impose legal obligations or led to legal sanctions in case of a breach. Conceptually, *wa'd* has some closeness to the civil law in that it can be treated as binding or not, depending on the intentions of the promisor.[378]

The modern understanding of *wa'd* (unilateral promise) is that this is a commitment by the promisor in a contractual transaction that he will undertake or abstain from one or another course of action. Furthermore, while in the past *wa'd* was largely part of the realm of voluntary offer (*tabarru'āt*), it has now crossed over to the area of commutative contracts (*mu'awadāt*).[379] More recently, *wa'd* (promise) has become part of more typical *Shariah* compliant contracts such as *murabaha*, *ijarah* or the typical sale-purchase contract. In addition, in the view of the Islamic *Fiqh* Academy, *wa'd* is deemed to be legally binding if it pertains to commercial transactions, it is a unilateral promise, and it has caused the promisee to incur liabilities. Furthermore, the concept of *wa'd* requires that there is an actual sale and that the promise was given with regard to the sale of a specific asset. Furthermore, the promisee was entitled to claim actual damages from the promisor if the latter goes back on his promise.[380]

Wa'd is not a contract in the traditional sense but a feature of it. It is a *quasi*-contract, which guarantees that the promisee can rely on the unilateral promise extended by the promisor. In the context of financial contracts, this promise relates to the conditions of the contract and constitutes an obligation to be fulfilled at a future date. [381] Simply put, the difference to an actual contract is that *prima facie wa'd* is not legally binding; whether it could be interpreted as such will depend on the approach taken and on the interpretative authority. Importantly and regardless the legal ambiguity of *wa'd*, the promise is religiously and morally binding on the promisor; however, the

[377] Syeliya Md Zaini and Nosrah Mohd Isa, 'The Application of Wa'd in Islamic Banking Contract', (2011) 10(2) Malaysian Accounting Review 27, 30.
[378] Gregory Klass, 'Intent to Contract' (2009) 95 Virginia Law Review 1437, 1442.
[379] Rafic Yunus Al-Masri, 'The Binding Unilateral Promise (wa'd) in Islamic Banking Operations: Is it Permissible for a UnilateralPromise (wa'd) to be Binding as an Alternative to a Proscribed Contract?' (2002) 15 J.KAU: Islamic Econ. 29, 29.
[380] See Resolution No.2 and 3 of the 5th Conference of the Islamic Fiqh Academy, Kuwait 1409H, published in the Majallah Majma` al-Fiqh al-Islami, No.5, Vol.2, p.1599.
[381] Cima, 'Wa'd' (2019) https://www.cimaglobal.com/Qualifications/Islamic-finance-qualifications/Islamic-finance-resources/Glossary-A-Z/Wad/ accessed 27th December 2018.

promisee has nothing more than a moral right to enforce the promise or at least this is what the orthodox approach to *wa'd* should be.[382]

7.2.1. How wa'd compares to unilateral promises in the common and civil law

The following section will consider how the concept of *wa'd* fits in the global picture of contractual relationships. This will be done by more generally comparing *Shariah* approach to contract with the conventional one and by stopping specifically on the area of unilateral promises. To begin with, at first glance the past understanding of *wa'd* resembles, but on a closer look, fundamentally differs from the common law concept of unilateral contract. Under the latter, the promisor undertakes to do something in exchange of or upon the promisee doing something in return. Importantly, in the common law interpretation, this concept does *not* refer to delivering a benefit to the promisee *without* him or her providing consideration to the promisor in return.[383] In this sense, the common law contract requires a degree of reciprocity.

Before delving into the *wa'd* concept in depth, let's first consider what interpretations of *wa'd* have been favored by Islamic scholars over the years. Broadly speaking, in the past there were three different approaches to *wa'd*. The majority of scholars preferred to interpret the performance of the promise as simply desirable. It was *recommendable* that the promisor honours his promise. This approach was arguably rather weak as it gave the promisee no firm guarantees that the unilaterally undertaken obligation will be acted upon by the promisor. In reality, this approach did not promote sanctity of contract in the sense conventional contract law understands it.

According to other Islamic scholars, for instance the jurist Ibn Shubrimah, there was an obligation to fulfill the promise, subject to performance being, however, possible for the promisor. Note that only obstacles that would justify going back on the promise would release the

[382] Syeliya Md Zaini and Nosrah Mohd Isa, 'The Application of Wa'd in Islamic Banking Contract', (2011) 10(2) Malaysian Accounting Review 27, 29.
[383] *Carlill v Carbolic Smoke Ball Company* [1892] EWCA Civ 1.

promisor from the unilaterally taken obligation.[384] In this interpretation the focus is on the obligation of the promisor, which is treated as broadly strict, subject to justifiable exceptions. In Ibn Shubrimah's approach, therefore, the contractual obligation from one party to another was seen as *prima facie* binding, thus affirming the idea of sanctity of contract.

Lastly, the Maliki School deemed *wa'd* obligatory when its non-fulfillment brings detriment to the promisee, for example, if the promisee incurs costs in reliance on the promise.[385] Note the School's meaningful similarities to the common law understanding of contract, and in particular with its doctrine of consideration.

The doctrine of consideration states that "a promisee should not be able to enforce a promise unless he has given or promised to give something in exchange for the promise or unless the promisor has obtained (or been promised) something in return."[386] Reciprocity is therefore at the foundation of the common law unilateral and bilateral contract. This has been elaborated upon by the English courts in the case of *Currie v Misa* (1875), which provided the classic definition on what constitutes valuable consideration.

> *"A valuable consideration, in the sense of the law, may consist either in some right, interest, profit, or benefit accruing to the one party, or some forbearance, detriment, loss or responsibility, given, suffered, or undertaken by the other..."*[387]

Nevertheless, despite the apparent similarity between the Maliki School and the common law respective approaches, the former is focused predominantly on the rights of the promisee. The Maliki School treats a *wa'd* as obligatory only if non-performance will bring detriment (usually material) to the promisee. In distinction, the common law tradition treats both parties as equal. Only upon establishing that the interests of both parties have been considered in accordance with the doctrine, could the contract be deemed valid or not.

Similarities with the operation of *wa'd* are found in the commutative contract – a concept of the civil law, found in many jurisdictions, including in the US. In this contract, typically a contract of

[384] According to Ibn Shubrimah in Rafic Yunus Al-Masri, 'The Binding Unilateral Promise (wa'd) in Islamic Banking Operations: Is it Permissible for a Unilateral Promise (wa'd) to be Binding as an Alternative to a Proscribed Contract?' 15 J.KAU: Islamic Econ., 29 (1422 A.H / 2002 A.D), 29.
[385] Ibid.
[386] Ewan McKendrick, *Contract Law* (Palgrave Macmillan 8th edition, 2009), 67.
[387] *Currie v Misa* (1875) LR10 Ex 153, 1-15.

sale, often in marine, territorial and aviatic transportations or insurance transactions, the two contracting parties give and receive an equivalent; the seller requests a certain price for his goods or services, which is then paid by the buyer. In this sense, there is equivalent in the position of both parties. As far as the commutative contract respects the rights of both parties, it strongly resembles the common law bilateral contract as the doctrine of equivalence appears to bear similarity to the doctrine of consideration and more specifically, its aspect of reciprocity.

Two things have to be noted in this regard though. First, it is far from established that the common law has indeed espoused a coherent doctrine of consideration. In support of this Professor Atiyah argues that historically the English courts have only deemed consideration good i.e. enforceable, when they have felt that a promise deserves to be enforced. To this end, if in their view it was not desirable to enforce a promise, they would declare that there was no good consideration on the facts of the case. Such an approach brings to the mind the conclusion that the term "consideration" was but a placeholder for having a sufficient or compelling reason to enforce a promise.[388] Such reason would always be well justified by judges, usually on policy grounds (such as the ground that contracts are made to be performed).

The second point to consider is that under the common law, consideration must be sufficient but need not be adequate. This requirement has long troubled the minds of many a student of contract law with its complexity or shall we say, vagueness. However, this confusion is misplaced as the doctrine states nothing more but that the promisee must provide something valuable to the promisor, in exchange for his promise. In this context, the civil law doctrine of equivalence in the commutative contract differs to the common law one, as it applies to strictly equivalent duties and benefits (rights and obligations).

Furthermore, while, due to historical reasons, Islamic Contract Law has absorbed influences from the common and civil law (which it adopted to suit the *Shariah* framework), *wa'd* has remained dependent on the interpretation of the specific school. It appears that not only is the approach to *wa'd* not unified within the Muslim scholarship, it cannot be transposed intelligibly into the Western legal tradition, because the civil law and the common law are not in perfect alignment with respect to some important building elements of contract. Among them are the notions of

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[388] Patrick Selim Atiyah, 'Consideration A Restatement', in P S Atiyah, *Essays on Contract* (1986 OUP).

reciprocity and consideration, to name a few. This lack of harmonisation on so many levels should concern Western counterparties or investors.

This is unfortunate because the importance of the *wa'd* concept for Islamic contract law is crucial. Without relying on *wa'd* for the structuring of complex *Shariah* compliant contracts, much of the currently used Islamic derivative contracts will become defunct in the Islamic framework. This begs the conclusion that although harmonisation of the concept may be challenging to reach, it is the only workable solution.

7.2.2. The relevance of the United Nations Convention on contracts for the international sale of goods (the Vienna Convention)

The complex fabric made of contractual obligations as they are understood by the common law and the civil law systems respectively, and the different expectations from the transacting parties have necessitated some degree of harmonization, applied to cases where goods are sold cross-border and particularly cross-system. The United Nations Convention on Contracts for the International Sale of Goods (UN CISG)[389] has been adopted in response to this need. It has been deemed a success and it has been hailed to be a 'summary of the most important law systems, in the field of international merchandising, i.e. mostly between the Romanist (Roman-Germanic) system and the Anglo-Saxon one (of common law)'.[390] This attempt at quasi-harmonisation has been deemed to be the main engine of the Convention and instrumental for its success. Furthermore, the CISG has provided a useful definition of what a contract for sale of goods should be in legal terms, which is relevant to this study. According to this definition, the international contract for sale is a bilateral contract, involving a reciprocal obligation which is mutual for both parties. Furthermore, "it is a contract with onerous title, the parties aiming for patrimonial interests….[it] is a commutative agreement, extending the parties *rights and obligations* (emphasis added) being known in the moment of concluding the act of will."[391] This definition arguably sits at cross purposes with the *wa'd* proper, which is first, not a bilateral

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[389] United Nations Convention on Contracts for the International Sale of Goods, Vienna, 11 April 1980, S.Treaty Document Number 98-9 (1984), UN Document Number A/CONF 97/19, 1489 UNTS 3 (the Vienna Convention).
[390] Daniel Berlingher, 'The Effects of the International Contract for Sale of Goods', (2017) 19(33) Journal of legal studies 96, 96.
[391] Ibid, 97.

contract and second, to the extent there is some reciprocity to *wa'd*, it is very labored and depending on interpretation.

While it may be argued that much of the possible discrepancies between the respective regimes could be rectified by reference to the CISG, this may not be without its problems either.[392]

Firstly, the Convention does not apply to sales 'of stocks, shares, investment securities, negotiable instruments or money,'[393] which leaves very little Islamic finance contracts to which it actually applies. Among them are, however, contracts for the sale of commodities, which form a big part of the international trade of the Middle Eastern countries. Specifically, the CISG includes sales of crude gas and oil.[394]

However, while the CISG was introduced with the ambition to remove the choice of law conundrum from the area of international trade, this was not necessarily welcomed by all stakeholders, some of which (for example, the UK) would not renounce their position as a choice of law jurisdiction and some other would accept it only nominally.[395] Furthermore, although the Convention was intended to benefit exporters mostly, regulators from Islamic countries are unlikely to be happy with some of the provisions of the CISG, for example that 'unless excluded by the express terms of a contract, the CISG is deemed to be incorporated into (and supplant) any otherwise applicable domestic law(s) with respect to a transaction in goods between parties from different Contracting States.'[396] While the last statement applies only to the US, China and the Czech Republic (the first two major trading partners of the Middle East), it is hard to imagine that Muslim states with prominence of *Shariah* law would agree to substitute the latter with the principles of CISG. This would be done as a matter of principle but also because Article 78 of the

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[392] United Nations Convention on Contracts for the International Sale of Goods, Vienna, 11 April 1980, S.Treaty Document Number 98-9 (1984), UN Document Number A/CONF 97/19, 1489 UNTS 3 (the Vienna Convention or CISG).
[393] Ibid, Article 2.
[394] Franco Ferrari, 'Specific Topics of the CISG in the Light of Judicial Application and Scholarly Writing', (1995) 15 Journal of Law and Commerce 1.
[395] For an interesting discussion on the US approach, see Monica Kilian, 'CISG and the Problem with the Common Law Jurisdictions (2001) 10(2) J. Transnational Law& Policy 217.
[396] Andrea Lista, *International Commercial Sales: The Sale of Goods on Shipment Terms* (Informa Law, Routledge 2017), 5.

CISG sanctions the application of interest by stating that 'If a party fails to pay the price or any other sum that is in arrears, the other party is entitled to interest on it.'[397]

Secondly, a *wa'd* is a type of contract solely applicable within a State or within a geographical area, such as an area where contracts are governed by *Shariah* law. It is unlikely that an US judge, for example, will endeavor to interpret the meaning of *wa'd*, even if the parties have explicitly opted out of the CISG's rules on formation and elected US domestic or *Shariah* law as the governing law of the contract. Regardless of how accommodating the US law may be to the relevant provisions of *Shariah*, a common law judge will be perplexed by the many different interpretations of the concept, as they currently are.

Thirdly, by now the CISG has been ratified by only seven of 37 Muslim countries (Iraq, Lebanon and Turkey being the most relevant among these seven members).[398] This leaves the remaining 30 states without the protection of the Convention. Importantly, the same applies to their foreign contractual counterparties. [399] Considering the spread of foreign investment in the Middle East and the lively trade relations between Islamic and non-Islamic countries, expansion of the membership base of the CISG could support the further development and sophistication of *Shariah* finance framework. This is all the more the case, because due to its colonial past, Middle Eastern countries are said to 'follow the French civil law tradition, which is consistent with the CISG in most areas,'[400] thus making a transition to the CISG regime potentially much easier for them.

Given that, however, there are some notable absentees from the Convention (in this number, major trading countries, such as the UK, Nigeria, India and South Africa, as well as Saudi Arabia, Iran, Malaysia, Kuwait and Indonesia), the common law is likely to retain its place with respect to settling of commercial disputes. This is particularly the case, because of the prominence of the UK as "the choice of law" jurisdiction in international commercial contracts.

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[397] CISG (n 389), Article 78.

[398] Ahamed A. Syed, 'A Comparison of the Shari'ah and the Convention on Contracts for the International Sale of Goods in International Business Transactions' (2015) 44(3) American Bar Association (ABA) International Law, https://www.zawiyaperspective.org/ahamed_shariah accessed 20th February 2019, 1.

[399] See some of the points raised by Ali Janipoor and Behnam Akbari, 'Observing international commutative contracts and the damage of postpone in rendering properties in the 1980 Convention and comparing it with Iran Civil law' (2016) 2(6) International Journal of Law 59.

[400] Ibid; See, Fatima Akaddaf, 'Application of the United Nations Convention on Contracts for the International Sale of Goods (Cisg) to Arab Islamic Countries: Is the CISG Compatible with Islamic Law Principles?' (2001) 13 PACE INT'L L. REV. 1, 19.

7.3. How wa'd contributes to the structuring of Islamic derivatives

7.3.1. Discussion on wa'd, wad'an and muwa'ada from a technical perspective

The meaning of w*a'd* is a promise to deliver something good (as opposed to bad) in the future. Its literal translation is "delivery of good or bad news", to distinguishes it from *wa'id*, which means "warning of bad news".[401]

The translation suggests that *wa'd* captures both the subject matter (something beneficial to the promisee) and the time of completion of the contract, the delivery of the subject matter, which is set to happen in the future.[402] Note that this excludes past or current delivery. As highlighted above, *wa'd* acts as a unilateral *promise* (not a warning).

In addition and despite its strong connotation to an unilaterally undertaken obligation, *wa'd* has been perceived by some theorists as referring to both unilateral and bilateral promise. Later another interpretation of *wa'd* was suggested, namely that it lends itself to use in bilateral contracts - as a combination of two unilateral promises operating with relation to the same subject matter.[403] This approach was however feared to produce too much semantics and vagueness which was why another, perhaps neater, way to deal with *wa'd* was suggested: to conceptually distinguish between unilateral and bilateral promises by placing them under a separate heading. Following this, the term *muwa'da* was introduced, meaning a "bilateral promise or undertaking by two parties to do something for each other in the future, either with or without any condition" (conditional or unconditional promise).[404]

In distinction to the *wa'd*, the bilateral promise *muwa'ada* (or *muwaada*) comprises of *exchange of obligations* with respect to the same subject. It is reiterated that the promisee in *wa'd* is free from the obligation to perform anything with respect to the contract; this is not the case under

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[401] Syeliya Md Zaini and Nosrah Mohd Isa, 'The Application of Wa'd in Islamic Banking Contract', (2011) 10(2) Malaysian Accounting Review 27, 28. See also, Azlin Alisa Ahmad, Salmy Edawati Yaacob & Mat Noor Mat Zain, 'The Use of Wa'Dan in Islamic Contract FX Forward: Weighting between Maslahah and Mafsadah' (2014) 11(22) Asian Social Science 332, 333.

[402] Suraiya Osman & Abdullaah Jalil, 'An Islamic Perspective of Promise and Its Relationship with the Islamic Law of Contract' (2013) Paper presented at the iSUFI : International Seminar on Usul Fiqh, Nilai.

[403] Ibid.

[404] Aznan Hasan, 'Pengunaan al-wa'ad, al-wa'dan dan al-muwa'adah' (2008), Paper presented at the Muzakarah Cendekiawan Syariah Nusantara 2008, in Suraiya Osman & Abdullaah Jalil, 'An Islamic Perspective of Promise and Its Relationship with the Islamic Law of Contract' (2013) Paper presented at the iSUFI : International Seminar on Usul Fiqh, Nilai., 3.

muwa'ada, where there are "two parties performing two unilateral promises on the same subject."[405] A different view of *muwa'ada* states that this bilateral promise is apparently *not* permissible in a sale because in this instrument 'each of two parties issues a promise dependent on the other promise, to the other party'.[406]

It has been commented earlier in this paper that while *Shariah* and *Fiqh* have similar roots and objectives they differ in the way these objectives are fulfilled. This is exemplified by the case of *muwa'ada* which, while permitted under the *Fiqh corpus juris*, should be, strictly speaking, prohibited under *Shariah* law.

Bringing to mind an analogy with the Common Law concept of consideration, *muwaada* indicates that one of the parties promises to do something of interest to himself and beneficial to his promisee. This promise must be met by a counter promise by the promisee that he or she would make it possible for the other party to fulfill their promise. This means that the intended transaction should be honored by the counter party, which is expected to support the contract by doing what is reasonably expected of them. For instance, if the first party promised to sell something to the promisee, the promisee undertakes to buy it at the originally agreed price.

As stated above, *Fiqh* permits *muwa'ada* contracts because this allows two parties to carry out transactions to the best of their mutual interest. Permitting *muwa'ada* demonstrates that *Fiqh* is flexible and mutable, capable of accommodainge change when it is practically beneficial to do so. By granting this permission, *Fiqh* successfully serves the interest of the community while fulfilling its purpose, which solidifies its influence. At the same time, accommodating the needs of the market and thus gaining influence over it, enables Islamic scholars to shape the development of Islamic finance in ways they feel justified and at times when this development is felt to be necessary. As touched upon, the *muwaada* case was controversial and the scholars invested in resolving the matter had to exert their influence over the public in order to have the use of *muwa'ada* legitimised.

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[405] Islamic Economy and Finance Isssue, 'Islamic Contract Law', (2008) http://107644.blogspot.com/2008/10/islamic-contract-law.html accessed 2nd April 2019. See also, Azahari Jamaludin, 'Shariah Issues in Islamic Capital Market' (n.d.) https://www.academia.edu/17323571/Shariah_Issues_in_Islamic_Capital_Market accessed 2nd April 2019.

[406] Imran Iqbal, Sherin Kunhibava & Asyraf Wajdi Dusuki, 'Application of Options in Islamic Finance' (2012) ISRA Research Paper (No46/2012), 23.

Note that under *Shariah* law, the *muwa'ada* contract should be forbidden (*haram*) because it is, in essence, a forward looking contract. As discussed, this type of contracts is not permitted in Islam. If, therefore, the matter was solely governed by *Shariah*, *muwa'ada* contracts would not have become a part of the Islamic commercial practice. However, this would have diminished the range of Islamic finance instruments and hurt the market, which would benefit from the greater freedom to form contractual relationships.

Furthermore, forming successful contractual relationships requires a measure of certainty which, in the case of *muwa'ada*, was achieved at the price of a compromise. In a scenario like that of the *muwa'ada* contract, scholars typically first consider what would be absolutely impermissible under *Shariah* law, making sure, before anything else, that the contract in question stays away from a forbidden territory. Only then would the permitted features of the contract be outlined. As an example, the Hanafi School, which adheres more literally to *Shariah*, permits *muwa'ada* only if it could be executed without resorting to practices forbidden by *Shariah*. Among those fall uncertainty (*gharar*) and short selling.[407]In addition, *muwa'ada* is as a general rule permitted by AAOIFI (the Accounting and Auditing Organisation for Islamic Financial Institutions) and the Islamic Fiqh Academy (IFA) only under certain, well defined conditions, such as that the permission is more readily given for transactions, relating to economic and financial matters. The permission is further qualified, as it requests that the contract be executed in line with the law i.e. it must be possible that the contract could be validly executed.[408]

Note, however, that while the Islamic Fiqh Academy's rulings inform both practitioners and policy-makers, they are not binding on them, despite these judgments being intrinsically linked to *Shariah*. Since *Fiqh* is flexible, some of its rulings and approaches to legal problems would be more lenient than the *Shariah* approach would be; some would be more restrictive. Practitioners are therefore given the freedom to choose how they would want to proceed, subject to acknowledging that all principles embedded in *Shariah* law, the fundamental laws of Islam, must be obeyed by all Muslims.

[407] But note the latest developments in Islamic short-selling.
[408] Islamic Markets, 'Islamic Contract Law' (n.d.) https://islamicmarkets.com/education/islamic-contract-law accessed 9th May 2019.

On the topic of permissibility, another instrument, which together with *wa'd* is permitted under *Shariah*, is the *wa'dan*, which has often been used to facilitate trade in structured products.[409] *Wad'an* means 'two independent unilateral promises given by two parties to each other but dependent on two different conditions.'[410] Note that *wad'an* is permitted but 'the conditions for the exercise of each promise should be different and each promise should have different economic effects.'[411]

It may be tempting to perceive the imposed distinction between two *wa'ds* (two unilateral promises) operating with regard to the same contractual relationship and a *muwa'ada* (two unilateral promises on the same subject) as simple semantics. However, this would be misguided because a closer look at the definition makes it clear that the *muwa'ada* applies to commutative operations, which is arguably not the entire purpose of *wa'd*.[412] At the same time, there are indications that *wa'd* will develop further. For example, the latest decisions on *wa'd* demonstrated that it could be treated as binding, the only exception to performance being *force majeure*.[413] In this vein, it is expected that should the promisor, on his own will, fail to make good on his promise and the promisee suffers financial losses in return, the former must compensate the later on account of these losses.

There are other voices, however, which argue that:

> *it is inadmissible for the unilateral promise (wa'd) as an alternative to a proscribed contract, such as selling goods that are not in one's possession, to be binding, because a binding unilateral promise (wa'd) is analogous to a contract. Any views for making it binding upon both or either parties, explicitly or implicitly, by virtue of a Memorandum of Understanding (MOU), a sideline agreement, or any other circumvention, are not founded on any legitimate basis.*[414]

[409] Md. Faruk Abdullah and Asmak Ab Rahman, 'Is Wa'dan any different to Muwa'adah? Empirical evidence from Malaysia' (2015) International Journal of Islamic and Middle Eastern Finance and Management.
[410] Imran Iqbal, Sherin Kunhibava & Asyraf Wajdi Dusuki (n 406).
[411] Imran Iqbal, Sherin Kunhibava & Asyraf Wajdi Dusuki, 'Application of Options in Islamic Finance' (2012) ISRA Research Paper (No46/2012), 23. See also, Azlin Alisa Ahmad, Salmy Edawati Yaacob and Mat Noor Mat Zain, 'The Use of Wa'Dan in Islamic Contract FX Forward: Weighting between Maslahah and Mafsadah' (2014) 10(22) Asian Social Science 332.
[412] Rafic Yunus Al-Masri (n 379), 32.
[413] Syed Alwi Mohamed Sultan, 'Ijarah — key issues for consideration' (August 2017) https://themalaysianreserve.com/2017/08/14/ijarah-key-issues-consideration/ accessed 8th May 2019; but see the decision of the Islamic Fiqh Academy of 1409H in Al-Masri (n 263), 31.
[414] Al-Masri (n 379), 31.

The above suggests that the *wa'd/muwa'ada* area breeds some controversy and the instruments have been criticized for not being applied in agreement with *Shariah*, arguing, *inter alia*, that one cannot contract for something one does not yet own. Unsurprisingly, the main problem connected to the use of these instruments has been the difficulty reconciling the strict adherence to *Shariah* law, which is expected and non-negotiable in Islam, with the requirements and realities of a market, which has become increasingly sophisticated.

7.3.2. The binding force of promise

It is arguable that if *wa'd* is considered binding, than it is akin to a contract.[415] At the same time, structured Islamic contracts (*quasi* derivatives) rely on the notion of the binding force of *wa'd* to justify both its suitability to market and compliance with *Shariah*.

To this end, how binding would such a promise be on the promisor has been a matter of different and often conflicting interpretations. At present, the prevailing opinion is that of the Islamic *Fiqh* Academy, which accepts *wa'd* to be binding in principle. It states:

> *'[F]ulfilling a promise is accepted if the following points are met:*
>
> 1. *The promise should be unilateral (one-sided)*
> 2. *The promisee incurs a loss or expense in an effort to meet the promise.*
> 3. *The actual sale is completed.'* [416]

Importantly, the above is subject to further qualification depending on whether the judgment is done according to *Shariah* law's theory or to judicial precedent.

Following this, a promise is currently treated by Islamic law 'as a commitment made by one person to another to undertake a certain action beneficial to the other party.'[417] In addition, a

[415] Al-Masri (n 379), 31.

[416] Islamic Fiqh Academy (1409H) ruling on Wa'd in Islamic Markets, 'Islamic Contract Law' (2017) https://islamicmarkets.com/education/islamic-contract-law accessed 9th May 2019.

promise in a *Shariah* compliant contractual setting covers both what the common law recognises as an "offer" and its notion of "acceptance". To this end, a promise (offer) becomes binding on the offeror/promisor at the moment when the offeree/promissee makes good on his promise (i.e. his acceptance) to fulfill the conditions or requirements laid out by the offeror.[418]

In line with the tradition of conventional contract law and more specifically, that of the common law, Islamic scholars largely believe that promises should be fulfilled and that their breach is reproachable under Islam.[419] Breach of a promise creates a very serious jurisprudential issue (for example, the *Qur'an* speaks of *wa'd* on many occasions) as the approach of Islamic law is to equate the party who has breached their promise and dishonoured their covenant with a liar (*munafiq*) or a hypocrite.[420]

Despite the controversy surrounding it, *wa'd* is used widely by a number of Islamic financial institutions. For example, the Malaysian Central Bank, Bank Negara, has adopted unilateral *wa'd* for the purposes of hedging in the course of forward exchange transactions. In this case, the *wa'd* binds the promisor who is the party ordering the foreign exchange transaction. Importantly, the AAOIFI agrees with this and reiterates the prohibition on the use of *muwa'ada* (promises binding both parties), regardless of the context. This means that *muwa'ada* must not be implemented by Islamic traders, even if the objective is to protect against transactional risk.[421]

7.3.3. Structuring a murabaha contract through wa'd

As pointed out numerous times, *Shariah* has difficulty accepting contracts about things happening or goods delivered in the future, when such goods are not yet in the possession of the contracting party at the moment of transacting. This is a fundamental point of *Shariah* law yet it has been a point which has long created obstacles for *Shariah* finance. This conflict is particularly visible in Islamic banking.

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[417] Ahmad A A, Yaacob S E & Zain M N M, 'The Use of Wa'Dan in Islamic Contract FX Forward: Weighting between Maslahah and Mafsadah' (2014) 11(22) Asian Social Science 332. .
[418] Muhammad Masum Billah, *Islamic and Modern Insurance (Principles and Practices)*, (Ilmiah Publishers 2003), 51-57.
[419] Azlin Alisa Ahmad, Salmy Edawati Yaacob & Mat Noor Mat Zain (n 417), 333.
[420] Azlin Alisa Ahmad, Salmy Edawati Yaacob & Mat Noor Mat Zain (n 417), 333.
[421] Azlin Alisa Ahmad, Salmy Edawati Yaacob & Mat Noor Mat Zain (n 417), 333.

As discussed, the *Qur'an* prohibits *riba* (charging interest) because it perceives it to be morally degrading and leading to the corruption of society, including through creation of debt. For this reason, turning money into a commodity by loaning of money or trade based financing (such as *murabaha*) should be forbidden in Islamic finance by default. Since conventional loans are exchanges of commodity for cash or cash for commodity, they should be unacceptable in *Shariah*-compliant regulatory regimes. This is the case because the product constituting the loan is subject to a deferred delivery and, depending on the type of transaction, this deferred product could arrive either in cash or kind.

In the understanding of conventional finance, involving a deferred product into a transaction justifies the imposition of extra payment as a compensation for the delay. Due to the prohibition on *riba*, this is not permitted under *Shariah*. Despite that, Islamic finance offers a number of products (for example, *murabahah*, instalment sale, *bay'mu'ajjal* (deferred payment sale),[422] and *ijarah* (leasing) contracts) where future repayment of the advanced sum is allowed.

The next section will focus on one of the "offending" instruments - the *murabaha* contract (and on its variation known as *tawarruq*), because of its popularity as a source of financing. This type of transaction, very broadly put, generates funding by resale of a commodity.

7.3.4. Murabaha from a technical perspective

Originally, *murabaha* contracts were trade-based contracts for sale with a pre-determined mark up.[423] The object of sale in a *murabaha* is known as *mabi'*. *Mabi* must exist with certainty and be identifiable, it must be of a *Shariah* compliant nature and for legitimate use, and its value must be substantial and determinable. Furthermore, if the *mabi* is not defined, the contract becomes void. In addition, there is a requirement that *mabi* is 'deliverable at the time of the contract and, absent certain destruction scenarios, at the time of the sale.'[424] To this end, *murabaha* where the price is not precisely indicated is *fasid* (voidable).

[422] Concepts in Islamic Economics and Finance. 'Bai' Mu'ajjal' (2006) https://cief.wordpress.com/ accessed 6th May 2019.
[423] Michael J T McMillen, 'Islamic Home Purchase Financing: A Conceptual Introduction', 12.
[424] Ibid.

Fasid means unsound, invalid, voidable, not viable, foul, or corrupt. An Islamic contract may be declared *fasid* if it contains impermissible term or condition. This entitles the wronged party to rescind unilaterally.[425] Furthermore, the law requires the seller to have actual or constructive possession of the *mabi*. The latter is proven if the seller agrees to bear all responsibilities and liabilities linked to ownership and possession and assume all the consequences of *mabi*'s perishing. In this sense, constructive possession does not require physical position of the item.

Lastly, regarding the delivery of the object of sale,

> *mabiʿ must be deliverable at the conclusion of the sale. Delivery of the object must be certain and not contingent or dependent upon conditions, events or circumstances. The sale must be immediate and not contingent on future conditions, events or circumstances. If not immediate, or if contingent, it is void as a present sale and will have to be renewed and reaffirmed at the specified future date or upon the occurrence of the contingency*[426]*.*

One final point concerns the need for disclosure characteristic for the *murabaha* contract, because of its being a *quasi*-trust or fiduciary sale (*bayʿ al-amanah*) type of transaction. Clarity and transparency are fundamental to this contract and they should be applied across its main elements and particularly so with respect to the initial costs for the *mabi*. This aspect is essential because the amount of profit that can be structured in each *murabaha* transaction depends on what could be accepted as initial costs. Depending on the School, the approach could be less or more restrictive. For instance, the Maliki School will distinguish between ' that which is permissibly appended to the cost and has a right to earn a profit; (ii) that which is appended to the cost but may not earn a profit; and (iii) that which may not be appended to the cost and may not earn a profit.'[427] The Ḥanafī School is more permissible and in practice allows all costs directly linked to the acquisition and sale of the *mabi* to be included in the capital or principal.[428]

[425] Investment& Finance, 'Fasid' (2015) https://www.investment-and-finance.net/islamic-finance/f/fasid.html accessed 9th July 2019. Note that if English common law is applied in this case, there could be two types of rescission – the first one both retrospective and prospective and the second one only prospective. Which type it would be depends on whether there has been misrepresentation (first scenario) or a breach. Whichever the case, the injured party can elect whether to affirm the contract or to cancel it. See, Ewan McKendrick, Contract Law, (8th edition, Palgrave Macmillan 2009), 228.
[426] McMillen (n 423), 12.
[427] McMillen (n 423), 13.
[428] McMillen (n 423), 13.

Murabaha consists of two parties whereby one party (A) provides financing to the other (B) for the purchase of certain goods. During the transaction, party A buys the goods, then sells them to the end buyer at a spot price plus a mark-up. This transaction depends on the buyer's agreement to buy at the agreed price (spot price plus mark-up). [429] Instrumental for the transaction is the promise (*wa'd*) extended by the customer (party B) that he will honour his obligation to repay the advanced (or spent) money. [430]

The party advancing the money (A) profits because the cost plus always exceeds the spot price of the commodity. This price is agreed upon in advance and the commitment on behalf of the consumer with respect to the date and amount of the future payment is the first step of the *murabaha* contract; without such commitment the transaction cannot go forward. This could potentially open *murabaha* to the argument that it introduces the time value of money into Islamic finance. While this is in principle unacceptable according to *Shariah* law, the cost plus charged in *murabaha* is justified by and based on the passage of time.[431]

Another point to consider is that the buyer's purchase (party B) takes place in the future and at a date specified in advance. Importantly, if during the period of the transaction the market price of the goods diminishes, this does not affect buyer's duty to pay the pre-agreed price. This makes *murabaha* very similar to loaning of money in conventional banking because of the mark-up function of the transaction.[432] Admittedly, *murabaha* is a debt creating transaction and once this has been acknowledged, it is hard to argue that, unlike conventional finance, Islamic finance disallows indebting one of the transaction parties.[433]

A *murabaha* transaction has another challenging aspect, which is that it fails to deliver on the *Shariah* requirement for profit sharing between the parties. It is apparent that the profit falls to the party securing the funding because this is the party charging a markup. The purchaser enjoys the possibility to use or possess the goods in question but as far as the *murabaha* transaction is concerned, he does not share the profit from it. However, despite not sharing into the profit, the

[429] Mohammad Nejatullah Siddiqi, 'Riba, Bank Interest and the rationale of its prohibition', Islamic Development Bank, Islamic Research and Training Institute, Visiting Scholars' Research Series No.2 (2004), 72.
[430] Mufti Muhammad Taqi Usmani, 'An Introduction to Islamic finance, Idaratul Ma'arif', (1999) <http://www.mcca.com.au/uploads/58942/ufiles/an-introduction-to-islamic-finance.pdf>accessed on 2nd April 2017, 72.
[431] Mohammad Fahim Khan, *Essays in Islamic Economics* , (The Islamic Foundation, 1995), 160-63.
[432] Mohammad Nejatullah Siddiqi, (n 429), 72.
[433] Ibid, 72.

buyer shoulders the possible loss by himself because – much resembling conventional loans – any detrimental externalities are borne by the buyer of the loan.

One notable difference between the conventional and the *Shariah* compliant system consists in the possibility for customers in conventional banking to purchase insurance in order to hedge their loan against risks. While this makes the process in a conventional banking scenario more expensive, insurance grants some peace of mind and security which is not readily available to the consumer in the Islamic Finance context. This security and peace of mind cannot be attained in an Islamic finance context because *Shariah* is generally opposed to a person seeking to protect themselves from future risks; this is particularly frowned upon in Islamic finance.[434] While *Shariah* practitioners have adopted an insurance instrument known as *takaful*, this is not a tool particularly suitable for the purposes of loan protection.

Islamic finance does not allow hedging of risk because of the two fundamental *Shariah* law proscriptions: against *gharar* (uncertainty)[435] and *maysir* (speculation).

Consider that in a conventional loan transaction the debtor can purchase insurance at the point of entering into the loan contract; this insurance payment is made *ex ante* which means that the debtor risks that the event he is insuring himself against will not come to pass. In such a situation, any amount paid for the insurance policy is an added cost to the transaction. The debtor pays the extra cost of the insurance policy because it provides him with the feeling of security that the insurer will compensate him if the feared outcome eventually *does* come to pass. Taking a loan and insuring it therefore requires that the consumer balances between the potential losses insured against and the certain loss of money paid for that insurance; debtors take out insurance when the loss they fear is sufficiently serious to make losing the policy amount worthwhile. On the other hand, such rationale is not possible in Islam since paying money ex ante to protect against future risk could be qualified as *gharar*. [436]

Furthermore, as was touched upon above, if the commodity purchased through a *murabaha* gets damaged in some way, the detriment falls on the consumer (party B). To this end, bad performance of the commodity or losses due to circumstances within or without the control of the

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[434] Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar 2009), 26.
[435] Muhammad Ayub, *Understanding Islamic finance*, (John Wiley and Sons Ltd, 2007), Chapter 5, 5.5.2, 110.
[436] Ibid, 26.

purchaser (such as bad management, for instance) do not mitigate the obligation. [437] If the commodity is insured by the bank, then the price of the insurance is passed on to the consumer. In this aspect, the contract resembles conventional loans.

7.3.5. Variations of murabaha: tawarruq (Islamic Loans)

As discussed earlier, Islamic finance has recourse to instruments which in their structure and purpose are substantially very similar to *murabaha*. One such contract is the *tawarruq*, which would be discussed at some length below. The case of *tawarruq* is instructive because it demonstrates how vulnerable to critiques from a *Shariah* law perspective some of the most popular Islamic finance instruments are. Furthermore, because of the controversy of the instrument, its analysis highlights the on-going ideological debate in Muslim countries. As a last point, the discussion on the customer protection issues attached to *tawarruq* supports the argument (which will be further developed in this work), that the current format of Islamic financial instruments is inadequate to protect the parties in case the contract breaks down. As will be later argued, this could be particularly the case when cross-border trade is concerned and even more so, when one of the contracting parties is a Western business.

7.3.5.1. Overview of tawarruq

Tawarruq is a specific loan contract used to monetise a commodity.[438] The Saudi Arabian National Commercial Bank (NCB) was the first to use *tawarruq* under the name of "*taysir*" in 2000.[439] In the following years the contract gained popularity in the rest of the Gulf Cooperation States (The United Arab Emirates, Kuwait, Oman, Bahrain and Qatar). The term derives from the words *tawarraqa* (to eat leaves) and *wariq* (minted or non-minted dirhams of silver), suggesting

[437] Siddiqi (n 429), 72.
[438] M A El-Gamal, *Islamic finance: Law, Economics, and Practice*, (CUP, 2006), 69; El-Gamal, 'Overview of Islamic finance', (2006), http://www.ruf.rice.edu accessed 5th July 2019], 4.
[439] Nagaoka Shinsuke, 'Critical Overview of the History of Islamic Economics: Formation, Transformation, and New Horizons' (2012) 11(2) Asian and African Area Studies 114, 127.

that the contract was used initially as a way of sourcing silver money and later for monetisation of any kind.[440]

The instrument allows a borrower (the *mutawarriq* - party A) to purchase certain goods on credit, which has been issued to him by a lender (party B) only to sell these goods immediately to a buyer (party C). This demonstrates that *tawarruq* consists of two transactions; the first one takes place when party B grants party A the requested credit. The payment in this transaction is arranged on a deferred basis.[441]The second transaction happens when party B sells the goods to party C for cash. [442]

Tawarruq is the Islamic version of the conventional model of financing of retail commerce by credit from the bank. Such transactions are very popular in secular commerce because they enable retailers to start a business without capital or alternatively, to win business without worrying how they will source the capital. Such loan contracts are also widely used in Islamic commerce. Furthermore, this type of financing has proven suitable for the real market (mortgages) and among bank customers for personal finance and credit cards market. In addition, it has been widely used by modern Islamic bankers for liquidity management.[443]

The simplest as well as the most popular version of *tawarruq* is a transaction where an Islamic bank would buy a commodity of interest at a spot price on behalf of the *mutawarriq*, then sell it back to him via a *murabaha* contract. The *mutawarriq* then sells the commodity to the open market at a price which should be higher than the spot price at which the bank purchased the commodity. Finally, the borrower pays the bank back at maturity and at the rate determined in the *murabaha* contract.

While used in a number of jurisdictions, (for example, the Gulf Cooperation States deem *tawarruq Shariah* compliant), the instrument remains controversial as many schools do not approve of it at all, whilst others accept it but under certain conditions. Among those who reject

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[440] Muhammad Masum Billah, 'The Prohibition of Ribā and the Use of Ḥiyāl by Islamic Banks to Overcome the Prohibition' (2014) 28(4) Arab Law Quarterly 398, 408.
[441] Banka Negara, 'Tawarruq' (2015) http://www.bnm.gov.my/guidelines/05_shariah/PD_Tawarruq.pdf accessed 6th July 2019, 1.
[442] Ibid.
[443] Islamic Market, 'Tawarruq' (2019) https://islamicmarkets.com/education/tawarruq accessed 7th July 2019.

tawarruq are the International Islamic Fiqh Academy in Jeddah, Saudi Arabia and the Muslim World League Fiqh Academy, based in Mecca, also Saudi Arabia.

The Mecca Academy issued its first ruling on *tawarruq* in 1998,[444] approving its use without reservations about its structure. However, as a result of the development of an opinion among scholars that *tawarruq* is at the least controversial, in its second ruling issued in 2003,[445] the Academy distinguished between *tawarruq haqiqi* (intrinsic *tawarruq*), which it approved and *tawarruq munazzam* (organized *tawarruq*), which it rejected.

Tawarruq munazzam was inadmissible because it contained three elements that were not permissible under *Shariah* law:

> *(1) An Islamic bank is involved in a resale and liquidization process as an agent of its customer.*
>
> *(2) The involvement of Islamic bank in the entire process of tawarruq makes the transfer of the title of the relevant good unclear.*
>
> *(3) Providing tawarruq becomes merely a stable way for the bank to earn profits.*[446]

With this ruling, the Mecca Academy addressed the considerable body of opinions on *tawarruq* which doubted its legality under *Shariah* law. Indeed, the instrument raised some serious scholarly objections, in addition to the three points included in the Mecca judgment. For example, of great concern was the connection of *tawarruq* to *riba* and its similarity to *bai al inah*,[447] leading many academics to believe that the contract should not be deemed *Shariah* compliant. The main weakness of the arrangement was found to be the practice of 'bundling and stipulating the resale and liquidization process … with the original sale.'[448] The issue here is that in most cases *tawarruq* is carried out entirely by the lender, who profits from the difference in the price at which the product is originally purchased and the final payment delivered by the

[444] No. 5 resolution of the meeting) [MWL 1999: 161-162].
[445] No. 3 resolution of its meeting) [MWL 2004: 287-288].
[446] Nagaoka Shinsuke (n 439), 128.
[447] Bank Negara Malaysia defines *bai` `inah* as "an arrangement that involves sale of an asset to the purchaser on a deferred basis and subsequent purchase of the asset at a cash price lower than the deferred sale price or vice versa, and which complies with the specific requirements of bai` `inah." In Bank Negara, 'Bai``Inah (Shariah Requirements and Optional Practices)' (2013), 7.1
[448] Nagaoka Shinsuke (n 439), 128.

borrower. For many commentators, this appears to be just a dress up of a conventional loan in a *Shariah* compliant form because 'the actual transactions of the real good tend to become just nominal on paper.'[449]

Critics comment on the fact that *tawarruq* mimics conventional loans not only from a micro but also from a macroeconomic perspective.[450] There have been arguments that despite being a *quasi*-replica of conventional interest-based loans, *tawarruq* is deficient in comparison as it leaves the transacting parties economically worse off than they would have been had they used a conventional instrument instead of *tawarruq*.[451] This concern prompted the recommendation:

> *If the bank appoints the Mutawarriq himself as its agent to purchase the commodity on behalf of the bank, then to sell it to himself, this transaction is invalid. However, if the bank appoints him as an agent only for the purchase of a commodity on behalf of the bank, then once it is purchased, the bank itself sells it to Mutawarriq through a proper contract with offer and acceptance, the transaction is valid, but not advisable.*[452]

The suggested approach indicates that in order for a *tawarruq* transaction to be deemed acceptable (note that even if the conditions are fulfilled, it is still not advisable to resort to *tawarruq*) a certain degree of transparency would have to be demonstrated as well as the existence of a legally binding contract between two distinct parties. The *mutawarriq* contracting with himself, despite acting as an agent of the bank would be something that would clearly invalidate the contract, because the elements of offer and acceptance would be missing. These elements are essential for a contract, also from the perspective of the common law, which would deem such a contract void and therefore unenforceable for want of consideration. The common law could be relevant to this type of transactions because *tawarruq* is often structured for the purpose of buying and selling commodities at the London Metal Exchange.

Furthermore, it has been noted that:

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[449] Nagaoka Shinsuke (n 439), 128.

[450] N Siddiqi, 'Islamic Banking and Finance in Theory and Practice: A Survey of State of the Art' (2006) 13(2) Islamic Economic Studies 1, 16.

[451] Monzer Kahf, 'Outlines of a Brief Framework of Tawarruq (Cash Procurement) and Securitization in Shariah and Islamic Banking' (2004) a paper written for the Seminar of the AAOIFI in Manama, 15th February, 6.

[452] Islamic Market, 'Tawarruq' (2019) https://islamicmarkets.com/education/tawarruq accessed 7th July 2019.

> *If the 'Mutawarriq' after purchasing the commodity from the bank, appoints the bank his agent to sell it in the market and this agency is stipulated in the contract of sale as a condition, the translation is not valid. However, if the agency was not a condition in the sale contract, and it has been affected after unconditioned sale, the transaction is valid, but not advisable.*[453]

The above focuses on whether the contract has been pre-determined in its entirety or there has been an element of freedom retained by the borrower. The issue here is with the stipulation, at the point of signing of the contract, of all the steps that need to be taken in order for the contract to be performed. To this end, making the bank an agent of the *mutawarriq* and turning this into a condition of the contract (i.e. something that goes to the heart of the contract), demonstrates that the arrangement between the parties is nominal. Furthermore, it intimates that the only purpose of entering such a complex process is to avoid an accusation that the parties have committed *riba*.

This confirms that unless the transaction was staged the way proposed by the Academy, it could be perceived as containing interest, which would put the validity of the contract under serious doubt. Furthermore, it could allow an inference that the specific structure was consciously used to conceal the contract's illegality under *Shariah* law. It is evident that even after the second Academy ruling, a great deal of uncertainty remained on the *tawarruq* market, prompting, in 2009, the addressing of the situation by the AAOIFI. The AAOIFI's standard 30, [454] had the purpose to guide the market along a *Shariah* compliant way of using the *tawarruq* arrangement.

Broadly speaking, the AAOIFI confirmed the second ruling of the Mecca Academy. This was to be expected as the standard was issued under the Muslim World League's auspices. Most notably, AAOIFI

> *(a) prohibits a linkage between the contract for the mutawariq's purchase of the commodity on a deferred basis and the contract for the sale of the commodity by the mutawariq to a third party;*
>
> *(b) prohibits the entity that sells the commodity to the mutawariq on a deferred payment basis from acting as, or arranging for, the sales agent for the mutawariq in its cash sale to a third party, unless required by law;*

[453] Islamic Market, 'Tawarruq' (2019) https://islamicmarkets.com/education/tawarruq accessed 7th July 2019.
[454] Shari`a Standard No. (30), Monetization (*Tawarruq*), SHARI`A STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS 1432 H - 2010, AAOIFI (the "AAOIFI Monetization Standard"). This standard is applicable to both deferred payment *murabaha* and deferred payment *musawamma* transactions.

> *and (c) requires the mutawariq to itself sell the commodity it acquired on a deferred payment basis or to sell that commodity through an agent other than the entity that sold the commodity to the mutawariq on a deferred payment basis.*[455]

However, the standard goes further that the Mecca Academy's ruling by stating that:

> *The contemporary definition on organized tawarruq is: when a person (mustawriq) buys merchandise from a local or international market on a deferred-price basis. The financier arranges the sale agreement either himself or through his agent (tawkil).*[456]

In reality this indicates that a *Shariah* compliant *tawarruq* would be increasingly difficult to structure. Most of *tawarruq* transactions necessitate a bank to step in as the lender and in that case it is hard to remain entirely outside the organised *tawarruq*. Despite the difficulties, the instrument remains popular and this suggests that a lot of the contracts that have been concluded in the last decade could be deemed void on a stricter reading of the law.

7.3.5.2. Structuring organised tawarruq

Breaking down the arrangement should assist the reader's understanding of the *Shariah*-related concerns of the organised *tawarruq* arrangement.

As a first step the client C applies to the bank B for *tawarruq* financing. C delivers the necessary transaction documents to B. Upon approval, B proceeds to purchase the commodity, typically at the London Metal Exchange, using the services of Broker 1 (B1). B concludes a *murabaha* contract with C, selling the commodity to C at a pre-agreed selling price and on a deferred payment basis. This would be the price of purchase plus a cost plus. The cost plus could be a lump sum or a percentage but this must be agreed between the parties in advance. C concludes a *wakalah* contract (contract of agency) with B, instructing B to sell the commodity on the open market. Upon receiving the instruction, B sells to Broker 2 (B2) and credits the proceeds (*wariq*)

[455] Michael J T McMillen (n 423), 6-7.
[456] AAOIFI, OIC 2009: 12-13.

of the sale to C's account. C pays B back the pre-determined amount (principal plus mark-up) at maturity or in instalments, as per the parties' agreement.[457]

7.3.5.3. Structuring permitted tawarruq

The three party *tawarruq* contract applies to the sale of commodities, for example metal (note however that gold and silver cannot be traded in Islam; therefore, if metal is traded, it must be non-precious). There are different types of non-organised *tawarruq* structures. The simplest one is when the bank B buys certain goods on behalf of the client C upon which time the parties sign a contract that the money will be paid in instalments or at a later date. The bank profits from this transaction because if the goods cost a certain amount A, it will receive back from the borrower A+ a pre-determined mark up. C profits by obtaining cash (from reselling the goods that the bank initially purchased, usually at the same price at which the goods were originally bought), which C could then use to invest. [458]

As is seen from this explanation, the transaction is identical with that of a *murabaha*, but is limited to commodities. This explains why *tawarruq* is often referred to as commodity *murabaha*. Of course, this applies to the permitted version of *tawarruq* (*tawarruq haqiqi*). Another type of *tawarruq* would take place when B purchases the commodity from a broker, after which it sells it to C with a cost plus, on the basis of deferred payment. At this point C has two options: either to resell the commodities to the original broker or to seek a buyer on the market. Whichever option is pursued, however, C will receive immediate cash satisfaction as a result of the trade. The choice of a third party buyer is important because under the stricter approach to *tawarruq*, selling back to the original broker would render the transaction organised *tawarruq* and therefore, illegal under Islamic law.

It is an interesting fact that *tawarruq* is used mostly in territories where the *Hanbali* (Saudi Arabia, Qatar) and *Maliki* (Kuwait, United Arab Emirates, some parts of Egypt) schools have the most followers, in addition to Malaysia (*Shafi'i* School). While *Hanbali* is the strictest *Sunni* School, it is known to allow greater flexibility in financial matters, which is why *tawarruq*

[457] Mohammed Khnifer, 'Maslahah and the Permissibility of Organized Tawarruq', Opalesque Islamic finance Intelligence, 8.
[458] Visser (n 85), 30.

arrangements proliferated under its auspices. However, it was perhaps in appreciation of this fact, that the Saudi Arabia based Organisation of Islamic Cooperation (OIC), which is a party to the Islamic Fiqh Academy of the OIC and AAOIFI, took a more restrictive stance on *tawarruq* and particularly so, on organised *tawarruq*.

7.3.5.4. Problems with tawarruq from a jurisprudential perspective

7.3.5.4.1. Tawarruq mimicking murabaha

Some of the problems marring *tawarruq* stem from its suspicious similarity to other instruments, giving force to arguments that *tawarruq* is nothing more than a clever legalistic exercise. For example, as pointed out above, there is a significant resemblance between the structures of *tawarruq* and *murabaha*. However, in the *murabaha*, the bank provides the customer with cash instead of goods or commodities although the cash can be obtained through the sale of goods and commodities. To this end, note that *tawarruq* does not require physical possession of the commodity because the exchange of title between the parties is only nominal.

While *tawarruq* is a more complex arrangement than the *murabaha* one, it has the benefit of providing the customer with a quicker way to source financing. However, this does not change the fact that *tawarruq*, *murabaha* and *reverse murabaha* (which is a contract effectively identical with *tawarruq*) contracts are the same in substance. For this reason either could be used for the same transaction; their terms are deemed interchangeable.[459]

7.3.5.4.2. Objections to tawarruq: legal basis

The reason some schools take a restrictive approach to *tawarruq* is that the arrangement often entails a very quick exchange, which is rarely a physical exchange of the goods and is more often done by employing the method of warehouse warrants. This means that title is exchanged quickly between the parties. While this may be acceptable on the conventional market, for instance on the

[459] Atif Hanif, 'Islamic finance - an overview', (2008) 1 IELR 9, 11-12.

securities market, the *tawarruq* trade structure appears suspect from an Islamic finance perspective. This remains the case regardless of the usefulness of *tawarruq* for sourcing of capital. In fact, precisely because, or rather when[460] the arrangement is used as an artificial devise for the above purpose, it triggers suspicion of incompliance with the requirements of *Shariah* law. In such a scenario, not only the *tawarruq* instrument conceals the use of *riba* but it abides by the requirement of *Shariah* finance law to deal exclusively with tangible products (satisfied by the commodity, subject of the trade) only nominally, in order to generate money which could then be utilised for purposes or products outside the compliant framework.

Other objections to *tawarruq* point out that it is unsecured lending. [461] This makes its usage potentially very risky. Furthermore, it has been noted that although, due to its resemblance to unsecured conventional loans, *tawarruq* has been successfully used by conventional financial institutions opening an “Islamic” window, [462] this should not be seen as justification for the instrument’s use on the Islamic market. In fact, it could be argued strongly that if any resemblance between Islamic instruments and their conventional counterparts could be accepted in the Islamic financial market, it should not be in the area of unsecured loans.

Furthermore, comparison with conventional loans would make it clear that a *tawarruq* transaction is potentially riskier. While in both type of loans the lender bears the credit risk, in *tawarruq* he also bears the risk generated by the trade of the commodities subject to the *tawarruq*. This could be a risk that the commodities will not be delivered or that they will perish prior to being monetised. In addition, *tawarruq* increases the risk borne by the debtor, again because of the involvement of commodities the price of which is possible to drop with respect to the price the lender paid to obtain it. [463]

Other points that have been raised with respect to *tawarruq* include impracticality of the contracted commodity. This is because very often, and particularly so in organised *tawarruq*, the bank is not interested in the quality of the commodity, subject to the contract. Also often, the bank is not concerned whether the commodity really exists in its contracted form and its stated

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[460] Mahmoud Amin El-Gamal, ‘Limits and Dangers of Shari'a Arbitrage’, available at: <http://www.ruf.rice.edu>accessed 9th July 2019.
[461] Hjh Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, (2009) 30(6) Comp. Law 176, 183.
[462] El-Gamal, Overview of Islamic finance, (n 460), 5.
[463] Atif Hanif, ‘Islamic finance - an overview’, (2008) 1 IELR 9, 11-12.

location because the selling and reselling of said commodity takes place without it leaving its purported location.[464] This is in line with how *tawarruq* is used in present time because the commodities, subject of the organised *tawarruq*, are usually only available to licenced customers i.e. big financial companies, including banks. This would exclude retail customers from the list of potential buyers. With this in mind, very often contracts for organised *tawarruq* contain an explicit or implicit clause to the effect that the customer is not entitled to take delivery of the commodity.[465] With a view of the commodities which traditionally have been used in *tawarruq* transactions, namely barrels of crude palm oils or tones of metals, it is understandable why delivery was not considered a viable part of the contract, particularly in the case of retail customers. However, this raises an issue with *Shariah* finance law as one of the main principles applicable to this context is that the commodities must be good, valuable, *Shariah* compliant and deliverable to the end customer.

Another controversial issue is the pre-arrangement structure in *tawarruq*, concerning future purchase undertakings with respect to the different stages of the transaction. This has been closely linked to the already discussed agency problem, accusations of fictitious sale and liability for lack of transparency regarding purchase price, profit and mark-up. While pre-arrangement is impossible to fully avoid with a view of adopting a risk management strategy, the case of *tawarruq* creates the strong impression that the entire structure is built with the intention to generate cash and conceal the use of *riba*.[466]

The so-called agency problem has implications on consumer protection. While appointing the bank as an agent effectively displaces the customer from directly taking part in any of the transactions, it also conceals possible conflicts of interest regarding the transactions. Furthermore, the lack of direct participation by the customer makes assigning responsibility for the commodities and subsequent liability for them in case that damage has occurred much more challenging.[467]

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[464] Global Islamic Finance Report, 'Shari'a Analysis of Tawarruq Based Products' (2016) 10 Islamic Financial Policy 296, 309.
[465] ISRA, 'Fatwa in Islamic Finance', (September 2013), 3.
[466] Global Islamic Finance Report, (n 464), 309.
[467] Global Islamic Finance Report, (n 464), 308.

In light of the discussion that took place above, it would be valuable to consider the *tawarruq* guidance issued in 2015 by the Malaysian Nigara Bank (in force from 2016 onwards).

> *9. Definition*
>
> *S 9.1 A tawarruq consists of two sale and purchase contracts. The first involves the sale of an asset by a seller to a purchaser on a deferred basis. Subsequently, the purchaser of the first sale will sell the same asset to a third party on a cash and spot basis.*
>
> *10. Nature*
>
> *S 10.1 Each sale and purchase contract in the tawarruq is binding in nature and shall not be terminated unilaterally by any of the contracting parties.*
>
> *S 10.2 The common inherent nature of each sale and purchase contract in the tawarruq is the transfer of ownership of the asset from the seller to the purchaser for a consideration.*
>
> *G 10.3 The sale and purchase contract in the tawarruq may take in the form of a murabahah or musawamah.*[468]

While the guidance is easy to follow, it arguably oversimplifies *tawarruq*. It is for example not clear why the bank should characterise *tawarruq* as consisting of two sale and purchase transactions.[469] Although the same definition is employed in other sources,[470] in fact, *tawarruq* is better defined as an umbrella term for a complex transaction consisting of a number of smaller transactions. For example, the guidance does not mention the *wakalah* contract (agency contract) between the *mutawarriq* and the bank or the sale and purchase contract between the bank and the broker. Furthermore, the guidance states that each contract is binding and it shall not be terminated unilaterally.[471] As was seen this is not entirely correct because existence of aspects to the contract which will render it *Shariah* incompliant are basis for the contract to be declared voidable or even void. However, even more importantly, *Shariah* law requires that when two or more contracts are bundled together to structure a complex transaction, they stand independently from one another. Claiming that each contract is binding and cannot be terminated unilaterally

[468] Bank Negara Malaysia, 'Tawarruq' (2015), 6.
[469] Ibid, 9.1.
[470] Global Islamic Finance Report, 'Shari'a Analysis of Tawarruq Based Products' (2016) 10 Islamic Financial Policy 296, 297.
[471] Bank Negara (n 468), 10.1.

suggests that the contracts are not considered independent from each other. Note that, combining two transactions into one is proscribed in Islam and so is combining of contracts for sale and contracts of debt.[472] While it is obvious that the second leg of the proscription is breached in the case of *tawarruq* as a matter of principle, the first one is arguably breached in the example of Bank Negara's guidance.

Finally, the bank states that the *tawarruq* could be executed in the form of *murabaha* or *musawamah*. While *murabaha* is largely acceptable for this type of transactions, consider the definition of *musawamah* (bargaining), offered by Investopedia: "Musawamah is an Islamic finance term that describes a sale in which the seller is not obligated to disclose to a buyer the price paid by the seller to create or obtain the good or service."[473] Although the AAOIFI defines *tawarruq* 'as the process of purchasing a commodity for a deferred price determined through musawamah (bargaining) or murabaha (mark-up sale), and selling it to a third party for a spot price so as to obtain cash',[474] this does not in itself guarantee or require that during the process of bargaining the price of the principal will be disclosed to the customer. This is arguably problematic by the AAOIFI's own criteria.

The issue arises because in order for *tawarruq* to be deemed legal, it needs full transparency. It is of particular importance that this transparency runs deep into the transaction and concerns all elements, including the price at which the commodity was initially purchased. This is relevant to the additional costs which the bank is entitled to include in the final price and which are payable by the customer in addition to the pre-agreed mark-up. It is evident that Bank Negara is aware of the implications of the inclusion of *musawamah,* because it states that documentation for the *tawarruq* should include: '(e) the selling or purchase price including breakdown of cost and profit, if murabahah is adopted".[475] In addition, with respect to transparency and disclosure to the customer at the pre-contractual stage, the bank states that "the information shall include: a

[472] See Chapter 7:[7.8.1.].
[473] Will Kenton, 'Musawamah' (2018) Investopedia, https://www.investopedia.com/terms/m/musawamah.asp accessed 9th July 2019.
[474] AAOIFI (2010), Shari'a Standards for Islamic Financial Institutions, Bahrain: AAOIFI, pg. 525, in Global Islamic Finance Report, 'Shari'a Analysis of Tawarruq Based Products' (2016) 10 Islamic Financial Policy 296, 297.
[475] Bank Negara (n 471), 27.8.e.

description of the approved asset and/or asset exchange used, price and disclosure of cost and profit where murabahah is applied."[476]

Furthermore, the bank states that "For the avoidance of doubt, where the IFI is performing a dual-agency role, performance of each role must be evidenced by appropriate documentation or record."[477] According to standard 30, dual-agency role is not permitted because this is one of the issues with organised *tawarruq*.[478] Furthermore, dual-agency may easily transcend into selling back the commodity to the original seller, which is not allowed. Consider that according to 2016 analysis of the Global Islamic Finance Report, similar arrangement is characteristic for *bai-inah* (buy back transaction), rather than *tawarruq*. The buyback (*inah*) contract has the same objective as *tawarruq*, namely to secure cash or liquidity. However, scholars perceive *inah* as containing *riba* and the different Islamic schools are largely suspicious if not outright disapproving of it.[479] Scholars argue that the final price in *inah* contracts is arrived at without providing real counter value[480] and the mark-up is imposed 'neither for a consumption nor trading purpose'.[481] Notably, *bai-inah* contracts are permitted in Malaysia while they are not in the Gulf States.[482]

Regardless, the Bank Negara appears confident in the legality of the instrument citing verses from the *Qur'an* and a general understanding of the *Sunnah* stance on trade in support of its opinion:

> *The following verse of the Quran implies the general permissibility of sales contract including tawarruq: "…whereas Allah SWT has permitted trading and forbidden usury…" (Surah al-Baqarah, verse 275)*
>
> *There is no direct juristic authority from the Sunnah of the Prophet (peace be upon him) regarding the legitimacy of the tawarruq. It is deemed permissible based on the general permissibility of sales in Islamic law.*[483]

[476] Bank Negara (n 471), 27.4.d.
[477] Bank Negara (n 471), 27.10.
[478] "(c) requires the mutawariq to itself sell the commodity it acquired on a deferred payment basis or to sell that commodity through an agent other than the entity that sold the commodity to the mutawariq on a deferred payment basis" in Michael J T McMillen (n 423), 6-7.
[479] Global Islamic Finance Report (n 470), 304.
[480] Per Ibn Taimiyyah as pointed out in Global Islamic Finance Report (n 470), 297.
[481] Per Imam Malik as pointed out in Global Islamic Finance Report (n 470), 297.
[482] Hans Visser ed., *Islamic Finance: Principles and Practice*, (Edward Elgar 2009), 69. See also, Islamic Bankers Resource Centre, 'Financing: Tawarruq (Commodity Murabaha)' (n.d.) https://islamicbankers.me/islamic-banking-islamic-contracts/financing-commodity-murabaha-tawarruq/ accessed 30th August 2019.
[483] Bank Negara (n 471), 38.

It should be noted that while in the opinion of the bank the above confirms the legality of the instrument *tawarruq*, it does not indicate that it confirms the legality of all iterations of the instrument. It is suggested that the on-going successful use of *tawarruq* will very much depend on how precisely its structure adheres to the existing *Shariah* finance requirements. This opinion is supported by the latest OIC and AAOIFI's publications on the matter, most notably, standard 30, discussed earlier.

The apparent controversy in the Malaysian approach to *tawarruq* becomes even more worrying if one considers that over 50% of the total financing of Bank Negara comes from *murabaha*, which *tawarruq* is deemed a form of.[484] In addition, consider that according to a 2015 survey

> *'tawarruq represented more than 80 per cent of the total financing portfolio in three Malaysian Islamic banks, between 61 per cent and 80 per cent in six Islamic banks; and between 40 and 60 per cent in two Islamic banks. The rest applied tawarruq in relatively smaller portions, constituting less than 40 per cent of their total financing portfolio.'*[485]

Despite the above arguments, it must be acknowledged that since the AAOIFI's standards are compulsory for only a small number of Islamic countries, namely Bahrain, Jordan, Qatar (Qatar Financial Centre), Sudan and Syria, the Malaysian Central Bank is not under an obligation to follow them. A much larger number of countries have chosen to voluntarily follow AAOIFI's guidance with some modifications. Among them are the United Kingdom, Saudi Arabia, Egypt, United Arab Emirates, Brunei, Dubai International Financial Centre, Kuwait, Lebanon, France, South Africa, as well some countries in Africa and Asia. Relevantly, Malaysia is among these countries.[486] Furthermore, most of the Islamic (*Sunni*) schools of thought allow the instrument albeit with some reservations, mostly regarding organised *tawarruq*. The resulting conflict of opinions contributed to a confusion on the market and even in opinions that Malaysia must put in place some parameters and limitations in the use of the instrument.[487] Quite correctly, it has been

[484] Global Islamic Finance Report, 'Shari'a Analysis of Tawarruq Based Products' (2016) 10 Islamic Financial Policy 296, 296.
[485] Mohammad Mahbubi Ali, 'Tawarruq - the 'new kid' in Islamic banking' (2017) https://www.nst.com.my/news/2017/03/225846/tawarruq-new-kid-islamic-banking accessed 9th July 2019.
[486] Ibid, 305.
[487] Ali (n 485). See also, Habeebah Simisola Fa-Yusuf1&Ndeye Djiba Ndiaye, ' Issues with the Use of Tawarruq in Malaysia' (2017) 5(2) Journal of Islamic Banking and Finance 30, 35.

noted that if the Malaysian IFIs refrain from doing this, they risk becoming isolated with their *tawarruq* trading volume remaining outside the international market network. This outcome is expected on the basis of the finding that *tawarruq* is still considered controversial in many Islamic countries. Secondly, it has been argued that overusing the instrument 'does not substantially add to the IFI value preposition and economic growth due to debt nature inherent in the concept.'[488] Lastly, commentators are wary that 'tawarruq requires more prudent risk mitigation because it is prone to exposure to a large volume of syariah non-compliance events.'[489]

The analysis of *tawarruq* was intended to bring together the most significant scholarly concerns about the arrangement, without ignoring the benefits of using this instrument (or rather, this umbrella term, as some suggest).[490] Although many theorists consider *tawarruq* a variant of *murabaha* (terming it "*commodity murabaha"*), the two instruments do not completely overlap (for example, *murabaha* has a wider application), which makes it necessary to examine the advantages and disadvantages of *murabaha* as a loan arrangement. In the interest of impartiality, this analysis will begin with examination of the benefits of the *murabaha* instrument to conventional loans.

7.3.6. Murabaha's advantages to conventional loans

Unlike *tawarruq*, which creates potential risks for the parties to the arrangement, *murabaha* is ostensibly beneficial both to the buyer of the loan and the financial system.

For example, what sets *murabaha* apart from conventional loans is the lack of penalty for late payments or defaults resulting in less consumer debt than the traditional credit purchase model. Furthermore, *murabaha* contracts are deemed safer for the financial system because they contain a low degree of risk.

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488 Ali (n 485).
489 Ali (n 485).
490 See Islamic Bankers Resource Centre, 'Financing: Tawarruq (Commodity Murabaha)' (n.d.) https://islamicbankers.me/islamic-banking-islamic-contracts/financing-commodity-murabaha-tawarruq/ accessed 30th August 2019.

In addition, conventional loans are perceived as less fair than the Islamic ones because by imposing excessive interest they promote profit sharing (party A share into the profit of party B) without sharing of the loss. The comparatively more beneficial conditions of *murabaha* financing could therefore, if properly administered, stimulate enterprise at a higher rate than its conventional counterpart. Overall, *murabaha* is extra appealing because of the greater degree of reciprocity and justness it brings to transactions, compared to conventional loans. [491]

As touched upon earlier, Islamic finance distinguishes between penalisation and compensation for late payments and defaults. While conventional banks would penalise a customer, defaulting on his loan, by adding extra charge to his obligation (which is rational behaviour for the bank as it adds to its profit), this is not the case for Islamic banks. *Shariah* does not approve of penalising the debtor. Also, it holds a more relaxed stance as regard the compensation of the creditor (the bank). *Shariah* generally rewards the expended in a transaction skills and labour. As far as a *murabaha* contract is concerned, the bank is expected to have expended an amount of effort and knowledge in the course of the transaction. This has to be rewarded and *Shariah* does not, in principle, object to a reward. However, while the cost plus serves this purpose, it is unclear whether any amount on top of the cost plus could justifiably reward the bank as the default is not due to a contribution of the bank but to mismanagement or bad luck on the part of the debtor.[492] This is the reason why imposing extra payment onto the existing obligation of the consumer for reason of his defaulting under the contract could be interpreted as *riba*.[493] To put this in context, *Shariah* promotes charitable attitude towards people of lesser means and the rules of Islamic law are in place, to a great degree, to guarantee that poor people are not taken advantage of. This is proven by the fact that in like circumstances more wealthy debtors are not considered so favourably and interest exceeding the initially agreed sum could be allowed by the court. [494]

[491] Siddiqi (n 208), 73.
[492] Of course, this approach disregards the policy reasons behind penalization of late payments I the conventional system.
[493] Ibn al-Haj Mohammad Saleh, (2002), 'al-Ta'wid 'ind al-Takhir fi al-Sidad bain al-Mu 'aradah wa'l Ta' id', in Majallat al-Masarif (Khartoum), No. 1, June, 92-93.
[494] Mustafa Ahmed Al-Zarqa, (1996), 'Hawl Jawaz Ilzam al-Madin al-Mumatil bi-Ta'wid al-Da'in', in Dirasat Iqtisadiyah Islamiyah, (Jeddah), Vol. 3, no. 2, Rajab 1417, 9-37.

7.3.7. Murabaha: challenges from a Shariah-compliance perspective

One of the main challenges of the *murabaha* contract is that supposedly includes interest, despite this being presented in a *Shariah* acceptable form. Interest is tacked on the commodity rather than on the money, however, which makes it, at least nominally, less challenging from a *Shariah* perspective. However, it is possible that while assisting with the legality of the contract, the artificial distinction between commodity and money imposed by Islamic finance could be one of the reasons why Islamic banks are performing substandard in terms of liquidity. This is because their investments are necessarily dependant on the increase or decrease of the price or performance of the specific commodity. As a result, underperformance of the commodity would be more detrimental to a *Shariah* bank than it would be to a conventional bank, the attention of which is largely focused on the money invested.

Apart from accusation of *riba*, arguably the greatest challenge for *murabaha* based transactions is that the subject matter of the contract is something that the parties do not yet own. In order to solve this problem, Islamic financiers resorted to structure *murabaha* contracts with the help of *wa'd*. Consider a typical case in which a *murabaha* contract is used by banks to assist customers with the purchase of a certain financial facility. In such a scenario, because the purchase refers to something the bank does not yet own, it should be forbidden under *Shariah* law. In order to sidestep this problem, banks added a *wa'd* to the *murabaha* transaction (prior to it), thus turning it into a *Shariah* acceptable one. An example of how banks may operate in respect to *murabaha* contracts is a study published by the Malaysian Central Bank (Negara Bank), which refers to the above operation as "Arrangement of murabahah with other contract or concept".[495] The Bank's section on the above is instructive and for this it is given below in full:

> *"15.1 Murabahah to the purchase orderer (MPO) refers to an arrangement whereby the purchase orderer (purchaser) promises (wa`d) to purchase an identified and specified asset from a seller on murabahah terms upon the latter's acquisition of the asset.*
>
> *15.2 The wa`d to purchase the asset shall be binding on the purchase orderer when the seller has taken an action to acquire the asset.*
>
> *15.3 The wa`d shall be executed separately from, and before entering into the murabahah contract*

[495] Bank Negara Malaysia, 'Murabahah' (2013) BNM/RH/STD 028-4 Islamic Banking and Takaful Department, 15.

15.4 Pursuant to paragraph 15.3, the wa'd may be incorporated in other legal document such as–

(i) a master agreement provided that the master agreement does not carry the effect of murabahah contract; or

(ii) in a stand-alone document.

15.5 The purchase orderer who promised to purchase and take delivery of the asset but refused to enter into the murabahah contract upon the seller's purchase of the asset as per the agreed terms shall be held liable for breach of wa`d.

15.6 Pursuant to paragraph 15.5, the purchase orderer shall compensate the seller for actual costs incurred in the acquisition of the asset and its disposal to a third party and the shortfall in the disposal price compared to the purchase price (if any).

15.7 The murabahah contract shall not be entered into prior to the purchase of the murabahah asset by the seller.

15.8 In the event that the purchase orderer has purchased the asset from the supplier, the seller in the MPO arrangement shall establish his ownership of the asset either by terminating the purchase contract and entering into a new purchase contract with the supplier, or by any other means of transfer of ownership which is in compliance with Shariah.

15.9 The purchase orderer may request the seller to purchase the assets intended for the murabahah transaction from a specific market place or a supplier. However, the seller may decline this request for whatever reason deemed reasonable by the seller as long as the assets fulfil the agreed specifications.

15.10 Upon acquisition of an asset by the seller and until the murabahah contract is entered into with the purchase orderer, the seller shall assume the ownership risk of the asset.

15.11 Pursuant to paragraph 15.10, the seller may obtain takaful coverage on the asset acquired before selling it to the purchase orderer. The takaful contribution paid by the seller may be added to the acquisition cost.

15.12 Under the MPO, at the stage of acquisition from the supplier, the seller shall not require the purchase orderer to subscribe to takaful coverage to ensure the payment of the price by the seller to the supplier.

15.13 Assets purchased by the seller according to the purchase orderer's requirements may be delivered to the purchase orderer to be held as a trust before entering into the murabahah contract.

15.14 Pursuant to paragraph 15.13, loss or damage of asset in the possession of the purchase orderer before entering into the murabahah contract due to negligence of the purchase orderer shall be borne by the purchase orderer.

15.15 The purchase orderer at the stage of wa`d may act as a kafil to the seller to guarantee the safe delivery of the asset by the supplier to the seller.

15.16 Pursuant to paragraph 15.15, any loss incurred due to late delivery of the asset to the seller shall be borne by the purchase orderer as the kafil. Damage or defects that arise after the delivery of the asset to the purchase orderer shall not be covered under this guarantee arrangement.

15.17 Loss or damage of assets in the possession of the purchaser (seller under the MPO) after acquisition of the asset from the supplier and prior to sale to the purchase orderer shall be borne by the purchaser.

15.18 The purchase orderer may seek recourse from the seller for any defect of asset delivered to the purchase orderer based on the defect option (khiyar al-`ayb).

15.19 Notwithstanding paragraph 15.18, both parties may agree to incorporate in the contract a clause to exempt the seller from any defect in the asset and assign the right of recourse to the purchase orderer against the supplier for the defect subject to the consent of the supplier."[496]

This extract arguably manifests some of the problematic aspects of the *murabaha* usage. For this reason, its provisions will be broken down and analysed from the perspective of *Shariah* compliance.

As an initial thought, quite apart from the excerpt's legalistic fluency, the question remains whether the *wa'd* to purchase something in the future when this is not yet in the possession of the would-be seller is compliant with the letter of *Shariah*.[497] (It is arguable that the text contradicts the spirit of the Islamic prohibitions.) To this end, clause 15.3, which requires that "The wa`d shall be executed separately from, and before entering into the murabahah contract"[498] seems to be a way to avoid "contaminating" the *wa'd* with *murabaha*'s contentious potential; although the differentiation between the two contracts may seek to guarantee the clarity of the separate contractual obligations. Clause 15.4 of the Negara Bank's manual continues in pursuance of clause 15.3. The purpose of this clause is to clearly delineate the *wa'd* and the *murabaha* created with respect to the same deal. However, note that the very next clause (15.5) appears to negate

[496] Bank Negara Malaysia, 'Murabahah' (2013) BNM/RH/STD 028-4 Islamic Banking and Takaful Department, 15-18.
[497] Ibid, 15.2.
[498] Bank Negara (n 496), 15.3.

these efforts, because it links non-performance under the *murabaha* to a breach of the *wa'd*, consequently leading to penalties under 15.6.

Clause 15.7 already sets the *murabaha* contract on firm grounds by stating that the item subject to the contract must be obtained by the seller (i.e. the bank) prior to concluding the *murabaha*. Furthermore, even though 15.10 states that "Upon acquisition of an asset by the seller and until the murabahah contract is entered into with the purchase orderer, the seller shall assume the ownership risk of the asset.", this in itself does not break the connection between the two contracts because should the asset be destroyed by some reason, this does not affect the obligations (and also the rights) of the buyer. The only thing that changes is that the seller has to purchase the same item twice or perform a similar operation, depending on the circumstances. To this end, the legality of the *takaful* (discussed in clause 15.11) may become questionable due to the overall questionability of the underlying contracts.[499]

In addition to that, the clause referring to holding the asset to be purchased on a trust until the *murabaha* contract is entered into (clause 15.13), confirms, at least from the point of view of the common law, that the beneficial ownership of the asset is assumed to belong with the buyer rather than the seller of the item. The reference to the common law is relevant because most civil jurisdictions do not work with the concept of trust (Roman law not accepting the division between legal and equitable rights inherent in trusts), although they do have at their disposal instruments that perform a similar function.[500] While *Shariah* law draws a lot from the civil law and more specifically, from the French legal system,[501] the concept of trust is something that has been borrowed from the common law.[502] Furthermore, while some may argue that the trust in question is different, notably that it is the Islamic trust (*waqf*), this argument is unsustainable because *waqf* refers only to family property, mostly in the context of inheritance.[503] The

[499]Arif A Jamal and Ms Ferzana Haq, 'Muslim Law Practice Committee Seminar: "Introduction to Islamic Finance"', (April 2015), CBFL-Rep-AJFH1, 4.
[500] Vera Bolgár, 'Why No Trusts in the Civil Law?' (1953) 2(2) The American Journal of Comparative Law 204.
[501] Walid S Hegazy, 'Contemporary Islamic Finance: from Socioeconomic Idealism to Pure Legalism', (2007), 7(2) Chicago Journal of International Law, https://chicagounbound.uchicago.edu/cjil/vol7/iss2/13/ accessed 10th April 2019 581, 581.
[502] This is underlined by the fact that *Shariah* law recognises a division between legal and beneficial property rights; having said that, it must be emphasised that the trust instrument as such is not developed in Muslim countries.
[503] Shafaq Sadiq, 'Trusts in Islamic Law' (2017) https://wedlakebell.com/trusts-islamic-law/ accessed 10th April 2019. See also, John Riches and Christian Miceli, 'Trusts and Sharia Law' (2002) 20 TACT http://www.tact.uk.net/review-index/trusts-and-sharia-law/ accessed 10th April 2019. See also, Aida Othman,

remaining clauses could also be interpreted as confirming the indivisibility of the *wa'd* and the *murabaha*, which could be a problem should an interpretative authority adopts a more restrictive stance.

The above analysis of Bank Negara's document demonstrated that a permissive approach to *wa'd* and *murabaha* working in conjunction may become open to criticisms. Such criticisms, however, cannot be targeted at Negara Bank at this moment in time, because the bank has produced the document with the necessary due diligence: the *wa'd murabaha* product has, in principle, been endorsed by the Fiqh Academy Resolution 5, Vol. 2, which defines it as: 'a unilateral promise from the purchase ordering party to the institution that upon the institution making available a commodity he/she will fulfill the agreed conditions'.[504]

It appears that a considerable effort has been expended, by legal and finance experts, to justify the use of the *murabaha* instrument. Some context is in order.

As the Islamic alternative of cost plus transactions, *murabaha* was particularly favoured by Islamic banks because it was only through this instrument that they could finance projects of their customers without imposing outright interest on loans. Once introduced in the framework, *murabaha* transactions accounted for 70% of all transactions carried out by Islamic financial institutions in the Middle East. In some countries, such as Indonesia, for example, the number was even higher.[505] However, the heavy reliance on *murabaha* created confusion in the market - among customers - and also scholars. Some of the latter openly critisised the practice, for example by arguing that it replicates 'conventional tools by complicated scams which hold

'Islamic Trusts: An Alternative Option for the Wealthy' (2014) 11(3) Islamic Finance News 19, http://www.eurekahedge.com/Research/News/1213/Islamic_Trusts_An_Alternative_Option_for_the_Wealthy accessed 10th April 2019.

[504] Fiqh Academy, Resolution 5, Vol. 2 in Olorogun Lukman Ayinde, 'A Critical Evaluation of The Compatibility Between Traditional And Contemporary Applications of Murabahah Transactions' (2012) 1(1) Aceh International Journal of Social Sciences 36, 36.

[505] Walid S Hegazy, 'Contemporary Islamic Finance: from Socioeconomic Idealism to Pure Legalism', (2007), 7(2) Chicago Journal of International Law 581, https://chicagounbound.uchicago.edu/cjil/vol7/iss2/13/ accessed 10th April 2019; S K Wiryono, Barli Suryanta and O Y Sudrajad, 'Analysis on the Dynamics of Yield Curve of Murabaha in Indonesian Sharia Mortgage Financing: The Case of Indonesian Sharia Banks', Annual International Conference on Micro and Macro Economics (MME 2011), July, 25 – 26, 2011, Singapore.

Arabic names'.[506] This is obviously a serious accusation, which undermines the trust in the instrument.

In addition, from a purely legalistic perspective, it is possible that customers and scholars lacked confidence in the *wa'd murabaha* product because of the widely held belief that *wa'd* permits exit under certain circumstances. While it is true that over the course of the years the approach to *wa'd* has become more and more rigid, gravitating towards a stricter obligation, this did not, up until recently, change the core of the concept. Customers, therefore, were and still are left hoping that the *wa'd* part of the *wa'd murabaha* contract will hold and scholars are at a loss, and at a disagreement, as to whether to accept this tool or to condemn it.[507]

The challenges, potentially flowing from the situation, should not be underestimated. Whether a contract will be honored or not has immediate consequences for all parties concerned. Moreover, the lack of certainty that contracts will be performed could have a long-term negative impact on trade and economy.

As a last remark, it should be questioned whether the desire to create a visibly compliant with *Shariah* regime of Islamic Contract Law is sufficiently efficient in terms of transaction costs, which are increased proportionally to the number of the separate transactions carried out within the confines of a single contract/or the number of separate contracts under the umbrella arrangement.[508] Furthermore, the more transactions there are, the greater the sum of transaction risks. These risks may play out in a different way. For example, in the case of *murabaha*, the bank acting as an interim owner of the goods shoulders for a time the responsibility for the goods, which may include a risk of damage or loss. The bank is trying to compensate itself for the trouble by adding a mark-up to the cost of the goods; however, arranging all these transactions involves more staff hours, more costs and may result in a more onerous tax obligation. Adding to

[506] Ahmet Suayb Gundogdu, 'The Rise of Islamic Finance: Two-Step Murabaha', (2018) 13(1) Asia-Pacific Management Accounting Journal 107, 107.

[507] M Abdullah and A Ab Rahman, 'The Role of Wa'd in Risk Management: The Malaysian Experience', (2016), Mutum, D., Butt, M. and Rashid, M. (Ed.) *Advances in Islamic Finance, Marketing, and Management*, (Emerald Group Publishing Limited 2016), pp. 131-158. https://doi.org/10.1108/978-1-78635-899-820161008 accessed 23rd August 2019; See also, Olorogun Lukman Ayinde, 'Critical Evaluation of The Compatibility Between Traditional And Contemporary Applications of Murabahah Transactions' (2012)1(1) Aceh International Journal of Social Sciences 36.

[508] Mahmoud A El-Gamal, *Islamic Finance: Law, Economics, and Practice* (CUP 2006), 1,6,&12; Alice van Duyn, 'US: Presence and role of market remain marginal', *Special Report The Future of Islamic Finance*, Financial Times 14 December 2010.

that Islamic regulators' lack of acceptance of banks trading on the market,[509] even though they are doing it on behalf of a client, complicates the situation further, making it perhaps less worthwhile for banks to offer such services.

7.3.8. Post scriptum

Another application of the *murabaha* instrument is in creation of contracts resembling the conventional overdraft and credit card facilities. *Murabaha* makes sense in this context as far as the function of the credit card is to finance the purchase of goods. The difference with the conventional banks is that an Islamic financial entity would provide its customer with the end commodity for which the cash was needed. Of course, this limits the choice of the customer a lot as there are certain goods and services (such as erotic art, weapons, pork or alcohol) which are not accepted under *Shariah* law and which will, for this reason, not be provided by the bank. Furthermore, the customer does not have the flexibility to decide when exactly they will proceed with the purchase of the desired commodity – it will largely depend on the speed with which the set of transactions has been carried out. From a bank's point of view, another downside of *murabaha*, compared to conventional credit cards and overdrafts is that if the customer defaults, the Islamic finance operator is not permitted to impose a penalty reflecting the late payment. This is not the case with conventional banks. Furthermore, conventional banks could restructure the debt and make it last longer resulting in more money received in terms of interest paid. This is not allowed with the *murabaha* instrument. [510]

7.3.8.1. Wa'd vs. murabaha: a drive for efficiency

It appears undisputed that the area of derivative contracts necessitates further innovation in the way transactions are constructed. This sentiment has been appreciated by many. For example, Reuters reported back in 2016 the recent launch by the International Islamic Financial Market

[509] Visser (note 85), 30.
[510] Muhammad Hanif, 'Differences and Similarities in Islamic and Conventional Banking' https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1712184 accessed on 10th April 2018, 12.

(IIFM) of standard templates to be used for *Shariah* compliant foreign exchange forwards in an effort 'to improve hedging practices in the sector.'[511] These instruments require fixing of the exchange rate at the outset which however 'remains a promise until offer and acceptance is completed at the forward date, which is when the transaction becomes a contract'.[512] The templates are based on *wa'd* or double *wa'd* – two counter promises committed to independently by each party. This is expected to provide greater credit security and avoid having to resort to *murabaha*, which is considered a slower and more cumbersome instrument.[513] To recall how much effort is involved in a FX forward contract facilitated by a commodity *murabaha*, consider the following:

> *In this scenario, the customer and the bank enter into separate murabaha transactions to facilitate the FX forward contract. The customer will buy a commodity for spot value and sell it to the bank for the purchase price plus agreed profit, the basis point in a conventional FX forward deal, payable on a deferred basis. To address the other side of the FX forward deal, the bank will buy another commodity and sell it to the customer, again for the purchase price plus agreed profit, on a deferred basis. Both the customer and the bank typically will sell the commodity back into the market to recover their initial investment.*[514]

It is obvious that commodity *murabaha* is not suitable for fast-paced environments, which explains the tendency among traders to elect *wa'd* instead. The question, however, remains whether just replacing it with a tool which appears non-controversial while keeping the controversy of the transaction will remain sustainable in the long run.

It could be concluded that although useful for Islamic entrepreneurs, the *murabaha* contract does contain weaknesses, which may render the use of the instrument particularly challenging in a radical political environment.

[511]Reuters, 'Islamic finance body IIFM launches FX forward standards' (2016) https://www.reuters.com/article/islamic-finance-hedging-idUSL8N18Y01G accessed 10th April 2019.
[512] Ibid.
[513] Reuters (n 511).
[514] Paul Golden, 'Shariah-compliant FX hedging takes centre stage' (2015) Euromoney https://www.euromoney.com/article/b12km3319gggws/shariah-compliant-fx-hedging-takes-centre-stage?copyrightInfo=true accessed 11th April 2019.

7.4. Islamic Options

To recall, conventional options allow the transacting parties to contract for the right to buy or sell a certain amount of an underlying financial asset at a specified price for a given period of time. Islamic law recognises 'option as a condition or stipulation (*khiyar al-shart*); options for defect (*khiyar al-ayb*); option of determination or choice (*khiyar al-tayeen*); option of inspection (*khiyar al-ruyat*); and option of acceptance (*khiyar al-majlis*).'[515] Of them, *khiyar al-shart* is the most popular.[516] In this option contract, one of the contracting parties is in a much more beneficial position than the other because it can freely affirm or wave the contract. [517] This party is allowed to hedge against increases or decreases of the underlying price of the asset, as well as against unrelated but undesirable events.[518]

Another option contract, the third-party guarantee, resembles a conventional put option. In this contract the third party receives a fee, which compensates it for relieving the relevant contractual party from an undesired onerous obligation under the contract. Usually, such contracts are concluded with an agency. In addition to the fee, this organisation may also receive a lien on the contracted asset**.**

Generally speaking, Islamic finance law allows options if they:

> *"are employed to address genuine hedging demand on asset performance associated with direct ownership interest;*
>
> *disavow mutual deferment without actual asset transfer; and*
>
> *eschew avertable uncertainty (gharar) as prohibited sinful activity (haram) in a bid to create an equitable system of distributive justice in consideration of public interest (maslahah)."*[519]

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[515] Mohammed Ovaidullah, 'Financial Engineering with Islamic Options' (1998) 6(1) Islamic Economic Studies 73, 75.
[516] Ibid.
[517]See Chibli Mallat, 'Commercial Law in the Middle East: Between Classical Transactions and Modern Business' (2000) 48 Am J Comp L 81.
[518]Malkawi (n 25), 283.
[519] Andreas A Jobst, 'Derivatives in Islamic Finance' (2008) International Monetary Fund http://www.eurekahedge.com/Research/News/728/Derivatives_in_Islamic_Finance accessed 20th February 2019.

We shall now see how these conditions compare to the example of conventional options discussed earlier. Suppose that we have a company (A) situated in a Middle Eastern country, which carries out its business in this country's currency (C). As C is potentially volatile, A would like to hedge its income revenue into US Dollars. C approaches an Islamic Bank (B). For the purposes of this exercise it will be assumed that the spot exchange rate is 1 US Dollar = 4 C. The structuring of an option that would be compliant with *Shariah* would take place in one of the following two ways.

1) B undertakes to exchange a pre-determined amount of C into US $ at a pre-determined exchange rate, which could coincide or diverge from the spot rate (for example $1 = 4.10 C) and within a predetermined time frame (for example 2 months European option).
2) B will be remunerated through a fee (F) by A for its undertaking (promise).
3) On the specified date, A has the right but not the obligation to call the option. It will elect to do so or it will otherwise waive its right to call, depending on the course of the currency at the material time.
4) If A decides to call the option (which it will do if the exchange rate is = or > $1=4.10C), B's only gain is the fee obtained in exchange of the promise. It could also make a loss unless it has hedged its position with a third party. The gain of A constitutes of the difference between the option conversion rate and the current exchange rate, subject to deducting F.
5) If A decides to revoke its right to call instead (which it will do if the exchange rate is < of $1 = 4.10C), both parties are released from an obligation to act. However, B will retain the above fee (F). In this scenario, A's gain is that it is not obliged to convert at the expensive rate. However, it still loses F which becomes the price of having such peace of mind.

It is clear that the above option does not differ from the conventional one. It retains all the objectionable features of the latter such as 'the prohibition of a counter value for a promise [and] the impermissibility of the tradability of the promise'.[520] Furthermore, its implementation in Islamic transactions is supported by a small number of experts, most notably, Kamali, but it is objected to by the majority of experts.[521]

7.4.1. Islamic option based on a combination of wa`d, wakalah and commodity murabaha

In this option a company (A) and a bank (B) first enter into an agreement (*wakalah*) where B serves as A's agent, first to buy a commodity on his behalf and then to sell said commodity on his behalf. The second stage of this options is where each party undertakes a binding unilateral promise (*wa'd*) pertaining to different conditions and time-frames.[522] As a part of the *murabaha* agreement, first A undertakes to, at the time of entering the option, purchase the underlying commodity from B at a spot price and denominated in US$ (the spot price is arrived at as a cost plus mark-up). Secondly, B undertakes to, at the time of exercising the option, purchase the underlying commodity from A at the agreed strike price (this also contains a mark-up). Note that B is the option writer and therefore B receives a premium which gives the right to A but does not oblige it to call for the exercise of the option at the exercise time. Lastly and depending on the exchange rate of the currency, A will either invoke or revoke its right under the option. Should A elect the latter, it can engage B (under the *wakalah* agreement) to act as its sale agent and sell the commodity to a third party.[523]

This version is considered better suited to *Shariah* requirements because it avoids having to pay for the promise with a fee. Additionally, as it engages both parties (A and B) in the transaction or series of transactions, it is truer to the *Shariah* understanding of shared efforts and risk.

7.4.2. Islamic option based on earnest deposit (urbun)

520 Mohamed Bengana and Mohamed Yassine Khouildi, 'Options: From Conventional and Islamic perspectives Analyses on the Islamic solutions (2018) https://webcache.googleusercontent.com/search?q=cache:8F1JKpd79G8J:https://ideas.repec.org/p/pra/mprapa/84499.html+&cd=1&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 23rd August 2019 (n 227), 12.
521 Ibid, 12.
522 Bengana and Khouildi (n 520), 13.
523 Bengana and Khouildi (n 520), 13.

Urbun or *arbun* is a contract where the buyer will make a partial payment at the point of signing of the contract. The buyer has the right to make up the outstanding amount at the time of delivery of the goods or not honour the contract at all in which case he will forfeit the down payment. [524]

This flexibility is enjoyed by the buyer only but it is paid for with the down payment. The seller must deliver the contracted goods. He has no right to abandon the contract. This makes his position less than beneficial because of the possibility for him to miss a business opportunity either by selling the product or to invest the money and effort elsewhere.[525] This type of instrument is equivalent to the conventional call option.

The main objective of structuring an Islamic option as an *urbun* is to avoid the premium paid as an exchange of a promise (*wa'd*). From a *Shariah* perspective, the premise is compliant with it but the fee paid for it is not.[526] In *urbun* options, the *urbun* (the earnest deposit) is paid by the purchaser to the seller. In the scenario where the purchaser elects to go ahead with the purchase, the *urbun* is deemed to be a down payment, therefore a part of the final price. In cases where the buyer decides not to carry out the purchase, the *urbun* will remain with the seller as a gift to them.[527]

Dali & Jalil call *urbun* "deposit for rethinking and reconsideration".[528] In this scenario, a buyer who is interested to purchase a certain item, places 10% of the price with the seller, upon which the latter agrees to sell the item to the buyer at the agreed price (strike price) and at the agreed time. At the time of exercise of the option, if the buyer decides to go ahead and make use of his right to buy, the seller must comply because the *urbun* is deemed an early settlement. If, however, the market price is higher than the strike price, the buyer can decide how to proceed. He could honour the contract and in that case the *urbun* is still deemed an early settlement. Or,

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[524] See Angelo L. Rosa, 'From Mecca to San Fransisco: Harmonizing Shari'a-Compliant Contractual Remedies with California Law' (2005) 6 U.C. Davis Bus. L.J. 108, 117.
[525]Malkawi (n 25), 283.
[526] O I Bacha, 'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration' (1999(1(1) INTERNATIONAL JOURNAL OF ISLAMIC FINANCIAL SERVICES 1, https://mpra.ub.unimuenchen. de/12752/1/MPRA_paper_12752.pdf accessed 15th April 2019.
[527] N. R. S. B. M Dali & A. Bin. Jalil, 'Urbun Call Options : A Proposal for an Islamic Risk Management Tool' (2006) National Seminar in Islamic Banking and Finance: Islamic Wealth Management: Prospects, Issues and Challenges, (2006), 1–16.
[528] Ibid.

alternatively, he can revoke the contract and the *urbun* is considered forfeited to the benefit of the seller (a gift).[529]

The above implies that if *urbun* options are accepted as a *Shariah* compliant alternative to conventional options (something that is still debatable), they will cover only call options.[530] They will not apply to put options because the term “earnest deposit” pertains to the deposit paid for the purchase of something and not to the right to sell it.

As intimated, there is some controversy surrounding the *urbun* based options. One of their most controversial aspects is the tradability of rights under them. This comes to pass if, for instance, the buyer decides to exercise the option but requires the seller to sell to a third party or if the buyer decides to altogether trade his right to buy or sell under the *urbun* option to an external to the contract party. The above has been explicitly prohibited by the AAOIFI.[531]

Furthermore, Obaidullah points out that *urbun* options are similar to the *bai al-urbun* contract in that in both cases the purchaser forfeits the deposit to the seller if he decides to abandon the purchase. In the call option version this would be when the purchaser decides not to exercise the purchase option and confirm the contract. However, in the *urbun* option, the deposit is lost also when the buyer elects to confirm the contract and exercise his right to buy.[532] It should be recalled that in *bai al-urbun* the deposit is adjusted in, i.e. deducted from, the total price.

Nevertheless, it is notable that most schools of Islamic thought, apart from the Hanbali School, do not accept even the *bai al-urbum* version of Islamic options, considering ‘the retention of earnest money or premium by the seller [is] akin to misappropriation of the property of others’.[533]

Despite this general lack of acceptance, there have been voices arguing that tradability should be allowed under certain circumstances such as inheritance[534] or when the intention to sell the right has been communicated to the seller at the point of entering into the contract.[535]

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[529] Dali & Jalil, (n 527).
[530] Mohammed Obaidullah, ‘Financial Engineering with Islamic Options’ (1998) 6(1) Islamic Economic Studies 73, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3164812 accessed 15th March 2019, 81.
[531] AAOIFI, standard No.(20), issued on May 2004.
[532] Mohammed Obaidullah, (n 530), 80.
[533] Ibid.
[534] Dali & Jalil, (n 527). See also, Obaidullah (n 530).

Furthermore, the Islamic *Fiqh* Academy of the Organization of Islamic Cooperation has backed the general usage of this option, subject to the following conditions being satisfied:

> *- The predetermination of the contract's time frame*
>
> *- If the contract proceeds, the Urbun is considered as part of the selling price.*
>
> *- Urbun is not applicable in the sales which stipulate the reception of the two exchange elements of the contract (price and delivery).*[536]

The AAOIFI joined, reiterating that it is allowed in "contracts that do not require payment on spot of one or both counter values"[537] also as an alternative for options with the "stipulation that the buyer has the right to revoke the contract within a specific period".[538]

In addition, followers of the Hanbali School have more recently adopted a generally more permissive attitude to *urbun* options, deeming them both suitable to the modern world and having their origin in *Shariah* compliant practices of the past.[539]

What could be taken away from the above is that out of the four Islamic options, discussed here, the *urbun* option seems to be the least objectionable and even then only if it is applied to call options. Furthermore, while there are approaches that permit both stand-alone and embedded options (for example those advocated by Kamali, Usmani, de Lorenzo and the OIC Fiqh Academy), adhering to the embedded option appears to be the least controversial and the closest to the strict interpretation of *Shariah* law.[540]

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535 Mohamed Bengana and Mohamed Yassine Khouildi, 'Options: From Conventional and Islamic perspectives Analyses on the Islamic solutions (2018) https://webcache.googleusercontent.com/search?q=cache:8F1JKpd79G8J:https://ideas.repec.org/p/pra/mprapa/84499.html+&cd=1&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 23rd August 2019, 18.

536 Ibid, 16.

537 AAOIFI, standard No.53, issued on November 2014.

538 AAOIFI, Standard No. (20).

539 Mohamed Ali El Gari, 'Towards an Islamic Stock Market, (1993), 1(1) Islamic Economic Studies 14, 14-16. See also, Mohammad Hashim Kamali, Islamic Law : An Analysis of Options, (1995), Paper presented at the Conference on Interest-free/Islamic Banking Products held at the Institute of Islamic Understanding, Malaysia on December 21. See also, Abu Sulayman "Al-Ikhtiyarat: Darasah Fiqhiyya Tahliliyyah Muqaranah," Mujallah al-Buhuth al-Fiqhiyyah al-Muasarah, p. 32, quoted in Kamali (1995).

540 Imran Iqbal, Sherin Kunhibava & Asyraf Wajdi Dusuki, 'Application of Options in Islamic Finance' (2012) ISRA Research Paper (No46/2012)

7.5. Islamic swaps

Islamic law accepts the so-called Islamic Profit Rate Swap (IPRS), generally still referenced to the conventional swap rate of KLIBOR.[541] This swap 'is an agreement that allows two parties to exchange a series of profit payments in a single currency in exchange for another series of payments in the same currency.'[542] In the IPRS a Fixed Rate Party and a Floating Rate Party enter into an agreement to exchange profit rates. This agreement is made *Shariah* compliant by structuring it through a series of *murabaha* contracts. In this swap, which concerns the difference in the price over and above the notional principal, the notional principal is netted off i.e. it is not exchanged.[543]

The objectives of the IPRS are:

> *'To match funding rates with return rates (from investment);*
>
> *To achieve lower cost of funding;*
>
> *To restructure existing debt profile without raising new finance, or altering the structure of the balance sheet;*
>
> *To manage exposure to interest rate movement as Islamic financial institutions still compete with conventional banks for market space'*[544]

As with all other instruments, the Islamic swap must abide by the *Shariah* rules, most notably, by the prohibitions on *riba* (interest), *maysir* (speculation) and *gharar* (uncertainty).

The IPRS works in the following way. First party A sells an asset to party B at notional principal C. In the second step, party B sells the asset to party A at notional principal C plus cost plus at a

[541] Amir Alfatakh, 'Treasury: Waad in Islamic Profit Rate Swap' (n.d.) Islamic Bankers Resource Centre https://islamicbankers.me/islamic-banking-islamic-contracts/in-focus-islamic-profit-rate-swap/ accessed 10th May 2019.
[542] Ibid.
[543] Syed Ehsan Ullah Agha, 'Shariah Review of Profit Rate Swap Strategies in Islamic Financial Institutions: the Case of Malaysia' http://webcache.googleusercontent.com/search?q=cache:TSdtbKQgDJEJ:www.ucd.ie/law/t4media/Islamic%2520profit%2520rate%2520swap.pptx+&cd=5&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 9th May 2019.
[544] Ibid.

fixed rate. Thirdly, C is set off. Lastly, the net difference, i.e. the fixed profit rate in step two is paid to B by A at the agreed interval payment date.[545]

IPRS are predominantly based on the Islamic instrument *bai'Inah*. *Bai'Inah* is a contract for sale and purchase of an asset. This arrangement allows the selling of an asset to another party and then purchasing it back on a cost plus basis. *Tawarruq murabaha* (commodity *murabaha*) could also be used as a basis of the IPRS instrument. The main underlying asset to facilitate IPRS *bai' Inah* contracts is the *Mudharabah* Islamic Interbank ("MII").[546] The sale and purchase of MII is done once, at the effective date of the swap and is used to establish Fixed Profit rate. The payment of the Fixed Profit rate is done quarterly. At the second stage, the sale and purchase of MII is used to establish a Floating Profit Rate, payable on 'every periodic or Payment Date i.e. the first day of each profit period until maturity'.[547] Here the floating profit rate is paid quarterly. The relevant to this discussion aspect of this arrangement is that at no point is the principal amount exchanged between the transacting parties in real terms. Although in theory transactions of sale and resale of the MII are carried out, these transactions are nominal. The focus of the swap is on the cost plus which is formed by the fixed profit rate (at the first stage) and the floating rate formed by 3-months KLIBOR. The contract therefore becomes a contract for differences where the bank pays the customer if the fixed rate is below the floating one and *vice versa*, the customer will pay the difference in rates to the bank if the fixed rate exceeds the floating one. The profit from an IPRS comes therefore from the interplay of conflicting rate based payment obligations.

There are two additional concepts working in the IPRS context: *wa'd* and *muqassah* (netting off payment in the cash flow). The reader is familiar with the meaning of *wa'd*. In the IPRS context the promise refers to an undertaking by each party to carry out 'a series of *bai' Inah* transactions on the effective date and each reset date for the life of the transaction'[548] and secondly, to 'enter into an asset sale and purchase transaction for the early termination amount in the event the transaction is terminated prior to maturity.'[549] The *muqassah* concept refers to netting off the

[545] Syed Ehsan Ullah Agha (n 543).
[546] Amir Alfatakh, Islamic Bankers Resource Centre (n 541).
[547] Amir Alfatakh, (n 541).
[548] Amir Alfatakh (n 541).
[549] Amir Alfatakh (n 541).

notional principal and/or to the expectation that the 'party with higher price is expected to pay the difference to the other party.'[550]

The *tawarruq murabaha* (buy and sell of commodities), which could serve as an alternative basis for IPRS, resembles *bai'Inah* apart from the nature of the underlying asset. In *tawarruq murabaha* the underlying asset is actual commodities and not a MII. In this scenario the *bai'Inah* aspect of the transaction is structured as a *murabaha* contract whether with a three-party structure (*tawarruq*)[551] or with a commodity *murabaha* structure (four-party transaction – one buyer, one seller and a broker for each of them). Note that a *murabaha* based IPRS is likely to make the instrument more attractive to counterparties from the Middle East, which rejects the *bai'Inah* contract.[552] This is not surprising given the characteristics of the *bai'Inah* contract and mostly, its disconnect from the actual commodity.

Despite its usefulness for the Islamic banking market, the documentation and mechanism of the instrument have not yet been standardised across the Islamic market. The IPRS is widely used in Malaysia where the swap is facilitated through the Islamic Derivative Master Agreement (IDMA).[553] As recently as 2012, the Bahrain-based International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association (ISDA) created a standard contract template for IPRS in a bid to harmonise the network but it is yet unclear whether this has been accepted outside this jurisdiction.[554]

Another instrument, known as Islamic Foreign Exchange Swap (IFXS), is of interest for Islamic banks which are restricted in the ways they can protect from and manage risks. Unlike forwards, the IFXS involves dual exchange – the exchange and re-exchange of foreign currency. To this end, banks find the IFXS useful because it 'is designed as a hedging mechanism to minimize

[550] Amir Alfatakh (n 541).
[551] 'Bai` al-tawarruq is set of sales contracts which involve transaction of buying a commodity on deferred payment basis and then selling it on cash basis to a person other than the first seller, i.e. at a lower price' in Asyraf Wajdi Dusuk, 'Shariah Parameters on Islamic Foreign Exchange Swap as Hedging Mechanism in Islamic Finance' (2009) International Conference on Islamic Perspectives on Management and Finance
University of Leicester; 2nd – 3rd July 2009, 8, f.n.9.
[552] Amir Alfatakh (n 541).
[553] Amir Alfatakh (n 541).
[554] Bernardo Vizcaino, 'Standard launched for Islamic profit rate swap' (2012) https://www.reuters.com/article/finance-islamic-swaps/standard-launched-for-islamic-profit-rate-swap-idUSL6E8ES55Q20120328 accessed 10th May 2019.

market participants' exposure to market currency exchange rate which is volatile and fluctuating.' [555] The hedging applies to the beginning and expiry of the swap.

In the context of conventional derivatives, this instrument works in the following way. Party A, for instance a foreign bank, wishes to invest certain amount of currency C in a country X. For these purposes, it concludes a swap agreement with another entity (party B), whereby, during the first leg of the swap an amount of C is converted into the local currency, at a spot rate. At the maturity date of the swap, the second leg of the swap, C is converted back to the original currency. However, this is carried out at a pre-agreed forward rate. IFXS are usually short-term (less than a year) contracts and they are sometimes considered a combination of a spot and a forward contract.

The characteristics of the FX swap make it problematic from a *Shariah* perspective and more specifically, from the viewpoint of *bay` al-sarf* (the area of *Shariah* governing currency exchange). *Bay` al-sarf* rules that foreign exchange must always be done at a spot rate. This is based on a *hadith* where it is reported on the authority of Ubaydah Ibn al-Samit that the Prophet said "Gold for gold, silver for silver – until he said – equal for equal, like for like, hand to hand, if the kinds of assets differ, you may sell them as you wish provided it is hand to hand."[556] The reference to "equal for equal, like for like" is interpreted to signify spot rate exchange. To this end, the deferred execution of the contract and the deferred exchange of counter values appear to contradict the above.

However, this is not the case with FX swaps. Let's first consider the *tawarruq* based IFXS. In this arrangement two sets of *tawarruq* are needed, both of them concluded at the beginning of the swap. For illustration purposes, let us assume that the objective of party A (the investor) is to exchange US dollars for Euros. During the first leg of the transaction, party A purchases a certain commodity, for example oil, for the price of US $1 million. They use an agent to sell said oil to the local bank on credit for one year for the original price plus a mark-up. The bank then sells said commodity to another broker (broker B), for the exact same sum, who settles the deal in cash. The bank uses the cash to convert the US dollars into Euros at the spot rate. During the

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[555] Asyraf Wajdi Dusuk, 'Shariah Parameters on Islamic Foreign Exchange Swap as Hedging Mechanism in Islamic Finance' (2009) International Conference on Islamic Perspectives on Management and Finance University of Leicester; 2nd – 3rd July 2009.
[556] Ibid, 7, f.t.8.

second leg of the transaction, the bank buys said commodity back from broker B but pays for it in Euros and in cash. Then it sells it to the investor on year-long credit, for a price estimated in Euros and including a mark-up. The investor sells the commodity to broker A and obtains an amount of Euros as was their initial objective.

One of the outcomes of the above is that each of the contracting parties has one year at their disposal to work with (invest) a specific amount of money, converted into a desired by them currency. The price of the conversion is expressed by the cost plus (paid by each party respectively), which while paid at the expiration of the swap is agreed upon at the beginning. On the other hand, the exchange rate between US Dollars and Euros is also arranged in advance although the payment is set in the future (so conversion is carried out at a forward rate).

The second type of IFXS is based on *wa'd*. In this transaction the first currency exchange takes place in the beginning and a promise is extended that a second currency exchange to convert to the original currency will be carried out on a future date and at a rate agreed upon on the first day of transacting. Although the result of the *wa'd* swap will be exactly the same as that of the *tawarruq* swap, the former is simpler and less costly in terms of effort and time consumed.

7.6. Islamic futures: the exception of the Crude Palm Oil Future (CPOF)

The discussion on conventional futures illustrated that, as a matter of *Shariah* law principles, this type of derivative should not be allowed in a *Shariah* compliant environment. This is indeed the case because under the majority opinion, futures contradict *Shariah* law on most important principles 'because of selling something that does not exist, deferment in the both counter values, excessive risk taking, uncertainty, pure speculation, and sale of one debt for another.'[557] The discussion on futures has been long and difficult and included notable organisations such as the Makkah-based Fiqh Academy, Jeddah's Islamic Fiqh Academy, the Permanent Research Committee of the Board of Great Scholars in Saudi Arabia and the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI). The conclusion of these bodies was that

[557] Md Akther Uddin, ' Futures: Derivatives from Islamic Law of Contract Perspective' (2015) MPRA Paper No. 70147, posted 22 March 2016, https://mpra.ub.uni-muenchen.de/70147/ accessed 9th May 2019, 1.

futures are against Islamic values and should not be adopted in practice.[558] Despite this, there have been certain voices in favour of the inclusion of futures in Islamic contracts.[559] These contrasting viewpoints will be presented below as an attempt to give a better idea of the tendencies taking place in the modern Islamic Contract Law.

Futures are contracts which could be usefully applied to the trade of commodities, for example to oil trade. In this context a transaction may be constructed so that the seller of the commodity (A) agrees with the buyer (B) that A will deliver the commodity (C) at a certain date and price in the future. As A and B have competing expectations of the future transaction (one that the price of commodity will increase by the due date and the other – the it will decrease), in order to ensure that both parties will honour their obligations, modern futures use futures exchanges, which act as an intermediary in the transaction. The performance of the contract is thereby guaranteed by a margin (a fee) put up by each party at the exchange.

The CPOF is arguably the only currently existing *Shariah* compliant future contract. It was developed in Malaysia and approved by the Malaysian *Shariah* Advisory Council (SAC) in 1997. The SAC based its ruling on the finding that there are no forbidden features to this contract such as *gharar* or *maysir*, or to the extent such elements existed they have been counteracted by the provisions of the existing trading regulation.[560]

According to the SAC, *gharar* (uncertainty) was not present in the CPOF because at the point of offering the contract, all the elements that constitute the contract such as the type of product, quantity, price and delivery date are notified to the relevant parties. While the main contentious issue was the delivery date, the SAC noted that since delivery is restricted within a number of dates (the period of the tender), it does not amount to *gharar*. Furthermore, with respect to the crude palm oil not being in existence, the SAC held that the *Shariah* prohibition of *bayʿ maʿdum* refers to uncertainty about the delivery of goods that are sold but are not in the possession of the seller and not to goods that are not yet in existence ‘at the time when the contract is being

[558] For example, the ruling of the Islamic Fiqh Academy of the Muslim World League IFA-MWA in 1985.
[559] See the discussion in Marilyn Siew-Ai Ong and Chun-Phuoc Jeong, Commodity Futures Trading: Its Permissibility According to Sunni Traditionalists Ijtihad and Ijtihad Maqasidi’ (2012) 13(2) International Journal of Business and Society 93.
[560] Securities Commission, 2006: 75.

made'.[561] This, in the view of the SAC was evident from the *salam* and *istisna* contracts. Particularly with the latter, because it refers to something that has not yet been produced, the subject matter of the contract is not existent at the time of signing the agreement. With respect to the former (*salam*), this contract, in the opinion of the SAC does not require that the subject matter is existent at the time of making the contract.

Another argument in favour of SAC's opinion that there was no *gharar* in the CPOF was the presence of a Clearing House which was tasked to ensure that the crude oil subject to the contract will indeed be delivered and paid for. Furthermore, the existing regulation fills the possible gaps of uncertainty as it governs the conduct of the contractual parties and in particular 'provides for surveillance and insurance against any cheating'.[562] This opinion is not shared by everyone, particularly on the point concerning the sale of something not yet in possession, which is seen as opposed to what is written in a relevant *hadith* ("sell not what is not with you").[563] Yet again, this argument has been questioned by others who suggest that the *hadith* in question was intended to serve for moral persuasion rather than to impose a prohibition. Furthermore, the Hanafi School holds that *qabd* (possession) is not an absolute requirement and to the extent that it is indeed a requirement, it is placed there for the sole purpose of efficiency. In addition, the Maliki School agrees with this position placing a restriction only as regard wheat and barley, which cannot be sold prior to possession by the seller.[564]

The second theoretical point of contention regarding the CPOF contract is with regard the deferment of both counter values (deferred delivery *and* deferred payment). It has been argued that the extra deferment (of the payment) in comparison to *salam* does not make the future contract any less compliant with *Shariah* in terms of uncertainty. The logic here is that whether one or two of the counter values is deferred and then not delivered, it will still amount to a breach of the contract, which as a result could not be performed. Furthermore, it has been argued that if one of the counter values is deferred, at least one of the parties will enjoy the commodity. If both

[561] Lahsen Oubdi and Abdessamad Raghibi, 'An Overview on the Practice and Issues of Hedging in Islamic Finance' (2017) https://mpra.ub.uni-muenchen.de/82646/
MPRA Paper No. 82646, posted 14 November 2017 08:55 UTC, 7-8.
[562] Ibid. See Mohammad Hashim Kamali, 'Islamic Commercial Law: An Analysis of Futures' (1996) 13(2) The American Journal of Islamic Social Science 197.
[563] See Muhammad Akram Khan, 'Commodity Exchange and Stock Exchange in an Islamic Economy', (1988) 5(1) The American Journal of Islamic Social Sciences 91.
[564] Lahsen Oubdi and Abdessamad Raghibi (n 561), 8.

are unduly deferred, the parties will share the transactional risk, which in theory would make the *gharar* the same.

However, this position is open to challenge on many grounds such as *Shariah* law,[565] the argument that contracts are meant to be performed and the notion of fairness which would be injured if one of the party is able to enjoy the commodity whereas the legitimate expectations of the other have not been fulfilled. Although *Shariah* law provides for addressing breaches of contract and arbitration to settle contractual disputes, it is arguable that deferment of counter values opens the Islamic market to more uncertainty compared to the *salam* contract. This is the case because contractual parties could often engage other stakeholders, in addition to their counterparty. Doubling the uncertainty can have a ripple effect within society, which is something that a strict application of the *Shariah* principle of *gharar* seeks to avoid.

Lastly, the CPOF contract was challenged on the grounds that it promotes sale of debt. This has been rejected with the argument that there is no explicit or implicit prohibition of *bay'al-dayn* (sale of debt) in *Shariah* and even more so, on a close analysis, the principles of *Shariah* do not contradict the practice. In addition and insofar as there have been some restrictions, they concerned a sale of debt involving two or more parties. In distinction, the sale of debt under the Islamic future contract refers to guaranteed debts.[566]

7.7. Islamic contracts in the courts: case studies

The following section will present a resume of case studies involving Islamic contracts which for one reason or another reached the English or Malaysian courts. The case studies suggest that the current contractual framework needs to be fine-tuned because it could still create some challenges to the contractual parties, particularly when contracts are intended to be governed by English law.

[565] Note that there are views that the hadith referring to deferred sale is not genuine ; see Rafiq al-Misri, al-Jami' fi Usul al-Riba, Damascus: Dar al-Qalam, 1991, p. 339f, quoted in Lahsen Oubdi and Abdessamad Raghibi (n 561), 9.
[566] Lahsen Oubdi and Abdessamad Raghibi (n 561), 9.

7.7.1. Case Study 1: Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems and others [2004][567]

Symphony Gems was the first Islamic finance case decided by an English court. Furthermore, Zul Kepli mentions it as 'one of the earliest Islamic finance cases decided by a secular court in non-Muslim country.'[568] On the facts, the parties signed a contract for financing, structured as a *murabaha*. Under the contract, which was governed by English law, the claimant in this case agreed to purchase certain commodities, namely precious gems and stones at the price of $15 million and sell it to Symphony Gems at the price of $15.8 million.[569]

The main argument raised by Symphony Gems NV (Symphony) was that its *murabaha* agreement with the Islamic Investment Company of the Gulf (Bahamas) Ltd (IICG) was not *Shariah* compliant. The alleged non-compliance was demonstrated by the contractual clauses by which the IICG expressly protected itself from the *murabaha* associated risks. The impugned cl 4.4 provided that the purchaser was obliged to pay for the goods "whether or not" the goods were transferred to the purchaser. In other words, the buyer was obliged to fulfil its promise regardless of whether the seller fulfils theirs. Further, cl 5.7 completely excluded the bank's liability in case of any damage to the goods even before the goods were placed in the possession of the buyer.

While the English court accepted that the case should be decided by reference to the principles of *murabaha* contract, the judge declined to accept evidence provided by Islamic law experts. To the contrary, Mr. Justice Tomlinson felt that it was 'absolutely critical to note' that while 'the murabaha contract is intended in Islamic law to be a contract which complies strictly with the requirements of the Shariah … the contract with which I am concerned is governed not by Shariah law but by English law.'[570] The judge set out to examine whether the terms of the contract have been breached and not so much the validity of the agreement according to the

[567] Case Study 1: Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems and others [2004].
[568] Mohd Yazid Bin Zul Kepli, 'Introduction to Islamic finance' (2013) http://what-is-islamic-finance.blogspot.com/2013/06/analysis-cases-law-on-islamic-finance.html accessed 26th July 2019.
[569] Adnan Trakic, 'The adjudication of Shari'ah issues in Islamic finance contracts: Guidance from Malaysia' (2015) https://www.researchgate.net/publication/263244495_The_adjudication_of_Shari'ah_issues_in_Islamic_finance_contracts_Guidance_from_Malaysia/link/56af046008ae19a385164b16/download accessed 26th July 2019.
[570] *Symphony Gems* (n 461), per Justice Tomlison.

principles of *murabaha*. As to the latter, it has been stated by an Islamic expert that 'the Agreement in issue does not have the essential characteristics of a Morabaha contract.'[571]

After deliberation on the matter, the English judge declared the contract valid under English law. In the view of Islamic experts this was controversial because by holding so, Justice Tomlison ignored the wishes of the parties, the evidence by two Islamic law experts as well as the fact that the contract was incompliant under *Shariah*. This case is a stark reminder of the conceptual conflict between the two systems, despite the existence of certain comparability between them. A very important observation is that when analysed by a common law judge, the *murabaha* contract instrument would resemble a valid common law contract. This supports findings of Islamic finance's mimicry of conventional counterpart-instruments. To this end, if an Islamic contract case is due to be decided in the West, it is advisable to include within the terms of the contract that it would be governed by English law (or whatever law is applicable), however remaining subject to the principles of *Shariah*.[572] This was unfortunately not envisioned in *Symphony Gems* where the reference to *Shariah* law was made in passing in the recital of the contract.[573] Furthermore, since there was no possibility to refer to a uniform *Shariah* code, the English judge had no other option but to apply only the domestic legal principles to this *Shariah* finance case.

7.7.2. Case Study 2: Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd and Others [2004][574]

Shamil Bank was a more recent *murabaha* case, governed by English law and decided in England. The case turned on one of the parties (Beximco Pharmaceuticals Ltd) defaulting on its contractual obligations. The defaulting party raised in defense the issue of governing law clause. As per the parties' agreement, the governing law of the contract was to be English law; however, this was supposed to remain subject to English law's consistency with *Shariah* law. The argument extended by Beximco Pharmaceuticals Ltd was 'that the agreement is contrary to

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[571] *Symphony Gems* (n 461), per Justice Tomlison.
[572] For example, this approach was elected in the case of *Shamil Bank of Bahrain E.C. v Beximco Pharmaceuticals Ltd and others* [2004] 4 All ER 1072.
[573] Nicholas H D Foster, 'Encounters between legal systems: recent cases concerning Islamic commercial law in secular courts' (November/December 2006) 68 Amicus Curiae 1, 3.
[574] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd and Others* [2004] 4 All ER 1072.

Shariah principal and should be declared null and not enforceable.'[575] On first instance, the English court rejected the notion that *Shariah* law should be applied to the facts of the case, insisting that a case can only be governed by one legal system at a time. This was accepted by counsel of the appellant; however, he went on to claim that the relevant premises of *Shariah* law were incorporated in the contract by reference, which was in principle allowed by English law.[576] Furthermore, counsel for the appellant argued 'that the incorporation was specific enough to be meaningful, because it incorporated "simply those specific rules of Shari'a which relate to interest and to the nature of Morabaha and Ijarah contracts, thus qualifying the choice of English law as the governing law only to that extent"[577]

While the court accepted that certain provisions of foreign law could be incorporated in the contract and as a result, could be considered by the presiding court, this should have been done 'by expressly including a clear black letter provision'[578] to this effect. Specifically, the English court pointed out that it would not have objected to the inclusion of terms from the French Civil law, the Hague Rules or the Harter Act, subject to proper incorporation into the contract of the foreign rules.

On appeal,[579] the decision was confirmed by the English Court of Appeal, with Potter, Laws and Arden LJJ holding that:

> *The financing agreements were governed by English law alone. The intention of the parties at the outset had been for the agreements to be binding, and the court should lean against a construction which would or might defeat that commercial purpose. The reference to the principles of Sharia'a was simply intended to reflect the Islamic banking principles according to which the bank held itself out as doing business, rather than incorporating a system of law intended to 'trump' the application of English law as the law to be applied in ascertaining the liability of the parties under the terms of the agreement. Having chosen English law as the governing law, it would have been unusual and improbable for the parties to have intended the English court to proceed to determine and apply the principles of Sharia'a in relation to the legality and enforceability of the*

[575] Zul Kepli, 'Introduction to Islamic finance' (2013) http://what-is-islamic-finance.blogspot.com/2013/06/analysis-cases-law-on-islamic-finance.html accessed 7th August 2019.
[576] See *Shamil Bank* (n 579), para 43, referring to *Nea Agrex SA v Baltic Shipping Co Ltd* [1976] 1 QB 933 (CA).
[577] *Shamil Bank* (n 579), para 49; see, Foster (n 573).
[578] Ibid.
[579] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd and others* [2004] EWCA Civ 19.

> *obligations clearly set out in the agreement, and the appeal would therefore be dismissed.*[580]

Furthermore, Potter LJ focused in his judgment on the matter of interpretation of the contract, saying: "The central question in this appeal is one of construction".[581] This would have meant that the court must examine "the presumed intention of the parties" in the context of "the commercial purpose of the contract".[582] Importantly, Potter LJ stated that since the parties knew that the contract amounted to a loan and since they intended to be bound by the terms of the contract, the court had to construe this contract so as to give it effect as a loan contract.[583] This suggests, *inter alia*, that English courts would rather "translate" Islamic contracts into a language intelligible to the common law, rather than venture more deeply into the intricacies of *Shariah* law.

7.7.3. Case Study 3: Affin Bank Bhd v Zulkifli bin Abdullah [2006][584]

Islamic banks typically dress the majority of their transactions resembling interest-based loans as a sale and purchase financing models. However, this practice raises suspicions that the risk has been shifted to the customer, particularly if the operating legal system does not consider or sufficiently protects consumers' rights. For example, in a strict interpretation of *Shariah*, a default, which could often be caused by a third party (for example, a building contractor), would not negate the obligations of the loan or rather, of the sale-purchase facility's customer. In a traditional interpretation of *Shariah* principles and under some instruments – for example, *Al-Bai Bithaman Ajil* (BBA), such customer would be responsible for the entire amount of capital plus profit, irrespective that the contract has been terminated earlier than expected.[585] Under previous case law, the court would uphold banks' applications to recover the sale price, irrespective of the

[580] Ibid.
[581] *Shamil Bank* (n 579), para 46.
[582] see, Foster (n 573), 3.
[583] *Shamil Bank* (n 579), para 46.
[584] *Affin Bank Bhd v Zulkifli bin Abdullah* [2006] 3 MLJ 67.
[585] See *Bank Islam Malaysia Bhd lwn Pasaraya Peladang Sdn Bhd* [2004] 7 MLJ 355 (High Court in Alor Setar), *Bank Islam Malaysia Bhd v Adnan bin Omar* [1994] 3 CLJ 735, *Dato' Hj Nik Mahmud bin Daud v Bank Islam Malaysia Bhd* [1996] 4 MLJ 295 (High Court in Kota Bharu), *Dato' Hj Nik Mahmud bin Daud v Bank Islam Malaysia Bhd* [1998] 3 MLJ 393 (Court of Appeal at Kuala Lumpur) and *Bank Kerjasama Rakyat Malaysia Berhad v Emcee Corporation Sdn Bhd* [2003] 1 CLJ 625 (Court of Appeal).

actual tenure.[586] This approach becomes particularly relevant when the facility concerns the purchase of real estate, repaid by instalments over a long period. In such cases it is typical that the real estate is secured by a charge registered against the title. This gives security to the bank releasing the facility. In contrast, the customer is provided with far less certainty, being left with the hope that all will go according to his expectations, including the involvement of third parties, and being presented with fewer means of protecting his interests in a situation of default.

The 2006 case of *Affin Bank Bhd v Zulkifli bin Abdullah* made a positive contribution to the area of consumer protection in default. On the facts, the debtor was bound by a long-term tenure and defaulted on his obligations. Although typically, the courts would impose an obligation on the customer to repay up until the end of the tenure, the judge in *Affin Bank* held that the customer must repay up until the actual termination date. In the judge's opinion, doing the former would have meant that the creditor benefits from an unearned income. This meant that such income could not be claimed under the *Al-Bai Bithaman Ajil* facility. [587] The approach in *Affin Bank* was equitable and marked a distinct change in the court's attitude, particularly in Malaysia. This decision was later approved and followed in *Malayan Banking Bhd v Marilyn Ho Siok Lin* [2006],[588] *Arab-Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd* [2008],[589] *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeals* [2009][590] and *Bank Islam Malaysia Bhd v Azhar bin Osman and other*[2010].[591]

The latter case is significant with introducing in Malaysian law the notion of implied term and legitimate expectation on the part of the customer for being granted rebate on premature termination. According to the judge, 'where the BBA contract is silent on issue of rebate or the quantum of rebate, the bank must, by implied term, grant a rebate and such rebate shall be the amount of unearned profit as practiced by Islamic banks'.[592]

Furthermore, it should be noted that apart from being equitable, the approach adopted in *Affin Bank* is perceived as being in the public interest and in the interest of the development of Islamic

[586] Mohd Yazid B. Zul Kepli, 'Introduction to Islamic finance' (2013) http://what-is-islamic-finance.blogspot.com/2013/06/analysis-cases-law-on-islamic-finance.html accessed 7th August 2019.
[587] *Affin Bank Bhd v Zulkifli bin Abdullah* [2006] 3 MLJ 67, para 29.
[588] *Malayan Banking Bhd v Marilyn Ho Siok Lin* [2006] 7 MLJ 249.
[589] *Arab-Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd* [2008] 6 MLJ 295.
[590] *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeals* [2009] 6 MLJ 839.
[591] *Bank Islam Malaysia Bhd v Azhar bin Osman and other* [2010] 9 MLJ 192.
[592] *Bank Islam Malaysia Bhd v Azhar bin Osman and other* (n 345), paras 18, 20 & 22.

Finance. For instance, the judge in *Malayan Banking Bhd* (above) remarked that adopting the *Affin* approach would enhance the process of flourishing of Islamic banking, including abroad. Since people prefer the BBA facility to conventional loans because it is slightly cheaper for them and because it does not depend on market forces, those of them who elect the BBA facility 'should not be put in a worse position than had they taken a conventional bank loan.'[593]

7.7.4. Case Study 4: Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party) [2008][594]

The *Arab-Malaysian Finance* case, decided on the same day as *Tahan Steel*, concerned a BBA facility. This case is significant because of the judge Datuk Abdul Wahab Patail's decision that the BBA instrument is contrary to the Islamic Banking Act 1983 (IBA) and the Banking and Financial Institutions Act 1989 (BAFIA). The High Court Justice expressed the opinion that 'BBA is not a bona fide sale but a mere financing facility.'[595] Following from this finding, the judge held that the parties must be returned to their original positions. This decision is in line with the decision in *Tahan Steel* (delivered by the same judge), where it was held that *istisna* contracts are void *ab initio*.

Importantly, the Justice in *Arab-Malaysian Finance* supported his decision by stating that a civil court should remain functioning as a civil court and not as a *Shariah* one, even when it deals with Islamic financing facilities. In the latter scenario, a civil court would be obliged to examine whether the relevant *Shariah* principles have been applied in a proper way and particularly whether the examined transactions include elements forbidden in Islam.[596]

Furthermore, the judge indicated that because BBA is in essence a deferred payment facility, i.e. a type of a loan, in order for it to be *Shariah* compliant, it needs to avoid application of interest to the loan in question. This can only happen if the PSA is a genuine and independent transaction. If it can be supposed that the sale is not *bona fide* (which, in his opinion, was the case on the facts),

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593 *Malayan Banking Bhd v Marilyn Ho Siok Lin* (n 342), per David Wong J.
594 *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)* [2008] 5 MLJ 631.
595 Mohd Yazid B. Zul Kepli (n 586).
596 *Arab-Malaysian Finance* (n 483), paras F 8 & 31.

the transaction is marred by an element forbidden by Islam, namely *riba*. Even more importantly, the judge emphasised the importance for the financier to maintain a profit margin which remains lower in comparison to a loan with interest.[597]

Furthermore, the court noted that the text of the agreement must be analysed carefully with attention to its substance rather than form, in order to ensure that customers have not been treated unfairly, particularly in comparison to conventional interest-based loans.[598] On the particular case, the judge assumed that the parties have entered into a non *bona fide* transaction as a result of misapprehension rather than ill intent, which entitled them to a return to their original position as per s 66 of the Contracts Act 1950.[599]

This suggests that the trend, at least in Malaysia, is to adopt a practical approach to Islamic Finance. This would enhance consumers' confidence in this relatively new financial system, particularly because the court is open to discuss whether a certain outcome would be equitable to the parties. While this trend is commendable, the decision was not without critiques. For example, it has been suggested that the court did not avail itself of all the available legal instruments in order to mitigate the situation the parties found themselves in. It has even been argued that the harshness of the court posed a threat to the very existence of Islamic Finance because '[m]ost of the Islamic financial products in Malaysia are based on the BBA contract.'[600] More specifically, there were concerns that the BBA contract can no longer be used in Malaysia in its current form and that in order for it to be utilised, the bank must purchase the property by a third party before selling it on to the end customer. Perhaps this was the reason why the decision of Datuk Abdul Wahab Patail was overturned on appeal.[601]

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[597] *Arab-Malaysian Finance* (n 483), paras 52-56.
[598] *Arab-Malaysian Finance* (n 483), para 62.
[599] *Arab-Malaysian Finance* (n 483), para 70-71.
[600] Mohd Yazid B. Zul Kepli (n 586).
[601] *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and Other Appeals* [2009] 6 MLJ 839 (CA).

7.7.5. Case Study 5: The Investment Dar Company KSCC and BLOM Developments Bank Sal [2009][602]

This English case concerned a *wakalah* (agency) contract concluded between an investment firm and bank. The contract was intended to be governed by English law, subject to compliance with *Shariah*. The parties came to court because of the defendant's (TID) default on their payment obligations. In defense, TID's lawyers raised the argument that the contract was *Shariah* incompliant due to taking of deposits with interest. While the plaintiff bank was adamant that this was not the case, (having received an approval of the contract by a *Shariah* board prior to signing) the importance of this case goes beyond the material facts. It has been observed by the trial judge, Purle QC, that it was possible to suggest that the defense was a mere lawyer's construct. This appears to have happened in a number of cases where the defaulting debtor raises the argument that *Shariah* principles have been breached in the context of the particular agreement. This trend is worrying because it suggests that commercial actors are more than aware that they can use the complexity of the system to their advantage. Furthermore, exactly because of such complexity and the lack of uniform rules, including uniform legal framework, it is possible that judges in cases involving Islamic law deliver a confusing or contradictory judgment. Case law indicates that problematic *ratio decidendi* can be handed down by Muslim as well as English judges. For example, the Arab-Malaysian Finance case, discussed above, brought about criticisms for the learned judge, including on his pronouncement that *Shariah* principles must be agreed upon by the four main schools of Islam in order to be accepted as legally valid. This was rejected on appeal as plainly wrong.[603] Furthermore, Purle QC refrained from deciding on the validity of the *wakalah* agreement in the TID case, despite having doubts about the use of *riba*, because of lack of expertise on Islamic Finance. In that case, the judge chose to lean on the opinion of the expert provided by the plaintiff bank. Islamic finance experts are aware of the trend, which is considered worrying. For instance, Aldohni argues that:

> *... [T]he argument of the contract validity under Islamic law was brought to the court after the defendants defaulted without a valid ground, which means that the use of Islamic law was purely strategic. This can, to certain extent, explain the dismissive*

[602] *The Investment Dar Company KSCC and BLOM Developments Bank Sal* [2009] EWHC 3545 (Ch).
[603] Mohd Yazid B. Zul Kepli (n 586).

approach that the court adopted in deciding Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd & ors case, which can be argued is not directed to Islamic law, but rather to its tactical use. Nevertheless, the point that the judge made in relation to the court's inability to deal with Islamic law is still a source of major concern in this context.[604]

To understand the implications of this, at least in the Malaysian context, it suffices to recall that since the Central Bank of Malaysia Act 2009's sections 56-58 came into operation, civil courts are obliged to consider the published rulings of the *Shariah* Advisory Council. The relevant sections are given below:

Section 56: Reference to Shariah Advisory Council for ruling from court or arbitrator

(1) Where in any proceedings relating to Islamic financial business before any court or arbitrator any question arises concerning a Shariah matter, the court or the arbitrator, as the case may be, shall—

(a) take into consideration any published rulings of the Shariah Advisory Council; or
(b) refer such question to the Shariah Advisory Council for its ruling.

(2) Any request for advice or a ruling of the Shariah Advisory Council under this Act or any other law shall be submitted to the secretariat.

Section 57: Effect of Shariah rulings

Any ruling made by the Shariah Advisory Council pursuant to a reference made under this Part shall be binding on the Islamic financial institutions under section 55 and the court or arbitrator making a reference under section 56.

Section 58: Shariah Advisory Council ruling prevails

Where the ruling given by a Shariah body or committee constituted in Malaysia by an Islamic financial institution is different from the ruling given by the Shariah Advisory Council, the ruling of the Shariah Advisory Council shall prevail.[605]

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[604] Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*, (Routledge 2011), 121.
[605] Central Bank of Malaysia Act 2009, ss. 56-58.

This indicates tightening of the regime and departure from the old practice that a reference to the SAC was merely discretionary.[606] To a point this was introduced to relieve civil judges from the necessity to become familiar with Islamic finance even when they themselves were not Muslims. In addition, it was appreciated that even a Muslim judge who is not an expert in Islamic finance will not be in a position to judge the correct application of principles. On one hand, section 56 provided a clear separation in the responsibilities of the religious and civil courts. On another, it did so by taking away the ability of civil courts to decide on matters of particular importance to the outcome of the case – such as whether or not an agreement is *Shariah* compliant. This became evident after the *Bank Islam Malaysia Bhd v. Lim Kok Hoe & Anor and Other Appeals* [2009] case where it was stated that

> *'The court, will have to assume that the Shariah advisory body of the individual bank and now the Shariah Advisory Council under the aegis of Bank Negara Malaysia, would have discharged their statutory duty to ensure that the operation of the Islamic banks are within the ambit of the religion of Islam.'*[607]

Considering that Malaysia is a leader in Islamic Finance it is not unlikely that its example will eventually be followed by other countries. What is worrying in this scenario is that while Malaysia has so far demonstrated a pragmatic attitude to how Islamic Finance principles and concepts are applied in commercial practice,[608] the division (and the prevailing authority of the *Shariah* Advisory Council) may create some difficulties further down the line. For example, in a situation of radicalization, it is possible that contracts will be decided merely on points of religious purity. Considering that the majority of Islamic contracts are still a work in progress as far as compliance with *Shariah* is concerned, this could result in many contracts deemed void *ab*

[606] Mohd Yazid B. Zul Kepli (n 586). See *Tan Sri Abdul Khalid bin Ibrahim v Bank Islam Malaysia Bhd and another suit* [2009] 6 MLJ 416.

[607] *Bank Islam Malaysia Bhd v. Lim Kok Hoe & Anor and Other Appeals* [2009] 6 CLJ 22.

[608] Consider Per Raus Sharif JCA's firm statement that BBA contracts and conventional loans should not be treated as alike as they are "diversely different and indeed diametrically opposed", in *Bank Islam Malaysia Bhd v. Lim Kok Hoe & Anor* (n 359), paras 24-27, followed by *Arab-Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd* [2010] 3 MLJ 702. See also, B*ank Kerjasama Rakyat Malaysia Bhd v Sea Oil Mill (1979) Sdn Bhd & Anor* [2010] 2 MLJ 740 where the court held that the question of default can be decided without a reference to whether the bank creditor was authorized to carry out Islamic banking (which the court nevertheless found in the affirmative).

initio or at least voidable, with all the negative financial consequences attached to such outcome. Furthermore, the practice may cause an influx of “legal strategy” cases where defaulting parties fall back on the *Shariah* (in)compliant argument in order to escape liabilities.[609] At the least, this framework may create chaos on the market, distrust in the regulator among the public and a subsequent general drop in the financial wellbeing of the population. In a conventional system, where there is detachment of the financial regulation from the dominant religious principles, such negative outcomes can be dealt with through a variety of regulatory measures. This would be harder to do in a Muslim state for a number of reasons. To begin with, there is no consensus on all principles of *Shariah* or on their application. To this end, the following statement should be considered:

> *The freedom to interpret Islamic laws by qualified jurists and scholars has lead to a myriad diversity of opinions (al-ra'yu) among them. These differences of opinion are mainly due to juristic issues of the Islamic law. It could differ for various reasons such as the use of different methodologies of Islamic jurisprudence, different approach towards an issue, different understanding of the Quran and Sunnah etc. Furthermore, legal opinion, to a certain extent, is influenced by characteristics of races, societies and epochs, depending upon their customs, traditions, predilections, peculiarities and business culture of a particular society.*[610]

In theory, Islamic markets can accommodate all practices that are not explicitly forbidden by the *Shariah*. However, in practice, the lack of explicit agreement on the principles of Islamic finance or rather on their practical application may shift the development of Islamic Finance in any direction, including towards a more conservative understanding of *Shariah*. While the separation of jurisdictions between civil and religious courts (and subsequent deference of civil courts on matters of *Shariah* compliance to the SAC) currently facilitates a more relaxed *Shariah* finance framework in Malaysia, it can easily facilitate the introduction of a more conservative regime if and when the context allows it to happen. These are practical considerations which merit closer examination of radical Islamic thought.

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[609] Mohd Yazid B. Zul Kepli (n 586).

[610] *Mohd Alias bin Ibrahim v RHB Bank Bhd & Anor* [2011] 3 MLJ 26.

7.7.6. Case Study 6: Mohd Alias bin Ibrahim v RHB Bank Bhd & Anor [2011] [611]

The issue discussed above has certainly entered the view of Malaysian practitioners, which was reflected in the 2011 case of *Mohd Alias bin Ibrahim v RHB Bank Bhd & Anor*. This case discussed the constitutional validity (under article 121 [1] of the Federal Constitution of Malaysia) of sections 56 and 57 of the 2009 Central Bank of Malaysia Act[612] and most notably whether it is permissible to refer to the SAC under section 56(1)(b) as well as the extent of the finality of a decision by the SAC. The following three issues were raised by the plaintiff:

> *whether the said sections were worded to the effect that they usurped the judicial power of the court to decide the issue to another body [in this case SAC]*
>
> *whether by imposing a duty on the court to refer any Syariah Banking matter to the SAC and making the decision of the SAC binding on the court, the litigants were deprived of any chance to be heard*
>
> *whether the said sections could not have retrospective effects on the transactions since they were entered into before the Central Bank of Malaysia Act 2009 come into force.*[613]

The court answered this question in the affirmative, stating that the permissibility of the reference to the SAC is contained in the fact that the role of the SAC is 'to make an ascertainment, and not final determination, of Islamic laws related to the questions posed.'[614] The court added that the final determination on the case remained with the court[615] and more specifically, that cases of Islamic finance remain the domain of civil courts.[616] It has been suggested that the role of the

[611] *Mohd Alias bin Ibrahim v RHB Bank Bhd & Anor* [2011] 3 MLJ 26.
[612] Deliberated also in *Al Rajhi Banking & Investment Corp (M) Bhd v Hapsah Food Industries Sdn Bhd & Ors and another action* [2012] 1 MLJ 115. See also, Mohammad Azam Hussain, Rusni Hassan and Aznan Hasan, 'Analysis on the Development of Legislations Governing Shariah Advisory Council of Bank Negara Malaysia' (2015) 23(2) Shariah Journal 325, 336.
[613] Mohd Yazid B. Zul Kepli (n 586).
[614] Mohd Yazid B. Zul Kepli (n 586).
[615] *Mohd Alias bin Ibrahim v RHB Bank Bhd & Anor* (n 610), paras 87-88, 90.
[616] *Mohd Alias bin Ibrahim v RHB Bank Bhd & Anor* (n 610), paras 62-63;78-80.

SAC, as per ss. 56-58 of the Central Bank Act, is to create uniformity and consistency and this is to be commended. An additional benefit of the strengthening of the role of the SAC is that it would avoid the opening of the floodgates for lawyers willing to strategize at the expense of legal certainty. Furthermore, on a more general level, the move supports the independence of the Malaysian banking system by preventing interference into its development, including by foreign experts. This suggests that a strong(er) SAC is perceived as instrumental for a strong(er) Malaysian banking system and as such is unlikely that the framework will change in the future. What is more, it is within the possibilities that the example of Malaysia will be followed by other Muslim countries. This is even more likely in a climate of division in the understanding of *Shariah* and its application. From a pragmatic point of view, the alternative to ideological unification (which is admittedly hard to achieve) is hardening of the internal regulatory framework. Theoretically, this would endow the recipient country with the freedom to shape its development almost entirely independently from outside influence. Unfortunately, in an increasingly global world, this objective seems like an impossible dream.

7.8. Forbidden qualities of derivatives under Shariah law

The legal framework covering Islamic derivatives is governed by the paramount consideration that all transactions should be carried out in accordance to *Shariah* law and by extension, by Islamic Finance principles and rules.[617] The preceding discussion highlighted that many of the features of conventional derivatives would be outright incompliant in the Islamic framework. A point that has not been emphasised sufficiently until now is that certain features of the conventional derivatives may clash with the traditional *Shariah* approach to investor protection. To this end, the lack of acceptance of conventional derivatives is rooted also in the fact that investor payoffs are uncertain, thus infringing on the principle that all Muslims should enjoy justice and well-being.[618]

Derivatives are closely linked to an underlying asset. While this trite definition may not add to

[617] Bashar H. Malkawi, 'Financial derivatives between Western legal tradition and Islamic finance: a comparative approach' (2011) JIBLR 276, 276.

[618] Andreas A. Jobst and Juan Sole, 'The governance of derivatives in Islamic finance' (2009) JIBLR 556, 556.

the discussion, it does remind us that the status of the underlying asset i.e. whether it is *haram* (forbidden) or *halal* (permitted) is of utmost importance in Islamic finance. Derivatives originating from underlying assets, which are products forbidden by *Shariah* will not be considered for trading by default. The ones that would be considered would be derivatives on equity instruments, currencies and *halal* input commodities.[619]

The Islamic derivatives discussed above display a number of features that are suspect under *Shariah*. The following section will summarise the main *Shariah* issues potentially presented by Islamic derivatives.

7.8.1. Combination of contracts within one transaction

This is *prima facie* forbidden under *Shariah* law because the Prophet has proscribed combining two transactions onto one and combining of contracts for sale and contract of debt.[620] The fusion of the latter is prohibited because the nature of the two contracts is in conflict. The sale contract is about exchange whereas the loan contract (the one creating debt) is intended to be a charitable one. Furthermore, in terms of their duration, the contract for exchange is limited in time whereas the loan contract could in theory be extendable indefinitely due to its benevolent nature and due to the premise that an obligation under a loan that cannot be met, because the debtor is destitute, could be waived by the creditor.[621] In this sense, a sales contract is binding, whereas a loan contract is not or at least not binding in the strict sense of the contract for exchange. This clash of the nature of the two obligations makes combining them unacceptable as a matter of *Shariah* law.[622]

In practice such fusion takes place in Islamic derivatives where more than one contracts or contracts of different type are combined into one transaction. This is not done illegally because despite the strict inference to their illegality found in religious texts, Resolution No.25 of the AAOIFI's Council of *Shariah* Advisors states that such combination is allowed if certain conditions are met. Among them is the requirement that the contracts must be *Shariah* compliant

[619] Uddin (n 557).
[620] Asyraf Wajdi Dusuki (n 344), 15.
[621] Asyraf Wajdi Dusuki (n 344), 15.
[622] Asyraf Wajdi Dusuki (n 344), 15.

on their own. This however suggests that the AAOFI does not accept combination of contracts for sale and contracts for loans including interest. Furthermore, each of the combined contracts must be self-sustaining i.e. they must be able to function independently from and without binding each other. Note that this would create a problem with the *murabaha* structure adopted by Negara Bank, whereby the *murabaha* was dependent on the *wa'd*.[623] Furthermore, it is not permitted to make one of the contracts conditional on something done under the other, as it is forbidden to use complex contract structures to commit *riba* or other breaches of the fundamental principles of *Shariah*.[624]

7.8.2. Forbidden purposes of the derivative instrument

With respect to the purpose of the derivative instrument, an interesting point is that, according to experts, Islamic derivatives should be used predominantly for risk hedging and cost reduction purposes and not to profit by speculation.[625] This is arguably challenging to achieve. For example, statistics indicate that almost the entire amount of traded swaps (97%) is due to activities by dealers and not ordinary investors,[626] which suggests that trade in Islamic swaps largely breaks this principle. As regard *tawarruq* and *murabaha*, which are contracts for funding, their purpose is obviously not risk hedging. To the extent that they may contain a sub-contract intended to hedge the risk of default by a contractual party, the element of hedging is not the objective of the contract. As regard the point on cost reduction, *tawarruq* and *murabaha* are indeed used to generate funds rather than anything else. They are products intended to generate profit for the transacting parties, although admittedly, not necessarily a speculative one. With this in mind, it may be concluded that while swaps are suspect under this principle, *tawarruq* and *murabaha* are not. With respect to the rest of the discussed derivatives, Islamic options are compliant on this point because they are structured to protect from market risks. Futures are not

[623] See

[624] AAOIFI (2007), the guidelines and conditions for combining several contracts into one single transaction in Asyraf Wajdi Dusuki (344), 16-17.

[625] Sami Al-Suwailem, 'Hedging in Islamic Finance' (2006) Islamic Development Bank: Occasional Paper no.10, 43. See also, Financial Islam, 'Derivatives and shari'a' (2012) http://www.financialislam.com/news/derivatives-and-sharia accessed 31st August 2019.

[626] Sami Al-Suwailem, 'Hedging in Islamic Finance' (2006) Islamic Development Bank: Occasional Paper no.10, 43.

allowed on the basis of fundamental incompliance with *Shariah* and as far as the CPOF contract is concerned, it should not be permitted either, due to its inherent speculative nature.

Chapter 8: Islamic derivatives for project financing: sukuk's compliance with Shariah law and its implications for risk management and investor protection

8.1. Sukuk in context

The preceding chapters outlined the jurisprudential aspects of *Shariah* law relevant to Islamic finance and the author's viewpoint on Islamic derivatives, how they compare with their conventional counterparts and the degree of their *Shariah* compliance. In order to provide context, the discussion also referenced the rules on creating a valid contractual relationship under Islamic Contract Law, while drawing comparisons with the relevant provisions of the English common law of contracts. This allowed the work to establish that Islamic financial contracts suffer from some conceptual weaknesses, which may undermine their proper use further down the line and particularly on a breakdown of the contract. Furthermore, the analysis highlighted that to the extent some features of these contracts have been borrowed from the common law, their structural elements may need substantial fine-tuning in order for the contracts to withstand the scrutiny of the common law courts. The relevance of the last point should not be understated, particularly with respect to trading on a cross-border basis.

In addition, the analysis concluded that two Islamic contractual or *quasi*-contractual forms (*murabaha* (cost plus financing) and *wa'd* (promise/undertaking)) are often used for the structuring of Islamic derivatives in order to sidestep the prohibitions of *Shariah* law, namely those of *riba* (interest) and *gharar* (uncertainty). While the former is connected to *Shariah*'s affinity to social fairness and the moral health of society more generally, the latter has a specific connection to risk management and by extension, to the stability of the respective financial market.

Considering the importance of these two objectives of *Shariah*, it would be of extreme relevance to examine the extent to which they have been achieved and generally dealt with respect to another very popular instrument, the Islamic bond (*sukuk*). Although bonds are not considered derivatives in the conventional market; rather, they are used (along with shares) as underlying assets for derivatives, *sukuk* are deemed 'Islamic derivative instruments [which] are as efficient as that of conventional derivative products and apply … similar securitization principles'.[627] In addition, *sukuk* is closely linked to standard derivatives. For example, it has been argued that 'a Sukuk issuance that is structured around a Salam contract can also be seen as similar to a structured note with an embedded derivative.'[628] These considerations, as well as the prevalence of the instrument on the Islamic financial markets, justify its inclusion in the current research.

It has been widely acknowledged that, '[t]he key purpose of a derivative is the management and especially the mitigation of risk.'[629] To this end, this Chapter will discuss whether the *sukuk* instrument, as the preferred funds raising tool of the current Islamic finance instrumentarium, is suited to address the issues of risk management and investor protection, including in situations of default by contractual parties. The answer to this question is directly relevant to the viability of *sukuk* in a more radical legislative environment. Arguably, failure to deliver on *Shariah*'s objectives would make the instrument less appealing to a legislator with a more traditional (revivalist) take on Islamic law.

Engineered to make Islamic finance more competitive with regard to conventional finance, the Islamic bond is, broadly speaking, a hybrid between a conventional bond and a conventional share, structured however in a *Shariah* compliant manner. This genetic closeness between *sukuk* and the main conventional project-funding tools justifies a thorough analysis of the latter before delving into the intricacies of the former. To this end, the Chapter will begin with a short overview of risk from the perspective of investors and companies respectively. After providing a

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[627] Muhammad Umer Rattu, 'Exploring Legal, Regulatory and Shari'ah Compliance Issues in Islamic Financial Instruments: Derivatives and Sukuk' (2013) Durham University http://etheses.dur.ac.uk/7349/ accessed 31st August 2019.

[628] Nabilah Annuar, 'Derivatives and Hedging in Islamic Finance' (2015) EurekaHedge, http://www.eurekahedge.com/Research/News/1324/Islamic_Finance_News_Derivatives_and_Hedging_in_Islamic_Finance accessed 31st August 2019.

[629] Parliament UK, 'Definition of Derivatives' (n.d.) https://www.parliament.uk/documents/documents/upload/supplemetaryisda.pdf accessed 31st August 2019.

concise definition of default, the Chapter will proceed with a discussion on the relevant financial instruments.

8.2. Calculation of risk in conventional finance

The technical definition of risk is: a possibility for a wrong investment outcome or return projection.[630] This refers to the possibility that the actual return or outcome will differ from the expected one. 'Different versions of risk are usually measured by calculating the standard deviation of the historical returns or average returns of a specific investment.'[631] Investment, which has historically shown low swings is typically considered to contain low risk and *vice versa*. Bigger swings on the performance of investment are consistent with high standard deviation risk, meaning higher degree of risk. Despite risk being mathematically symmetrical, it is its negative outcome which interests investors and regulators and causes the developments of varied risk assessment and risk management techniques.

Approaching this issue adequately is fundamental because the degree and manifestation of risk could differ too and range from an underperforming investment to a total loss. Conventional finance perceives the relationship between risk and return as fundamental for profit, with greater risk being linked to greater expectations for return. The possibility that these expectations will prove wrong is hedged on an individual level by insuring against risk, i.e. investing in derivative products or by adjusting one's investments to one's specific risk tolerance profile. On the level of the financial market, the issue of risk is dealt with by legislators and regulators through market stability and investor protection targeting regulation and supervision.

8.2.1. Retail investors' perspective of risk

Investors are exposed to a broad range of risks, the most important of which is market risk: an umbrella term encompassing equity, interest rate and currency risk.

[630] James Chen, 'Risk' (2019) Investopedia, https://www.investopedia.com/terms/r/risk.asp accessed 11th July 2019.
[631] Ibid.

Market risk arises from the possibility of investments to lose their value due to events impacting on the market. For example, investors in shares could experience loss due to the declining price of their shares. Bonds investors could be affected by fluctuations of interest rate where a rise in rates brings the price/market value of bonds down. Investors owning foreign investments are dependent on currency fluctuations, which can make them profit but could also cause them losses. Investments in foreign stock usually lose market value when the foreign currency (the currency of the investment) falls relative to the home currency of the investor.

In addition, investors should protect themselves, or be protected by the regulator to the extent this is possible, from liquidity, credit, concentration, reinvestment, inflation, foreign investment, horizon and longevity risk.

Liquidity risk is the risk related to whether you can sell your investment at the time you need to (or at all) but at the right price - without taking an unfair cut to the price. Concentration risk is the risk of having "all your eggs in the same basket"; not diversifying your investments in terms of type, location and industries. Reinvestment risk may become an issue if reinvesting principal or income at a lower interest rate.[632] Inflation risk could be more relevant to bonds than shares. If the value of this investment does not keep up with the inflation, this will affect the purchasing power of the investor. In difference to bonds, shares offer some insulation against inflation because companies can pass the inflation rate on to their customers by raising prices. Horizon risk could arise due to circumstances affecting the particular investor such as losing a job and prompting a quick sale at a lower price, typically prior to maturity. The shorter horizon you have, the greater the need to make safer investments and *vice versa*. Longevity risk is the risk of living longer than your savings could cover. Foreign investment risk could affect investors if the companies in which they have invested become subject to nationalisation.[633]

Credit risk is one of the most serious types of risk which an investor should consider. This type of risk is most relevant to the current narrative. Credit risk comes to pass when the company or the entity in which the investment has been made, fails to pay the interest or repay the principal at

[632] Ontario Securities Commission, 'Types of investment risk' (2018) https://www.getsmarteraboutmoney.ca/invest/investing-basics/understanding-risk/types-of-investment-risk/ accessed 11th July 2019

[633]Ibid.

maturity. Credit risk typically applies to bonds[634] as this is the risk that would manifest when/if the debtor defaults on his obligation to return the debt.

8.2.2. Companies' perspective of risk

There is no doubt that, and particularly so following the latest financial crisis, regulators of conventional finance do not take the matter of market risk lightly; consider, for example, the avalanche of legislation following the 2008 financial collapse. For their part, conventional financiers are alive to the fact that risk is a factor that could bring positive as well as negative outcomes.[635] As a result, conventional finance has learnt to deal with risk by balancing between what would be too much and the too little of it. Admittedly, the former could endanger the market by destabilising it but so could the latter, particularly if it is practiced in excess. Although caution on the financial market does not seem like a negative thing *per se*, excessive market caution has been known to inhibit market development and market regulation, create deflation, market bubbles, poor asset allocation and use of resources, leading to socially problematic outcomes such as insufficient pension funds or too expensive insurance policies. Furthermore, excessive caution could cause poor liquidity and it is as likely to increase volatility on the market just as the opposite behaviour.[636]

A point in case is the way conventional banks approached mortgages (loans intended to finance purchasing of a real estate) prior to the 90s and after. Although such loans are paid back with interest, as is the case with all conventional loans,[637] they are often, in addition, collateralized. This means that banks would require a personal or real guarantee to back the loan. What this signifies is that banks wanted the risk taken by them to be very small and even if it came to pass, to have a secondary arrangement in place which would provide them with (additional) compensation for the loss.

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[634]Ontario Securities Commission (n 632).
[635] Adam Odar, 'Risk Aversion' (n.d.) NYU Stern School of Business, http://pages.stern.nyu.edu/~adamodar/New_Home_Page/risk/riskaversion.htm accessed 1st July 2019.
[636] Granite Hills Investments, 'Why Risk Aversion is bad?', <http://www.traderslog.com/forum/showthread.php?p=24133> accessed on 1st July 2019.
[637] Hanif (n 164), 15.

Note that prior to the 90s most conventional banks would require security for the commercial and industrial loans provided by them. In the US, [638] Germany and the UK this practice accounted for around 70% of all issued loans.[639] The collateral- based *modus operandi* of mortgage providers was motivated by a high drive for security and desire to lower the risk for themselves. However, while banks were correct in assuming that their credit risks diminished by taking a collateral, they did not consider (or were not interested) that this would also diminish their credit efficiency.

For instance, there are empirical studies proving that banks which require backing by a guarantee do not perform sufficiently rigorous credit checks.[640] This is hardly surprising because from the point of view of the bank, the above is indeed a win-win situation. The bank (the creditor or the mortgagee) is not invested to thoroughly check the creditworthiness of its customer (the debtor or the mortgagor) because it will receive the loaned amount or the real estate back either by the client meeting his obligation or by the bank making use of the guarantee. (There are a number of scenarios of how this could play out depending on the type of loan contract.)

Meanwhile, which is for the duration of time the debtor honours his contractual obligations, the lender is free to continue profiting from the interest charged on the principal at least until such time that the client defaults. This practice, while good for the bank in the historical frame of the transaction, is not necessarily beneficial for it in the long-term by bringing possible 'credit rationing or a partial break-down in financial markets in circumstances that do not warrant it, creating problems in resource allocation and macroeconomic policy.'[641] From the perspective of society, such excessive drive for security is inefficient because it underuses the ability of the bank to assess the viability of the financed project and therefore shape the market in the most efficient way.[642] Further, it is arguable that such conduct by bankers is irresponsible to borrowers and likely to promote systemic instability while still remaining potentially very risky for lenders.

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[638] A N Berger, and G F Udell "Collateral, Loan Quality, and Bank Risk", (1990) 25 Journal of Monetary Economics 21.

[639] D Harhoff, and T Körting, 'Lending Relationship in Germany–Empirical Evidence from Survey Data', (1998) 22 Journal of Banking and Finance 1317; M Binks, C Ennew and G Reed, 'Small Business and Banks: A Two Nation Perspective', prepared for the Forum of Private Business, UK and the National Federation of independent Business, USA, (1988).

[640] M Manove, A J Padilla and M Pagano, 'Collateral vs. Project Screening: A Model of Lazy Banks', (2000) CEPR Discussion Paper no. 2439.

[641] Paolo Savona and George Sutija, *Strategic Planning in International Banking*, (Palgrave MacMillan 1986), 8.

[642] Alberto Franco Pozzolo, 'Secured Lending and Borrowers' Riskiness', (2008) <http://www.bis.org/publ/cgfs19bdi1.pdf>accessed on 22nd November 2017, 3.

Another way of risk management by banks is banks making investments with the objective to preserve their liquidity. This could include, *inter alia*, short notices, short term loans, government securities, leasing company bonds, money at call or investment in shares. In addition, banks are expected to keep an interest earning reserve distributed between a deposit in their respective central bank and investments in government bonds. Even more importantly, conventional banks can rely on the support of their respective central bank if they experience illiquidity. Note however, that whatever the arrangement, interest continues playing a major role because even in the case of intervention by the central bank, the cash injections delivered to the failing bank would be subject to interest.[643]

The summary of the above is that for the sophisticated conventional financier, risk is neither a positive nor is it a negative devise. It is simply a devise which could, if used carefully, facilitate the process of value creation. To this end, financiers and regulators put measures in place, each in their respective area of responsibility, to protect the already created value from excessive or deficient risk.

As mentioned previously, while financiers are mostly concerned with value generation and in generally, with the profitability of their business, regulators are mainly concerned by two fundamental issues. The first one is financial stability on a systemic level and the second one is protection of investors. With respect to the former, regulators are constantly on the lookout for newly appeared or highly possible future micro and macro prudential threats to which they react either reactively (if the risk has already manifested on a systemic level) or proactively.

Regarding the latter objective, ensuring that all types of risk will be properly controlled and managed is part of the investor protection regulatory package in the conventional market.[644] In the conventional regulatory framework, investor protection applies to all types of investors –

[643] Hanif (n 164), 16.
[644] See MiFIDII (n 177); Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC (Text with EEA relevance) OJ L 337, 23.12.2015, p. 35–127 (PSD2), BRRD (n 89).

retail and institutional alike, subject to the principle that the less sophisticated the investor, the greater the protection enjoyed by him.[645]

With a view that the following Chapters will make numerous references to the extent Islamic finance investors can rely on redress in a situation of debtor's default, a definition on what is perceived default in debt instruments would be useful.

A debtor is considered to be in default if he or it fails to repay his or its debts. This includes obligations to pay back the principal as well as the attached interest. To this end default encompasses missed payments, the inability of the debtor to make timely payments, or the avoidance of or the complete termination of making payments. Any legal and physical persons, such as individuals, corporate entities and even countries, could find themselves in a situation of default should they become unable to meet their payment obligations.[646]

However, *Shariah* law's approach to defaults is complex. This is caused by the need to balance the relevant *Shariah* finance principles, which are general and immutable, with various practical considerations which have impact on the financial wellbeing of the specific Muslim society at the specific point of time. In this endeavour, Islamic finance practitioners are often exposed to the dilemma whether to follow the example of conventional finance, for which financial wellbeing is (often) reached through (careful) undertaking of risky ventures or to remain true to the letter of *Shariah*.

[645] MiFIDII (n 177), Prospectus Directive/Regulation: (Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (Text with EEA relevance) OJ L 345, 31.12.2003, p. 64–89 and Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/ECText with EEA relevance, OJ L 168, 30.6.2017, p. 12–82)

[646] James Chen and Chris B Murphy, 'Default '(2019) Investopedia, https://www.investopedia.com/terms/d/default2.asp accessed 11th July 2019.

8.3. Project financing: the sukuk instrument

Although in Arabic the singular of *sukuk* is *suk or sakk,* the word *"sukuk*" is used for both the singular and plural forms of the instrument. *Sakk* means "certificate of entitlement".[647]

Sukuk is a real asset-based or real asset-backed trust certificate, created and legitimized by the Fiqh Academy of the Organization of the Islamic Conference in February 1988. The compliance of any *sukuk* issuance is determined and adjudicated by the respective dedicated *Shariah* boards.[648] Since Islamic Finance does not permit interest based transactions, *sukuk* was developed to avoid the *riba* prohibition, while at the same time offering the benefits of the bond instrument to Muslim customers. However, in addition to being similar to bonds, *sukuk* displays some of the characteristics of a share. Because of this, it is referred to as the *Shariah* compliant alternative of Islamic Finance to conventional bonds and shares. [649]

Indeed, *sukuk* was engineered with the idea to increase the competitiveness of Islamic issuers *vis-a-vis* their Western counterparts. Also, it was (correctly) anticipated that the bond could be offered to Muslim investors living in the West as an alternative to the Western interest-based debt and interest-based financing.

From a technical perspective, *sukuk* is defined as tradeable, asset-backed, medium term notes,[650] structured on the basis of a contract. This could be either a contract of exchange (e.g. *ijarah*, *murabahah*, *istisna'*) or contract of participation (for example, *musyarakah* and *mudarabah*).[651] Currently, the AAOIFI recognizes a number of different types of *sukuk*. Currently, the biggest *sukuk* market in the world is Malaysia[652] and a disproportionally big part of the global *sukuk* issuance is traded on the Malaysian Scripless Securities Trading System (SSTS)38.[653]

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[647] Hans Visser, *Islamic Finance: Principles and Practice*, 2nd Edition 2013, 79.
[648] Andreas A Jobst, 'The Economics of Islamic Finance and Securitization' (2007) IMF Working Paper, WP/07/117, 19.
[649] Investopedia, 'Sukuk' (2018) https://www.investopedia.com/terms/s/sukuk.asp 28th September 2018.
[650] Visser (n 647), 79.
[651] Tan Wan Yean, 'Sukuk: Issues and the Way Forward' (2008), http://www.iln.com/articles/pub_1674.pdf, 2.
[652] Elias Bischof, 'The influence of Islam on banking and finance' (2013) 24(10) ICCLR 369, 370.
[653] Note Andreas A Jobst's explanation of the system: "The SSTS is a system operated by the Bank Negara Malaysia (BNM)'s real time gross settlement/delivery versus-payment system through which sovereign and unlisted corporate bonds are registered, cleared, and settled via the Real-time Electronic Transfer of Funds and Securities (RENTAS), Malaysia's scripless book-entry securities trading and funds transfer system. SSTS also maintains securities accounts

For the Western investor, the varied issuances of *sukuk* offer the possibility of investing in the fast-growing Gulf Cooperation Council (GCC) markets, which are usually underrepresented on the conventional bond market.[654]

However, *sukuk* was considered beneficial not just for the Islamic but also for the Western economy because it promoted stability and appeared to ward off insolvency, thanks to being based on real assets and its link to LIBOR (providing LIBOR pegged returns). Additionally, the Islamic bond was hoped to perform an important social function because it attracted customers who would have otherwise remained unbanked. To this end, *sukuk* demonstrated a potential to include marginalized and disenfranchised prospective customers into the mainstream economy.[655]

Furthermore, Islamic finance instruments contribute to the development of the host economy in a number of ways. For example, they allow a previously non-banking and non-participating in the commercial turnaround parts of the population to contribute to the GDP. Furthermore, they make it possible for Muslims to carry out financial transactions, including on the capital market, without the feeling of guilt accompanying incompliance with *Shariah*.

A typical and very popular financial arrangement, *sukuk* has a number of purely technical merits. For example, it provides a way for originators to increase their liquidity. Furthermore, the use of a Special Purpose Vehicle (SPV) gives originators the opportunity to dispose from low liquidity assets and replace them with cash, while preserving access to these assets.

Furthermore, because investment in asset-backed *sukuk* is a relatively low risk, this reduces the cost of financing. In addition, *sukuk* arrangements could help improve originator's credit rating, which too will in effect reduce financing costs. A more indirect benefit of *sukuk* is that the instrument allows turning assets into securities, which assists in the development of the capital

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for financial institutions." In Andreas A Jobst, 'The Economics of Islamic Finance and Securitization' (2007) IMF Working Paper, WP/07/117, 19.

[654] Renoy Kundukulam, 'The appeal of investing in sukuk' (2017) Golf News Business, https://gulfnews.com/business/banking/the-appeal-of-investing-in-sukuk-1.1984369 accessed 19th July 2019.

[655]

market. Lastly, in jurisdictions where *sukuk* could be traded on the secondary market, this would improve their liquidity.[656]

Given all of the benefits of the instrument, it has been suggested that further development on the *sukuk* market may have direct positive effect on alleviating poverty[657] and closing the global infrastructure financing gap.[658] The current situation is that despite *sukuk*'s popularity in the Muslim populated markets, there is no sufficient governmental issuance at different maturities. It has been argued that making progress with the latter would contribute to the deepening of the *sukuk* market and would create a yield benchmark for corporate *sukuk*,[659] thus making the instrument even more attractive to institutional investors, including for cross-border investment.

Furthermore, it has been noted that there are potential growth markets for the *sukuk* in European markets. It is notable, in this respect, that analysis of Deloitte ME suggests that 'the growth of the Sukuk market in Europe and elsewhere in the world could bridge the gap in infrastructure funding/financing, particularly with respect to real economy projects and public-private partnerships (PPPs).'[660]

Despite its popularity in the West, certain downsides to *sukuk* have been identified, applicable specifically to the Middle East. It is these downsides that have so far prevented *sukuk* from achieving its best potential. First, although it has been developed as a trust certificate, it has been operating in a system where there are no trust laws in place. To function properly, however, the *sukuk* needs a trust law framework, as well as a market microstructure for the *sukuk* markets; without this the benefits of the instrument cannot be enjoyed fully. In addition, for various reasons aligning *sukuk* with other legal jurisdictions is expected to prove potentially problematic.

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[656] Capital market Central Asset Management, 'Sukuk benefits and its essential infrastructure for developing Sukuk market' (2016) http://sukuk.ir/en/news/item/166-sukuk-benefits-and-its-essential-infrastructure-for-developing-sukuk-market accessed 6th September 2019.

[657] M Bennet and Z Iqbal, "The Role of Sukuk in Meeting Global Development Challenges" (2011) World Bank , Euromoney Books (Eds.) *Global Growth Opportunities and Challenges in the Sukuk Market*, Souhaiel Jaffer.

[658] Arif Orçun Söylemez, 'Current Issues of the Sukuk Market and Using Sukuk for the Global Infrastructure Projects' (2016) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2865549 accessed 12th June 2019, 1.

[659] Ibid, 3.

[660] Hatim El-Tahir, 'Corporate Sukuk in Europe Alternative financing for investment projects' (2019) Deloitte, https://www2.deloitte.com/ly/en/pages/financial-services/articles/corporate-sukuk-in-europe.html# accessed 6th September 2019.

Regardless the above misgivings about the product, ever since the first *sukuk* was issued (in Malaysia) at the turn of the 21st century,[661] *sukuk* has been and has remained very popular among issuers and investors alike. Subsequently, the *sukuk* market has grown enormously during the last two decades. Among other reasons, this was due to the greater resilience manifested by *sukuk* during the 2008 crisis compared to its conventional counterparts.

8.4. Conventional alternatives to sukuk: covered bonds

Covered bonds and their risk management and investor protection arrangements will be outlined before venturing into a technical discussion of the *sukuk* instrument. It is expected that the conventional finance experience in the area (mainly by reference to the EU as the main global supplier of covered bonds) will help understand the structure and workings of the Islamic bond.

Conventional bonds are broadly divided into covered and unsecured (debentures). In the definition of the EU Commission, covered bonds are financial instruments issued by banks to fund the economy and offered predominantly to institutional investors. They are referred to as "covered" because they are backed by a separate pool of assets accessible to investors to make a preferential claim in case of the issuer becoming insolvent.[662] Typically, the pool of assets contains high quality assets, for example residential and commercial mortgages or public debt.[663] The pool of assets is held by a Special Purpose Vehicle (SPV) which buys the asset using capital provided by the issuer. This pool remains 'virtually unaffected from the post-bankruptcy recourse and claims of the other creditors.[664] The degree of riskiness of these instruments is lower compared to other products, which is why banks investing in cover bonds are not required to set

[661] FT.com Lexicon, 'Definition of sukuk (Islamic bonds)' (n.d.) http://lexicon.ft.com/Term?term=sukuk-(islamic-bonds) 30 September 2018.
[662] EU Commission, 'Capital Markets Union: covered bonds, cross-border distribution of investment funds and cross-border transactions in claims and securities' (Brussels, 12 March 2018) http://europa.eu/rapid/press-release_MEMO-18-1425_en.htm accessed 11th July 2019.
[663] Ibid.
[664] Silviu Eduard Dinca, 'Covered bonds vs. assets securitization' (2014) 21(11) Theoretical and Applied Economics 71, 73.

aside the same amount of regulatory capital as they do in the case of investment in other assets. Furthermore, covered bonds enjoy preferential prudential and regulatory treatment.[665]

Covered bonds are considered by some practitioners a hybrid financial instrument, due to being a mixture of secured corporate bonds and mortgage-backed securities.[666] Although there is no a universally accepted definition on bonds, they are considered to have ‘ 1) dual recourse mechanism; 2) asset segregation and dynamic cover pool; and 3) strict legal and supervisory frameworks.’[667]

The dual recourse mechanism refers to creditors being able to claim redress on default from both the asset pool and the issuer. First, each investor is entitled to make a claim to be made whole from the pool of assets. Secondly, if the pool of assets proves to be insufficient for this purpose, issuers are liable to investors with their own capital.[668] The EU Commission offers more detail in its Final Report on ‘Covered Bonds in the European Union: Harmonisation of legal frameworks and market behaviours’:

> *5.1.1Qualifying covered bonds would be defined as "dual recourse" debt instruments. This means that covered bond holders would have a claim on the covered bond issuer and, in case of their insolvency, a priority claim on the proceeds from assets in the cover pool, both claims limited to the fulfilment of the payment obligations attached to the covered bond. If the assets are insufficient, the covered bond holders would have a claim on the issuer’s insolvency estate that ranks pari passu, but not senior to the claims of the issuer’s unsecured creditors.*[669]

The second characteristic of covered bonds – asset segregation is intended to reinforce the possibility to satisfy creditors’ claims in the event of insolvency. In the definition of the EU Commission:

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[665] European Parliament, ‘A framework for EU covered bonds’ (May 2018) http://www.europarl.europa.eu/RegData/etudes/BRIE/2018/615679/EPRS_BRI(2018)615679_EN.pdf accessed 11th July 2019.
[666] Dinca (n 664), 72.
[667] European Parliament, ‘A framework for EU covered bonds’ (May 2018) http://www.europarl.europa.eu/RegData/etudes/BRIE/2018/615679/EPRS_BRI(2018)615679_EN.pdf accessed 11th July 2019.
[668] EU Commission (n 662).
[669] Richard Kemmish, Charu Wilkinson and Oskar Andruszkiewicz, ‘Covered Bonds in the European Union: Harmonisation of legal frameworks and market behaviours’, European Commission Final Report, (2017), 57.

> *5.1.2The covered bond should ensure identification and effective legal segregation of all assets in the cover pool either by (i) a cover register (ii) transfer to an SPV or (iii) segregation in a specialised credit institution. The segregation should be binding and enforceable including in the issuer's insolvency or resolution. This relates to all assets that contribute to the coverage requirement (primary assets, substitution and liquidity assets and derivatives and connected collateral). This should also include "voluntary over-collateralisation i.e. cover assets set aside by the issuer for the benefit of the investors in addition to the required coverage."*[670]

In addition, having a dynamic asset pools refers to a practice whereby the pooled assets can be transformed or replaced with new during the lifetime of the SPV with the objective of preserving certain pre-determined level of credit quality. Typically, such pooled assets consist of mortgage loans or public sector loans. This raises the importance of control over the quality of each loan, the underwriting standards applicable to them and the procedures for accepting new loans. At the end of the day, how well an asset pool will perform its investor protection task on default will depend on local legislative and regulatory framework, the oversight by the regulator and the due diligence of the bond issuer.[671]

The purpose of having an assets pool is twofold. First and foremost, it exists to provide investors with security in times when the issuer undergoes financial distress. Secondly, and this is linked to the previous objective, the pool serves to enhance the credit rating of the issuer. The purpose of this enhancement is to absorb the credit exposure of the issuer through over collateralisation, meaning that the value of the asset pool should exceed the notional value of the bonds.[672]

One issue that could be picked up is that over collateralisation may shift performance towards inefficiency. As previously discussed, the adoption of excessive caution as a risk management technique, may bring a host of problems down the line. For example, in the context of the EU, due to a disparate bonds regime across the Union, investors are not provided with certainty as to the risk management markers of their investments. This is certainly a downfall of the current system bringing with itself, among other things, informational asymmetries (between investors and between investors/issuers) and inefficient allocation of resources, which have an immediate effect on the quality of investor protection.

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[670] Ibid, 58.
[671] Dinca (n 664), 74.
[672] Dinca (n 664).

Another point to be considered is that the loans that constitute the asset pool remain on the balance sheet of the issuer (not the SPV) at their original values. This means that if for any reason the SPV needs to sell them quickly on a depressed market, it is likely to do so at a loss. This loss will be reflected on the balance sheets of the originator, potentially leading to leverage problems and/or problems with the applicable capital regulatory levels.[673]

Lastly but most relevantly, the Commission offers a definition of bankruptcy remoteness of covered bonds, according to which:

> *5.1.3Payments under the covered bond should not automatically accelerate upon insolvency or resolution and [frameworks should] ensure that the options available to the covered bond administrator are not constrained. In the event of insolvency, bond claims should have priority over proceeds from assets in the cover pool. Claims of other creditors should be subordinated to these claims. The issuer should have a plan in place specifying the operational procedures upon their insolvency or resolution to ensure an orderly functioning of the covered bond programme.*[674]

This means that issuer's insolvency or resolution should not affect covered bonds' maturity by shortening it automatically. Furthermore, the new legislation will ensure 'that investors are repaid in line with the contractual schedule even in the event of default.'[675] This feature makes bankruptcy remoteness closely connected to the dual recourse mechanism.[676]

At the time of writing, covered bonds' national regimes have not yet been harmonised in the EU, leading the EU Commission to suggest in March 2018 'EU rules that will establish common definitions and standards for covered bonds'. The proposed change is arguably long overdue in the EU especially from the point of view of investor protection because the efficiency of the asset-backing facility of the asset pool depends to a big extent on the ability of national regulators

[673] Dinca (n 664), 76.
[674] Richard Kemmish, Charu Wilkinson and Oskar Andruszkiewicz (n 669), 60.
[675] EU Commission, Proposal for a Directive of the European Parliament and of the Council on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU, Brussels, 12.3.2018 COM(2018) 94 final, 9.
[676] Ibid.

to enforce it '(in case of the legislative/regulatory covered bonds) or on the effectiveness of transactions' legal structure (in case of the structured/private contractual covered bonds).'[677]

Furthermore, the stance of the EU Commission on the issue of covered bonds is relevant for many reasons but particularly because the EU holds 84% of all global issuance of bonds.[678] Covered bonds regimes are well-developed in Germany, Denmark, France, Spain, Italy, Luxembourg and Sweden due to their long-standing traditions (over 250 years)[679] in the area.[680] The proposed by the EU Commission framework:

> *provides a common definition of covered bonds;*
>
> *defines the structural features of the instrument;*
>
> *defines the tasks and responsibilities for the supervision of covered bonds;*
>
> *sets out the rules allowing the use of the 'European Covered Bonds' label;*
>
> *strengthens the conditions for granting preferential prudential treatment to covered bonds under the capital requirement regulation.*[681]

The Commission proposes the changes to take the form of a Regulation and a Directive. The latter will make provision for higher quality assets in the asset pool. Those which will likely make the final cut will be assets which market value or mortgage lending value would be easy to determine. For example SME and infrastructure loans are unlikely to meet these requirements as they are considered too risky.[682]

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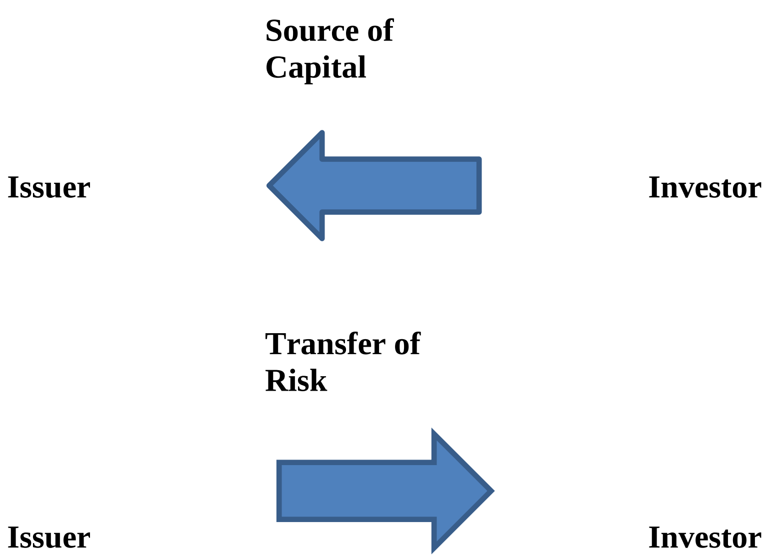
[677] Dinca (n 664).
[678] EU Commission (n 675).
[679] Dinca (n 664), 72.
[680] European Council, Council of the European Union, 'Capital markets union: political agreement reached on EU framework for covered bonds' (February 2019) https://www.consilium.europa.eu/en/press/press-releases/2019/02/27/capital-markets-union-political-agreement-reached-on-eu-framework-for-covered-bonds/ accessed 11th July 2019.
[681] Ibid.
[682] EU Commission (n 675).

8.5. Asset-backed securities as another inspiration for sukuk

We looked at covered bonds as a conventional alternative to the Islamic bond *sukuk*. However, *sukuk* manifest features which make them conceptually close not just to bonds but also to Asset-Backed Securities (ABS). A brief overview of how ASB function and what their risk control mechanisms are, particularly in the area of default would be necessary before we continue with a discussion of default arrangements in Islamic Finance Law.

8.5.1. Asset Securitisation

Securitisation provides issuers with two main benefits – a source of funding and risk transfer from the issuer to investors.



Through the method of securitisation one could finance and refinance a number of asset classes- from the most simple such as ordinary loans and consumer credit to the very complex ones such as sovereign debt. The process of financing takes place by moving assets off-balance sheet. Refinancing refers to borrowing against the assets in order to obtain refinancing of their origination at a fair market rate.[683] The refinancing feature of ABS is very useful when used for assets which the originator cannot dispose of. Such assets could be locked-up for a period or subject to another obligation which prevents immediate disposal. Refinancing may be appropriate

[683] Dinca (n 664), 76.

when capital is needed but disposing of the assets at the particular moment would not provide the right (best possible) price; for example, when there are liens granted on various assets, which must be waited out or for assets which are included in a will. Transferring such assets to a securitisation vehicle can guarantee return while being bankruptcy remote.[684] Typically this is done by the refinancing enterprise selling assets of its business operation to a SPV for refinancing purposes.[685]

8.5.2. ABS in focus

Similarly to covered bonds, ABS are collateralised by a pool of assets, (typically placed in a SPV). The pool provides investors with income. The value of the pool determines the value of the ABS.

The pool is detached from the assets of the originator as well as from the originator's credit rating notch. This assists issuers in raising cheaper finance, while not expanding the originator's balance sheet, which contrasts with the way bonds and other debt-based instruments work.

The process of creating ABS works in the following way. The originator pools those assets that he will not want to retain on his balance sheet into a portfolio which he then sells to the issuer (SPV). This SPV is specifically created with the purpose to purchase this asset pool and detach it in legal and accounting sense from the balance sheet of the originator. The SPV generates capital to purchase the asset pool by issuing tradable ABS which are then traded on the capital market, typically to institutional investors. The ABS provide interest payments which could be on either fixed or floating rate, paid out from a securitization trustee account. The trustee account is funded by the incomes of the underlying reference portfolio. This is one of the differences between ABS and covered bonds. In the latter case, interest payments are typically paid out of the originator's main account. This creates a discrepancy between assets and liability, and a certain payment dynamic which is intended to raise the credit rating of the issuer to the extent this is possible. If the discrepancy between the income from the covered bonds and the regular business-based cash

[684] Creatrust, 'Refinancing Assets through Securitisation' (n.d.) https://www.creatrust.com/investments-funds/securitisation-vehicle-and-security-issuance/refinancing-assets-through-securitisation accessed 13th July 2019.
[685] Rick Watson and Jeremy Carter, *Asset Securitisation and Synthetic Structures: Innovations in the European Credit Markets*, (Euromoney Institutional Investor, 2nd edition, 2006), 177.

flows of the originator is wide, covered bonds will rely on how liquid the bond issuer is. In the opposite case, covered bonds will rely heavily on the performance of the pool of assets. The chances of higher ratings are greater in the first scenario. In contrast, because in the case of ABS regular payments are provided by the asset pool, any possible asset-liabilities mismatch is passed on to investors. This means that ABS provide a more detached from the originator performance.

Table.5

Aspect	**Covered Bonds**	**Asset Backed Securities**
Transfer of title of the assets allocated to the assets pool	No, just security interest created	Yes, assets are sold out to the SPV
Arrangements on bankrupt of the originator	Recourse to national insolvency law/vulnerable to the bankruptcy risks of the originator*	Bankruptcy remote with respect to originator
Preferential claims to collateral on issuer's insolvency	Yes, legislative basis*	Yes, contractual basis**
Paid from the asset pool	Not necessarily; often paid by the originator	yes –pass-through structures
Fixed or floating rate instruments	Typically fixed with long-term maturities	Could be either – medium and long-term maturities
Pool of assets	Dynamic	Static
Tranche Structure	One tranche	Numerous tranches
Accounting treatment	On-balance sheet	Off-balance sheet
Investor base	Institutional investors	Institutional investors
Collateral	Residential and commercial mortgage loans, public sector loans	No restrictions on the type of assets**
Payment of interest and principal	Typically from the originator's main business inflows	From the assets pool
Periodic payments	Mostly fixed rate	Could be fixed or floating rate
Prepayment risk	Borne by the originator	Borne by investors

Source: the author

*But see the EU Commission's Proposal on Covered Bonds

**But see the EU Securitisation Regulation

8.5.3. Case Study 1: Germany and the latest developments in EU securitisation law

In 2006 Germany introduced refinance registers intended to be used by banks to ensure that a securitisation SVP has insolvency-remote access to the assets registered in the refinance register by the refinance entity.[686] The effect of this law is that assets that have been registered properly in a refinance register are deemed assets belonging to the beneficiary and may be claimed by him in case of the originator's insolvency. This is possible because, as a result of the new law, the assets are no longer part of the insolvency estate of the originator. Importantly, the protection extends over assets replacing properly registered assets, such as, collections cashed at the disposal of such assets. The effect of this will be that in case of insolvency, the beneficiary will be able to claim such replacement assets instead of the original properly protected asset.[687]

The 2012 German Banking Act (Kreditwesengesetz, KWG) i.e. the CRD IV-Implementation Act introduced some updates, extending the benefits of these provisions to insurance companies. Following this update, German insurance companies will have '"insolvency-proof" access … to the relevant assets of the originator/seller of the loan and security in the event of the originator's insolvency without requiring a German law transfer of title to such asset.'[688]

The above was an example of the approach of one EU country to the default related risks of securitisation. This becomes largely redundant from 1st January 2019 onwards when the new EU Securitisation Regulation (SR)[689] applies. The Regulation came to consolidate 'the patchwork of

[686] Ibid.
[687] Watson and Carter, (n 685).
[688] Mayer Brown, 'Current developments in the Bank Asset Sale market in Germany and Spain' (2012), 1.
[689] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised

legislation governing European securitisations'[690] represented by the Capital Requirements Regulation,[691] the Alternative Investment Fund Managers Directive,[692] and the Solvency II Delegated Act.[693] Furthermore, the Regulation came to reform the EU securitisation market by introducing a framework for "simple, transparent and standardised" (STS) securitisations. The new EU securitisation framework also consists of, in addition to the Securitisation Regulation, Regulation (EU) 2017/2401 (the Securitisation Prudential Regulation, or SPR).[694]

The package introduces a number of new rules; however, this discussion is mostly concerned with and will therefore focus solely on the rules for risk retention,[695] re-securitisations and ABS backed by unverified residential loans and the issue of policing non-compliance.

8.5.4. The new EU securitisation framework

Risk-retention is a device which regulators of conventional finance have put to use after the 2008 financial crisis. Significantly, the approach resembles very closely the Islamic finance principle of risk sharing in funded commercial enterprises. In the conventional context, risk retention serves to align the interests of originators and investors in the context of securitisation. Prior to the SR, such provisions (now repealed by the SR) were found in the Capital Requirement Regulation (CRR). These provisions dictated that 'institutional investors must ensure that originators, sponsors or original lenders retain a five per cent economic stake in the viability of a

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securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 OJ L 347, 28.12.2017, p. 35–80.

690 Norton Rose Fulbright, 'Securitisation framework: Ten things you need to know' (2018) https://www.nortonrosefulbright.com/en/knowledge/publications/20c69602/securitisation-framework-ten-things-you-need-to-know accessed 13th July 2019.

691 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance OJ L 176, 27.6.2013, p. 1–337.

692 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 Text with EEA relevance OJ L 174, 1.7.2011, p. 1–73.

693 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) Text with EEA relevance OJ L 12, 17.1.2015, p. 1–797.

694 Regulation (EU) 2017/2401 of the European Parliament and of the Council of 12 December 2017 amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms OJ L 347, 28.12.2017, p. 1–34.

695 Securitisation Regulation (n 564), Article 6.

transaction.'[696] Under the CRR therefore, the onus is on investors, for example through a contractual undertaking, to ensure that the risk retention obligations of originators, sponsors or original lenders are met. The SR changes this by placing the onus on the latter to ensure that they meet the 5% risk retention requirements. This applies also to investors established outside of the EU.[697] Furthermore, the SR tightens the regime on originators by requiring a clear designation of who will be the originator and what his obligations regarding risk retention are. For example,

> *If multiple entities could be subject to the direct obligation by virtue of being an originator, sponsor or original lender, they will need to agree the allocation of responsibility between themselves. In the absence of agreement, responsibility will rest with the originator.*
>
> *The definition of "originator" has been tightened so that only an entity of substance can act as originator, to ensure that the retention requirements cannot be satisfied by using an SPV whose sole purpose is to securitise exposures*
>
> *The new Securitisation Regulation also prohibits an originator from deliberately selecting assets for securitisation on the basis that they are more likely to suffer losses than the assets that the originator will retain on its balance sheet for the same period.*[698]

Another significant risk-control feature of the SR is that it bans re-securitisations (with rare exceptions) and ABS backed by unverified residential loans which is defined as 'residential mortgage-backed securitisations (RMBS) that are backed by loans that were marketed and underwritten on the premise that the loan applicant or intermediaries were made aware that the information provided by the loan applicant might not be verified by the lender.'[699] The SR also 'restricts sales of securitisation positions to MiFID II retail clients unless a MiFID II-compliant suitability test has been carried out by the seller on the client, and a number of other conditions have been met.'[700]

The policing of the SR is based on the premise that Member States are allowed to gold-plate the harmonised set of rules embedded in the Regulation. These remedial provisions could include administrative and/or criminal sanctions. While sanctions are expected to be "effective,

[696] Norton Rose Fulbright (n 690).
[697] Arthur Cox, 'What you need to know about the new EU Securitisation Regulation' (2018), 2.
[698] ibid, 2.
[699] Norton Rose Fulbright (n 690).
[700] Arthur Cox, (n 697), 3.

proportionate and dissuasive", Member States retain a great measure of discrepancy as to how exactly this will be achieved or measured. Sanctions must take account of whether the breach was intentional or negligent, which indicates that there will be no strict liability for non-compliance. Furthermore, in making a decision as to the appropriate sanctions, supervisors should consider the materiality, gravity and duration of the infringement. This is liable to create vagueness in the securitisation framework, because different national regimes are likely to interpret the above in the letter and spirit of their regulatory culture, potentially discouraging cross-border securitisation.

The SR underlines the need for proportionate due-diligence requirements supporting the management of the different types of risk caused by securitisation:

> *Investments in or exposures to securitisations not only expose the investor to credit risks of the underlying loans or exposures, but the structuring process of securitisations could also lead to other risks such as agency risk, model risk, legal and operational risk, counterparty risk, servicing risk, liquidity risk and concentration risk. Therefore, it is essential that institutional investors be subject to proportionate due-diligence requirements ensuring that they properly assess the risks arising from all types of securitisations, to the benefit of end investors. Due diligence can thus also enhance confidence in the market and between individual originators, sponsors and investors*[701]

In order to protect against the above, the SR requires that the transfer of title to the SPV (securitisation special purpose entity (SSPE)) is obtained by means of a true sale or in any other legal way, which would have made the transfer enforceable against the seller or a third party. Furthermore, this transfer should not be subject to severe clawback provisions in the event of the seller's insolvency, such as provisions of invalidating the sale due to not enough time passing between the sale and the declaration of insolvency[702] or provisions that the invalidation referred to previously could only be prevented by the SSPE if it can prove that it was not aware of the seller's insolvency at the time of sale.[703] However, note that national insolvency law provisions

[701] Securitisation Regulation (n 689), Preamble (9).
[702] Securitisation Regulation (n 689), Art. 24, (2)(a).
[703] Securitisation Regulation (n 689), Art. 24, (2)(b).

allowing ‘the liquidator or a court to invalidate the sale of underlying exposures in the case of fraudulent transfers, unfair prejudice to creditors or transfers intended to improperly favour particular creditors over others shall not constitute severe clawback provisions’.[704]

8.6. Bonds & shares and sukuk: a technical perspective

8.6.1. Sukuk and Bond

It is correct to say that s*ukuk* resembles conventional bonds in that it allows enterprises to finance their ventures by obtaining cash or capital injections[705] from the public. However, in the *sukuk* structure, the parties are known as *sukuk* issuers and investors, whereas in conventional bonds, their relevant counterparts are referred to as lenders and borrowers. Furthermore, bonds are debt instruments (more specifically, “units of corporate debt issued by companies and securitized as tradeable assets”),[706] whereas *sukuk* is generally perceived as a mixture of debt and equity.

That said, it is notable that according to some scholars, *sukuk* should be divided in debt-based and equity-based form.[707] The latter type provides investors with variable returns. In distinction, the former type (essentially a form of fixed income debt) is seen as very much alike conventional bonds because its pre-determined returns are akin to interest. Furthermore, it has been argued that while all *sukuk* are asset-based, not all of them are real assets backed. Had the latter been the case, investors would have felt much more secure in the knowing that should the debtor go bankrupt or default, they would be compensated through a resort to the underlying asset.[708]

Sukuk has proven to be very popular over the first two decades of its introduction, the only drop being around the years following the financial crisis. Since then, it has made a comeback claiming an ever enlarging cohort of investors. Initially, the instrument was intended to serve

[704] Securitisation Regulation (n 689), Article 24, Transaction-level requirements.
[705] “A capital injection is an investment of capital into a company or institution, typically in the form of cash, equity, or debt”, Caroline Banton, ‘Capital Injection’ (2019) Investopedia, https://www.investopedia.com/terms/c/capital-injection.asp accessed 31st August 2019.
[706] Adam Hayes, ‘Bond’ (2019) Investopedia, https://www.investopedia.com/terms/b/bond.asp accessed 15th June 2019.
[707] Hans Visser, *Islamic Finance: Principles and Practice*, 2nd Edition 2013, 79.
[708] Ibid.

predominantly institutional investors. However, it has gradually become attractive also to retail investors. Notably, initiatives facilitating issuance and trading of *sukuk* aimed at retail investors are taking place in Malaysia, which is the biggest *sukuk* issuer in the world, since 2012.[709] Similar trends have been observed in Egypt where Egypt's National Bank for Development has issued a 5-year *sukuk* in 2011 with a value of $168 per certificate.[710] Relevantly, it has been claimed that there are less *sukuk* on the market than the market requires. This is the case even though the instrument has proven popular not only among Muslim issuers but also conventional ones. For example, the German state of Saxony-Anhalt issued a Euro 100 million *sukuk* in 2004, followed by the World Bank, issuing *sukuk* for $202 million in 2005 (under Malaysian jurisdiction).[711] Since then, *sukuk* has been issued and listed, in addition to many Islamic countries, also on the markets in London and Luxembourg.

The popularity of *sukuk* and its close connection to bonds requires understanding of the potential problems that may arise from mirroring this conventional instrument in a *Shariah*-compliant manner.

As mentioned above, conventional bonds allow governments and corporations to obtain financing from outside investors. They do that by borrowing money from lenders. In this sense, a bond resembles an I.O.U (I owe you) note. Furthermore, the bond is a fixed income instrument, meaning that the returns derived from it come *via* fixed periodic (typically every 6 months) interest payments, known as coupon payments. The size of the payments is known in advance[712] and the investment is made with the expectation that the principal will be returned at maturity.

Note that fixed-income instruments differ from variable-income securities, which provide variable returns 'based on some underlying measure—such as short-term interest rates'.

As regard to their provenance, bonds are government or corporate, depending on the issuer. Furthermore, they are distinguished on the basis of the degree of credit risk they contain. Bonds that are relatively secure – for example those issued by stable companies - are classified as

[709] Visser (n 707), 79-80.
[710] Visser (n 707), 80.
[711] Michael Bennett and Zamir Iqbal, 'The Role of Sukuk in Meeting Global Development Challenges' Chapter 7, in *Global Growth, Opportunities and Challenges in the Sukuk Market*, Sohail Jaffer ed., (Euromoney Books 2011), 69.
[712] James Chen and Chris B Murphy, 'Fixed-Income Security' (2019) Investopedia https://www.investopedia.com/terms/f/fixed-inco]\]mesecurity.asp accessed 15th June 2019.

investment-grade bonds. They provide a comparatively low interest-based return; however, they are a less risky instrument, compared to non-investment grade bonds or some other types of investments. In this connection note that while corporate bonds issued by stable companies are generally considered safe, they are less safe than their government's issued counterpart. This is because in the case of government bonds the bond is backed by the government, typically by the Treasury (which is, for example, the case in the US) but in the case of a corporation, the security of the investment depends on the financial health of the company.

Compared to investment in equity (stocks and shares), bonds are more secure although they provide a smaller return in comparison. The relative volatility of shares is linked to their short-termism and on their dependency on the volatility of the market. The latter is partially why equities can bring big wins but also big losses. This said, it would be wrong to assume that fixed-income investments provide the expected return at all times. For example, if the bond-holder decides to sell the bond prior to maturity, he will not receive its face value (the pre-established value at maturity) but the market value of the bond at the time of sale. In addition, the bond issuer may default on the bond, meaning that the issuer may have difficulties providing the semi-annual interest payments or the principal payment when it is due. This means that even investment grade bonds contain a certain measure of risk, which is something to be considered by prospective bond-holders. Still, however, in a case of default, bond holders are usually repaid prior to other creditors, such as common stock holders.[713]

Non-investment grade bonds (also known as junk or high-yield bonds) are riskier and they compensate for that by providing higher return on the investment. The higher interest rate is the way for such issuers to attract lenders.

Last but not least, it has recently become more common for bonds to provide for variable and floating (typically LIBOR-based) interest rates. In the case of floating rate bonds, the rates are reset at shorter intervals, compared to fixed-income bonds. This usually takes place every 3 months but could be done more often than that. Note that while such bonds provide a greater possibility of profit and loss compared to fixed-income bonds, this applies to the interest payment solely because the principal does not become affected by the floating market rates.

[713]Ibid.

There are differing opinions on whether the new types of bonds should be preferred by investors. For example, it has been argued that for such bonds ‘the interest rate risk is largely removed from the equation’ and that, in addition, investors can profit from the increase in interest rate.[714] It should not be forgotten, however, that in the opposite case – when the rates fall, the investor is likely to incur a loss. In addition, a floating or variable interest rate bond still bears the credit risk inherent in all types of bonds although it does not provide the bond-holder with certainty as to what his gains will be in the future (these gains will largely depend on the movements of the interest rate). Due to this uncertainty, although floating rate bonds are issued by some governments, municipalities or corporations, they are not given investment grade status. This is because in terms of risk or price they resemble the so-called junk bonds but critically, do not provide their high yields.

The variable rate bonds, also known as demand (muni) bonds work in a similar to floating rate bonds way but they can be monetized by the bondholder on demand in case there is an interest rate change.[715] They are often used by municipalities to fund public projects. One peculiarity of these bonds is that although they are themselves long-term (20-30 years), the debt notes are considered short-term investments.

What should be taken away from the above is that despite the potential challenges, bonds could be socially useful because they make it possible to channel some of the funds of the public into selected socially valuable projects. This is particularly the case with government and muni bonds. In an ideal scenario, even in the case of issuance by companies the bonds operation could be (even more) regulated by governments in order to ensure that lenders will only fund “socially good” projects. Whether there could be any value in this, for the conventional investor and society as a whole, is a matter that could be discussed at length but will not be covered here. This socially positive quality of bonds, however, is an important argument for their existence generally and particularly in the framework of Islamic finance.

[714] Thomas Kenny, ‘Investing in Floating Rate Bonds’ (2019) The Balance, https://www.thebalance.com/what-is-a-floating-rate-bond-416911 accessed 15th June 2019.
[715] Adam Hayes, ‘Variable-Rate Demand Bond Definition’ (2019) Investopedia, https://www.investopedia.com/terms/v/variable-rated-demand-bond.asp accessed 15th June 2019.

The next section will discuss the nature of the Islamic bond, making a reference to conventional shares. This will be followed by an analysis on how *sukuk* compares more generally to its conventional counterparts.

8.6.2. Unpacking sukuk

S*ukuk*[716] is an instrument issued by a *sukuk* originator to investors through a special purpose vehicle ("SPV") and in exchange for payment. [717] It is also possible that the notes are issued by the asset originators themselves; these notes are backed by existing *Shariah* compliant assets. The money collected by the sale is used by the originator to purchase assets. These assets then generate certain revenues which are then used to return a profit to the investors.[718] Notably, the structure allows that the asset is partially owned by the issuer and partially by the investor group. Due to the specific to Islamic finance prohibitions (most of all the prohibition on trading of debt), the *sukuk* structure must clearly represent the link between the returns and cash flows of the financing and the underlying assets, or the returns generated from them. This explains why financing could only be raised for identifiable assets.[719]

Furthermore, the issuer is under an obligation to buy back the *sukuk* at a future date at face value (at maturity, at par value). However, note that "the value repaid at maturity should reflect the current market price of the underlying asset - not the original amount invested."[720]
Andrea Jobst offers an explanation of the *sukuk* structure in the following quote:

> *The notes are funded by the proceeds from the underlying assets paid to the SPV as part of the repurchase obligation by the asset originator. Depending on the claim-generating asset type of Islamic finance, the SPV acquires ownership rights on either (i) existing assets within a lease-purchase or sale-repurchase agreement,*

[716] For the latest changes in the sukuk standard, see Appendix A (SS17).
[717]A Saeed and O Salah, 'Development of sukuk: pragmatic and idealistic approaches to sukuk structures' (2014) 29(1) JIBLR 41, 41.
[718]Elias Bischof, 'The influence of Islam on banking and finance' (2013) 24(10) ICCLR 369, 370.
[719] S R Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', The Journal of Structured Finance [2009] 58, https://www.academia.edu/6164679/An_Overview_of_Islamic_Sukuk_Bonds_AND_SABAHUDDIN_AZMI accessed 25th June 2019, 59.
[720] Christophe J. Godlewski, Rima Turk-Ariss and Laurent Weill, 'Sukuk vs. conventional bonds: A stock market perspective' (2013) 41 Journal of Comparative Economics 745, 746.

> *or (ii) future assets as equity investor, and structures the anticipated cash flows from these assets into sukuk payment obligations of different risk and maturity. These obligations entitle investors to a pro rata ownership in the SPV and the proceeds generated from the net revenue of a loan, a lease or an investment project. The amount of debt issued is limited to the value of assets held by the SPV*[721].

8.6.3. Analysis of the AAOIFI's definition

In the AAOIFI's definition, *sukuk* are '… certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity …'[722] As underlined, a link to a tangible underlying asset is needed and it is to this tangible asset that the holders of a *sukuk* certificate have a claim.[723] Furthermore, the underlying asset must be *Shariah* compliant 'in both nature and use'.[724] In addition, '[t]he eligibility of sukuk rests on identifying an existing or a well-defined asset, service, or project capable of being certified by a third party, and for which ownership can be recorded in some form.'[725] It is evident that the characteristics of the underlying value-generator and the matter of ownership are two fundamental aspects of *sukuk*.

For example, with regard to the former, apart from the already discussed need for compliance with *Shariah* law, the attractiveness of the asset (and as a result of that, of the *sukuk*) depends very much on its ability to produce revenue or otherwise put, to deliver economic value. Note that economic value is generally estimated based on some kind of projection consisting of a 'discounted present value analysis of the future revenue and profit stream that the asset can produce'.[726] How high this projection or estimation is, would or should influence the success of

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[721] Andreas A Jobst, 'The Economics of Islamic Finance and Securitization' (2007) IMF Working Paper, WP/07/117, 19.
[722] *Section 2 AAOIFI Shari'ah Standards No.17 on Investment Sukuk*.
[723] A Saeed and O Salah, 'Development of sukuk: pragmatic and idealistic approaches to sukuk structures' (2014) 29(1) JIBLR 41, 44.
[724] Christophe J. Godlewski, Rima Turk-Ariss and Laurent Weill, 'Sukuk vs. conventional bonds: A stock market perspective' (2013) 41 Journal of Comparative Economics 745, 746.
[725] Ibid.
[726] Florida Public Service Commission, 'Replacement Cost Method of Valuing Utility Generation Assets' (2001), Prepared by Division of Policy Analysis & Intergovernmental Liaison March 2001, 1.

the *sukuk* issuance, despite the fact that *sukuk* is a fixed-income instrument. This is particularly the case with asset-backed *sukuk*, where the appreciation of the asset, appreciates the value of the derivative - of course, the opposite is also true – a distressed asset will influence negatively the price of the derivative.

The specific nature of *sukuk*, as distinct from both bonds and shares, means that the benefit generating ownership in the underlying asset is expressed doubly: by bringing profits derived from the asset and by delivering 'the proceeds of its realization'[727] at the time of maturity. This double connection with the asset serves as a guarantee that only potentially profitable projects will benefit from a successful *sukuk* issuance.

It is also significant that the definition of *sukuk* refers to undivided shares. Despite indivisibility of shares being a fundamental feature of the conventional share instrument, it is plausible that this may become problematic for the *sukuk* further down the line. The business dictionary defines undivided shares (also known as undivided interest) in the following way:

> *Claim of ownership of commonly-owned assets or property (as in a corporation, partnership, or tenancy-in-common) where each co-owner has unrestricted claim to all the assets or the entire property but no co-owner has exclusive claim to any single asset or part of the property.*[728]

The form of undivided unit of ownership used in *sukuk* could become potentially problematic when the bond holder elects to seek premature realization of the derivative. Such early settlement may be prompted by market fluctuations. As already mentioned, in the *sukuk* context an early settlement would trigger a return of the principal at its spot value, which is to say at its current market price. To this end, if some of the risks inherent in *sukuk* come to pass, a negative movement in the value of the investment could occur, prompting a run on the asset pool.

Furthermore, note that although *sukuk* is widely considered to be a safe instrument, it has been acknowledged that it nevertheless faces a number of risks (the list is not exhaustive):

[727] Falak Athar Khan and Danish Ahmad Siddiqui, 'Islamic (Sukuk) vs. Conventional Financing: Analysis of Profitability' (2018) 3(2) International Journal of Experiential Learning & Case Studies 246, 247.
[728] Business Dictionary, 'Undivided interest' (2019) http://www.businessdictionary.com/definition/undivided-interest.html accessed 17th June 2019.

• Interest rate risk: One of the primary risks faced by sukuk is interest rate risk; with sukuk price being inversely proportional to its yield based on the underlying interest rate.[729] *This risk has direct implication through any rise in market interest rates, leading to a fall in sukuk values, and indirectly through interest rate market fluctuations as their financing operations are widely benchmarked against LIBOR/SAIBOR.*

• Currency risk: In case of a difference between the currency denomination of sukuk asset pool and that of sukuk funds, exchange risk arises.

• Shariah compliancy risk: This risk does not exist in conventional bonds, as there is need to adhere to Shariah laws very strictly.

• Counterparty and credit risk: Under Shariah laws, the option to restructure a loan is not available, being strictly prohibited in Islam as it can constitute interest. As these laws prohibit interest in any form, the entire transaction would become invalid if it occurs. Hence, the risk related to credit arises, based on the assumption that the debt may be irrecoverable at the end of the maturity period.

• Coupon (profit rate) payment risk: If the issuer does not pay the scheduled profit (coupon) on time, extra amount may be charged and can only be used for charitable purposes. The extra charge may not be used for any other purpose as it is strictly prohibited by Shariah laws.

• Default risk: This risk is associated with almost every financial transaction. In case of disputes over scheduled payment delays or payment failures with sukuk, means for redress are more complex than those for conventional notes and bonds.[730]

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[729] For an explanation on this process see James Chen, 'Bond Yield' (2019) https://www.investopedia.com/terms/b/bond-yield.asp accessed 19th June 2019.

[730] Abdullah Alawi and Saleh Al-Quati, 'Sukuk: The Sharia Fixed Income Alternative Strategy' (2014) Strategy Report, AlJazira Capital, http://webcache.googleusercontent.com/search?q=cache:qpJsdQPkzScJ:www.aljaziracapital.com.sa/report_file/ess/spe-171.pdf+&cd=3&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 17th June 2019, 5.

All of the above risks are potentially significant for any potential and current bond holder. However, the counterparty and credit risk, as a function of the *Shariah* compliant risk will be of specific importance to our discussion and as such will be revisited later in this work.

Considering the number and complexity of risks accompanying *sukuk* investments, the reference to “undivided shares” becomes worrying if one takes into account that the *sukuk* instrument is largely based on the concepts and mechanisms of English Common law, closely intertwined with the rules of *Shariah* law. The problem here is that *sukuk* is by definition neither a share, nor a bond. And while it bears some specifically elected positive qualities by virtue of combining the two instruments, it also unwittingly absorbs some of their downsides.

To this end, the reference to undivided shares may create some problems in situations where redress is sought because of the particular distinction English law makes between divided and undivided interest. In order to understand how all of this relates to *sukuk*, and before returning to the discussion on undivided shares, one would be assisted by a brief account of the concept of shares, as it is applied in the common law.

8.6.4. The common law concept of shares and how they fit in the common law idea of a company

The common law recognises the concept of a corporation, the most important and popular iteration of which is the limited liability company (LLC). In the LLC, it is the company that owns the company assets and it is the company’s shareholders who own the shares in the company.[731] The company accumulates assets in the initial stage by using the money invested in it by shareholders. Shareholders receive, as compensation for their investment, shares in the corporation. Shares can benefit their holders by appreciating over time and by bringing dividends, provided that the enterprise generates a profit. Should the corporation incur losses, shareholders will not receive dividends and it is possible that their shares will depreciate (their market price will drop). This is one of the main risks inherent in shareholding.

[731] Harold Demsetz, ‘Towards a Theory of Property Rights’, (1967) 57 American Economic Review 347.

The technical definition of shares is "units of ownership interest in a corporation or financial asset that provide for an equal distribution in any profits, if any are declared, in the form of dividends."[732] As we can see, the definition utilises the bundling of rights and fragmentation of property interests approach discussed earlier in this work. More to the point though, the reference to "distribution in any profits, if any are declared" separates shares from *sukuk*, where the returns on the investment are predetermined. Yet another definition describes shares as 'a form of security that indicates the holder has proportionate ownership in the issuing corporation.'[733] The most popular legal definition of shares (under English law) defines them as 'the interest of a shareholder in the company measured by a sum of money, for the purposes of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders in accordance with (now sec33(1) of the Companies Act 2006).'[734] The UK Companies Act 2006 does not provide a definition.[735]

8.6.5. Types of shares

There are two main types of shares which corporations can opt for: common shares and preferred shares. Common shares provide shareholders with voting rights and more control over the company. They could also contain pre-emptive rights entitling the holder to preserve their percentage of ownership should the company issue new stock. This means that the relevant shareholder is entitled to buy newly issued shares, this way avoiding the dilution of his shareholding. In distinction, preferred shares do not provide for voting rights or appreciation but guarantee the payment of dividends at regular intervals. This makes them less risky than the common shares. Furthermore, in case of the company going bankrupt, shareholders holding preferred shares take precedence over the investors holding common shares, meaning that the business will pay the former their due before they settle with the latter.[736]

[732] James Chen, 'Shares' (2018) https://www.investopedia.com/terms/s/shares.asp accessed 18th June 2019.
[733] Akhilesh Ganti, 'Stock' (2019) https://www.investopedia.com/terms/s/stock.asp accessed 18th June 2019.
[734] *Borlands Trustee v. Steel* [1901] 1 Ch. 279, per Farwell J. at p. 288.
[735] C.f. with the definition of *sukuk*, given by AAOIFI.
[736] Chen (n 732).

A comparison with *sukuk* would demonstrate that it is designed on the model of preferred shares because it provides for no control over the company's assets, the returns are predetermined in terms of their size and lastly – similarly to bonds, *sukuk* holders are given precedence over other creditors in case of bankruptcy of the corporation.

As the name of the entity suggests, shareholders of a limited liability company are under a liability limited to the size of their share and even this is questionable because under English law, a court cannot make an order for the shareholder to dispose of his share.[737] That said, a situation of insolvency, when followed by bankruptcy, usually makes shares defunct and possibly worthless. To this end, note that the Securities and Exchange Commission (SEC) states that 'the shares of a defunct company may continue to be traded until the company has the shares re-registered or until the stock's registration has been revoked.'[738] This being the case, the *de facto* outcome for shareholders is that they will more likely than not lose the money invested in the company and represented by their shares.

The limited liability has, however, another implication. If the company falls on hard times, shareholders are not required to meet the obligations of the company by adding extra money. The liabilities of the companies are met by its own assets.[739] To recall, a company has a legal personality which is why the personal property of its owners is not relied upon in times of bankruptcy. This rule does not preclude an owner from syphoning money into the entity in an attempt to rectify insolvency as has been recently shown in the UK in the Jamie Oliver's case.[740] This is an important point, because the physical division between shareholders' and company's property is an attractive feature of shareholding investment. The line that indicates who owns what is very clear and does not allow a major shareholder who has gone bankrupt to sell the

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[737] Department for Business, Energy & Industrial Strategy, 'Insolvency and Corporate Governance' (2018 Government Response; See also, Neal Watson and Beliz McKenzie, 'Shareholders' rights in private and public companies in the UK (England and Wales): overview' (2019) https://uk.practicallaw.thomsonreuters.com/5-613-3685?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1#co_anchor_a980915 accessed 31st August 2019

[738] Will Kenton, 'Defunct' (2018) Investopedia, https://www.investopedia.com/terms/d/defunct.asp accessed 19th June 2019.

[739] Alison Clarke & Paul Kohler, Property Law (CUP 2007), 321.

[740] Rob Davies, 'Jamie Oliver spent £13m to save Italian chain hours before bankruptcy' (2018) The Guardian, https://www.theguardian.com/food/2018/aug/30/jamie-oliver-spent-13m-to-save-italian-chain-hours-before-bankruptcy accessed 19th June 2019.

assets of the company in order to meet his private obligations. Vice versa, the company cannot infringe on its shareholders' personal property by its own volition or by a court order, for any purpose whatsoever.

The division between company and investor is, of course, preserved in *sukuk*, largely because *sukuk* is still a debt instrument. However, to the extent that the return of the debt is guaranteed by ownership in the company's assets, the typical for shareholding waving of risk seems out of place in an Islamic finance environment. To recall, sharing of risk (as well as profit) is one of the fundamental features of Islamic finance. It is possible that by becoming less vulnerable to risk, which is the result of absorbing shares' features and particularly, features of preferred shares, *sukuk* is becoming controversial and this controversy may increase should the regime change towards radicalism.

Another point to consider is that although the title to the assets of the company belongs to the company, the managing of the entity's assets is carried out by the company's board of directors. This indicates that the company, despite being considered a legal person, does not exercise the *de facto* control over its assets. This is done by the managers of the company's assets, who carry out their work with the objective to secure profit for the entity's shareholders. As previously mentioned, profit (in the case of common shares only if available)[741] is distributed periodically in the form of dividends on the shares.

As expected, directors are under an obligation to manage the assets in line with the purposes for which the company was formed. To this end, although shareholders have no direct control over the way the company's assets are managed, they have control over who will be the directors of the company and exercise it *via* shareholder meetings. In addition to the power to dismiss and appoint directors, in the case of shares with voting power, shareholders have the power to consent or not to the exercise by the directors of various powers.[742]

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[741] Adam Hayes, 'Preferred vs. Common Stock: An Overview' (2019) Investopedia, https://www.investopedia.com/ask/answers/difference-between-preferred-stock-and-common-stock/ accessed 1i9th June 2019.
[742] Ibid.

This is, however, the traditional model of a limited liability company. In practice, and particularly in the case of very large corporations in the Anglo-Saxon world,[743] the control which in theory should belong to and be exercised by shareholders is held by the board of directors which hires and fires managers of the company. In this scenario (big corporations), senior management is closely monitored by the board while also remaining more and more extensively controlled by the regulator. As Justin Fox and Jay W. Lorsch argued not that long ago, 'In legal terms, shareholders don't own the corporation (they own securities that give them a less-than-well-defined claim on its earnings). In law and practice, they don't have final say over most big corporate decisions (boards of directors do).'[744]

In addition to having the effective control of the company transfer from shareholders to the board, the commitment of the typical Anglo-Saxon shareholder to the prosperity of the company seems to have become a thing of the distant past. While in theory accountability towards shareholders continues to exist, the tendency of short-termism among shareholders is more and more prevalent, [745] creating disconnect between the interests of the managing body and the body of shareholders. The prevailing short-termism shifts shareholders' interest from the long-term success of the company to the profit that could be generated from the movement of the share prices on the stock market and the subsequent resale of the shares.[746]

This has broader implications. While it could be said that the first shareholders of a company have contributed directly to the profits of the enterprise, by securing the initial investment (thus providing the necessary funds for the company to start operating), consequent shareholders rarely add to the capital of the company and when they do, it is when they buy new issuance. The link to the company often remains indirect, nevertheless, because even in such cases they often purchase from existing shareholders on the stock market rather than from the company itself. Far from being a pure technicality, this suggests that the new shareholders are having less interest in

[743] Note that the situation may be different in Continental Europe, where large holdings by a few shareholders is rather the norm – often, big companies are held by the same family for generations.
[744] Justin Fox and Jay W. Lorsch, 'What Good Are Shareholders?' (2012) Harvard Business Review, https://hbr.org/2012/07/what-good-are-shareholders accessed 19th June 2019.
[745] Daniel Ferreira, Edmund Schuster, Tom Kirchmaier and David Kershaw, 'Measuring Management Insulation from Shareholder Pressure' (2016) LSE Legal Studies Working Paper No. 01/2016; ECGI - Finance Working Paper No. 345/2013; Asian Finance Association (AsFA) 2013 Conference, https://ssrn.com/abstract=2170392 or http://dx.doi.org/10.2139/ssrn.2170392 accessed 15th August 2019.
[746] Alison Clarke (n 739), 323.

the company's purpose, ethos and long-term prognosis. It further suggests that instead of being invested in the company's long-term prosperity, they are approaching the shares of the corporation the same way they would approach commodity trading. This trend supports arguments that the share prices on the stock market and the profitability of the company originator are not necessarily correlated and neither is the correlation between the movement of share prices and a company's profitability straightforward.[747]

Considering the above, it seems logical that the predecessor of the limited liability company was the joint stock company, of which Adam Smith was deeply distrustful, having observed its consistent failures to get ahead in a competition with the privately held company.[748] This state of things has given cause to concerns expressed by more modern theorists,[749] although for the moment, things in conventional company law do not seem to change by much. What could be taken away from the above is that shareholding in the Anglo-Saxon tradition may provide individual shareholders with the possibility to make quick speculative gains; however, this could often be disconnected with the company's long-term interests or it could even be contrary to them. Considering this, it may be possible to expect that under certain conditions, the extent to which *sukuk* resembles conventional shares would be revisited by Islamic financiers and their advisors. One of the possible reasons to do so, according to this author, is the reference to undivided shares, included in the definition of *sukuk*.

8.6.6. Undivided shares in focus

The issue of undivided shares will be discussed below by reference to the English common law for the following reasons:

- First, *sukuk* was engineered on the example of conventional bonds and shares; therefore, the input of the common law would be helpful.
- Secondly, *sukuk* is a contract and, as established, much of the vocabulary of Islamic contract law, utilises concepts of the common law. This calls for clarity on the relevant concepts, which can only be achieved with analysis of the source.

[747] Clarke (n 739), 323; Tom Hadden, *Company Law and Capitalism*, (Fred B Rothman & Co; 2 edition 1977), 71-5.
[748] Adam Smith, *The Wealth of Nations*, vol. II, p.229.
[749] Justin Fox and Jay W. Lorsch, 'What Good Are Shareholders?' (2012) Harvard Business Review, https://hbr.org/2012/07/what-good-are-shareholders accessed 19th June 2019.

- Thirdly, it is possible that due to its hybrid characteristics, *sukuk* has adopted features from bonds and shares respectively, which are not suited to work in conjunction.
- Fourthly, *sukuk* is subject, before anything else, to the governance of *Shariah* law and as such, it could be that its hybrid characteristics make it difficult to reconcile the adopted concepts with the host jurisdiction.
- Lastly, as a substantial part of *sukuk* issuance takes part in the UK and some in the US (along with other conventional finance jurisdictions), it is vital to ensure that *sukuk* is structurally sound. Any weakness of the contract could be explored in the common law courts, should they have to decide a *sukuk* case, to the possible detriment of one or both of the contractual parties.

Let us consider a situation where a case of *sukuk* default reaches the English courts. Although there are instances where *Shariah* law has been considered in English courts, as has been seen from the case studies section of this work,[750] this has been done only in passing and not for the entirety of the legal issues. Relevantly, if the case involves *sukuk* holders in the UK, the judge will decide it under the provisions of English company and insolvency law. The challenge of deciding a *sukuk* case under English law is that *sukuk* is a hybrid instrument, which combines the features of a bond with that of a share. Because of that, in a case of default in the bond payments, the court may need to decide whether to treat the *sukuk* under the UK law provisions for bondholders or under the country's shareholders regime, particularly if the matter at hand is satisfaction of *sukuk* holders' claims on insolvency of the issuer.

Relevant to this question is the fact that *sukuk* holders are not shareholders in the real sense of the term. The reference to "undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity"[751] has been included in the definition with the purpose of diminishing the connection to debt while creating a link to the equity of the issuer. Herein lays the main problem, however, because the structure of *sukuk* is based on transfer of assets to a SPV.

[750] Chapter 7:[7.7.].
[751] Section 2 AAOIFI Shari'ah Standards No.17 on Investment Sukuk.

The issue of transfer to a SPV and its implications will be discussed later in this work. At this point it would suffice to consider that among the two versions of *sukuk* (asset-based and asset-backed), the former could be only indirectly linked to the underlying asset. To this end, let us recall that the relevance of securitisation to derivatives is that the former can use the latter in order to transfer risk. For example, synthetic structures use credit derivatives or guarantees in order to transfer the risk and as a result, the securitised exposures remain on the originator's balance sheet.[752] The parallel with *sukuk* issuance is notable and could give additional force to arguments that the rights of asset-based *sukuk* holders on liquidation following default are inferior to that of asset-backed *sukuk* holders.

For the purposes of this inquiry, we are interested in the rights of investors in asset-backed *sukuk*, who are deemed entitled, during financial distress of the issuer or at another times, to initiate the sale of an SPV's assets or of assets belonging to a trust, held by the SPV for the benefit of the beneficiaries.[753]

To this end, it is relevant that although the SPV of asset-backed *sukuk* is bankruptcy remote, meaning that it is not exposed to the liabilities of the originator, it is still exposed to the liabilities of the underlying assets. [754]

Furthermore, consider that the *sukuk* structure requires that a clear link between the performance of the financing and the underlying assets, as well as the generated from them return, is established. Having identifiable assets is therefore crucial to the ability to raise financing through *sukuk* issuance.[755] There is no reason why this link should be severed on liquidation since, in addition, it has been established that the claim of a holder of a *sukuk* certificate is to the tangible underlying asset.[756]

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[752] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (Text with EEA relevance) OJ L 177, 30.6.2006, p. 1–200, Art.4 (38).

[753] Mohammed Khnifer, 'Lex Islamicus: When Sukuk Default - Asset Priority of Certificate-holders vis a vis Creditors' (2010) http://www.opalesque.com/OIFI181/Lex_Islamicus_Sukuk_Default_Asset_Priority81.html accessed 3rd July 2019.

[754] Ibid.

[755] S R Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', The Journal of Structured Finance [2009] 58, https://www.academia.edu/6164679/An_Overview_of_Islamic_Sukuk_Bonds_AND_SABAHUDDIN_AZMI accessed 25th June 2019, 59.

[756]A Saeed and O Salah, 'Development of sukuk: pragmatic and idealistic approaches to sukuk structures' (2014) 29(1) JIBLR 41, 44.

An argument could be made that holders of asset-backed *sukuk* certificates would have difficulties asserting their rights in a common law jurisdiction and in jurisdictions that have built their relevant insolvency and company law provisions on the example of the English law (which is the case of Malaysia).[757] These difficulties would be caused by the uncertainty as to the certificate holders' exact legal position and to the liberal use of concepts, borrowed by the common law, which are unlikely to contribute to the satisfaction of the holders' claims. This brings the focus once again to "undivided shares", which is a concept covered by the English common law provision of ownership in common.

In ownership in common, shares in the co-owned interest are defined but not yet separated off. They could be of equal value or not. Importantly, although such shares entitle their holder to use and benefit from the asset and no holder can exclude other holders of shares in the same asset from the enjoyment of the asset, no transaction with the asset could take place unless there is cooperation and agreement between all shareholders. However, the holder of the share is entitled to sell it privately to someone else and to enjoy the proceeds of the sale entirely by himself. The undivided share could also pass on intestacy. In comparison, *sukuk* holders are not entitled to sell it on the secondary market, because of prohibitions on debt selling.

If we exemplify this with the shares of a company, it is clear that the individual shareholder cannot pinpoint a particular share and claim it as his own. This may become an issue in the case of asset-based *sukuk* and in cases where the *sukuk* is purportedly asset-backed but the reviewing authority does not accept that the sale of assets to the SPV was a true sale (and therefore treats it as asset-based).

A physical division of the shares of the company would mean a physical division of the company's assets – something that in theory could not happen by shareholders' volition, because the assets are owned by the company and not by its shareholders. The only exception to that would be if all shareholders come together and decide to wind up the entity. For example, under

[757] See BIX Malaysia, 'What Happens When Your Bond or Sukuk has Defaulted?' (2019) https://www.bixmalaysia.com/Learning-Center/Articles-Tutorials/What-Happens-When-Your-Bond-or-Sukuk-has-Defaulted accessed 31st August 2019.

the UK Insolvency Act 1986,[758] shareholders are entitled to put in course a voluntary winding-up by adopting a special resolution, which however requires a 75% majority of those voting. If successfully voted, the next step would be the appointment of a liquidator who would wind up the company and distribute its assets. In case the majority required for the special resolution is impossible to obtain, shareholders may ask the court to order that the company be wound up. Under the Insolvency Act 1986, UK courts have very limited rights to order the winding up of a company but being unable to pay its debts is among the exceptions.[759] Furthermore, it is possible that the company itself decides to redistribute the assets among its shareholders: 'In some instances, financial assets such as stocks, bonds, warrants, or other securities may be distributed to shareholders in capital return programs.'[760] This is known as "in specie".[761] It is however highly unlikely that holders of asset-based *sukuk* will receive recourse through the company's resources.

While the above scenarios are admittedly very rare in conventional jurisdictions, should they arise, there are no moral or other restrictions for shareholders to obtain their shares *in specie* and *pro rata*. If a similar arrangement exists in the relevant *Shariah* environment, it will envision conventional shares and not *sukuk,* which is a hybrid between debt and equity and for this reason, requires its own legal provisions. To the knowledge of this author, there is no such legislation in force in the Islamic finance market. Perhaps this is because of the challenge to reconcile *Shariah*'s requirement for a defined, certain and tangible underlying asset with the above provisions.

Relevantly, English courts would always give precedence to bondholders over shareholders (as per current English insolvency law).[762] In the case of *sukuk*, the structure of the instrument suggests (and this would be the ideal scenario for certificate holders) that they should be treated

[758] UK Insolvency Act 1986, c.45.
[759] Neal Watson and Beliz McKenzie, 'Shareholders' rights in private and public companies in the UK (England and Wales): overview' (2019) https://uk.practicallaw.thomsonreuters.com/5-613-3685?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1#co_anchor_a980915 accessed 31st August 2019.
[760] James Chen, 'In Specie' (2019) Investopedia, https://www.investopedia.com/terms/i/in_specie.asp accessed 31st August 2019.
[761] Ibid.
[762] UK Insolvency Act 1986, c.45.

as bondholders who have recourse guaranteed by equity in the SPV's assets. [763] This indicates that an English court would likely approach the *sukuk* as asset-backed rather than asset-based one. If the *sukuk* was issued in the UK jurisdiction, the potential claims of the *sukuk* holders would be addressed *via* the trust instrument inherent in the SPV. However, if the *sukuk* was issued in a Muslim country, and English law was applied, the reference to trusts would not suffice because the trust instrument has not been developed in the Muslim countries.

For this reason, the court may grant a solution whereby the claim would be satisfied through a physical division or a division of the proceeds of the assets held by the SPV.
Since the claim of a *sukuk* holder cannot be satisfied by a reference to his potential rights as a shareholder and neither could it be met under the existing regime on bonds, English judges may need to fall back on the English Property Law provisions, for instance those related to tenancy in common and division of chattels.

This indicates that a holder of an undivided share has a less than well-defined right for redress in case he wants to sever his relationship with the issuer. Indeed, his only hope is that the company will not default or defraud him and he will be paid what he is due. In this scenario, the problem facing *sukuk* holders grows worse if one considers that as assets held by the requisite SPV ought to be tangible, they could be all kinds of tangibles, including a chattel. In fact, investing in an expensive chattel via a SPV could be a good way to accumulate the assets and to generate the yields necessary to successfully develop a project.

To put things in context, English law is rather confusing in the part pertaining to chattels belonging to different people in undivided shares. As has been pointed out, "[W]hile it is possible to create a joint tenancy and tenancy in common over chattels, the law in this area is less established. This then leads to uncertainty when issues arise over the division of assets."[764] Note the provision of s.188(1) of the Law of Property Act 1925[765] stating that:

[763] As will be discussed later, English law tends to support the bankruptcy remoteness of the SPV and is likely to find that the sale of asset was a true sale, rather than a loan, see Chapter 8: [8.5.1.].
[764] William Hancock, 'Divide and conquer: the division of chattels' (2017) https://www.collyerbristow.com/item/2089-the-division-of-chattels accessed 17th June 2019.
[765] UK Law of Property Act 1925, c.20.

> *Where any chattels belong to persons in undivided shares, the persons interested in a moiety or upwards may apply to the court for an order for division of the chattels or any of them, according to a valuation or otherwise, and the court may make such order and give any consequential directions as it thinks fit.*[766]

This means that under English law, cases of dispute may be referred to the court and it could be expected that the court will make an order for the division of the chattel. However, note that this could only happen if the asset is itself divisible. If it is divisible, the court may later proceed to make an order for sale. In the opposite case, where the chattel is indivisible, the court will not be able to make an order for division and logically, a later order for sale. This is particularly unfortunate where at stake are valuable but indivisible assets such as paintings.

This issue was discussed most recently in the 2016 case of *Butler v Butler*.[767] The case concerned the division of a 17th century Chinese porcelain item collection (the Butler Family Collection) accumulated by an aide to Margaret Thatcher.[768] The issue was whether the collection will be divided between the four children of the testator or maintained as one collection and kept in the family Museum as per the wishes of the deceased. The court held in favour of division thus providing some guidance for like cases. However, it has been argued that while *Butler v Butler* provides some guidance with respect to divisible assets, 'uncertainty remains as to the position of co-owners of indivisible property.'[769]

This indicates that if English law is resorted to, there is no legal certainty as to the outcome for the potential *sukuk* holding claimant. This is even more worrying, considering that *sukuk* itself offers no clear guidelines on what investors' rights are in case of default and how to approach the issue of redress. The only exception to that could be found in the contractual terms of the particular issuance, but unfortunately, this is not backed up by appropriate legislation in the Islamic Finance world.[770] A possible solution to the problem could be the use of contingent

[766] Ibid, s.188(1).
[767] *Butler v Butler*, 2016 EWHC 1793 (Ch).
[768] William Hancock, 'Divide and conquer: the division of chattels' (2017) https://www.collyerbristow.com/item/2089-the-division-of-chattels accessed 17th June 2019.
[769] Ibid.
[770] Mohd Faizal Kamarudin et al., 'Defaulters profile in Malaysia Sukuk market' (2014) 145 Procedia - Social and Behavioral Sciences 277, 279.

convertible (CoCo) *sukuk*, which allows the bond claims to be converted to equity in situations where the issuer is unable to satisfy the claims of the *sukuk* holders. This appears to be a workable solution, despite the reluctance of many Islamic scholars to see the Islamic bond becoming in any way similar to CoCo bonds.[771]

What could be taken away from the above discussion is that because of the structural weaknesses of the *sukuk* instrument, holders of issuance originating in a Muslim country could have difficulties obtaining a satisfactory outcome on default. Since the available means for redress are very limited, legal risks and risks related to imposition by court rulings should be added to the already discussed *sukuk* specific risks.[772] Furthermore, the discussion suggested that the wide-spread understanding that asset-based *sukuk* is potentially riskier than the asset-backed variety, this perception is misguided.

It is suggested that as a consequence of the inherent volatility of the instrument, its use may contribute to unfair distribution of wealth and unjustly set up financial market. This indicates that *sukuk* may become of interest for scholars, not only because of its apparent mimicry of conventional instruments but also because it could potentially fail to deliver on the social objectives of Islam. This and other relevant to *Shariah* compliance aspects of the *sukuk* instrument will be discussed in the following chapter.

[771] Mohammed Khnifer, 'The Challenges of structuring CoCo Sukuk' (2014)SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2537229 accessed 27th July 2018.
[772] Abdullah Alawi and Saleh Al-Quati, 'Sukuk: The Sharia Fixed Income Alternative Strategy' (2014) Strategy Report, AlJazira Capital, http://webcache.googleusercontent.com/search?q=cache:qpJsdQPkzScJ:www.aljaziracapital.com.sa/report_file/ess/spe-171.pdf+&cd=3&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 17th June 2019.

Chapter 9: Assessment of sukuk from a religious perspective

9.1. Overview

There have been many voices claiming that *sukuk* is not entirely consistent with Islamic values some of them coming from very convincing authorities.[773] *Shariah*-based objections to *sukuk* have been founded on two main points: "(i) the discount on the issued bonds could be construed as equating to interest return, and (ii) the guaranteed ex ante profit from a discounted offer does not exposure investors to investment risk."[774]

For example, Sheikh Muhammad Taqi Usmani, who presides over the AAOIFI's *Shariah* board, has expressed his concerns about the instrument as early as 2007, which prompted AAOIFI to issue as guidance a "Resolution" on what requirements must be met by a *sukuk* issuance in order for it to be *Shariah* compliant.[775] To this end, being *Shariah* compliant would mean that *sukuk* is tradable. The main points of this Resolution are as follows:

- *Sukuk, in order for them to be tradable, must be owned by the sukuk holders, together with all of the rights and obligations that accompany such ownership. The manager of a sukuk issuance must establish the transfer of ownership of such assets in its books, and must not retain them as its own assets.*
- *Sukuk must not represent receivables or debt except in the case of a trading or financial entity selling all of its assets, or a portfolio with a standing financial obligation.*
- *It is not permissible for the manager of sukuk to undertake to offer loans to sukuk holders when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve for the purpose of covering such shortfalls to the extent possible, on condition that the same is mentioned in the prospectus.*

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[773] See an interesting discussion, including this point, by Muhamed Zulkhibri, 'A synthesis of theoretical and empirical research on sukuk' (2015) 15(4) Borsa Istanbul Review 237, 240-241.
[774] Andreas A. Jobst, 'The Economics of Islamic Finance and Securitization' Journal of Structured Finance (2007) 13(1), 19-20.
[775] AAOIFI Shariah Board 2008.

- *It is not permissible for the investment manager, partner, or investment agent to agree to re-purchase assets from sukuk holders at nominal value when the sukuk are extinguished at the end of their maturity. It is permissible, however, to agree to purchase the assets for their net value, or market value, or fair market value, or for a price agreed to at the time of their purchase, in accordance with Shariah rules of partnership and modern partnerships, and on the subject of guarantees.*
- *It is permissible for the lessee in a Sukuk Al-Ijarah to agree to purchase the leased assets when the sukuk are extinguished for their nominal value, provided that the lessee is not also an investment partner, investment manager, or agent.*
- *Shariah supervisory boards should not limit their role to the issuance of fatwa on the structure of sukuk, but should also oversee its implementation and compliance at every stage of the operation.*[776]

Because *sukuk* has quickly become a preferred way of investment for Muslims, a number of new *sukuk* structures came to be created, presenting heterogeneity caused by the differences in the underlying contracts.[777] The most significant *sukuk* iterations (*sukuk al-wakala*, *sukuk mudarabah*, *sukuk al-musharaka*, *sukuk al-ijara* and *sukuk al-salam*) will be unpacked below, along with the contracts underlying them, both from a technical perspective and from the perspective of their respective impact on investor protection and market stability. The section will conclude with an in-depth discussion on perpetual *sukuk*, an instrument representative for the *Shariah*-compliancy issues that could arise from the use of the *sukuk* instrument.

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[776] Tan Wan Yean, 'Sukuk: Issues and the Way Forward' (2007) http://webcache.googleusercontent.com/search?q=cache:bId-akzlO44J:www.iln.com/articles/pub_1674.pdf+&cd=5&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 25th June 2019, 1-2.

[777] Mohammed Sawkat Hossain, Md Hamid Uddin and Sarkar Humayun Kabir, 'Sukuk as a Financial Asset: A Review' (2018) 22(1) Academy of Accounting and Financial Studies Journal https://www.abacademies.org/articles/sukuk-as-a-financial-asset-a-review-7134.html accessed 19th July 2019.

9.2. Sukuk al-wakala: the investor adviser-investor dynamic

Sukuk al-wakala is the Islamic alternative to the conventional investor/ investment adviser relationship, because in this contract the adviser (*wakeel*) lends his skills to invest and manage the money provided by the investor, for a particular duration and against a fee.

The concept of *wakala* refers to an arrangement where, similarly to an agency agreement, one party acts on behalf of the other in conditions of trust. Notably, the investor entrusts the *wakeel* (agent) with his funds to invest them in a pool of assets or investments. The *sukuk* subscription is premised on a fixed principle amount payable to the SPV. The agent contributes with his skills and expertise, managing the investments for a period of time with the purpose of achieving a pre-agreed return. The contract consists of a *wakala* agreement addressing the obligations of the *wakeel* and his remuneration, as applicable. In distinction to the *mudarabah* structure,[778] in *wakala* there will be no pro rata division of profit; rather, the investor will receive the profit agreed upon at the signing of the contract. The *wakeel* is entitled to keep any excess of profit as an incentive for his performance.

The assets or investments comprising the pool or portfolio are selected by the *wakeel* following certain criteria. The pool or portfolio is built by the *wakeel* with the help of the *sukuk* proceeds. The assets or investments will form part of the trust assets held by the trustee (SPV) on behalf and for the benefit of the investors. They could be purchased from one seller (who could be the originator) or from different sellers. Note that if the seller and the originator are the same person or belong to the same group, this may create issues with some *Shariah* Boards.

In the *sukuk* scenario, *wakala* could be used when the assets underlying the *sukuk* are not a specific tangible asset but a pool of assets or investments. The role of the *wakeel* (which could be the originator) is to select those investments or assets from the pool that are most suitable to the needs of the investor i.e. those investments or assets, the return of which will most likely match the desired by the investor rate of profit.

The *wakala* structure could be useful for originators for a number of reasons, most of them related to the possibility to use a pool of assets or investments. As expected, the pool, selected by

[778] Discussed in Chapter 9:[9.3.].

the *wakeel*, could comprise a wide selection of assets; however, all of them must be *Shariah* compliant and approved by the relevant *Shariah* Board. As long as the *Shariah* compliancy aspect has been met, there are no restrictions on what may enter the pool; it could include equities, contracts such as *murabaha* or *istisna*, or other *sukuk* as well as Islamic derivatives. Since the *wakala* structure allows *murabaha* and *istisna* (essentially debt based contracts) into the pool, it enables the originator to avoid the restriction placed on these two contracts *vis-à-vis* participation in the secondary market.

Note that contracts of this type could be used as part of a portfolio of assets, as long as at least 30% of the portfolio contains tangible assets, which could be *ijara*, equities or other asset-based *sukuk*.[779] Furthermore, the *wakala* enables the originator to build his balance sheet by building the asset pool/investment portfolio *and* to then use this portfolio to back up a *sukuk* issuance. Considering that most of the balance sheets of Islamic banks contain debt-based instruments such as commodity *murabaha* and *istisna*, *wakala* could give them the opportunity to put these contracts to a better, more efficient use. Having said that, it is significant that *wakala* has not been used much in practice due to some issues with its structuring.

Most of the elements of the *wakala sukuk* mirror the usual *sukuk* structure such as the fact that the *sukuk* certificate represents undivided property interest in the *wakala* assets (the pool), the right to receive a periodic return from the Periodic Distribution Amounts and Dissolution Amounts (fixed or variable and pegged against a benchmark),[780] enforceable against the issuer SPV.

The *wakeel* holds the *wakala* assets and the profit return derived from them on behalf of the trustee for the duration of the *sukuk* contract. He undertakes to deliver a certain amount of profit return used to fund the Periodic Distribution Amounts (PDAs), remaining entitled to the rest of

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[779] Islamic Markets, 'Sukuk al-Wakala' (2019) https://islamicmarkets.com/education/sukuk-al-wakala accessed 17th July 2019.

[780] Such as LIBOR, against which over $350 trillion worth of contracts across the globe are currently pegged; however, note that after December 2021 'the transition to alternative reference rates will involve considerable efforts for Libor users for impact assessments, amending contracts and updating systems.' See, Kuntal Sur, 'Saying goodbye to Libor, the world's most valuable benchmark' (2019) Financial Times, https://economictimes.indiatimes.com/markets/stocks/news/saying-goodbye-to-libor-the-worlds-most-valuable-benchmark/articleshow/69532390.cms?from=mdr accessed 17th July 2019.

the profit divided into a remuneration fee (which could be nominal) and the remainder (to serve as a performance or incentive fee).

In the event that the profit falls below the expected PDAs, the obligor may agree (under a purchase undertaking) to purchase some of the assets or investments from the pool/portfolio at regular intervals. The exercise price of the assets/investments should be equal to the PDAs. Note that as a result of the AAOIFI statement, *Shariah* scholars largely disapprove of this practice, because of the resemblance with a guarantee of profit. The only exception is when the seller of the *wakala* assets and the obligor are not the same entity.

In the event of default or at maturity, the trustee SPV 'will exercise its option under the Purchase Undertaking to require the Obligor to purchase the *wakala* assets at an Exercise Price that is equal to the Dissolution Amount payable to investors together with any accrued but unpaid Periodic Distribution Amounts.'[781] Such purchasing of *wakala* assets at the above conditions may take place in pursuance of the exercise of an optional call or for tax purposes; however, in this scenario it is the obligor who will make use of its option under a sale undertaking. Whichever of the two scenarios has taken place, the trustee will use the proceeds of the sold *wakala* assets or investments to pay the dissolution amount to investors and redeem the *sukuk*. This will effectively dissolve the trust.

In order for the *wakala* to properly underline a *sukuk* contract, it needs to be structured in the following way. First, the agent must operate in a *Shariah* compliant way. Secondly, he must receive a fee for his services, even if the fee is only nominal. This resembles the common law principle that consideration must be sufficient but it need not be adequate.[782] Furthermore, the subject of the *wakala* contract must be clear and unambiguous and the agreement must contain a breakdown of the duration of the contract, the criteria for election of assets or investments, the fees payable to the agent and the conditions for termination of the *wakala*.[783] In addition, the agreement must clarify that the principal, which is the trustee SPV, is only entitled to the pre-agreed profit return, which will fund the PDAs, with the rest remaining for the agent.

[781] Islamic Markets, 'Sukuk al-Wakala' (n 779).
[782] *Carlill v Carbolic Smoke Ball Co* (n 383).
[783] Islamic Markets, 'Sukuk al-Wakala' (n 779).

Importantly, AAOIFI requests that a minimum of 30% (but this is often raised up to 51% by some Islamic scholars) of the portfolio or asset pool should contain tangible assets. Asset-based *sukuk,* equities or *ijarah* would qualify for these purposes. Furthermore, the originator needs to bear in mind that equities-based pools should be filled solely by purchasing from companies that engage in *Shariah* compliant activities. To this end, if the company is involved with *haram* activities such as alcohol, gambling, or the pork processing industry, its equities are not eligible for the asset pool. The only exception to this, allowed by some but not all *Shariah* boards, is if such *haram* activities form up to 5% of the revenue of the company.

Furthermore, there could be *Shariah* restrictions on the acquisition of equities based on the ratio of conventional debt to equity on the relevant listed or unlisted company. This requirement can be side-stepped by the agent if he acquires equities only from a *Shariah*-approved list.

In the event that any of the assets of the pool loses its *Shariah* compliant status, it must be replaced with a *Shariah* compliant asset. This means that the *wakala* agreement must include a provision, possibly a purchasing undertaking by the obligor, for such substitution of incompliant assets with *Shariah*-compliant ones.

As previously discussed, the obligor may undertake to purchase some of the assets in order to ensure that the correct PDAs will be paid to investors even if the profit from the investment is lower than the expected. However, this effectively detaches the performance of the asset from the performance of the investment. It was also mentioned that such practices are only permitted by AAOIFI if the obligor and the seller are not the same entity or do not belong to the same group. It is important to note that the practice takes away some of the risks related to the investment, borne by the investors, and vests them into the originator.

One last point to consider is that the *wakala* assets are “locked” into the pool until such time that the originator purchase them through a purchase or sale undertaking. This may be less than efficient because the originator may be able to apply some of the assets to a more efficient use. This could be alleviated by incorporating a *salam* contract into the *wakala*, which would allow a gradual introduction of the assets into the pool, for instance on a pre-determined dates, and not their delivering at the point of purchase. Using a *salam* contract would ensure that the entire purchase price is paid up front, which would allow the *sukuk* issuance to operate as envisioned;

however, there is a requirement that at least 1/3 of the total of the assets comprising the pool should be delivered up front.[784]

The *wakala* contract is rather versatile and for this reason it has been used in addition to the *sukuk* structure described above in the context of term deposits, Islamic insurance or letters of credit. However, despite its usefulness, the contract has some issues, among which are a possible conflict of interest between the agent and the investor. This becomes more pronounced when the *wakeel* is also the bank (in the case of term deposits) or the originator (in the case of bonds). In some extreme cases this may lead to adversary outcomes, a mismatch between the objectives of the parties, particularly evident in a default scenario. Additionally, it is significant that while any profits in the excess of the agreed returns will remain with the *wakeel* as a performance fee, the risk of default and the losses following from that will be borne by the investor (*muwakkil* or *muwakeel*) alone, except for those risks and losses that are caused by the *wakeel*'s misconduct or negligence.[785]

A similar to *wakala* structure is found in *sukuk mudarabah*, where both parties are investors but only one of them manages the investment. The profit from the investment is divided between the parties on *pro rata* basis. Given the popularity of this structure, a brief account of the *mudarabah* contract will be presented below.

9.3. Outlining the concept of mudarabah partnership

Mudarabah is a partnership agreement where one party invests all the capital while the other manages the business. The investor in this structure is called "*rabb-ul-maal*" (owner of the capital). The plural of this – investors - is "*arbab al mal*". The managing party (*mudarib*/entrepreneur) holds the capital and bears the exclusive responsibility of its management. There are two kinds of *mudarabah* structures: restricted and unrestricted *mudarabah*.

[784] Islamic Markets, 'Sukuk al-Wakala' (2019) https://islamicmarkets.com/education/sukuk-al-wakala accessed 17th July 2019.
[785] Islamic Markets, 'Wakala Deposit' (2019) https://islamicmarkets.com/education/wakala-deposit accessed 17th July 2019.

The restricted *mudarabah* places limits on the managing power of the *mudarib*. For example, the *mudarib* cannot invest in a business or asset class not pre- approved by the investor. This is not the case with the unrestricted *mudarabah*, where the *mudarib* is motivated mainly by the investment's potential to maximize value, subject to compliance with *Shariah* law.[786]

The mudarabah contract is based on profit sharing, which is subject to strict rules.[787] The sharing of profit or the remuneration of the contractual parties must be agreed in advance.

Firstly, the parties must agree on the proportion of the actual profit to be allocated to each of them. If no explicit arrangement was made, it is presumed that the parties agreed to split the profit evenly. Secondly, the *mudarib* could be incentivized by bonuses in case he met a target. Thirdly, despite the previous point, remuneration for work done is not allowed under this contract. The parties share the profit at the pre-agreed rate, the *mudarib* may receive a bonus but the parties cannot receive a wage. This is because remuneration will defeat the purpose of the agreement, which is that one party provides the capital and the other the work (on the management of the capital). Fourthly, '[t]he parties involved cannot allocate a lump sum amount of profit for either of them neither can they determinate the share of any party at a specific rate tied with the capital invested.'[788]

In addition, there are some relevant differences between *mudarabah* and another popular partnership agreement - the *musharakah*, which have been laid out below.

To begin with, in the *mudarabah* contract only one party (the *rabb-ul-maal*) is permitted or required to invest. This is not the case with *musharakah* where investing is an obligation borne by all parties. Furthermore, the *mudarabah's rabb-ul-maal* is not allowed to take part in the management of the partnership. Contrary to this, all parties in *musharakah* can take part in the management of the enterprise. Moreover, parties to *musharakah* contracts are under unlimited liability whereas in *mudarabah* the investor is liable with and only up to the extent of his investment. In the *mudarabah* structure, the *rabb-ul-maal*'s losses are represented by the loss of

[786] Mohammed El Youssofi Oulad Ibrahim, Funding Social Business: a recognition of Islamic Finance, (2014) MSc Thesis, (Utrecht University 2014), 21.
[787] Ibid, 22.
[788] Mohammed El Youssofi Oulad Ibrahim, Funding Social Business: a recognition of Islamic Finance, (2014) MSc Thesis, (Utrecht University 2014), 22.

the invested capital (financial losses). The *mudarib* loses his contribution of time, skills and effort.

However, the assets in *musharakah* are owned jointly by the contracting parties. This means that should the value of the investment rise, all parties benefit (or all parties lose in the opposite scenario). In distinction, the assets, subject to a *mudarabah* contract, are owned by the investor who will be the sole beneficiary of any appreciation in value.[789]

9.4. The musharakah concept on a more detailed view

9.4.1. Musharakah contract – partial ownership in a business

Musharakah means sharing or merging.[790] The definition of *musharakah* represents it as 'the co-mingling of money, work or obligations of two or more parties in order to earn a profit, yield or appreciation in value [and] … it implies a share in any losses that are incurred according to their proportional ownership.'[791]

There are five principles that must be followed in order for the *musharakah* transaction to be deemed valid. They relate to capital, management, profit & loss, settlement and security.

Musharakah is flexible regarding the nature of the capital provided for the contract – it could be goods in kind or liquid. However, *musharakah* requires that there is certainty with respect to capital in the sense that it must be quantified and specified. Furthermore, if the capital is in the form of assets, the parties must consent on their value.

In principle, all *musharakah* partners could act as managers. It is also possible to agree that only one partner or just some of the partners will be involved with that. It is also possible to have a silent partner, in which case the relevant party does not participate in the management of the business.

789 Ibid, 23.
790 Mohammed El Youssofi Oulad Ibrahim, *Funding Social Business: a recognition of Islamic Finance*, (2014) MSc Thesis, (Utrecht University 2014), 17.
791 Ibid, 17.

As regard profit and loss division, *musharakah* requires that the partners agree on the ratio of profit& loss sharing prior to entering into the *musharakah*. Importantly, the agreed profit ratio must be pegged to the actual profit and not to the amount of the invested capital. This means that investors will agree to take a certain percentage from the profit from the venture and not a certain percentage of what they contributed to the partnership. Note that if investors are happy to link their profit returns to their contributions, this could be done but requires consensus. Also, this exception does not apply to silent partners. While it is possible to argue that the link to the invested capital is an incentive for those who have made greater contributions in terms of capital and management of the investment, this could not be said for the silent partner who is simply an investor.

It is also not acceptable to arrange for a lump sum to be received as profit under the contract (as to avoid calculating the percentage).[792] The rationale for this is that *Shariah* law does not favour delinking of the profit from the performance of the investment. The opposite would be an introduction of *riba* through the back door because it would give a guaranteed mark-up on the invested money. Furthermore, *Shariah* promotes investors' effort in the creation of value; an investor who is certain that they will receive a profit return despite the performance of the asset is a disinterested investor and one who cannot be expected to carry out the investment with adequate due diligence. This is an interesting point which has to do with *Shariah*'s drive towards efficiency and sustainability of resources. Another view of this practice would be that the arrangement promotes self-discipline and self-regulation of conduct *in lieu* of formal regulation.

Musharakah offers some flexibility regarding profit ratios in the sense that once the venture has started operating, partners can agree to raise the profit margin of the silent partner or of any other partner, for that matter. Furthermore, profit shares could be flexible or fixed and they could be capped at a certain amount. It is also possible to retain part of the profit within the venture in order to boost its performance.

Unlike division of profits, sharing of loss is proportionate to the partners' contributions. Not complying with this rule will invalidate the contract. It could be concluded that while there could be some flexibility to division of profit, the same does not apply to sharing of loss, which is estimated in accordance with the amount contributed by each partner. This *musharakah* rule

[792] Mohammed El Youssofi (n 790).

reflects *Shariah*'s principle that alleviation of hardship should take precedence to creating benefit.

The matter of settlement of *musharakah* is relatively straightforward. The agreement may be terminated with a notice or subject to certain conditions being satisfied. Among the latter is withdrawing or death of one of the partners, expiration of the duration of the partnership (if applicable), meeting the objectives of the partnership or insolvency. In order to dissolve the partnership, the assets are distributed between the partners commensurate to their contribution. Again, the contract structure offers flexibility since the partners can agree on the specific form of asset distribution or for only some of them to leave the partnership while the others remain partners. However, in order for such decisions to be taken, it is necessary to have the agreement of all partners. Furthermore, those partners who wish to preserve the partnership are required to buy out the leaving partners at a mutually agreed price. Dispute over the value of the share entitles the leaving partner to request the liquidation of the business.[793]

Finally, because partners in a *musharakah* contract have the same rights and responsibilities, partners cannot ask the other partners to provide security. As a result of this, each partner acts as agent of the other.[794]

9.4.2. Musharakah sukuk from a technical perspective

Musharakah sukuk is an asset-backed *sukuk* structure whereby the originator transfers part of his assets into the SPV *sukuk* issuer. The *sukuk musharakah* contract is concluded between the SPV and the originator. [795]

Following this transfer, the newly acquired by the SPV assets are invested in a business venture. To this end, the SPV acts as a trustee with respect to the material assets and for the benefit of the beneficiaries (the *sukuk* holders). These investments provide a stream of returns, out of which

[793] Mohammed El Youssofi Oulad Ibrahim (n 790), 19.
[794] Mohammed El Youssofi Oulad Ibrahim (n 790), 19-20.
[795] Sweder van Wijnbergen and Sajjad Zaheer , 'Sukuk Defaults: On Distress Resolution in Islamic Finance' , (July 2013) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2293938 accessed 16th July 2019, 7.

periodic payments are made out to the originator and investors at a pre-agreed rate. The parties share the loss from the investments at a rate proportional to each party's respective investment.

Compared to other structures, most notably *ijarah sukuk,*[796] *musharakah sukuk* allows more freedom to originators if the investment is commercial in nature. This is the case because the latter enables the originator to share ownership of the assets with the *sukuk* investors. In contrast, in the *ijarah sukuk*, 'sukuk holders are the sole owner of the underlying assets.'[797]

Furthermore, in the *musharakah* structure, it is the originator who manages the assets and not the SPV or the investors. This is formalized through a management contract. Similarly to other *sukuk* structures, the originator undertakes to redeem the *sukuk* held by investors at the maturity date and at the market price.

Note that the periodic returns in *musharakah* are pre-determined and not commensurate with the profit stream, which is the case with periodic returns on *ijarah sukuk*. This is justified by the greater fluctuation of performance attached to *musharakah* structures. Furthermore, *musharakah* structures are flexible and allow that the SPV increase the return (by cutting into its own profits) in order to match the return expected by the investors.[798] However, by doing so, the parties may make themselves vulnerable to accusations of *riba*.

9.5. Sukuk al-ijara (Islamic leasing)

Alternatively, the *sukuk* could function as an Islamic leasing product representing investors' ownership of an asset which they then lease to the issuer. The latter could be a government, a quasi-governmental organisation, a multilateral lending institution or a private institution. Such instruments are known as *ijarah sukuk* (or *sukuk al-ijara*).

[796] To be discussed in Chapter 9: [9.5.].
[797] Sweder van Wijnbergen and Sajjad Zaheer (n 795), 8.
[798]Sweder van Wijnbergen and Sajjad Zaheer , 'Sukuk Defaults: On Distress Resolution in Islamic Finance' , (July 2013) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2293938 accessed 16th July 2019, 8.

9.5.1. Ijara contract

The *ijara* leasing contract is an exchange-based contract. In addition to *sukuk*, the *ijara* contract can be used in Islamic banking and Islamic project financing.[799] *Ijara* could also serve as a mortgage instrument, arranged as a contract between an Islamic Bank and a customer. The parties in this contract are a lessor (the bank) and a lessee (the customer). The lessor would purchase the house and rent it out to the lessee, keeping the title to it until such time that the obligations of the customer had been fulfilled. On his part, the lessee would pay rent to the lessor until the total cost of the house had been covered. This total cost will include the purchase price of the house plus management costs. Once the total had been reimbursed to the bank, the title to the house would be transferred to the lessee.[800]

Because of its usefulness, the *ijara* instrument has been used since the initiation of Islamic finance. The first Malaysian case involving *ijara* contract (*Tinta Press Sdn Bhd v Bank Islam Malaysia Bhd* [1987])[801] is notable for two main reasons. The first reason is that, given the novelty of the Islamic finance framework, the court did not venture to dismantle the applicability of the contract to *Shariah* law. The second one is that the decision of the court still stands, mainly due to the relevant *ratio decidendi*.

On the facts of the case, the parties had concluded an *ijara* contract for the lease of certain printing equipment. When the lessee defaulted on their obligations *vis-a-vis* the monthly rental payments, the lessor brought a legal action to recover the rent as well as possession of the equipment. This was complemented by an ex parte application for a mandatory injunction to allow the return of the equipment to the lessor (allowed at first instance).[802] The appellants endeavored to set aside the mandatory injunction but their application was rejected. The case turned on the appellants' appeal from this decision.[803]

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[799] Islamic Finance, 'Ijara Contract' (2015) https://www.islamicfinance.com/2015/01/ijara/ accessed 26th July 2019.
[800] Ibid.
[801] *Tinta Press Sdn Bhd v Bank Islam Malaysia Bhd* [1987] 2 MLJ 192.
[802] *Bank Islam Malaysia Bhd v Tinta Press Sdn Bhd & Ors* [1986] 1 MLJ 256.
[803] Mohd Yazid Bin Zul Kepli, , 'Introduction to Islamic finance' (2013) http://what-is-islamic-finance.blogspot.com/2013/06/analysis-cases-law-on-islamic-finance.html accessed 26th July 2019.

The judges held that the *ijara* was a lease as opposed to a loan contract, which made it so much easier for the court to impose the sought mandatory injunction and allow the return of the equipment to the lessor. More specifically, they stated that:

> *the learned judge rightly concluded from the documents and the affidavit evidence that the agreement in this case was a lease agreement and not a loan agreement;*
>
> *there was a clear breach of the lease agreement in this case by the appellant and the respondent therefore became entitled to immediate possession of the equipment. The learned Judge was confident that the court would grant a mandatory injunction at the trial of the suit and rightly held that if the injunction had not been granted earlier the respondent would suffer irreparable damage and greater hardship. The balance of convenience was very much in favour of the respondent and the application was one of urgency.*[804]

Note that in contrast, English contract law has traditionally been reserved in the granting of injunctions, which are given rarely and typically in the case of a breach of a negative contract or a negative stipulation in a contract.[805] This approach arguably follows the English Property Law position of enforcing covenants in equity. In order for a covenant to be considered enforceable, it has to abide by a number of conditions, the first of which is to be a negative (restrictive) one.[806] Note also, that as a matter of principle, English law would only allow covenants if by allowing them, some value (benefit) is created or alternatively, if they do not restrict trade. This is, for example, the approach English Employment Law would take to covenants in employment contracts; they would be

> *unenforceable as a matter of public policy, unless they are no broader in duration, geographical scope and nature of restriction than necessary for the protection of an employer's legitimate business interests (i.e. protection of confidential information, client relationships and a stable workforce).* [807]

[804] *Tinta Press* (n 801), per Salleh Abbas LP, Syed Agil Barakbah J and Wan Hamzah SCJJ.
[805] Ewan McKendrick, (n 386), 363.
[806] *Tulk v Moxhay* [1848] 41 ER 1143. See also, Land Registry Documents, 'All You Need to Know About Covenants' (2012) https://www.land-registry-documents.co.uk/news-blog/covenantswhat-you-need-to-know-about/ accessed 26th July 2019.
[807] Daniel L Peyton, 'English law and restrictive covenants – getting the basics right' (2019) McGuireWoods LLP, https://www.lexology.com/library/detail.aspx?g=7e09c631-97a3-431c-97bd-c6a868530e1d accessed 26th July 2019.

Going back to the stipulations of English Contract Law, as an equitable remedy and given at the discretion of the judge, '[a]n injunction will not be granted where its effect would be directly or indirectly to compel the defendant to perform acts which he could not have been required to do by an order of specific performance.'[808] This brings a conclusion that there is a considerable difference between the approaches of English and *Shariah* law; the latter, at least in the Malaysian interpretation of the principles, is far more willing to accommodate the lessor rather than to consider the implications of the decision for all parties concerned.

9.5.2. Sukuk ijara: structuring and associated risks

Sukuk Ijara comprises of securities representing ownership of assets tied to a contract of lease.[809] When the *ijarah sukuk* are asset-backed, they represent partial ownership in an asset (which could be real estate, land parcels and/or building or leasehold rights) purchased by the issuer (a SPV) from the originator through a transaction.[810] The purchase of assets is funded via the sold *sukuk*. The SPV acts as a trustee for the *sukuk* holders (the beneficiaries of the trust).

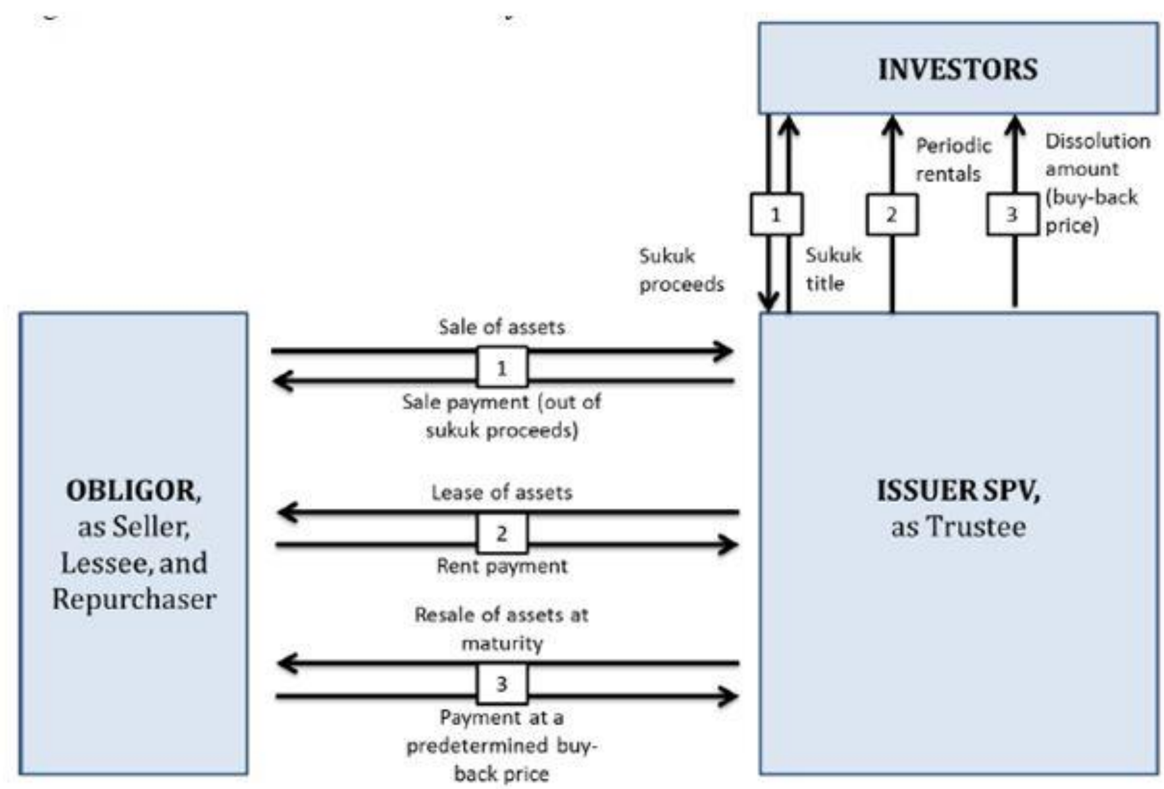
As suggested, the *sukuk ijarah* structure involves two parties – a lessor (issuer) and a lessee. The *ijarah sukuk* instruments represent financial obligations, the profit of which is generated by the periodic rentals which the lessee (the originator) pays to the investor(s)[811] through the trustee (the SPV). Effectively, notes issued by a lessor, the *sukuk* certificates are 'backed primarily by cash flows from lease receivables from a credit lessee (*guthrie*).'[812] The lease in this structure would always relate to tangible assets such as the aforementioned real estate, motor vehicles, or other equipment, purchased with the subscription amounts and then leased out to their ultimate users, who are charged a rent for this service. There could be cash flows in addition to the rent, if the

[808] Ewan McKendrick, (n 386), 363.
[809] Islamic Finance, 'Ijara Contract' (n 799).
[810] Sweder van Wijnbergen and Sajjad Zaheer (n 798), 7.
[811] Al Ameen Online, 'Islamic Investment Funds' (n.d.) http://www.ublfunds.com.pk/alameen/resources-tools/learning-center/shariah-compliant-investments/ accessed 28th September 2018.
[812] Andreas A. Jobst, 'The Economics of Islamic Finance and Securitization' Journal of Structured Finance (2007) 13(1), 20.

transaction structure allows it. All assets remain property of the investment fund and the rentals are distributed among the fund's subscribers.[813]

Some of the associated with *ijara* risks include the lessee being unable or unwilling to fulfill his obligations. Furthermore, changes in the market conditions may affect the *ijara sukuk* unfavourably; for instance, fluctuations in the price of the asset or in the cost of maintenance and insurance. In addition, the expected net return on the *ijara sukuk* may be subject to uncertainty because it may be difficult to determine in advance. The same consideration applies to the respective maintenance and insurance expenses. These disadvantages of the instrument are somewhat compensated for by the fact that 'ijara are completely negotiable and can be traded in the secondary markets.'[814]

Generic Structure of Sukuk al-Ijara



[813] Ibid, 4-5. See also, Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' Australian Journal of Basic and Applied Sciences (2011) 5 (12) 473.
[814] Islamic Finance, 'Ijara Contract' (n 799). Sweder van Wijnbergen and Sajjad Zaheer, 'Sukuk Defaults: On Distress Resolution in Islamic Finance' , (July 2013) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2293938 accessed 16th July 2019), 7.

Source: Islamic Finance.com (https://www.islamicfinance.com/2015/01/ijara/)

As with other *sukuk* structures, the originator undertakes to buy the *sukuk* back at maturity or upon insolvency. The price could be the market price, a fair price or an agreed price. Importantly, the periodic returns payable on *ijarah sukuk* must be commensurate with the value of the underlying assets.[815]

There are a number of *Ijarah sukuk* structures available to investors. One of the most popular is the sale-leaseback structure. Here, the legal title to the assets is vested in the SPV, which acts as the lessor. In this scenario the lessee is the company that uses the assets. The lessor receives rental payments from the lessee, typically benchmarked against the LIBOR, and passes part of them on to investors minus a profit margin which is preserved by the SPV. These payments form the predetermined periodic returns received by *sukuk* holders. The sum of these returns (which comes from the periodic rental payments) is agreed between lessor and lessee in advance. The rate is rather low however, because this type of *sukuk* is considered a relatively safe investment – 'a low-risk fund with a minimum risk of capital loss'.[816] In order to diminish the risk of default due to underperformance of the underlying assets, the SPV holds a repurchase obligation for a price equal to the amount of outstanding debt. Alternatively, on maturity the SPV sells the assets to the seller (the issuer) at a predetermined value.[817]

The headlease-sublease transaction structure is another variety of the *Ijarah sukuk* model. In this scenario, the lease is carried out in two steps. First, the assets' owner headleases them to the issuer and secondly, he rents them back from him. This transaction does not include a repurchase obligation of transferred assets, held by the SPV. In order to meet the existing credit risk of non-performance, the headlease-sublease structure incorporates a quasi-guarantee on payments due to sukuk holders.[818]

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[815] Sweder van Wijnbergen and Sajjad Zaheer (n 798), 7.

[816] Ali Saeed Al-Shamrani , *Islamic Financial Contracting Forms in Saudi Arabia: Law and Practice* (2014) PhD Thesis, Brunel Law School, 90. See also, S R Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', The Journal of Structured Finance [2009] 58, https://www.academia.edu/6164679/An_Overview_of_Islamic_Sukuk_Bonds_AND_SABAHUDDIN_AZMI accessed 25th June 2019, 59.

[817] S R Vishwanath and Sabahuddin Azmi, Ibid, 61-62.

[818] Andreas A. Jobst, 'The Economics of Islamic Finance and Securitization' (n 688), 20.

This guarantee is arguably controversial from a *Shariah* compliance point of view because it violates the principle of profit-loss sharing embedded in Islamic finance.

9.6. Sukuk al-salam

Sukuk al-salam is an exception of the rule that the subject matter of the contract must be present and in the physical or constructive possession of the seller at the time of signing of the contract. The same exception applies to *istisna* contracts. In *salam* contracts, the asset is paid for up front but delivered to the purchaser at a later stage. This is known as deferred delivery contract. The price paid for the asset (*al-muslam fhi*) is known as *salam* capital. Being that *salam* is a deferred delivery contract, it resembles the conventional forward contract, which is generally not permitted under *Shariah* law. In order for *salam* to be accepted as a valid contract, it must exclude the element of uncertainty. This is achieved by satisfying a number of criteria, for example, the originator undertaking to deliver certain standardised assets to the issuer, which could create complications in scenarios where the originator's business model does not allow this. For example, it is fundamental that the originator clarifies at the point of structuring of the contract whether they can provide the said standardised assets. Failure to do that would make it impossible to enter into a valid *sukuk al-salam*. [819] In addition, *sukuk al-salam* is suspect under *Shariah* rules because it creates indebtedness of the seller.

Admittedly, the convoluted structure and the fact that it is non-tradable makes *salam* unattractive for issuers despite its ability to provide short-term liquidity for their operations.[820]

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[819] Islamic Markets, 'Sukuk al-Salam' (2019) https://islamicmarkets.com/education/sukuk-al-salam accessed 17th July 2019.
[820] Ibid.

9.7. Perpetual Sukuk

9.7.1. Overview

Perpetual *sukuk* is considered an innovative hybrid instrument, which resembles shares to a greater degree than its ordinary counterpart. [821] While the instrument may indeed be innovative for the Islamic financial market, it has been in use in the conventional market for centuries. The invention of the perpetual bond (a bond giving interest to its holders forever) has been credited to the British government as far back as the 18th century, although, a bond issued by Dutch water authority Stichtse Rijnlanden in 1648 still pays interest.[822] Perpetual bonds are seen as a good solution for capital sourcing in times of financial troubles; however, they carry-on credit risk, which can come to pass if the issuer experiences financial distress or has to cease its operations.[823]

The permanency of the instrument, expressed in carrying perpetual legal tenure, makes it *quasi* equity from accountancy point of view. Note that the instrument entitles the issuer to a call option, namely the right but not the obligation to redeem the *sukuk* after the initial non-call protection period. Typically, in order for the *sukuk* to qualify as permanent, this option cannot be exercised before five years from the issuance of the *sukuk* has taken place.

In practice, like shares, perpetual *sukuk* have no maturity date, which makes these instruments more akin to equity than to debt.[824] For this reason perpetual *sukuk* are considered part of the capital of the company. In order to qualify as equity, however, perpetual *sukuk* must contain a profit deferral feature, which is the ability of the issuer to defer profit without being in default. The deferral could be optional or mandatory. It could also be cumulative when deferred profit accrues or non-cumulative, when missed profit payments are forgone. The profit deferral feature

821 Muhammad Ramadhan Fitri Ellias et al., 'Perpetual Sukuk: A Preliminary Shariah Assessment' (2018) https://www.researchgate.net/publication/312946320_Perpetual_Sukuk_A_Preliminary_Shariah_Assesment accessed 17th July 2019.
822 Lisa Smith, 'An Overview of Perpetual Bonds' (2019) Investopedia, https://www.investopedia.com/articles/investing/082313/perpetual-bonds-overview.asp accessed 19th July 2019.
823 Lisa Smith, ibid. Muhammad Ramadhan Fitri Ellias, Muhamad Nasir Haron, Ahmad Firdaus Kadir and Nur Hidayah Salim, 'PERPETUAL ṢUKŪK: A PRELIMINARY SHARĪʿAH ASSESSMENT' (2016) 8(1) ISRA International Journal of Islamic Finance 125, 127.
824 Ibid.

has the consequence that if the issuer's financial state deteriorates, holders of perpetual *sukuk* will absorb losses prior to senior creditors.[825] Perpetual *sukuk* could, on some occasions, provide its holders with the entitlement to receive profit on the deferred profit. This extra payment could be accrued up until such time that the deferred profit is outstanding.

Furthermore, because there is no final redemption date for this instrument, holders of perpetual *sukuk* cannot redeem them unless a specific event occurs, which would trigger the redemption process. In the event of such process beginning, the *sukuk* can be redeemed in whole but not in part.[826] In terms of arrangements on default or insolvency, perpetual *sukuk* always ranks senior to common equity 'and typically to preference shares as well'[827] and it is contractually subordinated to debt and other liabilities of the issuer.[828] This feature allows the *sukuk* to be used as a capital cushion at times of financial distress and as a protection mechanism targeting senior and external creditors, while preserving its main quality of source of funding. In the case of corporate issuers, in addition to the above specificities, perpetual *sukuk* protects its investors by providing a step-up profit rate, triggered after the first exercise of the call option or occasionally, after a change in issuer ownership. This feature serves as incentive for issuers to remain in place as well as to exercise the call option at the first possibility to do so.[829] Furthermore, as another protection measure, should the issuer decide to defer the payment of profit, it should also stop the payment of dividends or capital distributions to ordinary shareholders.[830]

Perpetual *sukuk* are issued by banking institutions to shore up Tier 1 (T1) Capital. To this end, they are subject to a more complex framework, thus reflecting the eligibility criteria for regulatory capital of the Basel III framework.[831] For example, perpetual *sukuk* issued by Negara Bank do not provide for a step-up feature or other incentives for the bank to redeem the *sukuk*. In addition, redemption should be subject to regulatory approvals and the bank should not assume or create expectations that such approval will be given.[832]

[825] Muhammad Ramadhan Fitri Ellias et al. (n 821), 128.
[826] Pegah Zolfaghari, (n 647), 32-33.
[827] Muhammad Ramadhan Fitri Ellias et al. (n 821), 127.
[828] Muhammad Ramadhan Fitri Ellias et al. (n 821), 127.
[829] Muhammad Ramadhan Fitri Ellias et al. (n 821), 128.
[830] Muhammad Ramadhan Fitri Ellias et al. (n 821), 129.
[831] BIS, 'Definition of Capital' (2019) https://www.bis.org/basel_framework/chapter/CAP/10.htm?inforce=20190101 accessed 18th July 2019.
[832] Muhammad Ramadhan Fitri Ellias et al. (n 821), 130.

Furthermore, similarly to the Basel III approach, the bank places a heavy emphasis on the subordinated character of the instrument and stipulates that 'cancellation of discretionary payments must not constitute an event of default.'[833] The framework adopted by Negara Bank follows closely Basel III in all its Tier 1 requirements. The only substantial difference is in the way the instrument is supposed to be structured. To this end, only 'unrestricted non-exchange-based contracts (e.g., *mushārakah*, *muḍārabah*, or *wakālah*)' are allowed and the instrument must abide by all pertinent *Shariah* requirements.[834]

The *musharakah* contract too is deemed by Islamic jurists a non-binding one; therefore, similar considerations apply. This is the approach of the *Shafi* School,[835] which holds that:

> *The ruling of non-bindingness [of mushārakah] and the right to dissolve [the mushārakah contract] are similar to the ruling of wakālah (agency). If one of the contracting parties exits from the contract prior to profit computation, then according to al-Qāḍī, the manifest meaning of Imam Ahmad's statement is that the contracting parties shall not exit from the contract until the profit has been computed.*[836]

It is submitted that this view perceives the rule that *musharakah* is non-binding as having the possibility to create unfair outcomes for one of the parties. This is treated as undesirable by the respective jurist who clarifies what needs to be done in order for each party to receive its dues. Respectfully, the quote does not confirm that in the jurist's opinion 'the maturity period is not considered a requirement' as Ellias et al. suggests.[837]

AAOIFI stipulates in a similar vein that:

> *Each partner is entitled to terminate the sharikah (i.e. to withdraw from the partnership) after giving partner/s due notice to this effect, in which case he shall be entitled to his share in the partnership, and this withdrawal would not necessitate the termination of the partnership of the remaining partners. It is permissible for the partners to enter into a binding promise for the continuity of the partnership for a period of time. In this case, it is permissible for the parties to agree to terminate the partnership before such a fixed period. In all these cases, the obligations and actions that took place before termination will remain*

[833] Muhammad Ramadhan Fitri Ellias et al. (n 821), 130.
[834] Muhammad Ramadhan Fitri Ellias et al. (n 821), 131.
[835] Yaḥyā ibn Sharaf Imām al-Nawawī , *Minhāj al-Ṭālibīn* (2005 Dār al-Minhāj), p. 271, quoted in Muhammad Ramadhan Fitri Ellias et al. (n 821), 147.
[836] ʿAbd Allāh ibn Aḥmad Ibn Qudāmah, *Al-Kāfī*, (1994 Dār al-Kutub al-ʿIlmiyyah), 2: 147, quoted in Muhammad Ramadhan Fitri Ellias et al. (n 821), 147-148.
[837] Muhammad Ramadhan Fitri Ellias et al. (n 821), 147.

unaffected and they will continue to exist. This rule applies to non-stock companies as well.[838]

9.7.2. Shariah compliance deficiencies of perpetual sukuk

Due to the obligation to be structured by non-exchange-based underlying Islamic contracts, perpetual *sukuk* displays a number of *Shariah* compliance issues. In this context, Ellias et al. analyse three cases of perpetual *sukuk*, two of which were based on *musharakah* (Malaysia Airline System Berhad's (MAS) perpetual junior ṣukūk (2012)[839] and Malaysia Airports Holdings Berhad's (MAHB) perpetual subordinated ṣukūk (2014)).[840] The third *sukuk* was Abu Dhabi Islamic Bank's (ADIB) AT1 capital perpetual ṣukūk (2012),[841] based on *mudarabah*. The problems that have been identified by Ellias et al. concern 'perpetuity, deferral of periodic distribution, capitalization of deferred periodic distribution, non-payment of profit, step-up and top-up rate, conversion into shares in the case of non-viability and redemption of perpetual ṣukūk.'[842]

9.7.2.1. With regard to perpetuity

Perpetual *sukuk*'s lack of maturity date and the ability of the issuer to dissolve the contract after exercising a call option at a certain moment past the issuance date invalidate *mudarabah* and *musharakah* contracts, in the opinion of various Islamic scholars. For example, the *Shafi* School holds that a *mudarabah* contract concluded for a specific period is invalid.[843] The *Hanbali* School treats such a contract null and void, because the determination of duration is contrary to the non-

[838] AAOIFI (n 676) Shariah Standard No. 12, clause (3/1/6/1), p.209.
[839] Bernama.com, Malaysian National News Agency, 'KWAP Takes Up RM1 Billion Of MAS' RM2.5 Billion Perpetual Sukuk' (June 12, 2012) http://aviation.bernama.com/printable.php?id=672502 accessed 9th June 2019.
[840] Islamic Markets, 'MAHB Perpetual Subordinated Sukuk (Malaysia Airports Holdings Berhad) 5.75% - 13-Dec-2024 Issue 1' (2014) https://iq.islamicmarkets.com/sukuk/mahb-perpetual-subordinated-sukuk-5-75-13-dec-2024-issue-1 accessed 9th June 2019.
[841] Islamic Finance News, 'Abu Dhabi Islamic Bank leads the way with the world's first Basel III compliant Tier 1 Sukuk issuance' (March 2013) https://www.lw.com/thoughtLeadership/abu-dhabi-islamic-bank-leads-way accessed 9th June 2019.
[842] Muhammad Ramadhan Fitri Ellias et al. (n 821), 145.
[843] Muhammad ibn al-Khaṭīb al-Sharbīnī, Mughnī al-Muḥtāj (1997 Dār al-Maʿrifah), 2: 402, quoted in Muhammad Ramadhan Fitri Ellias et al. (n 821), 145.

binding nature of *mudarabah*.[844] On the other hand, the *Hanafi* School views *mudarabah* contracts where parties have agreed on a maturity date as valid.[845] A similar stance has been adopted by the AAOIFI which reconciled *Shariah* principles on *mudarabah* with considerations of the market.

> *The general principle is that a muḍārabah contract is not binding, i.e., each of the contracting parties may terminate it unilaterally except in two cases:*
>
> *a) When the muḍārib has already commenced the business, in which case the muḍārabah contract becomes binding up to the date of actual … or constructive liquidation;*
>
> *b) When the contracting parties agree to determine a duration during which the contract will remain in operation. In this case, the contract cannot be terminated prior to the end of the designated duration, except by mutual agreement of the contracting parties*[846].

Ellias et al. argue that the above stipulation should be taken to mean that:

> *the determination of maturity period is not regarded as a requirement for the validity of the muḍārabah contract. However, if such maturity period was stipulated and agreed upon in the muḍārabah agreement, the muḍārabah contract and its terms will be contractually binding on the parties.*[847]

It is suggested that such an interpretation of the AAOIFI's statement is confusing, if not misleading. AAOIFI makes it clear that the default position for *mudarabah* contracts is that they are not binding. AAOIFI provides for some exceptions to this rule, however, the first of which is underlined by the objective to avoid disrupting the business' normal operation by unnecessary termination of contracts. The second exception honours the intentions of the parties. While this approach is in tune with the common law's principles, it remains to be seen whether it will be accepted by the stricter Islamic legal Schools. Another point worth considering is that unless there is robust consumer and investor protection framework in place in the relevant jurisdiction, it is not entirely convincing whether all aspects of the contract have been voluntarily entered into by both parties. While the issue of duress is redundant in this case, it is clear that the higher yield

[844] Ibn Qudāmah (1994) (2: 153), quoted in Muhammad Ramadhan Fitri Ellias et al. (n 699), 146.
[845] ʿAbdullāh ibn Maḥmūd al-Mawṣilī, (n.d.), *Al-Ikhtiyār li Taʿlīl Al-Mukhtar*, (Dār al-Fikr al-ʿArabī.), 3:25, quoted in Muhammad Ramadhan Fitri Ellias et al. (n 821), 146.
[846] AAOIFI, 'Shari'ah Standards' (2010), Accounting and Auditing Organization for Islamic Financial Institutions, 235.
[847] Muhammad Ramadhan Fitri Ellias et al. (n 821), 147.

of the *sukuk* instrument compared to bonds attracts investors, including from the conventional financial market. Consider that the *sukuk* index of the S&P Mena, 'which tracks the performance of dollar-denominated investment-grade sukuk issued in the Middle East and African market, posted a 4.47 per cent gain in 2016, in contrast to a 3.99 per cent for the S&P bond index, which includes conventional bonds with the same characteristics.'[848]

As discussed previously, the price of bonds and *sukuk* are linked to interest rates meaning that when the latter rises, the price of the *sukuk* falls. In principle, the effect of the change in interest rate is more pronounced if the duration of the bond is longer. While ordinary *sukuk* are of a shorter duration, which makes them less sensitive to interest rates movements,[849] perpetual *sukuk* is typically of 5 years duration or longer. Consider that when the Malaysia-based multinational corporation Sime Darby came in the *sukuk* market in 2017 for the third time, issuing perpetual *sukuk* of $546.94 million at a yield of 5.65%, it offered a perpetual non-call of 10 years. Yet, this was a highly successful issuance in the sense that it was upsized almost doubly, mostly by investors from Malaysia.[850]

Note also that the overall distribution of *sukuk* issuances with a maturity over 18 months in the Gulf Cooperation Council (GCC) region, Malaysia, Indonesia, Turkey and Pakistan have increased to $40 billion in 2016 compared to $32 billion in 2015, making 28.5% of the total sukuk issuance for these jurisdictions in 2016.[851] This suggests that *sukuk* with longer duration has become very attractive for issuers. At the same time global *sukuk* issuance in 2016 has increased at a smaller rate (2.2%), compared to the year before (5.5%).[852] As an example of recent developments in the area, consider the following:

> *Dubai Islamic Bank PJSC ("DIB"), rated A3 by Moody's (stable) and A by Fitch (stable), successfully closed a USD 750 million Additional Tier 1 (AT1) Perpetual Non-Call 6yrs Sukuk with a profit rate of 6.25% per annum, which is equivalent to*

[848] Renoy Kundukulam, 'The appeal of investing in sukuk' (2017) Gulf News Business, https://gulfnews.com/business/banking/the-appeal-of-investing-in-sukuk-1.1984369 accessed 18th July 2019.
[849] Ibid.
[850] Islamic Finance News, 'Sime Darby's perpetual sukuk: a hybrid instrument' (2017) https://www.islamicfinancenews.com/sime-darbys-perpetual-sukuk-a-hybrid-instrument-2.html accessed 23rd July 2019.
[851] Renoy Kundukulam (n 848).
[852] Renoy Kundukulam (n 848).

366.4bps over the implied 6-year US Treasury yield. The transaction, was only the second AT1 Sukuk under the new Basel III capital guidelines issued by the Central Bank of UAE ("CBUAE") in 2018. This was also the first hybrid capital issuance from the GCC in 2019.[853]

While the Dubai based issuance boasts of having attracted many customers due to its stability, consider that an A3 rating by Moody's is in the lower end of the A generic category - upper-medium grade and subject to low credit risk, as Aaa, Aa1, Aa2, Aa3, A1 and A2 ratings come before A3.[854] Although A3 is still an "investment-grade" rating, which makes it one of the safest on the market, its being at the lower end makes it arguably less than ideal for investment in perpetual *sukuk*. Let's recall that the lower the rating, the greater the possibility to default. At the same time, default is the position at which holders of perpetual bonds (*sukuk* included) are most likely to lose their investment.[855] Importantly, the A3 rating falls into the P-2 (Prime-2) category of Moody's, which is defined as strong ability to repay short-term debt obligations. Note that in the Moody's definition a short-term debt obligation is of less than a year.[856] Perpetual *sukuk* is however not a short-term obligation. Furthermore, note that in the words of Fitch Ratings, which also rates DIB at "investment-grade" level, its

credit ratings do not directly address any risk other than credit risk. In particular, ratings do not deal with the risk of a market value loss on a rated security due to changes in interest rates, liquidity and other market considerations. However, in terms of payment obligation on the rated liability, market risk may be considered to the extent that it influences the ability of an issuer to pay upon a commitment.[857]

In this line of thoughts consider a statement that in May 2019, the 'Kuwait's Capital Markets Authority (CMA) approved Kuwait International Bank's (KIB) request to issue up to $300

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[853] Dubai Islamic Bank, 'Dubai Islamic Bank successfully closes USD 750 million AT1 Perpetual Sukuk' (2019) https://www.dib.ae/about-us/news/2019/01/23/dubai-islamic-bank-successfully-closes-usd-750-million-at1-perpetual-sukuk accessed 19th July 2019.
[854] Investment Grade Moody's, 'Rating Scale and Definitions' https://www.moodys.com/sites/products/ProductAttachments/AP075378_1_1408_KI.pdf accessed 19th July 2019.
[855] Investing Answers, 'A-/A3' (2019) https://investinganswers.com/dictionary/a/a3 accessed 19th July 2019.
[856] Investment Grade Moody's, 'Rating Scale and Definitions' https://www.moodys.com/sites/products/ProductAttachments/AP075378_1_1408_KI.pdf accessed 19th July 2019.
[857] Fitch Ratings, 'Rating Definitions' (2019) https://www.fitchratings.com/site/definitions accessed 19th July 2019.

million perpetual additional Tier 1 capital securities,' aimed at professional investors[858] This comes after a 19.4% year-on-year drop in profits during the first quarter of 2019, reported by the KIB. It is apparent that the bank is considering perpetual *sukuk* in order to assist its adhering to its Basel III capital and long term liquidity regulatory obligations.

The above examples give rise to some doubts in the suitability of perpetual *sukuk* for investors. Although the likelihood of bank defaults does not appear to be looming over *sukuk* holders, it is not inconceivable that the more popular the instrument, the more likely it will be that its market share will continue increasing in the future. It is arguable that the 28.5% achieved in 2016[859] are already a cause for concern. To this end, note that in the words of the International Islamic Financial Market, 'international Sukuk with medium to long term tenors maintained growth in volume during 2017'. This should be seen in the context that the international *sukuk* market remains the driver of the Islamic market forming 'just under 22.3% of overall Global Sukuk issuances since 2001'.[860]

Economists largely agree that inflation increases over time.[861] If this is the case, then the longer the duration of a bond, the greater the advantage of the issuer compared to the investor. As noted above, perpetual *sukuk* gives issuers 'access to relatively cost-efficient funding, which is non-dilutive, compared to a traditional equity instrument,'[862] while being very helpful for the issuer's balance sheet as such instruments are recognised in many jurisdictions (for instance in Malaysia)[863] as equity capital. Issuers make perpetual *sukuk* attractive to investors largely by offering a high yield. In addition to the data discussed above (6.25% per annum offered by DIB), the Al Baraka Banking Group B.S.C (ABG), a Bahrain-based leading Islamic banking group,

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858 ZAWYA, 'Kuwait's CMA approves KIB's $300mln perpetual sukuk' (2019) https://www.zawya.com/mena/en/markets/story/Kuwaits_CMA_approves_KIBs_300mln_perpetual_sukuk-SNG_144588055/ accessed 31st July 2019.

859 Renoy Kundukulam (n 848).

860 International Islamic Financial Market, 'IIFM Annual Sukuk Report April 2018' (2018, 7th Edition), 41.

861 Sami Oinonen, Maritta Paloviita and Lauri Vilmi, 'How Have Inflation Dynamics Changed over Time? Evidence from the Euro Area and USA' (May 1, 2013), Bank of Finland Research Discussion Paper No. 6/2013. https://ssrn.com/abstract=2268417 or http://dx.doi.org/10.2139/ssrn.2268417 accessed 19th July 2019. See also, Lisa Smith (n 698).

862 Islamic Finance News, 'Sime Darby's Perpetual Sukuk: a hybrid instrument' (2017) https://www.islamicfinancenews.com/sime-darbys-perpetual-sukuk-a-hybrid-instrument-2.html accessed 18th July 2019.

863 Bk Sidhu, 'KWAP takes up RM1bil of MAS's RM2.5b perpetual Sukuk (Update)' (2012) The Star, https://www.thestar.com.my/business/business-news/2012/06/12/kwap-takes-up-rm1bil-of-mass-rm25b-perpetual-sukuk-update/ accessed 19th July 2019.

offered issuance 'for an initial 5-year term set at an expected return of 7.875% p.a., with 5-year resets thereafter.'[864] The *sukuk* issue, which is currently listed on the Irish Stock Exchange, helps the ABG comply with its Tier 1 Basel III obligations and is based on *mudarabah*.[865]

It is suggested, however, that the benefits to investors of this particular kind of *sukuk* are much smaller, also because access to issuance which is underrepresented on the conventional financial market need not go through the structure of the perpetual *sukuk*. However, it does, which is evident by the increase in issuance discussed above.

Furthermore, it must be acknowledged that while issuers of perpetual bonds embed a call-out option in them, this does not guarantee that the option will be exercised. This happens in the conventional bond market where if the issuer decides to never exercise this option, investors are left with two options. The first one is to accept repayment in coupons forever and the second, to redeem their principal by selling it on the secondary market. While perpetual *sukuk* is tradable on the secondary market, subject to being underlined by a *murabaha*, *mudarabah* or *wakala* contract, whether the investor would actually be able to sell depends on the bond market liquidity.[866] Very recent evidence that a no call situation can actually happen could be seen in the February 2019 case of Banco Santander (Spanish Bank) where the bank 'chose not to call its 6.25% contingent convertible (CoCo) perpetuals with an amount outstanding of EUR 1.5 billion.'[867] Santander's decision was caused by business considerations, namely the fact that the floating rate coupon which the bank was supposed to pay after the first call date was lower than what the bank would have to pay had it chosen to redeem the bonds and issue new ones.[868]

The perpetual *sukuk* relationship with permanence seems even more troubling if one considers that the lower the credit rating of the issuer, the more likely it becomes that the product will attract private vs. professional investors. For example, Indian conglomerate Reliance Industries (Baa2/BBB) issued in 2013 a senior perpetual offering little guarantee of repayment of the principal. Furthermore, the issuer did not provide for a steep rise of the yields post the first call,

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864 International Islamic Financial Market, 'IIFM Annual Sukuk Report April 2018' (2018, 7th Edition), 90.
865 International Islamic Financial Market, 'IIFM Annual Sukuk Report April 2018' (2018, 7th Edition), 90.
866 CFA, 'Bond Market Liquidity' (2019) https://www.cfainstitute.org/en/advocacy/issues/bond-market-liquidity accessed 19th July 2019.
867 BondEvalue, 'Perpetual Bonds – Key Risks to Know Before Investing' (2019) https://bondevalue.com/news/perpetual-bonds-key-risks-to-know-before-investing/ accessed 19th July 2019.
868 BondEvalue, ibid.

which deterred institutional investors from participation. Despite the apparent investor protection issues with this issuance, Reliance sold an $800million perpetual at the very low yield of 5.875%. The result of the weak bond structure was that the bond performance was one of the weakest for an Asian investment-grade bond in 2013.[869] The problem with this is not limited to the particular investors, however. A decision by a big institution not to call the bond, would affect the entire market, as it would lower investor confidence and with that, the price of bonds of a similar type. This was 'evidenced when Deutsche Bank did not call a lower tier 2 bond in December 2008',[870] causing the drop of the price of similar bonds to $10 and affecting the performance of Deutsche Bank's subordinated credit default swaps.[871]

9.7.2.2. Shariah compliance issue regarding the deferral of Periodic Distribution Amount (PDA)

While 2008 may seem too far back (and too close to the financial crisis), data from 2016 indicates that the performance of European bank stocks that year was at best underwhelming resulting, *inter alia*, in a rapid rise of their credit default swaps (CDS).[872]

In December 2015, EBA issued regulatory guidance which was later supported by the ECB, which indicated that 'Pillar 2 capital requirements be positioned below the CBR (Combined Buffer Requirement), increasing the minimum capital a bank needed before it could distribute earnings (e.g.: AT1 coupon payments and dividends)'.[873] This meant that unless a bank was able to cover the Pillar 1, Pillar 2 and CBR requirements, it would have to comply with an MDA (Maximum Distributable Amount) calculation which would in a result limit PDA. The guidance made it possible to conceive that a coupon deferral was within the possibilities, despite the fact that every investor in perpetuals is motivated to invest in them trusting that a coupon deferral will never happen. Another consideration added to the risk of coupon deferral is that, falling AT1

[869] Christopher Langner, 'Bond investors troubled by lack of maturity' (2013) Reuters, https://www.reuters.com/article/perpetual-bonds/bond-investors-troubled-by-lack-of-maturity-idUSL1N0AZ1YN20130131 accessed 19th July 2019.
[870] Ibid.
[871] Christopher Langner, ibid (n 869).
[872] Barry Norris, 'Anatomy of the European Banks Rout – AT1 bonds' (2016) Next Finance, https://www.next-finance.net/Anatomy-of-the-European-Banks-Rout accessed 19th July 2019.
[873] Barry Norris, 'Anatomy of the European Banks Rout – AT1 bonds' (2016) Next Finance, https://www.next-finance.net/Anatomy-of-the-European-Banks-Rout accessed 19th July 2019.

prices reduce the prospect that the perpetuals will be called at the first call date, because calling them at 'low prices (and thus high yields), means refinancing costs increase rather than decrease for banks.'[874] The effect of this is that investors should start looking at the "yield to perpetuity" rather than the "yield to call" which eventually lowers the price of the bond further.[875] Ultimately, this movement is likely to affect the ability of bond holders to sell their investment on the secondary market, which has not unfortunately looked very liquid, because of a combination of falling bond prices and regulatory constraints affecting the ability of investment banks to step in and increase the liquidity in the market. This situation explains why investors have turned to CDS in order to hedge the risk from the perpetuals.

EBA's opinion has consistently been that '[t]he full flexibility of payments on AT1 instruments is, in this respect, a key feature, and altering it could create the expectation that coupons will always be paid.'[876] Such expectations, in the view of EBA would lower confidence in the loss-absorbing capacity of the AT1 instruments. Let's not forget that the Capital Requirement Regulation (CRR)[877] stipulates that in order to qualify as Additional Tier 1 instruments, they must be 'perpetual and the provisions governing them include no incentive for the institution to redeem them'.[878] Furthermore, such instruments must not be 'subject to any arrangement, contractual or otherwise, that enhances the seniority of the claim under the instruments in insolvency or liquidation'.[879] At the time of writing, the debate on AT1 instruments in the EU is ongoing, as is the review of the CRR. The main amendments proposed to the CRD IV package set, relevant to this discussion, include 'a binding leverage ratio (LR) to prevent credit institutions from using excessive borrowed capital compared to own funds [and] a harmonised standard for how much stable, long-term sources of funding an institution needs (net stable funding ratio, NSFR)'.[880] It appears that the position adopted by the EBA would be that there should be no

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[874] Ibid.
[875] Barry Norris (n 873).
[876] European Banking Authority, 'Opinion of the European Banking Authority on own funds in the context of the CRR review' (2017), EBA/OP/2017/07, para 14.
[877] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance OJ L 176, 27.6.2013, p. 1–337.
[878] Ibid, Article 52 (1)(g).
[879] CRR (n 877), Article 28(1)(m).
[880] European Parliament, 'Amendments of the Capital Requirements Directive/Capital Requirements Regulation' (2017) http://www.europarl.europa.eu/legislative-train/theme-deeper-and-fairer-internal-market-with-a-strengthened-industrial-base-financial-services/file-crd-crr-amending-capital-requirements accessed 19th July 2019.

change in the pecking order privileging AT1 instruments[881] which means that there should be no change 'to the absence of order in the restrictions on distributions.'[882] The basis of the EBA's opinion was that the CRR does not allow dividend stopper in the EU,[883] which is contrary to Basel rules. Furthermore, EBA holds that if any change to the *status quo* is introduced, something which the EBA is opposed to, it has to be aligned with a change in the legislation.[884]

In the Islamic regulatory environment, deferral of PDA is a necessary condition for the acceptance of perpetual *sukuk* as equity for accountancy purposes. Furthermore, the issuer is entitled to pay the entire or only part of the distributional amount or to defer it altogether, subject to giving a prior notice to investors.[885] Ellias et al. note that there could be arguments that, at least when the underlining contract is a *musharakah*, the deferred payment arrangement contradicts the principles of *Shariah* regarding the objectives of a partnership. *Shariah* requires that all partners receive their profit at the profit distribution date. In order for a *musharakah* to be valid, all parties must agree at the point of signing of the contract what proportion of the profit each of them will be entitled to.

Despite the above, Ellias et al. argue that on this particular occasion, there is no violation of *Shariah*'s rules, because the parties have agreed in advance to this and because the profit has been realized, it is only a matter of when it will be paid out to the *sukuk* holders. It is arguable, however, that this justification is a legalistic exercise devised to excuse an otherwise inexcusable, from a *Shariah* perspective, practice. To this end, *Shariah* postulates that all profit should be distributed and not that profit should be accrued. Furthermore, even if one accepts that the contractual parties agreed to the deferral *ex ante*, the rules on perpetual *sukuk* include that the issuer has the right not to pay the PDA at all (non-cumulative profit deferral) without this leading to the dissolution of the contract. This point has not escaped Ellias et al. who admit that a decision by the issuer not to pay the accrued profit at all would contradict the *muqtaḍā al-ʿaqd of*

[881] EBA, Opinion, (n 876) para 12.
[882] EBA, Opinion, (n 876)para 14.
[883] CRR (n 749), Articles 52 (1)(l)(v) and 53(b). Note that in the EBA's opinion, 'dividend pusher and stopper clauses interfere with the institution's flexibility to cancel distributions on other classes of capital instruments', EBA, 'Single Rulebook Q&A' (2013) https://eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2013_46 accessed 2nd September 2019.
[884] EBA, Opinion (n 876), para 12.
[885] Muhammad Ramadhan Fitri Ellias (n 821), 149.

muḍārabah, which entitles investors to receive their share of the venture's profit.[886] As the authors acknowledge:

> *This is the most contentious issue in AT1 capital perpetual ṣukūk. Though some might argue that tanāzul (relinquishing one's right) granted upon establishment of the contract can be the solution, the following Sharīʿah issues need to be scrutinised:*
>
> *1. Can the tanāzul be granted up-front when the subject of waiver has yet to be materialised?*
>
> *2. The non-payment of realised profit is considered a violation of muqtaḍā al-ʿaqd of muḍārabah/mushārakah. Can tanāzul be applied to justify the non-payment?*[887]

In addition, the position of AAOIFI on non-payment of profit can be indirectly deduced by its stance on the validity of step-up arrangements. AAOIFI has no objections to this practice, which is *Shariah* compliant, as long as the 'method does not lead to the likelihood of a partner being precluded from participation in profit'.[888]

However, Ellias et al. base their argument regarding deferral of PDA on the suggestion that such practices are accepted under *Shariah* as long as 'all contracting parties consent to such practice in all circumstances'.[889] This is based on the verse from the *Qur'an* "O you who believe, fulfill your undertakings",[890] on the hadith: "All the conditions agreed upon by Muslims are upheld"[891] and on the legal maxim: "The original ruling of the contract is the mutual consent of the contracting parties, and its consequences (obligation and rights) are as per the agreement in the contract".[892]

This position is certainly shared by the AAOIFI, which states that

> *It is permissible, based on the articles of association or a decision of the partners, not to distribute the profits of the company. It is also permitted to set aside periodically a certain ratio of profit as a solvency reserve or as a reserve for*

[886] Ellias (n 821), 154.
[887] Ellias (n 821), 154.
[888] AAOIFI (2010) in its Sharīʿah Standard No. 12, clause 3/1/5/5.
[889] Muhammad Ramadhan Fitri Ellias (n 699), 150.
[890] Qur'ān (n 209), 5: 1.
[891] Sunan Al-Tirmidhī, 2000: ḥadīth no. 1352 in Muhammad Ramadhan Fitri Ellias (n 699), 150.
[892] al-Zarqā, 1989: 482) in Muhammad Ramadhan Fitri Ellias (n 821), 150.

meeting losses of capital (investment risk reserve) or as a profit equalisation reserve.[893]

It is apparent that the feature of profit deferral is one of the fundamental features of perpetual bonds/perpetual *sukuk*. Without this feature, the instrument will be deficient in the sense that it will not be able to serve its purpose as *quasi*-equity and by extension, as an AT1 instrument. Furthermore, contractual freedom and the principle that the intentions of the parties must be honoured are seen as paramount in the common law.[894] This aligns the principles of Islamic law, discussed above with these of the common law, which is not surprising given the link between the two.

However, given certain historical links, Islamic law has absorbed some influence from the French Civil Law system. The French approach is much more paternalistic, compared to the common law one, with much less emphasis on the intentions of the parties than on the sensibility and viability of the contract. To exemplify this, it suffices to look at a leading French case[895] where 'a contract to create a video rental shop between the lessor and lessee in a rural community was voided for lack of cause, as it became apparent that the venture was doomed to fail as the shop was to be based in a rural community and thus was not economically viable'.[896] In the same situation it is likely that 'a common law court would ultimately not have reached the same result as there is little room for a judge to impinge upon parties' contractual autonomy to spare them from what turns out to be a bad bargain'.[897]

It is true that on this particular occasion, Islamic law displays a closer resemblance to the common law. There are, of course, many convincing arguments why it is practical that the stance on perpetual *sukuk* remains as it is; above all, from a *Shariah* point of view, the jurisprudential evidence is sufficient to merit the acceptance of the AAOIFI's approach. It is arguable, however,

[893] AAOIFI, ' Sharīʿah Standards' (2010) Shariah Standard No. 12, clause 3/1/5/14.
[894] Ashurst, 'Interpretation of contracts under English law' (2019) https://www.ashurst.com/en/news-and-insights/legal-updates/interpretation-of-contracts-under-english-law/ accessed 18th August 2019.
[895] lst Civil chamber of the Cour de Cassation on 3 July 1996 (Cour de Cassation, Chambre civile 1, du 3 juillet 1996, 94-14.800, Publié au bulletin.
[896] Beatrice Castellane, 'Continental Civil Law v Common Law in International Contractual Disputes' (2019), Cabinet Castellane Avocats, http://www.cabinet-castellane-avocats.fr/pdf/2018-03-26-civil-law-v-common-law-beatrice-castellane-paris-cle.pdf, accessed 18th August 2019, 6.
[897] Ibid.

that on this occasion French law would have been more suited as in this scenario protection of investors could have been at play. Furthermore, it is conceivable that Islamic law recognises some principles as overriding others (which is something characteristic for every mature legal system). For example, *Shariah*'s drive towards fairness and justice is so fundamental that when comparing it to the principle that the intentions of the parties in a contractual arrangement should be respected, the latter may be/should be perceived as subordinate to the former.

Furthermore, adopting this approach may be justified on the premise that the power of contractual parties is rarely equal. Asymmetry of power becomes more disturbing when one of the parties is a bank, a government, or an economically-significant institution such as the Malaysian Airline System Bhd (MAS), discussed by Ellias et al. in one of the case studies.[898] When such situations arise, one must ask what has made entering into the transaction so important for potential holders that to merit the acceptance of the risks discussed earlier. Research of this author has indicated two possible reasons for such investors' behaviour.

1) Scarcity of supply

While there are a number of *sukuk* instruments available to prospective investors, which prima facie would eliminate scarcity as incentive, data indicates that the global issuance of *sukuk* is insufficient to meet the demand of the market. Furthermore, since 2016 there is certain stagnation in issuance although the interest among investors appears to be strong. The IIFM 2018 Report states that '[o]n the back of record number of global Sukuk issuances during 2012 to 2017, the outstanding Sukuk issuances in 2017 reached USD 434.8 billion as compared to USD 367 billion in 2016 which is a clear indication of growing interest in Sukuk though supply and demand gap remains to be bridged.'[899]

2) Economic incentives

It appears that countries willing to introduce *sukuk* in their financial system have done so successfully by offering a number of economic incentives to both issuers and investors. Such policy of incentives typically starts with the introduction of a tax-neutral regime, the purpose of

[898] Muhammad Ramadhan Fitri Ellias et al. (n 821).
[899] International Islamic Financial Market, 'IIFM Annual Sukuk Report April 2018' (2018, 7th Edition), 73.

which is to make *sukuk* competitive to conventional bonds. In addition to tax-neutrality, countries tend to introduce tax deduction schemes and/or waivers.[900]

For example, Malaysia had provided for tax neutrality in the Income Tax Act 1967, also waiving stamp duty for Islamic securities issued under MIFC until 2020. Furthermore, Malaysian-based SPVs enjoy exemption from administrative tax procedures. In addition, expenses incurred during the issuance of *sukuk* are deductible from Malaysian tax. Lastly, Malaysia has liberalised withholding taxes in order to attract foreign *sukuk* issuers or investors.[901] The result is that Malaysia has provided a number of tax positive measures, in addition to the initial tax-neutral regime. This approach has proved to be successful at giving advantage to *sukuk* over conventional bonds.[902] One of the significant tax incentives provided for in Malaysia is the deduction of issuance costs for *sukuk*. As a result of the market-driven tendency to adopt only internationally-recognised Islamic contracts this incentive 'moved from sale-based contracts (particularly BBA, bay' al-inah) to partnership, lease, agency and selected sale-based contracts (i.e. ijarah, musharakah, mudarabah, murabahah based on tawarruq).'[903]

A bracket must be opened here that the market-influenced tendency to work with contracts acceptable in a conventional environment, drives the framework of Islamic contracts more deeply into a state of mimicking. As discussed on a number of occasions in this work, while commercially justified, this policy is loaded with potential challenges. The main issue here is that the patching of features belonging to conventional and Islamic instruments, in order to create a novel product acceptable under two fundamentally different sets of financial ideology, needs a correspondent framework of protections with respect to investors and market stability. Right now, however, *sukuk* is far from uniformly accepted in either of its target jurisdictions.

It is arguable that such lack of protections may ensue as a result of other pertinent legislative changes. As a possible example, consider the Malaysian Securities Commission's decision to remove the mandatory credit rating requirement from January 2017 onwards. Credit ratings and

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[900] COMCEC (Standing Committee for Economic and Commercial Cooperation of the Organization of Islamic Cooperation), 'The Role of Sukuk in Islamic Capital Markets' (2018) COMCEC Coordination Office, Proceedings of the 10th Meeting of the COMCEC Financial Cooperation Working Group http://www.comcec.org/en/wp-content/uploads/2018/05/10-FIN-PRO.pdf accessed 15th July 2019, 2.
[901] Ibid, 31.
[902] COMCEC, (n 900), 40.
[903] COMCEC, (n 900), 84.

credit rating agencies (CRAs) form a big part of the regulatory discussion post the 2008-2009 crisis, due to its unfortunate contribution (from Enron in 2001 to Lehman Brothers in 2008)[904] to the US and global financial collapse. CRAs are credited with determining the size of investor pool since “investment-grade” ratings draw buyers from a much larger pool instead of only drawing ‘financing from investors willing to invest in speculative-grade investments (a much smaller pool of investors.)’[905] Furthermore, CRAs are said to determine the price and yield of a bond bringing the price of higher-quality bonds at a premium to face value and offering yields substantially lower than non-investment-grade bonds. With this, CRAs determine the value of the stock, because ‘better bond ratings should lead to falling bond yields and higher stock prices, as they are all related in capital asset pricing models.’[906] It is evident therefore that CRAs address ‘the information asymmetry between issuers and investors: [becoming] reputational intermediaries that bridge the information gap.’[907]

CRAs are, therefore, instrumental to issuers, market and investors. With respect to the former, they lower the cost of funding. They help the market since, among other things, they prompt issuers to self-discipline in order to preserve or improve the already obtained rating. As to investors, CRAs direct them among the many choices towards issuances of higher quality and issuers that are less likely to default on their payments.[908]

Statistics for the rate of default regarding corporate bond (inclusive of *sukuk*) issuance in Malaysia during the period 1997-2009 highlight that there were 49 Issuers and 70 issuances taking place in the period. As far as *sukuk* is concerned, there were 24 default cases, mostly structured on *murabaha* and *Bai Bithaman Ajil* (*BBA*) contracts.[909] A look at the initial credit ratings of the defaulted issuers tells us that the issuance was largely treated as “investment-grade”

[904] Lawrence J. White, ‘Markets: The Credit Rating Agencies’ (2010) 24(2) Journal of Economic Perspectives Number 211, 218.
[905] BIX, ‘Why is Credit Rating Important for Bond and Sukuk?’ (2019) https://www.bixmalaysia.com/Learning-Center/Articles-Tutorials/Why-is-Credit-Rating-Important-for-Bond-and-Sukuk accessed 21st July 2019.
[906] Ibid.
[907] Frank Partnoy, ‘What’s (Still) Wrong with Credit Ratings? (2017), 92 Washington Law Review 1407, 1409.
[908] Francisco Endara Flores, ‘Does the regulation adopted in the US and EU in the aftermath of the financial crisis for Credit Rating Agencies (CRAs) resolve the Conflict of Interest (CI) the 'issuer-pays’ business model of CRAs creates between issuers and raters? (2017) 3(2) The Latin American and Iberian Journal of Law and Economics 1.
[909] *BBA* contracts will not be discussed in detail here. However, these are sale contracts similar to *murabahah* but with a deferred payment. They are also known as Bay’ al Muajjal (e.g. Pakistan) or Bay’ Muazzal (Bangladesh) – see Islamic Markets,’ Bai Bithaman Ajil’ (2019) https://islamicmarkets.com/education/bai-bithaman-ajil accessed 21st July 2019.

with subsequent revision and deterioration of grading as the default situation progressed.[910] The outcome of so many defaults is inevitably losses borne by investors and lack of reputation borne by issuer and by extension, the Malaysian financial market. To this end, the decision of the Malaysian Securities Commission to remove the mandatory credit rating may seem slightly rushed, particularly considering that according to theorists, 'defaults and potential defaults of sukuk was not caused by the fact that they are Islamic financial products, but driven by the market and credit risks. In other words, a sukuk default was not caused by faulty structures, but mainly due to the creditworthiness of the issuer.'[911] Still, what preserved the Malaysian system was a robust regulatory system where *sukuk* investors enjoyed the same level of protection as ordinary bond investors. This was not unfortunately what happened in cases of defaulted *sukuk* taking place in other countries.

Going back to Malaysia, currently, there are two rating agencies that have been approved by the Malaysian Securities Commission. These are RAM Rating Services Berhad (RAM Ratings) and Malaysian Rating Corporation Berhad (MARC). These agencies are national and their credit ratings are not comparable internationally. They measure only credit risk and do not address liquidity risk, the risk of the issuance losing its market value or the specific default probabilities of the assessed issuer.[912]

The removal is only one of the measures undertaken by the Malaysian government aiming at liberalization of the financial sector and broadening of the corporate bond market.[913] The move has been justified with claims that the withdrawal would align Malaysia to other developed countries allowing 'market forces to determine the added advantage of independent credit opinions'.[914] Although legislation requires that unrated bonds need regulatory approval prior to issuance, subject to the approval being obtained, such bonds become fully tradeable and

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[910] Shahida Shahimi, 'Sukuk Defaults and Its Implication: A Case Study of Malaysian Capital Market' (n.d.) 8th International Conference on Islamic Economics and Finance, https://www.academia.edu/1217021/Sukuk_Defaults_and_Its_Implication_A_Case_Study_of_Malaysian_Capital_Market accessed 21st July 2019.

[911] Mohd Faizal Kamarudin et al. 'Defaulters profile in Malaysia Sukuk market' (2014)145 Procedia - Social and Behavioral Sciences 277, https://www.academia.edu/15828482/Defaulters_Profile_in_Malaysia_Sukuk_Market accessed 21st July 2019, 278.

[912] BIX (n 905).

[913] Lidiana Rosli, 'Malaysian bond market to remain robust: CIMB' (2017) https://www.nst.com.my/business/2017/08/265020/malaysian-bond-market-remain-robust-cimb accessed 21st July 2019

[914] COMCEC, (n 900), 86.

transferable.[915] The government hoped that by removing the mandatory credit ratings for corporate bonds it would create stimulus for issuers of lower means to join the market place, until now populated predominantly by highly-rated issuers. The lower issuance costs were expected to 'further boost issuance and diversify the market.'[916] The result has been that investors showed interest in these unrated bonds whereas issuance of unrated bonds increased to 17-18 % during the first half of 2017. While the new measure is liberating for the business, the government admitted that 'unrated bonds comes with its own risk and the onus is on investors to do they own due diligence prior to investing'.[917]

The possibility should nevertheless be admitted that the decision of the Malaysian Securities Commission has been prompted by investor-protection considerations reflecting the problems accompanying CRAs in the last two decades. Taking into account that issuer-paid CRAs are marred by a persistent "conflict of interest" (CI) business model, and their measurements of the potential credit risk of financial institutions is an opinion, often misguided, not fully informed or plainly impacted by the CI, such shift from paternalism towards a system where investors are relied on to do their due diligence independently, makes sense.

Investors/issuers incentives in other Muslim populated countries follow a similar path. For example, in Hong Kong, conventional bond and *sukuk* are treated in the same way for tax purposes. In addition, individual investors in retail *sukuk* are given tax rebates. Following the Hong Kong Inland Revenue and Stamp Duty Legislation Ordinance 2013, additional profit tax and stamp duty charges prior to *sukuk* issuance have been removed. Nigeria exempted all categories of *sukuk* from Companies Income Tax, Personal Income Tax, Value Added Tax, Capital Gains Tax and Stamp Duties. In addition, holders of *sukuk* 'are exempted from withholding, state and federal income, and capital gains taxes.'[918]

Through the 2010 Taxation Laws Amendment Act, South Africa introduced tax neutrality with respect to *murabahah*, *mudarabah* and diminishing *musharakah* contracts. The TLAA 2010 recognised the equivalence between these contracts and other conventional contracts. The United Kingdom accepted *sukuk* as 'securities' for tax purposes in the 2007 Alternate Finance Investment

[915] Rosli (n 913).
[916] Rosli (n 913).
[917] Rosli (n 913).
[918] COMCEC, (n 900), 31.

Bond (AFIB) introduced by the Finance Act of 2007. The Finance Act eliminated VAT and stamp duty on transfer of certificates.

Furthermore, Turkey introduced Law No.6111 in 2011, providing *sukuk* with either tax exemption or favourable tax treatment, reducing its withholding tax on *sukuk* and deeming *ijarah sukuk* issuance tax neutral. Turkey granted tax neutrality to *wakalah*, *murabahah*, *mudarabah* and *istisna'* by introducing a 2016 law, amending the Stamp Tax Law, VAT Law and Law on Charges.

Indonesia removed withholding tax on interest payments for all types of government securities, including sukuk. Furthermore, since 2016 the Indonesian Financial Services Authority (Otoritas Jasa Keuangan (OJK) lowered the registration fees for corporate *sukuk* issuances, thus making issuance cheaper.[919]

Another significant incentive impacting on investors' appetite is the greater competitiveness of *sukuk* yields compared to those of conventional bonds. In the acknowledgment of the Standing Committee for Economic and Commercial Cooperation of the Organization of the Islamic Cooperation (COMCEC), this has created 'an environment which, in combination with the various tax and regulatory incentives, provides that tipping point [for sukuk] to become the preferred choice for issuers.'[920]

The above reiterates that the attention of global regulators has been focused firmly on the issuer; it is unclear, however, whether there has been any change in the respective investor protection framework to reflect these developments in a holistic and uniform way.

9.7.2.3. With regard to deferral of unrealised return

Deferral of unrealized return takes place in scenarios where the project fails to deliver the expected profit or incurs losses. As a consequence of this, the issuer becomes unable to continue paying the PDAs due under *sukuk musharakah*. Perpetual *sukuk* provides for a solution in such an event, which solution however, could, according to some views, be rendered incompliant with

[919] COMCEC, (n 900), 32.
[920] COMCEC, (n 900), 87.

Shariah principles. In the event of unrealized return, the parties proceed to dissolve the *musharakah* venture by exercising the purchase undertaking. Following that, the exercise price is applied as an investment in a new *musharakah* venture. In order to evidence the constructive payment of the exercise price *vis-à-vis* the dissolution and reinvestment, the respective accounting entries are reflected in the books of the managing partner. This restructuring of the original venture could be triggered by the *sukuk* holders, pursuant to the purchase undertaking granted to them at the point of concluding the contract by the issuer.[921] The new *musharakah* venture has capital comprising of the deferred return plus the original capital. By employing this method, the issuer avoids applying its debt to the capital of the new venture (doing so would be unacceptable under *Shariah* rules). Instead the issuer buys out the investors' interest in the original *musharakah* venture in cash or kind, which is permitted in Islamic finance.[922] The problem with this arrangement is that it would work out only if the new venture is commercially successful; if not, the buyout/reinvest exercise should be repeated until such time that a successful formula has been arrived at.

9.7.2.4. With regard to capitalisation of the deferred PDA

A similar situation may arise if the profit payment is distributed post the periodic distribution date. In principle, issuers are entitled to elect whether to pay on time or to defer the payment. Subject to the payment being deferred, issuers have two options. First, they could pay at a later date without capitalizing the return. This means that investors will receive the expected amount, albeit on a later date. This was the option chosen by the Malaysian Airline System Bhd (MAS or MAB).[923] Alternatively, issuers could choose to capitalize the PDA. From the perspective of investors, this is the more beneficial option because in a capitalization scenario, investors receive

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[921] Ellias et al., (n 821), 151.
[922] Ellias et al., (n 821), 151.
[923] BK Sidhu, 'KWAP takes up RM1bil of MAS's RM2.5b perpetual Sukuk (Update)' (12 June 2012) https://www.thestar.com.my/business/business-news/2012/06/12/kwap-takes-up-rm1bil-of-mass-rm25b-perpetual-sukuk-update/ accessed 9th June 2019.

a greater amount than the original PDA. This was the case with the perpetual sukuk issued by Malaysia Airports Holdings Berhad (MAHB).[924]

Both MAS and MAHB issuances had stipulated that the perpetual *sukuk* is redeemable after 10 years, on the optional call of the issuer. Note, however, that while no concerns have so far been expressed regarding the issuance of MAHB, the future of MAS's RM2.5b perpetual *sukuk* appears troubling. Data indicates that 'MAB lost a staggering MYR812 million (USD196 million) for the financial year 2017 (see below), adding to the MYR439 million and MYR1.13 billion losses in 2016 and 2015, respectively.'[925] The company's fragile finances make the perspective of profitability uncertain. Consider the following excerpt:

> *The airline – which received a MYR6 billion bailout from Khazanah Nasional in 2014 – has now accumulated total losses of nearly MYR2.4 billion in the last three years since it was delisted end-2014. It filed its 2017 financial statement only in August.*
>
> *In an interview with The Edge on 8 September, the airline's CEO spun a sexy story that MAB doesn't need more money from the government but he cleverly omitted one key point: the MYR812 million losses in 2017.*
>
> *He also failed to mention that by 2022, MAB would need to come up with a MYR5 billion payment for a Sukuk bond the company issued in 2012. How will MAB pay for this?*[926]

Apart from the implications for its investors, the case of MAS underlines that the problematic character of some of the aspects of the perpetual sukuk should not be ignored.

[924] Malaysia Airports, 'MAHB's Perpetual Subordinated Sukuk Wins The Asset's Coveted Best Local Currency Sukuk 2015' (2015) https://www.malaysiaairports.com.my/media-centre/news/mahbs-perpetual-subordinated-sukuk-wins-assets-coveted-best-local-currency-sukuk accessed 9th June 2019.
[925] Endau Analytics, 'Massive losses at Malaysia Airlines, again' (10 September 2018), https://endauanalytics.wordpress.com/2018/09/10/massive-losses-at-malaysia-airlines-again/ accessed 25th August 2019.
[926] Ibid.

Similarly to deferral of unrealized return, discussed above, the practice of capitalization of return could be deemed *ribā al-nasīʾah* (interest arising from deferment) and/or *qalb al-dayn* (debt rollover), both of which are forbidden under *Shariah*. Capitalization is, however, admitted on the premise that the increase in the payment amount is regarded as additional investors' capital, justified by the reinvestment activity. To recall, the same justification is applicable in the case of deferral of unrealized return discussed above. Ellias et al. suggest that as long as the capital is reinvested, issues of *ribā al-nasīʾah* (interest arising from deferment) and/or *qalb al-dayn* (debt rollover) do not arise.[927] However, it is arguable the practice could open perpetual *sukuk* to accusations of being true to Islam only in form but not in spirit. Such accusations are not new in the context of Islamic Finance and for the time being, the industry has been successful at avoiding them putting a stop to its development. What is worth examining, nevertheless, is whether the combination of jurisprudential uncertainty and lack of conceptual purity may affect the two main markers of interest to financial regulators, namely investor protection and systemic stability. It is suggested that perpetual *sukuk* has a potential to cause some disturbance. This need not happen, however, if the industry comes to an agreement with religious scholars on all contentious points, if it succeeds to reconstruct the instrument into something more robust and flexible *and* if the relevant legislative framework is further developed and harmonised in order to create legal certainty for all stakeholders.

In the case of banks, however, it is understandable that considerations of investor protection must be balanced out against considerations of systemic stability – which are the basis of the Basel III requirements.

Apart from transitioning towards novel iterations of *sukuk*, other measures undertaken by issuers with the idea of attracting investors include offering securities of fixed revenue where any risk that the value of the underlying asset will decrease is covered by the issuer or originator, via insurance policies.[928] While risk insurance is nothing new for conventional finance, the resort to insurance is problematic in the Islamic finance context because it undermines the fundamental principle of risk sharing. The importance of this point is significant, because it underlines the

[927] Ellias et al., (n 821), 153.
[928] Pegah Zolfaghari, 'An Introduction to Islamic Securities (Sukuk)' (2017) Uppsala Faculty of Law Working Paper 2017:2, 2.

argument that the lines between the conventional and Islamic finance framework have become increasingly blurred.

9.8. Interim overview of findings

As the above extensive analysis made clear, there are certain similarities and differences between the Islamic and conventional bond as well as between *sukuk* and shares. Looking at them in detail may give better insights into the nature of *sukuk* and how it complies with the fundamental principles of Islamic law.

For the purposes of clarity, Table.1 below compares *sukuk* to a conventional fixed-income bond and Table.2 outlines the comparison between *sukuk* and shares.

	Conventional Fixed-Income Bonds	**Sukuk**	**Preferred Shares**
Used to fund extensive projects	Yes	Yes	No
Based on debt only	Yes	No	No
Based on equity only	No	No	Yes
Based on a mix of debt and equity	No	Yes	No
Based on tangible assets	No	Yes	No
Periodic returns	Yes	Yes	Yes
Interest-based returns	Yes	No	Yes
Predetermined yields	Yes	No	Yes
Profit-based returns	No	Yes	No*
Use of SPV	No	Yes	No
Shared ownership of assets	No	Yes	Yes
Shared profit and loss	No	Yes	No**

Voting Rights	No	No	No
Control over the asset	No	No	No
Priority right over other creditors in case of bankrupt	Yes	Yes	Yes
Return of principal	Yes	Yes	Yes***
Buying back at maturity	Yes	Yes	No

Table 1. Source: author

**With some exceptions*

***With some exceptions*

**** In the case of shares, this works in a different way.*[929] *For example, sukuk allows return of capital via buying back at maturity. There is no buy back in shares.*

Alternatively, one could use the below table in order to compare conventional bonds to *sukuk*:

EXHIBIT 2 Sukuk Versus Conventional Bonds[930]

Islamic *Sukuk*	Conventional Bonds
***Sukuk* represent ownership stakes in existing assets.**	Bonds represent debt obligations due from the issuer to the investors.
The assets underlying a *sukuk* issuance must be Islamically permissible in their nature and use.	Bonds may be issued to finance any purpose be it Islamically valid or not.

[929] Adam Hayes, 'Return of Capital' (2019) Investopedia, https://www.investopedia.com/terms/r/returnofcapital.asp accessed 24th June 2019.

[930] The table is reproduced from S R Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', The Journal of Structured Finance [2009] 58, https://www.academia.edu/6164679/An_Overview_of_Islamic_Sukuk_Bonds_AND_SABAHUDDIN_AZMI accessed 25th June 2019, 61.

The subject of the contract in *sukuk* is a permissible Islamic contract or a defined business undertaking between the *sukuk* holders and the originator.	The relationship between bond holder and bond issuer is that of a lender/borrower, i.e., a contract whose subject is purely earning money on money (riba-usury).
***Sukuk* represent legal/beneficial interests in specified tangible assets and/or services and/or projects.**	Conventional bonds are debt investments offering fixed or variable rates of interest.
The sale of *sukuk* represents a sale of a share of an asset.	However, the sale of bonds is basically the sale of debt.
***Sukuk* prices are market driven and depend on the appreciation and depreciation of the market value of the underlying assets.**	Bondholders generally solely depend on the creditworthiness of the issuer and do not rely directly on specific assets.

The above table takes stock of the differences in the nature of the obligations forming part of the respective instrument: for *sukuk* this would be ownership of existing assets whilst bonds represent debt obligations without any link to equity. Furthermore, the authors rightly point out that bonds could finance any type of project, whereas *sukuk* is limited to *Shariah* compliant ones. This is linked to the permissibility under *Shariah* law of the subject of the contract in *sukuk*, which is contrasted to the lender/borrower relationship, inherent in bonds. This takes stock of the fact that the application of interest on the money lent (forbidden in Islam) is the only basis for profit for bonds investors. Linked to that, the table demonstrates that while *sukuk* confers beneficial interest on its respective holders and the sale of the certificate amounts to a sale of a share in the asset, bond holders have but an interest-based debt investment and the sale of the bond is merely a sale of debt.

Last but not least, the table indicates that profits from *sukuk* are typically market driven – therefore, they can rise and fall with the performance of the asset. Conventional bonds have predetermined returns and the bond holder would typically be interested in the creditworthiness of the issuer rather than the value of the underlying project. The bottom line here is that *sukuk* holders are more likely to display due diligence and join projects that are economically sound, which should potentially lead to greater market stability. On a more philosophical note, Muslim investors are always encouraged to invest their money in projects and businesses beneficial to society and the environment. This means that in ideal conditions, *sukuk* investment is more likely to be ethical, sustainable and in line with the interests of the collective than its conventional counterpart.

	Common Shares	Preferred Shares	Sukuk
Used to fund projects	No	No	Yes
Representing units of ownership interest in a corporation	Yes	Yes	No
Representing units of ownership interest in a financial asset	Yes	Yes	No
Representing units of ownership interest solely in a tangible asset	No	No	Yes
Use of SVP necessary	No	No	Yes
Based solely on debt	No	No	No
Based solely on equity	Yes	Yes	No

Based on a mix of debt and equity	No	No	Yes
Shared profit and loss	Yes	No*	Yes
Based solely on tangible assets	No	No	Yes
Periodic returns	Yes	Yes	Yes
Control over the asset	Yes	No	No
Voting rights	Yes	No	No
Priority right over other creditors in case of bankrupt	No	Yes	Yes
Return of principal	Yes**	Yes**	Yes
Buying back at maturity	No	No	Yes

Table 2: Source: author

**With some exceptions*

*** In the case of shares, this works in a different way.*[931] *For example, sukuk allows return of capital via buying back at maturity. There is no buy back in shares.*

Table 1 demonstrates that although *sukuk* and conventional bonds resemble each other on most of their main parameters (purpose, periodic returns and return of the principal invested amount), they differ on one crucial point – *sukuk* are debt instruments guaranteed by ownership in underlying tangible assets, whereas bonds are very simply put a debt note reflecting a loan between two parties. While they both provide for periodic returns and a return of the principal at maturity, bonds work with interest and *sukuk* do not. Instead of providing for predetermined yields, *sukuk* offer return only if there is a profit from the investment.

[931] Adam Hayes, 'Return of Capital' (2019) Investopedia, https://www.investopedia.com/terms/r/returnofcapital.asp accessed 24th June 2019.

This is a particularly significant point because it places the instrument in line with *Shariah*'s parameters –as has been mentioned numerous times - *Shariah* rejects profiting from interest and promotes the engagement of investors with the project at hand. Furthermore, *sukuk* provides for shared ownership of assets which is a logical consequence of the profit sharing aspect and, in comparison to bonds, makes the respective investor far more interested in the nature and prospects of the project.

As to the former, ownership suggests greater responsibility borne by the investor with respect to the rest of the investors, as well as the Muslim community, as regard forbidden by *Shariah* products and services. Of course, giving part of the project to investors in the form of units of ownership could potentially expose the originator to greater public scrutiny, although this will be moderated by the lack of voting rights and control inherent in *sukuk* (similarly to bonds). Lastly, as is the case with bonds, should the originator go bankrupt, *sukuk* holders enjoy priority over the rest of the creditors. This is, without a doubt, a very attractive feature of the instrument and one that should be preserved if any calibration of it takes place in the future.

With respect to the comparison between *sukuk* and **preferred shares**, Table 1 demonstrates that both *sukuk* and preferred shares allow for periodic returns and shared ownership of assets although in the case of *sukuk*, ownership interest is represented solely as regard a tangible asset. Furthermore, shares, in general, are units of ownership interest in a financial asset or a corporation. In contrast, the ownership interest in *sukuk* typically pertains to a project. Lastly, both *sukuk* and preferred shares give the respective holder a priority right over other creditors in case of bankrupt and a right to return of the principal. Note that in the case of *sukuk*, this is expressed by the right to have the investment bought back at maturity at market value.

Table 1 looks also at similarities and differences between *sukuk*, conventional bonds and preferred shares. It transpires that all three instruments offer periodic returns but do not provide for control over the investment or voting rights. In addition, they give the respective holder a priority right over other creditors in case of bankruptcy and a right to return of the principal. However, they differ on a number of important points, such as their basis – debt or equity, or a mixture of the two. Furthermore, due to *sukuk* being an Islamic financial instrument, it works without resorting to interest, which is, of course, fundamental for both shares and conventional bonds.

Linked to that, the three instruments differ on the points of predetermined yields and profit-based returns. With respect to the former, its applicability to bonds and preferred shares, but not to *sukuk,* is not surprising. Receiving predetermined yields on the investment for the *sukuk* holder would be equal to earning of interest. Instead of that, *sukuk* investors enjoy the possibility to receive profit-based returns, which is how they share in the profit of the investment (subject to them being parties to any losses from the investment too).

To put all of the above in context, note that both bonds and preferred shares give their holders the opportunity to receive interest-based periodic returns with predetermined yields, irrespective of the profit or loss of the project or company. Furthermore, both instruments do not provide for voting rights or control over the asset. They do guarantee their holders, however, priority right over other creditors in case of bankruptcy and return of the principal. It transpires that bonds and preferred shares are very similar on many important points. Their significant divergences are only on the matter of shared ownership of assets (but note that the protections that are in place for their respective holders all but negate this point) and on the matter of whether they are debt (bonds) or equity (preferred shares) instruments. A secondary difference between them is that bonds are used to finance projects. This explains the need for a debt based instrument - whereas shares belong to the much more extensive area of corporations and financial assets.

Table 2 outlined that, in comparison to the substantial resemblance between *sukuk* and preferred shares, few similarities exist between **common shares** and *sukuk*. The two instruments coincide on the points of providing for shared profit and loss and periodic returns as well as for return of the principal (although, this, in the case of shares, works in a different way compared to *sukuk*).

Table 2, on the other hand, demonstrates that shares and *sukuk* have a fundamentally different purpose, the traditional idea behind the former being to provide capital for the functioning of the company and that of the latter to finance certain company projects. Furthermore, Table 2 demonstrates that *sukuk* does not provide for ownership interest in a corporation, as a share would, but represents units of ownership interest solely with regard to a specific *Shariah*-compliant tangible asset held by a special-purpose vehicle. This means that *sukuk* holders are by definition more disconnected from the company’s interests than are traditional shareholders.

Although *Shariah* law promotes cooperation in business and distribution of risks and profits, such fragmentation as the observed in the *sukuk* instrument, is fine from a *Shariah* point of view. This is because, in order to be compliant with *Shariah*, traders must ensure that every transaction they carry out is performed according to the respective religious rules. However, a broader analysis of the *sukuk* instrument may give rise to possible arguments based on the principle that *Shariah* places greater value on the good of the community than on individual wellbeing. Under this approach, particularly when the project is of great social importance (for example, an infrastructure or a housing project) and is carried out by a socially important company (for instance, a company securing many jobs or a particularly needed service), disconnection from the long-term prosperity of the *sukuk* originator may not be perceived in a positive light. This may translate in practice into court decisions less favourable to *sukuk* holders, exacerbated by the lack of definite investor protections embedded in the *sukuk* instrument. Notably, this approach to *sukuk* would be aligned with the position taken by many leading scholars of conventional company law, who argue that shareholders in big companies should not be given so much voice after all.[932]

If we accept the above point, *sukuk* and shares being at cross-purposes can make it arguable that *sukuk* is deficient in comparison to shares as regard the long-term benefit for the company (and note that short-term shareholders are already suspect on this point). As suggested, this interpretation could interfere with the redress enjoyed by *sukuk* investors in case of default or early settlements. This could become relevant sooner than anticipated because there have been indications that *sukuk* and default are not incompatible in practice after all; it has been observed that a number of high profile sukuk have defaulted recently,[933] creating challenges for the *sukuk* market and a drop in investors' confidence.

9.9. The validity of the Islamic finance instruments: the case of sukuk

[932] Ferreira et al (n 745).
[933] Salman Syed Ali, 'Islamic Sukuk Default and Issues in Their Resolution: The Case of Villamar Sukuk' (2016) Working Papers 2016-5, The Islamic Research and Teaching Institute (IRTI), https://ideas.repec.org/p/ris/irtiwp/2016_005.html accessed 25th June 2019.

With respect to this point, it was relatively recently pointed out that 'there is still no international standardization in the accounting and statistical treatment of sukuk products and such ambiguity would distort the credibility of debt sustainability projections if governments relied heavily on sukuk instruments.'[934] This statement should be seen in the context of AAOIFI's 2007 pronouncement that around 85% of the issued *sukuk* is not *Shariah* compliant.[935] The justification of the AAOIFI's board was that the repurchase undertaking at a set price, accompanying *sukuk*, which in essence mirrors the conventional bond's 'promise that the borrower will pay back their face value at maturity, or in the event of default'[936] undermines the rule on risk and profit sharing, fundamental in Islamic finance.[937] This feature of *sukuk* prompted a number of banks, among them Abu Dhabi Islamic Bank, the European Islamic Investment Bank and Bahrain's Arcapita Bank to decline using *sukuk* with repurchase agreements. The position of the AAOIFI's board is compulsory for Bahrain, the Dubai International Financial Centre, Jordan, Qatar, Sudan and Syria and is advisory to the rest of the Muslim world. This stance is unlikely to shift, particularly considering that the Chairman of the 2018 IIFM Annual Sukuk Report (the Report) stated in the opening words to the Report that '[t]he risk sharing nature of Sukuk is a hallmark of Islamic finance itself which should not be compromised.'[938]

However, it cannot be ignored that one of the main weaknesses of *sukuk* is connected to its arguably murky provisions on investor protection in case of default. It is unfortunate that instead of going in direction of re-engineering the instrument in order to diminish this disadvantage of the bond, the AAOIFI preferred to return to basic principles.

Notice, furthermore, that tightening of the *sukuk* framework would transform the instrument from a debt-like one to equity. As a result, investors would be reduced to the hope that the underlying product (which they financed through the *sukuk*) will be sufficiently profitable so that after the

[934] Arif Orçun Söylemez, 'Current Issues of the Sukuk Market and Using Sukuk for the Global Infrastructure Projects' (2016) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2865549 accessed 12th June 2019, 3.
[935] Reuters, 'Most sukuk 'not Islamic', body claims' (2007) https://www.arabianbusiness.com/most-sukuk-not-islamic-body-claims-197156.html accessed 12th June 2019.
[936] Ibid.
[937] Reuters (n 935).
[938] Labuan IBFC, 'IIFM Annual Sukuk Report' (APRIL 2018), 7th Edition, 10.

profit-sharing process, their investment is not only returned but returned with meaningful gains.[939]

The question remains whether changes towards a stricter regime should be adopted considering that there are other forms of debt financing that could prove to be much more flexible and attractive to investors. For example, the CoCo (contingent convertible) *sukuk* would allow the conversion of the debt into equity if the price of the share reaches a certain benchmark. Although controversial in their own right (because of their potential to dilute the equity of the original equity holder) and largely discarded by *Shariah* authorities, CoCo *sukuk* have the double benefit of familiarity and security, which would guarantee interest among investors. Part of what is known as "mezzanine financing",[940] CoCo *sukuk* could align Islamic debt issuance with conventional regulation, this way making it more attractive to conventional investors. This appears uncontroversial because in the view of academics '[t]he basic structure of sukuk is in fact very much consistent and compatible with debt-based mezzanine financing.'[941]

Arguments in favour of liberalisation of the regime are supported by evidence of the market's growing preference for the novel hybrid *sukuk*. The hybrid is an instrument, comprising of more than one *Shariah*-compliant contract, of a mixture of debt and equity or of a pool of underlying assets, built out of tangible and intangible assets. It is deemed to provide an extra layer of security for investors, making it potentially very attractive to them.[942] Indeed, it was these qualities which have made the instrument the go-to formula for the construction and real estate industries.[943] However, due to the combination of tangible and intangible property as an underlying asset, hybrid *sukuk* is likely to be met with an unenthusiastic welcome by scholars, because the addition of intangibles to the contract has already been deemed controversial.[944]

One of the most prominent among the various critiques of *sukuk*, is the argument that the legal restrictions inherent in the *sukuk* instrument, as well as the lack of true ownership transfer typical

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[939] Labuan IBFC, 'IIFM Annual Sukuk Report' (APRIL 2018), 7th Edition.

[940] Adam Hayes, 'Mezzanine Financing' (2019) Investopedia, https://www.investopedia.com/terms/m/mezzaninefinancing.asp accessed 12th June 2019.

[941] Humayon Dar, 'Sukuk as a Tool for Islamic Mezzanine Financing' (2017) Islamic Economist, https://www.islamiceconomist.com/?p=1454 Accessed 14th June 2019.

[942] Farah Adilla, 'Hybrid sukuk' set to dominate future sukuk issuances' (2017) https://www.nst.com.my/business/2017/05/243622/hybrid-sukuk-set-dominate-future-sukuk-issuances accessed 14th June.

[943] Humayon Dar (n 941).

[944] Zolfaghari (n 928).

for asset-based *sukuk*, undermine investors' interest. As a 2018 study by Deloitte conducted among industry practitioners found out, out of all respondents '22% believe the issue of true transfer of ownership is the main reason that hinders Sukuk issuers and investors from opting for an asset-backed structure whereas 19% believe the problem stems from legal restrictions in asset ownership.'[945] This statistics suggests that the structure of the asset-based sukuk needs to be revised in order to overcome investors' distrust.

Chapter 10: Defaulting debtors: the perspective of Islamic Finance Law

10.1. Why is the Islamic finance framework on default relevant to the viability of Islamic finance instruments?

Why it is relevant to consider the treatment of defaulting debtors and default more generally under Islamic finance law? The simple answer is that the more the novel instruments could be perceived as unfair and placing the weaker party in a disadvantages position, the greater should be the opposition of Islamic scholars to their application in trade, investment and project financing. Such position would be justified under the premises of Islam, which demand fairness and justice. In particular, Islam demands that debts are to be paid, particularly in case of wealthy debtors.

Furthermore, due to some deficiencies in the structure of many Islamic finance instruments, which can potentially cause issues from an investor-protection and systemic stability point of view, this religion-based opposition can enlist the support of economists, regulators and law makers. The concerns about the Islamic finance framework on default are mainly caused by inherent inability of the respective instruments to properly deal with a situation of default. This is arguably due to culturally-specific factors as well as geo-political ones. With respect to the former, it is worth remembering that Islam imposes on Muslims very strict moral demands,

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[945] Hatim el Tahir and Mohamad Akram Laldin, 'Sukuk in focus The necessity for global common practices' (2018) Deloitte, https://webcache.googleusercontent.com/search?q=cache:TQFrTccgl8wJ:https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/financial-services/deloitte-isra%2520sukuk.pdf+&cd=13&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 12th June 2019, 13.

which require that contracts are to be performed and debts are to be paid. It is likely that these attitudes of respect to other people's property and wellbeing have been instrumental to somehow overlooking important aspects of investor protection in the creation of the Islamic financial instruments.

Regarding the latter, the engineers of Islamic contracts and Islamic financial instruments have been presented with the unique task to structure instruments that would be a) recognisable in the conventional market (by investors, industry practitioners, courts, regulators and supervisors); b) compliant with *Shariah* law and c) a sufficiently viable hybrid of the two systems to be able to actually function in the real world.

As the below analysis will demonstrate, not only have the novel structures left investors in a disadvantages position but defaults or pre-default situations have started piling up. Although such scenarios are nowhere near defaults in conventional finance, their number matters for a number of reasons.

First, Islamic finance is still in its nascent stages. The more it develops and the bigger its market share grows, the more often we will be seeing cases of default unfolding.

Secondly, Islamic finance is not limited within the boundaries of the Muslim world and even if it was, the increasingly global world means that a failure of the system in the Middle East and the rest of Muslim populated countries will reverberate in the West. To a great extent this would be due to the amount of foreign investment in the oil-rich countries. Such considerations are particularly applicable to investments in *sukuk* for reasons of its popularity among institutional investors and funds.

Thirdly and linked to the second point, due to oil money Gulf investors take a lively interest in investing in the West. Destabilisation back home, caused by rising dissatisfaction with the performance of Islamic finance, can halt the influx of this welcome capital to the Western markets and economies.

Lastly and perhaps more importantly for the Islamic world, a high default rate will undermine the trust of ordinary Muslims in a system, which was introduced with the purported objective to provide an example of ethical yet viable finance.

This work has until now dealt with the main principles applicable to Islamic contract law, making the reader familiar with the most important types of contract and financial instruments in Islamic law. What must have transpired from the discussion so far is that even the most complex Islamic contracts rely on the employment and combination of simple contracts of, for instance, sale such as *murabaha* (among others) and concepts, such as *wa'd*. Furthermore, the reality is that, due to the *Shariah* prohibitions, the Islamic investor is offered products, which are in most cases a hybrid between instruments of a different kind. A good example of that is the financial instrument *sukuk*, which displays features of conventional bonds, ABS and shares. The existing framework is made more complex by the requirement that any Islamic finance instrument must abide by the principles of *Shariah* law, which, if strictly followed, are very hard to implement in modern finance.

One point that should be treated especially carefully is what happens when one of the parties to a contract is unable to fulfil his obligations. Such a scenario may come to pass in ordinary, simple contracts for sale or contracts for services. It could arise also in the area of financial derivatives.

In the particular case of *sukuk*, which has been discussed at great length above, the requirements covering default by the issuer have not been clearly communicated to investors in neither of the applicable jurisdictions. While certain expectations exist as well as certain contractual undertakings confirming that investors have a preferential right to claim the assets of the SPV, the consequences of the debtor simply defaulting on his obligation to satisfy investors' claims are still far from clear, from a regulatory perspective at least. Furthermore, even if clear legislative provisions are introduced in place, which will guarantee the outcome of defaulting in such circumstances, the lack of consistent application of *Shariah* law across the entire Muslim demographics will make it difficult to harmonise such legal framework across borders. The immediate consequences of a lack of harmonisation are, as the discussion on EU covered bonds and ABS demonstrated, inefficient allocation of resources, including high cost of capital, investor protection issues and some prudential points of concern.[946] Conversely, moving towards greater harmonisation is expected to increase investor confidence, including for cross-border investment and make a cost-effective and long-term funding source available, thus helping finance the

[946] European Commission, 'Capital Markets Union: covered bonds, cross-border distribution of investment funds and cross-border transactions in claims and securities' (Brussels, 12 March 2018) http://europa.eu/rapid/press-release_MEMO-18-1425_en.htm accessed 13th July 2019.

economy. Note that in the EU context, by increasing cross-border flows of capital and investments, the new legislative package (a Directive and a Regulation) is hoped to 'provide investors with a wider and safer range of investment opportunities, contribute to financial stability and help finance the real economy.'[947] The last two objectives – financial stability and financing the real economy have been at the forefront of Islamic finance's objectives as demonstrated in practice over the course of the last 50 years. To a different extent, the rest of the objectives of the EU Commission could too be of interest to the Islamic finance regulator.

In the specific case of the *sukuk* industry, key issues that have been identified include 'lack of standardization of Shariah rules, high issuance costs, low liquidity in the secondary sukuk market, and low foreign participation.'[948] This analysis confirms that the problems in the industry tend to be of the same kind as the issues identified by the EU Commission with regard to the EU. This makes it reasonable to suggest that the approach of the conventional regulator should be given serious consideration.

Admittedly however, such harmonisation would not be as easily achieved in Muslim countries or in any other part of the world outside Europe, for that matter, as it was done in the EU. Since the European Union functions under a principle of *quasi* federalism, this makes it viable for the EU legislator to consider and pursue unification of relevant legal rules and principles. In the Islamic context, although the rules relating to the law of insolvency, including the treatment of creditors and debtors, would have been formulated on a strict adherence to the *Qur'an*'s verses and other respected sources of Islamic knowledge, the presence of so many different schools of thought makes any attempt at harmonisation difficult. The framework becomes further complicated because of the reasons enumerated below:

> *In case of disputes over scheduled payment delays or payment failures with sukuk, means for redressal are more complex than those for conventional notes and bonds. For sukuk, no clear guidelines regarding the rights of investors in case of a default and a redressal mechanism exist. Generally, English Common Law concepts and mechanisms are used for sukuk instruments, with the SPV playing a key role. The legal provision for sukuk represents a merger of English Common Law, which is primarily used for cross-border financial transactions, and Shariah laws, but it is sparingly used in practice. Hence, in*

[947] Ibid.
[948] Abdullah Alawi and Saleh Al-Quati, 'Sukuk: The Sharia Fixed Income Alternative Strategy' (2014) Al Jazeera Capital, http://www.aljaziracapital.com.sa/report_file/ess/spe-171.pdf accessed 14th July 2019.

case of default, due to limited recourse options, investors often do not have any collateral to rely on. Furthermore, besides the risk of capital loss and/or default on pro share payments, other risks involved in obtaining full recourse to the underlying assets include legal risks and risks related to imposition by the court ruling.[949]

Approaches to default in Islamic Finance law are disparate due to the existence in Islam of different denominations, doctrines and schools which are, in addition, spread around a huge geographical area. This variety contributes to the lack of uniformity of *Shariah* bankruptcy rules and/or their application in contradictory or incoherent way across jurisdictions. In any case, it would be inaccurate to hold that there is a harmonised *Shariah* law compliant bankruptcy framework in place in the Islamic world. [950]

Despite that, it is indeed the *Qur'an* where the study of the rules of default should start from. First, the reference to it is necessary because Islamic Finance functions on the presupposition that all financial transactions carried out by Muslims must be *Shariah* compliant. This idea necessarily informs any posited law that may be applicable to default in the relevant framework. Furthermore, even if there existed a posited law dedicated to default but differing in its requirements from *Shariah*, various factors such as cultural specificities, customs or differences in the interpretation of *Shariah* within the particular country may impact on the practical applicability of this law and its policing. Yet another possibility would be that a stricter approach to *Shariah* law may invalidate the relevant posited law, as applicable, and prompt a reversion of the framework to the religious fundamentals discussed at the beginning of this work. Such considerations justify a closer look at what the *Qur'an* instructs about debtors and how they should be treated. This will be laid out below, followed by discussion at the end of this Chapter, on three real life cases of *sukuk* default and what conclusions could be drawn from them.

In the *Qur'an*'s view, debtors defaulting on their payment obligations should be treated with leniency and this should be even more the case if the debtor is struggling to repay because of being poor or because of other, *Shariah* complaint reasons.[951] To this end, the *Qur'an* postulates

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[949]Ibid, 5.

[950] Jason J Kilborn, 'Foundations of Forgiveness in Islamic Bankruptcy Law: Sources, Methodology, Diversity' (2011) available at http://ssrn.com/abstract=1908896 , accessed 11th July 2019, 13-14.

[951] The Quran, The Qur'an in English Translation (MidEast Web for Coexistence 20004), <http://www.mideastweb.org/mew-quran.pdf> accessed on 4th July 2019, 2:280.

that if the debtor experiences hard times, he should be given relief (*fa-nadhiratun*) which means time to organise his affairs and become able to repay with ease. Even better than giving the debtor some respite (*nadhira*), the *Qur'an* preaches, would be to wave the obligation by way of charity. Should the creditor choose to do this willingly; this would be virtuous and the best path for him to follow.[952]

> *'[I]f the debtor is in a difficulty, grant him time 'til it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew'.*[953]

By way of contrast, the *Qur'an* instructs that affluent debtors should meet their obligations and that not doing so is immoral.

> *'[P]rocrastination [delay] in repaying debts by a wealthy person is injustice.'*[954]

The same approach to affluent debtors is adopted in the *Sunnah.*[955] This would indicate that in the event of *sukuk* default, the *Qur'an* would encourage issuers to pay; on the other hand, in "ordinary" Islamic contracts such as *quasi*-loan contracts, the creditor would be prompted to give relief to debtors, particularly if the latter's financial position renders them the weaker party.

The *Qur'an*'s charitable approach to worse-off debtors is well-known in the Muslim world but it is not followed strictly, due to various practical considerations. What is more, there is no uniform approach to the treatment of debtors and particularly on the matter of how it should be ensured that debtors pay their debts. There is no, as such, an agreement on how stringent the regime should be and what degree of persuasion over the debtor would be *Shariah* acceptable.[956] In this situation Islamic financiers are dealing with the need to balance between the ineffective and the inconsiderate, all the while staying alive to their business objectives.

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952 Ibid.
953 The Qur'an (n 951)2:280.
954 Qu'ran (n 951): Bukhari 41:585; 37:486, 487; Muslim 10:3796-97; Tirmidhi 14:1312-13.
955 Kilborn (n 950), 7.
956 Kilborn (n 950), 1.

In contrast, conventional finance law has historically accumulated considerable experience in the area of responsible debt management (personal,[957] corporate[958] or public[959]) and particularly during the last century or so. In the conventional view, debts are not waved unless a proper bankruptcy procedure is followed and whatever decision is taken, it is with the objective of making sure that the business creditor will not be crippled because of not fulfilled obligations.

The fundamental reason why this debt management approach has been adopted by conventional finance is that it operates in conditions of capitalism. Capitalism, unlike feudalism or socialism, which are different examples of the command economy (also known as planned economy) favours economic planning based on decentralized and voluntary decisions.[960]

Capitalism focuses on growth and offers stimulus to those who create value. It is largely accepted by the proponents of capitalism that the value that has been created by entrepreneurs will trickle down to the rest of the population, creating conditions for more growth and more value to be created. Crucially, what is understood here is value and growth that can eventually be represented materially, i.e. 'in the shape of money that by a definite process has to be transformed into capital'.[961]

While currently the West is experiencing a different, perhaps more socially aware version of capitalism, where checks and balances are put in place to prevent excesses of greed and

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[957] Julapa A Jagtiani and Catharine Lemieux, 'Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information' (2017-07-18), FRB of Philadelphia Working Paper No. 17-17, https://ssrn.com/abstract=3005260 ACCESSED 16[TH] July 2019.

[958] See Klaus J. Hopt, 'Better Governance of Financial Institutions' (2013) Law Working Paper N°. 207/2013 Max Planck Institute for Comparative and International Private Law and ECGI, https://ecgi.global/sites/default/files/working_papers/documents/SSRN-id2212198.pdf accessed 16th July 2019. For a FinTech perspective see, Papanikolaou, Nikolaos I., FinTech Credit and Traditional Bank Credit: Allies or Opponents? (September 21, 2018), https://ssrn.com/abstract=3253416 accessed 16[th] July 2019. See also, Whitehead, Charles K., Creditors and Debt Governance (February 12, 2011). RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW, Claire Hill & Brett McDonnell, eds., Edward Elgar Publishing, 2012; Cornell Legal Studies Research Paper No. 011-04, https://ssrn.com/abstract=1760488 accessed 16[th] July 2019.

[959] See International Monetary Fund and the World Bank, 'Strengthening Debt Management Practices—Lessons from Country Experiences and Issues Going Forward: Background Paper' (2007). See also, INTOSAI, 'Audit of Public Debt Management A handbook for Supreme Audit Institutions' (2018) http://www.intosaicommunity.net/document/exposure_draft/exp_V_0_Handbook_on_Audit_of_Public_Debt_Management_(1)_(1).pdf accessed 16[th] July 2019.

[960] Adam Smith, *The Wealth of Nations*, Book II. Jim Chappelow, 'Capitalism' (2019) Investopedia, https://www.investopedia.com/terms/c/capitalism.asp accessed 16th July 20919.

[961] Karl Marx, *Capital A Critique of Political Economy*, (1867) Volume One, Chapter 4 'The General Formula for Capital', 104.

exploitation (see consumer protection regulation) or to counteract it (see redistributive politics or the principles of the welfare state), this does not change the basic arithmetic of financial dealings.

This remains the case even though the decade following the financial crisis bore witness to many theorists questioning the current model, some of them even asking how to 'embed non-market norms as a disciplining force in modern market'.[962] Although occasional references to non-market norms do not in themselves suggest that conventional market will start abiding moral, in addition to the regulatory standards in their business practices, this may signal that conventional and alternative approaches to finance are getting a step closer to each other (or at the minimum, are moving in the same direction albeit at a different speed). This development may be a reflection of the rapidly changing times and demographics which require something more than pursuance of corporate responsibility strategies and investor and consumer-focused regulatory measures.

On the other hand, Muslims follow the *Qur'an* as best they can, but with a view of the practical demands of life. Let's not forget that instructions as to what constitutes *Shariah* compliant behaviour are found not only in the *Qur'an* but also sources outside it.[963] This makes sense, considering that the *Qur'an* presides predominantly over the spiritual realm and purity of the believer (*'ibadat*), serving as a connection between the human and the divine. Although the *Qur'an* instructs Muslims in all spheres of their life, its prescriptions and proscriptions are issued in a more general and philosophical way,[964] rarely venturing into detail or into the realm of personal interrelationships (*mu'amilat).*[965]

Nevertheless, the *Qur'an* has pronounced on the matter of contract performance, indicating that contracts should be performed 'O, you who have believed, fulfil [all] contracts' (*'awfu bil-*

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[962] Sarah Paterson, 'The cost of capital– the normative foundation of corporate law: a Reply' (2017) 14(2) European Company and Financial Law Review 316, 333. See, M Sandel, *What Money Can't Buy: the Moral Limits of Markets* (Penguin 2013).
[963] Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (3d rev. ed., Islamic Texts Society 2003), 16-18.
[964] See Chibli Mallat, *Introduction to Middle Eastern Law* (OUP 2007), 33.
[965] H. Patrick Glenn, *Legal Traditions of the World* (2nd ed., OUP 2004), 172.

'uqud),[966] and that debtors should conduct their business dealings in a way which will protect them from becoming insolvent; above all, they should endeavour to meet their obligations.[967]

This instruction should be seen in the context of the importance Islam places on charity and mercy, shown to debtors in particular. As mentioned on a few occasions, Islam considers the welfare of the community to be of greater importance than the wellbeing of community members. If this maxim is used as a starting point, a relaxed obligation to repay a debt sounds contradictory and potentially problematic, giving rise to arguments, that relaxing the obligation to return a debt may have a detrimental effect on the community due to a "trickle-down effect", to borrow from conventional terminology. An argument could be made that if no one returns their debts, businesses will have no incentive to develop which will be detrimental to the community. Furthermore, the instruction by the *Qur'an* could give rise to objections to a relaxed obligation to repay a debt, based on two considerations:

- Not honouring a debt is unfair to the creditor.
- There is no reason to treat one party to the contract less favourably than the other.

Despite the above, and in line with the spirit of Islam, the current *status quo* in the Muslim world is that defaulting debtors, and especially debtors falling on hard times, are enjoying a period of grace due to debts traditionally being seen as a relatively relaxed obligation.[968] This said, the *Qur'an* gives the creditor considerable freedom to elect whether to pursue the fulfilment of the obligation or not, and if he chooses the former, he could do so too.[969]

Part of why such a less than clear situation exists is due to the traditional discrepancies in the interpretation of the holy text by scholars belonging to different schools or denominations. Furthermore, it matters that the opinion of a learned scholar is persuasive in Islam. Considering that the *Qur'an* encourages creditors who deal with debtors in difficult circumstances to remit the debt, or in other words, to either give the debtor a full relief from the obligation or at least a temporary respite from it, this must have influenced the Islamic law of insolvency.

[966] Qur'an, http://quran.com/5accessed on 4th July 2019, The Table" (Surat-al-Ma'idah) in Chapter 5:1.
[967] Noor Mohammed, 'Principles of Islamic Contract Law', in Hisham M. Ramadan (ed.), *Understanding Islamic Law: From Classical to Contemporary* (AltaMira Press 2006), 95-96.
[968] Frank E. Vogel & Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk and Return* (Springer 1998), 67.
[969] The Qur'an (n 966), 2:280.

However, there are two key concepts that should be interpreted uniformly in order to achieve clarity on the matter: "difficulty" and "ease". "Difficulty" is arguably the harder to understand of the two because there are no clear instructions what constitutes difficulties, [970] how it is measured and what difficulty could be deemed too trivial to justify relief.

Despite that the presence of "difficulties" precipitates the state of *nadhira* (respite),[971] this is qualified, meaning that when the situation of the debtor improves and his circumstances allow him to repay the debt without this causing him hardship i.e. "until ease" (*ila maysara*), the debt should be paid. [972] In this narrative, the opposite state of "difficulty" is that of "ease"; however, similarly to the former, *ila maysara* is not sufficiently well clarified and leaves practitioners to question whether ease means that the debtor has achieved a state of financial wellbeing or just a slight respite from his problems.[973]

The discussion in the below case study from Malaysia sheds some light on the possible approach of the courts to default cases involving a bank as the creditor and a big corporation as the debtor. As will be seen, the response of the judiciary demonstrated sensitivity to context (i.e. impossibility to award penalty interest) and a desire to guarantee that the wronged party will not be left without redress.

Case study: Tahan Steel Corp Sdn Bhd v Bank Islam Malaysia Bhd [2004][974]

This case turned on an argument by the plaintiff (Tahan Steel) that the defendant bank defaulted on its obligation to provide to them the remaining balance of the contracted financing facility. The bank argued that the balance was withheld because the plaintiff 'failed to meet condition precedents of the al-Istisna' facility, namely to secure facilities totaling approximately US80

[970] Hans Wehr, *A Dictionary of Modern Written Arabic,* J. Milton Cowan (ed.) (4th ed., Spoken Languages Services 1979), 716; 809, 1145.
[971] Ibid, 1145.
[972] Wehr (n 970), 1296.
[973] Wehr (n 970), 1297.
[974] *Tahan Steel Corp Sdn Bhd v Bank Islam Malaysia Bhd* [2004] 6 MLJ 1; cited and approved in *Amazing Place Sdn Bhd v Couture Homes Sdn Bhd & Anor* [2011] 7 MLJ 52 (on the issue of damages) and in *Affin Bank Bhd v MMJ Exchange Sdn Bhd & Anor* [2011] 9 MLJ 787 (on the issue of judicial notice).

million from EXIM banks as agreed,' as well as that Tahan Steel has defaulted on its repayments.[975]

The judge held in favour of the bank, underlying that the condition precedent imposed by the defendant was 'neither whimsical nor belligerent, they were based on sound commercial basis'.[976] With respect to the effect of the plaintiff's default and their application for an injunction against the bank, the judge questioned whether, due to the prohibition on *riba*, the bank was likely to have incurred irrecoverable losses following the delays in repayment or to incur such losses as a consequence of a wrongfully granted injunction. The answer, in Abdul Malik Ishak J's opinion was that indeed the bank would have incurred and will incur irreparable damage because the court would not be able to compensate it for the default by ordering penalty interest. To this end, the judge held that 'Every single installment that is paid late to the defendant is a loss of use of money owed to the defendant for the period of delay.' Per the court, since interest could not be imposed to compensate the bank for this loss, fairness required that the application for injunction be rejected.

10.2. How the sukuk structure may affect provisions on default?

What makes the situation more worrying is that Islamic markets lack guidance on what should be done in case of *sukuk* default. The only existing guidance on default was issued by AAOIFI on 31st May 2000. Apart from being too general, as it oversees all possible types of default and does not focus specifically on *sukuk*, the timestamp of the guidance suggests that it could not have taken in consideration all new relevant developments in Islamic finance. Furthermore, the AAOIFI standard addresses only solvent debtors, guarantors and contractors or concessionaires who have delayed the completion of contracted work, thus becoming debtors by reason of a penalty clause. To this end, default for a reason of insolvency, bankruptcy or on basis of some *Shariah* law justification are not subject to this guidance. Last but not least, it should be taken

[975] Mohd Yazid B.Zul Kepli, 'Introduction to Islamic finance' (2013) http://what-is-islamic-finance.blogspot.com/2013/06/analysis-cases-law-on-islamic-finance.html accessed 7th August 2019.
[976] *Tahan Steel* (n 974), paras 45, 53, 70, 77, per Abdul Malik Ishak J.

into consideration that although highly persuasive, the AAOIFI standard is not binding on the contracting parties.

The following is a summary of the guidance with a commentary (the original could be accessed on the AAOIFI's website):

> ***Shari'a ruling***
>
> ***Default in payment by a debtor***
>
> *Default in payment by a debtor who is capable of paying the debt is haram (prohibited).*
>
> *It is not permitted to stipulate any financial compensation, either in cash or in other consideration, as a penalty clause in respect of a delay by a debtor in settling his debt, whether or not the amount of such compensation is pre-determined; this applies both to compensation in respect of loss of income (opportunity loss) and in respect of a loss due to a change in the value of the currency of the debt.*
>
> *It is not permitted to make a judicial demand on a debtor in default to pay financial compensation, in the form either of cash or of other consideration, for a delay in settling his debt.*
>
> *The debtor in default bears all legal and other expenses incurred by the creditor in order to recover his debt.*
>
> *The creditor is entitled to apply for the sale of any asset pledged as collateral for the debt, for the liquidation of the debt. He is equally entitled to stipulate that the debtor must give a mandate to the creditor in sell the pledged asset without recourse to the courts.*
>
> *It is permitted to stipulate that all outstanding installments become due once the solvent debtor fails to pay an installment. It is preferable that this clause should be implemented only after notifying the debtor and after the lapse of a reasonable period of time, not less than two weeks.*
>
> *In the case of a Murabaha sale, if the asset that was sold is still available in the condition, in which it was sold and the buyer has defaulted in the settlement of the price and has later become bankrupt, then the seller (the institution) is entitled to repossess the asset instead of initiating procedures to obtain a bankruptcy order.*
>
> *It is permitted to prescribe in contracts involving indebtedness (such as Murabaha) an obligation on the debtor, in the case of default in payment, to donate an amount or a percentage of the payment due on condition that this be*

donated to charitable courses under the supervision of the bank's Shar'a supervisory board.

Guarantor

It is permitted for a creditor to demand that a debt be settled by a guarantor according to established Shari'a principles. The institution is entitled to demand payment from either the debtor or the guarantor, provided that there is no condition in the contract to the effect that payment must be sought first from the debtor.

All rulings applicable to debtors in default are equally applicable to guarantors in default.

Contractor or concessionaire

It is permitted to include penalty clauses in contracts for construction, Istisna'a and supply contracts. In case of a refusal to pay the amount due under a penalty clause, the rulings relating to default by a debtor would be applicable. It is permitted to deduct the amount from outstanding amounts due to the contractor.

Non-material punishments for default in payment

The institution is entitled to include the name of a debtor in default in a list of undesirable customers (black list) and to send a warning admonition to other companies about the defaulting debtor, either when there is an inquiry from other companies about the debtor or when such 'black lists' are exchanged between companies directly.

General rulings

The institution is entitled to follow the affairs of a defaulting debtor and his financial dealings; this is considered a kind of pursuit of the debtor.

The institution may accept a payment from a debtor who is in default that is in excess of the amount of the debt, provided there is no contractual condition whether written or, verbal or custom or mutual agreement relating to this additional amount.

It is permissible for the institution to include a condition in a contract dealing with indebtedness to the effect that, if the debtor is late in making payment, the institution is entitled to recoup the amount due from any of the accounts of the customer with the institution.

The establishment of default in payment

> *Default in payment is established when, following a normal demand for payment, a debtor who has not proved that he is insolvent fails to settle the debt on its due date.*[977]

The bottom line of this guidance is that *Shariah* law expects debtors, who are in a position to return their debts, to do so. The guidance indicates that failing to meet one's obligations in circumstances of solvency is morally unacceptable under Islam. Furthermore, AAOIFI places a strict ban on imposing penalty clauses for a late payment, regardless of the reason, because this would amount to payment of interest. The ban is strict in the sense that even if the parties had agreed *ex-ante* that a certain sum of money will be payable by the debtor as compensation for the delay, such an agreement or a contractual clause could not be enforced in court. Moreover, in consideration of the possible detriment to the creditor, the AAOIFI refers to opportunity loss (similar to the pure economic loss concept in English and European Contract Law)[978] and losses related to currency fluctuations. In the AAOIFI's view, such losses cannot be recuperated by the creditor. Specifically, the creditor cannot insure himself against the possibility of such losses, by adding a compensation clause or by agreeing such compensation with the debtor at the time of signing. This is significant, particularly in the context that the common law does indeed allow 'agreed damages clause, applying on termination and … the recovery of loss of bargain damages'.[979] This could become a problem if *sukuk* cases are decided in the English courts or if English law is chosen on arbitration.

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[977] Naveed, 'AAOIFI Standard Number Three – Default in Payment by a Debtor' (2015) https://www.islamicfinance.com/2015/06/aaoifi-standard-number-three-default-payment-debtor/ accessed 26th June 2019.

[978] Vernon Valentine Palmer & Mauro Bussani, 'Pure Economic Loss: The Ways to Recovery' (2007) 11(3) Electronic Journal of Comparative Law 1; See also, J. Stapleton, Comparative Economic Loss: Lessons from Case-law-focused 'Middle Theory', 50 UCLA Law Review 531 (2002); J. Stapleton, Extra-Contractual Recovery of Pure Economic Loss in Europe, in M. Bussani (Ed.), European Tort Law. Eastern and Western Perspectives, 225 (2006);

[979] J W Carter and J C Phillips, 'The Liability of Debtors and Guarantors under Contracts Discharged for Breach' (1992) 22 Western Australian Law Review 338, 339; See *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241.

10.3. The common law framework relevant to default of the debtor

10.3.1. English law framework on sukuk and sukuk default from a regulatory and choice of law perspective

With respect to UK law, while there are no *sukuk*-specific regulations in place, the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2010 (the Amendment Order)[980] created a new category of specified investment known as an Alternative Finance Investment Bond (AFIB). Furthermore, the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001[981] exempted AFIBs explicitly from the scope of the United Kingdom collective investment scheme regime.[982] By virtue of the former, *sukuk* issued in the UK falls under the premises of "regulated collective investment schemes" as opposed to its previous "unregulated" status. The regulatory change was beneficial for *sukuk* issuers because it guaranteed that *sukuk* issuance will not be treated in a more unfavorable way than conventional bonds, lowering *sukuk*'s compliance and legal costs.[983] In addition, the instrument (and certain other Islamic finance arrangements, such as *murabahah* and *musharakah*) is treated in the same way as conventional debt instruments with regard to tax obligations.[984] The above provisions apply to the issuer.

As regard the rights of the counterparty, the provisions of UK law are not as clear. For example, in the event that a contractual party argues that there has been false marketing of the contract as *Shariah* compliant, the injured party may be able to rely on a contractual remedy and call an

[980] Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2010 (the Amendment Order) UK Statutory Instruments2010 No. 86.

[981] Anzal Mohammed and Jamie Durham, 'New Regulatory Definition of Sukuk in the UK' (2010) http://www.allenovery.com/news/en-gb/articles/Pages/New-Regulatory-Definition-of-Sukuk-in-the-UK.aspx accessed 13th August 2019.

[983] Ibid.

[984] See Chapter 6 of Part 6, UK Corporation Tax Act 2009. Note also that 'Finance Act 2009 provides relief from stamp duty land tax (SDLT) for sukuk (as alternative finance investment bonds), amends the law to classify sukuk as tax-exempt loan capital for stamp duty and stamp duty reserve tax purposes, and allows existing corporation tax and income tax rules on Islamic finance arrangements to be amended by regulation.' John Dewar and Munib Hussain, 'Islamic Finance & Markets', (n.d.) Milbank LLP https://www.lexology.com/gtdt/tool/workareas/report/islamic-finance-and-markets/chapter/united-kingdom accessed 13th August 2019.

event of default. In that case, the breach would constitute of misrepresentation by the Islamic finance institution of a material term of the contract.

The second avenue for redress is a civil claim for fraudulent or negligent misrepresentation. The redress in this case could be rescission of the contract and damages. In the event of innocent misrepresentation, subject to the right to rescind existing, the court has discretion to award damages *in lieu* of rescission, or rescission. It is not possible for the court to award both and in any case, if the right to rescind is lost, the law does not entitle the wronged party to receiving damages.[985]

The third option is only available in the event of public securities offering, the prospectus of which contained misrepresentation as to the *Shariah*-compliance of the product. The law provides that the wronged party (the relevant securities holder) is entitled to damages, subject to suffering a loss due to misrepresentation of information that has been included in the prospectus or an omission to include in the prospectus certain information.[986] Importantly, these provisions apply also to *sukuk* sold on the secondary market.

As will be seen further below, Islamic law does not treat awarding of damages as a legally valid measure. This means that with the exception of the second scenario, in which the wronged party may choose rescission of the contract in lieu of damages, a Muslim cannot rely to be made whole in a *Shariah*-compliant manner.

In the case a dispute reaches the UK justice system, it will be heard by a UK county court or the High Court of Justice since there is no specific court in the UK, designated to hear disputes on Islamic finance law. However, the UK has accommodated the most popular concepts of Islamic finance. For example, *mudarabah* is treated as a partnership agreement (and could be used to make deposits in a bank) and *murabaha* is interpreted for International Financial Reporting Standards (IFRS) purposes as a loan. In addition, the arrangements of *musharakah*, *ijara* and

[985] See section 2(2) of the Misrepresentation Act 1967, c. 7.
[986] Section 90 of Financial Services and Markets Act 2000, c.8.

wadiah are permissible in the UK and treated as akin to a joint venture or partnership arrangement, as an operating or finance lease and as a safekeeping agreement, respectively.[987]

As regard *sukuk*, UK law treats insolvency of the issuer along the lines of conventional bonds in the sense that *sukuk* holders would have a debt claim against the issuer. However, the legal position of the respective *sukuk* holder would change based on the instrument's structure and risk/reward arrangements. To this end, it has been argued that it would be possible to treat *sukuk* as either equity or debt instrument. Note that there has been no case law to date in the UK to check what approach the courts would take on the issue.

Nevertheless, the structural and conceptual differences between asset-based and asset-backed *sukuk* are likely to change the legal positions of the claimants in varied (so far unexplored by the courts) ways.

Whichever approach the UK judges decide to take, they will not decide the cases under *Shariah* law since the latter is not deemed competent with respect to contractual disputes in the UK.[988] The UK courts would not entirely disregard the provisions of *Shariah* law applicable to the contract but would rather see them as a part of the commercial as opposed to legal agreement. Unlike the civil law, common law rarely interferes with the commercial aspects of a contract. Furthermore, as a rule, English judges will not rule on the matter of *Shariah* compliance.[989] However, for parties willing to have the dispute decided under *Shariah* law, they may resort to arbitration (which is in any case, traditionally preferable for Muslims).[990]

The analysis suggests that the position of UK law as regard protection of investors under Islamic financial arrangements and parties to Islamic contracts is uncertain. To an extent this is due to the lack of sufficient turnaround of case law and to another, to the difficulty reconciling Islamic finance law to the circumstances of the common law. However, as has become evident, English law would be relevant to disputes based on the default of one of the parties, whether as the

[987] John Dewar and Munib Hussain, 'Islamic Finance & Markets', (n.d.) Milbank LLP https://www.lexology.com/gtdt/tool/workareas/report/islamic-finance-and-markets/chapter/united-kingdom accessed 13th August 2019.
[988] Based on the Convention on the Law Applicable to Contractual Obligations 1980 (the Rome Convention). See also Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) OJ L 177, 4.7.2008, p. 6–16.
[989] See *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd* [2003] 2 All ER (Comm) 84), reaffirmed in *Dana Gas PJSC v Dana Gas Sukuk Ltd & Ors* [2017] EWHC 2928.
[990] See section 46 of the Arbitration Act 1996.

governing law of the contract, under the choice of law arbitration doctrine or because parts of the contract have been governed by English (or common) law.[991]

10.3.2. The position of the common law regarding breach of contract

Because of the importance of the common law to settling of disputes in *Shariah* law, the common law governed approaches to termination of contract due to breach by one of the contracting parties of one of the conditions of the contract (for example, defaulting on its payment obligations) require separate attention. As the law currently stands, if the injured party elects to terminate the contract in circumstances of default,

> *'the contract is not rescinded as from the beginning. Both parties are discharged from the further performance of the contract, but rights are not divested or discharged which have already been unconditionally acquired. Rights and obligations which arise from the partial execution of the contract and causes of action which have accrued from its breach alike continue unaffected.'*[992]

This suggests that if English law is applied in case of *sukuk* default, as soon as the contract has been partially executed (meaning that a number of periodic payments have been paid out), creditors will retain their rights and causes of action (i.e. claiming damages) under the contract. While they could, there would be no practical benefit for them to terminate the contract. However, should the creditor elect to terminate the contract, both the investor and the issuer are discharged from their obligations to perform the contract in the future.[993] This means that if the injured party elects to terminate the contract, even if the work on the project continues in the future, the issuer will be under no obligation to continue with the periodic payments to this particular investor. In this scenario, the only redress for the claimant under English law would be to fall back on a claim for damages for breach of contract (which would most likely cover periodic payments only up until the termination of the contract plus the return of the principal).

[991] As was the case with *Dana Gas* (n 989).
[992] J W Carter and J C Phillips (n 979), 339.
[993] *McDonald v Dennys Lascelles Ltd*(1933) 48 CLR 457,476-477 per Justice Dixon; See also, *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827, 849-850, per Lord Diplock.

Whatever route is chosen, however, it is far from clear whether the AAOIFI's guidance allows investors to claim damages in circumstances of default because the proscription of the stipulation of 'any financial compensation,… as a penalty clause'[994] could be interpreted, on a strict view, as a prohibition to claim damages. Of course, AAOIFI's statements are intended for guidance only and if the case is seen by an English court, judges could elect to not consider them at all.

In this connection, it should be recalled that *Shariah* law does not permit the imposition of penalties on defaulted loans because the extra sum would not be due to the efforts of the lender but rather, to the incompetence or bad luck of the borrower. Furthermore, if the default was caused by the overall failure of the project, then the rule of profit and loss sharing would, in principle, prevent investors from receiving satisfaction irrespective of the lender's losses. In the event of bankruptcy of the issuer, to the extent that investors' interests are vested into the assets in the SPV's asset pool, they would be entitled to a part of the available assets, *pro rata* to their investment and subject to the applicable insolvency provisions. However, as to the periodic returns, it is unlikely that they could establish a valid right on them, as per *Shariah* law.

If the guidance should be understood in this sense (which is not clear), it appears that if English law is elected to fall back on, while still preserving the contract's *Shariah* compliant status, a *sukuk* investor looking for redress would be better advised *not* to terminate prematurely his contractual relationship with the issuer or with the SPV, incorporated in the *sukuk*. Note that while *sukuk* itself is not a contract but rather it is evidence for a debt, it would always be based on some kind of Islamic contract, for example *murabaha*, *mudarabah*, *bay al-inah* (sale and buy back between two parties) or *al-ijara* (lease contract).

Note further, however, that the position of the parties would change if the contract is rescinded because of matters going to the heart of its formation. This would, for example, be the case if any of the parties has committed fraud (for example, by falsely stating that the contract was *Shariah* compliant). To this end, the parties are supposed to be rehabilitated and restored to the position they were in prior to the conclusion of the contract.[995] In the *sukuk* case, this would mean that the *sukuk* holder would be entitled to the return of the principal and he will be required to return the periodic payments already received by him.

[994] See AAOIFI , Standard Number Three(n 832).
[995] J W Carter and J C Phillips (n 979), 339.

10.4. Analysis of the AAOIFI's penalty clause with a reference to the common law

To recall, the AAOIFI's stance is that a penalty clause is permitted under no circumstances. As intimated above, it is however not clear what the AAOIFI meant by a "penalty clause". In principle, damages for a breach of contract serve to compensate the creditor for the debtor not fulfilling his contractual obligations. In English contract law, applying damages is not considered a penalty in itself. Note that English law distinguishes between liquidated damages, which are damages based on a genuine estimate of a future loss and are enforceable, and a penalty clause, which goes beyond such estimate and is unenforceable in court.[996] The importance of a liquidated damages clause (LDC) is such that if a LDC was included in the contract and was deemed enforceable by the court, but the injured party had meanwhile suffered a loss greater than the estimate, the court would not impose compensation equal to the actual loss but would hold that the parties must settle at the amount foreseen in the LDC.[997] This sum is what the injured party will recover, if English law is to be followed.

With respect to "penalization" clauses, which is the case when the sum stated in the clause exceeds what would be a genuine pre-estimate of the future loss, such clauses will not be struck out of the contract but will be enforced to the degree the court sees fit. Typically the court will enforce such a clause to the level of the actual loss suffered by the injured party.[998] The rationale of the court is that contractual parties must incorporate into the contract their genuine[999] attempt to assess their future losses and to protect themselves against them. More recently, English courts started placing an even greater emphasis on the *reasonableness* of the parties' pre-estimate and this became 'the essence of the test'.[1000] As a consequence, if the parties' genuine pre-assessment of damages appears to the court to be unreasonable, the court will hold that it was not genuine

[996] McKendrick, (n 386), 350.
[997] *Diestal v Stevenson* [1906] 2 KB 345.
[998] *Jobson v Johnson* [1989] 1AII ER 621.
[999] *Dunlop Pneumatic Tyre Company Ltd v New Garafe & Motor Co Ltd* [1915] AC 79.
[1000] McKendrick, (n 386), 351.

and will not enforce it. Importantly, the court will look for a "substantial discrepancy" between the pre-estimate and the actual loss in order to declare the former unenforceable.[1001]

Last but not least, how a clause will be interpreted is a matter of construction for the court and in order to reason through it, judges have traditionally followed three rules of interpretation and have not enforced liquidation damages clauses if any of these rules have been breached. It is suggested that these rules could serve as an inspiration to or at least as a useful starting point for drafters of future *sukuk* focused guidance, which seems long overdue in the interest of legal certainty.

Furthermore, since *sukuk* becomes more and more popular among investors settled in different countries, there is all the more the need for a harmonized approach to default. This would guarantee that investors can freely invest across the Islamic world without having to learn new country-specific rules each time they cross a border. Furthermore, aligning the guidance with the most often applicable foreign law (i.e. English or French law) would guarantee an outcome within certain anticipated parameters in cases concerning foreign investors or investments in foreign funds. This would add more stability to the system and will increase consumer protection, particularly in the case of retail investors. Last but not least, certainty will increase interest in the instrument, thus further livening up the capital market in the Middle East.

With a view of the above, the three common law rules on penalty clauses are given below with a commentary. According to them, an English court will disallow a liquidation damages clause:

> *"if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach."*[1002]

This approach is in the spirit of the AAOIFI's general guidance and it should arguably be included in a future *sukuk* focused guidance issued by it.

Furthermore, the court will disallow a clause

> *"If the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid."*[1003]

[1001] *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] EWHC 271 (TCC)' [2005] BLR 271.
[1002] *Dunlop* (n 999) for Lord Dunedin, p. 87.

The latter raises a potentially tricky point for the Western investor because if applied to the *sukuk* context, it would certainly circumvent the issue of paying interest by way of compensation for late periodic payment or late return of the principal. However, exactly because of this, the second rule also appears to be in line with the AAOIFI's general guidance. If the issue of interest payment is ignored for the moment, applying this rule could potentially be useful in the *sukuk* specific circumstances because it could formally guarantee the return of the investment (principal and periodic payments expected).

This would be the case even if it is acknowledged that, since a *sukuk* holder could never be sure of the amount of the periodic payments due to him (see the difference with conventional bonds in Table 1),[1004] he could never stipulate it accurately. Regardless, this will not be an issue under English law, because if the discrepancy between the expected and the actual sum is not substantial, following *Alfred McAlpine* the court will likely accept such estimation. It is further suggested, that including this rule in a *sukuk* specific guidance could be potentially useful because it would guarantee that a liquidated damages clause containing a pre-estimate of the outstanding returns plus the principal would be enforced by the court.

The third rule states that

> *"there is a presumption (but no more) that it is penalty when "a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage".*[1005]

The bottom line here is that the court will be more inclined to accept the LDC and award damages if it could be ascertained that the event on which the LDC was predicated would cause serious as opposed to trifling damage. At the end, how a clause is worded would be relevant to whether it will stand in court or not. As a summary of the three rules, arrangements that are not done in good faith would not be enforced by the English courts.

[1003] *Dunlop* (n 999) for Lord Dunedin, p. 87.
[1004] Chapter 9: [9.8.].
[1005] *Dunlop* (n 999) for Lord Dunedin, p. 87.

The above discussion aside, there is no guidance on *sukuk* default at the moment of writing. This means that the AAOIFI's proscription of 'any financial compensation, … as a penalty clause in respect of a delay by a debtor in settling his debt', predetermined or not, should be considered at present the most persuasive point of reference.

Another point worth considering, because of the connection between the common law more generally and English law in particular, and Islamic finance, is the responsibility of auditors to third parties. Furthermore, the matter of auditors is relevant because, due to the lack of regulatory oversight on cases of Islamic finance default, potential investors are encouraged to do their own diligence before proceeding with an investment.[1006] To this end, an auditor's report could be relied upon by investors in the course of taking the decision to invest in a company or a project. Apart from being part of a due diligence process, such reliance could save the prospective creditors considerable time and effort.

The question that may be posed by the injured parties is whether, in a case of the debtor defaulting, the creditor could have a basis to claim damages from such third parties. If the common law is considered, the answer is in the negative, because under the established common law precedents, auditors do not owe a duty of care to third parties but only to those who have been audited by them.[1007] This is the position of the courts in Australia and the US, as well as the UK. Courts have expressed different policy reasons for adopting such an approach. One of the most popular of them is the famous Cardozo, C.J.'s line that the law should not allow "a liability in an indeterminate amount for an indeterminate time to an indeterminate class."[1008] The rationale of the Cardozo approach is to prevent excessive litigation which would be wasteful in terms of resources and time.

Another argument in favour of this approach was enunciated in *Esanda* where it was stated as part of the *ratio decidendi* that corporations are capable of making their own due diligence and should not be assisted in that by courts.[1009] The idea behind is to avoid both patronizing

[1006] BIX Malaysia (n 757).
[1007] *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241. See also, *ULTRAMARES CORPORATION, Appellant and Respondent v GEORGE A. TOUCHE et al., Copartners under the Firm Name of TOUCHE, NIVEN & COMPANY, Respondents and Appellants* 174 N.E. 441 (1932); the rule is still in force in the state of NY, see, *Credit Alliance Corporation v. Arthur Andersen & Co.* 483 N.E. 2d 110 (1985).
[1008] *Ultramares* (n 1007).
[1009] *Esanda* (n 1007).

businesses and doubling their work – conventional corporations are under an obligation imposed by the law[1010] and almost universally, by their bylaws,[1011] to act with due diligence in the carrying out of their business.

Generally speaking, the common law courts fail to find sufficient nexus between auditors and third parties,[1012] although some later US cases have put forward a more relaxed regime. For example, a US Court of Appeals held in 1972 that it is possible to hold an accountant liable in negligence if he has done careless financial misrepresentations, which have been relied upon by limited classes of persons that could be actually foreseen.[1013] It is suggested that these authorities could be referred to by counsel in cases of default on *sukuk* obligations, particularly if the class of persons injured is that of retail investors. Even if the class includes institutional investors only (and one should not forget that most of *sukuk* issuance is targeted at institutional investors), they could in certain cases be identified and foreseen as a group of people who would rely on the representation of the auditor.

Another point to consider is that provisions for default in *sukuk* must take account of and distinguish between default of periodic payments and return of the principal. As far as the AAOIFI guidance currently stands, it does not provide for such a distinction. That said, it is at least arguable that the guidance's reference to opportunity loss[1014] may be taken to apply to periodic payments – meaning that on default by a solvent debtor, creditors should not rely on compensation for the loss of (future) periodic returns but only for the loss of the principal. This point could however bring a lot of contention and should be clarified in future guidance on *sukuk*.

Furthermore, there could be confusion as to the amount of the principal debt. As per *sukuk* rules, the return of the principal will be at the current market price (not at the price paid at the time of signing of the contract). However, adopting this approach when settling the debt on default, may

[1010] Carsten Gerner-Beuerle & Edmund Schuster, 'MAPPING DIRECTORS' DUTIES: THE EUROPEAN LANDSCAPE' (n.d.) LSE, Study to be prepared for the European Commissionhttps://www.jura.uni-hamburg.de/media/ueber-die-fakultaet/personen/hirte-heribert/ecfr/7/gerner-beuerle-schuster.pdf accessed 22nd June 2018.
[1011] Carsten Gerner-Beuerle, Philipp Paech and Edmund Philipp Schuster. 'Study on Directors' Duties and Liability' (2013) LSE, prepared for the European Commission DG Markt.
[1012] *Ultramares* (n 1007).
[1013] See *Rhode Island Hospital Trust National Bank v. Swartz, Bresenoff, Yavner & Jacobs* 455 F. 2d 847, 851, (1972). See also, *Rosenblum Inc. v. Adler* 461 A. 2d 138 (1983); *Citizens State Bank v. Timm, Schmidt & Co.* 335 N.W. 2d 361 (1983).
[1014] See Chapter 10: [10.2.].

contradict the AAOIFI standard from 2000, namely its position that currency fluctuations cannot be taken into account. While market price is not the same as currency fluctuation, there could be arguments that the two are alike, if not in letter than in spirit. Both measurements take stock of the increase or decrease of the value of the investment due to movements on the market despite the former being a reflection of how the market perceives the enterprise and the latter a representation of the investment *vis-à-vis* other currencies. Furthermore, as *sukuk* will rarely be hedged against other currencies, the matter of currency fluctuations may become secondary; however, the matter of market price will remain extremely relevant. In a situation where the issuer defaults on payment, this will likely bring the market price of the investment down. Arranging the debt on the basis of the par value of the *sukuk* would be grossly unfair to the relevant investor. It is highly unlikely that such injustice would be allowed in the Islamic courts; and for this reason, it is unlikely that the AAOIFI standard had envisioned *sukuk* when delivering this guidance. To expect AAOIFI to include *sukuk* in the guidance would be ill-advised because while the *sukuk* instrument was engineered in the late 1980s, *sukuk* issuance really took off in the years after the AAOIFI standard came about.

Furthermore, in order to ensure that the *sukuk* holder will not be placed at a disadvantage, it should be distinguished between a claim in debt and claim in damages. Both could be relied upon in an action for return of the principal but with a different effect. With respect to how the common law would approach the matter discussed above, in addition to the claim in damages, English law recognises the concept of claim in debt. This claim could potentially be very useful in settling down the issue of the principal. Counsel should however bear in mind that in the English law understanding, "[a] debt is a definite sum of money which the defendant, under the terms of the contract, is due to pay to the claimant. It is therefore distinct from a claim in damages."[1015] The bottom line is that technically speaking, *sukuk* holders cannot make a claim in debt unless they have established the (undisputed) market price of the principal.

To understand the potential problem that may arise, imagine that investor A has invested principal P at an infrastructure project of the company C. At the time of signing, the price of P was $100 per certificate expressed in SAR (Saudi Arabia Riyal) or 375.00 SAR. Due to the default of C, which has become known to the market, the price of P dropped to 140.00 SAR. If

[1015] Ewan McKendrick, *Contract Law*, (8th ed., Palgrave Macmillan 2009), 349.

sukuk rules are followed and the contract performed at maturity, A will not be able to recover more than the face value of P, namely 140 SAR per certificate. In this scenario, making a claim in debt for the amount of 140.000 SAR would be grossly insufficient for the investor and therefore unlikely that he would voluntarily elect this option. From the perspective of the court, allowing this to happen would be unfair and unconscionable.

The other option that the investor A has is to request back (again in a claim in debt) the actual sum invested by him. While this sum can be ascertained and therefore can satisfy the condition of a definite sum, it is not a sum 'which the defendant, under the terms of the contract, is due to pay to the claimant'. Quite the contrary; the defendant is expected to return the principal at a par value.

Of course, the discussion is entirely theoretical because *sukuk* issuers resort to taking up insurance in order to guarantee that they will be in a position to satisfy their creditors in case of default. *Shariah* law does not look kindly upon insurance, however. This may become an investor protection issue if the political regime hardens, in the sense that if no insurance is taken up, the theoretical conundrum discussed above may become a part of the business negotiations accompanying a default.

Note that the concept of claim in debt applies to a debt action, which necessitates establishing first whether the money is in actual fact due to the claimant, who has an action to recover, without having the burden to mitigate his circumstances or consider the rules on remoteness.[1016] As the English concept of a claim in debt applies to money owed to the claimant (to the creditor in the case of *sukuk*) there could be difficulties introducing it into the *sukuk* specific circumstances. To begin with, it would be conceptually illogical to apply the claim in debt to the principal because in the *sukuk* structure, the principal is converted into an ownership interest in a tangible, identifiable asset. *Sukuk* is not a purely debt instrument but a fusion of debt and equity. Claiming the principal as debt and not as equity, would immediately make the instrument incompliant with *Shariah*.

While the concept of a claim in debt could potentially be applied to defaulting periodic payments, here the obstacle would still be that in many types of *sukuk* these payments are never pre-

[1016] Ibid. See *White and Carter (Councils) Ltd v McGregor* [1962] AC 413.

determined, because they are linked to the profits and losses of the project. Of course, for *sukuk* providing for pre-determined returns (fixed), such as *ijara sukuk* (lease) [1017] or *mudarabah sukuk* (partnership),[1018] the claim in debt concept could prove useful. However, this will cover only periodic payments and not the principal. Even if the argument that the characteristics of *sukuk* do not allow claiming the principal in debt are ignored, the money owed on the *sukuk* principal cannot be pre-determined upon signing of the contract (recall that the principal is returned at the current market value) and that unlike bonds, 'the value of sukuk could be varied according to the value of the asset that is backing them.'[1019]

Another point to consider is that from a technical perspective, making a claim in debt under English law would not contradict Islamic norms as such, since periodic returns are expression of the debt aspect of *sukuk* and not of its connection to equity. However, since *sukuk* is a mixture of debt and equity, a claim in debt only could be seen with suspicion. Furthermore, to reduce the claim of the injured party to a claim in debt, advanced with respect to both periodic returns and principal (the debt and the equity aspects of the *sukuk* respectively), could be seen as undermining the *Shariah* principles backing this instrument.

The way to avoid this would be to unbundle *sukuk* and formally allow for different claims for its different parts. Technically this could be done, by allowing a claim in debt for periodic payments and a claim in equity for the principal but it would be up to the AAOIFI or another comparable body to decide on whether this approach could work. The possible *Shariah* based challenge could be to decide whether separate claims (in debt and in equity) can be made separately or they have to be bundled together. The latter approach may be preferred in order to preserve the *Shariah* compliant spirit of the instrument. However, from a practical point of view, investors should be left free to advance either of the claims, according to their preferences and after they have assessed the likelihood of each claim to be satisfied.

[1017] The returns on which can slightly fluctuate due to the inclusion of maintenance and insurance expenses.

[1018] Siti Sarah Razak et al., 'The contracts, structures and pricing mechanisms of sukuk: A critical assessment' (2018) Borsa Istanbul Review 23, https://www.sciencedirect.com/science/article/pii/S2214845018301765 accessed 14th June 2019, 24.

[1019] Ibid, 26-27.

10.5. Analysis of case law: defaulting sukuk in the courts

10.5.1. Overview

The importance to have adequate rules on default has been increasingly appreciated by the market due to a number of high-profile defaults affecting *sukuk* investments. This section will look at some of them, while continuing the discussion on certain, relevant to default, *sukuk*-specific features.

A difference should be made between asset-backed and asset-based *sukuk* on the basis of the credit risks they present to the investor. In principle, asset-based *sukuk* would expose its holders to the insolvency of the originator while the asset-backed one will not. This is because in the latter case, holders have a title to the property. In case of financial distress affecting the asset, the associated losses will be passed on to the *sukuk* holders but to the extent that there is an asset left, it will continue paying the investors.[1020] At least this is the theory behind the arrangement – as discussed, there could be some disconnect between the intentions of the creators of *sukuk* and how the instrument will perform in the courts.

The objections to asset-based *sukuk*, which many *Shariah* researchers have made clear,[1021] stem from the apparent riskiness of these instruments but also from the realization that asset-based *sukuk* often has no direct link to the underlying asset. The rights such instruments confer are simply rights on a portion of the cash flows as opposed to rights akin to the rights of shareholders.[1022] By extension, this would mean that making investors in asset-based *sukuk* whole on default would be a challenging task. Unfortunately, most of the issued *sukuk* is asset-based (like most bonds),[1023] which suggests that a huge number of investors are potentially at risk of losing their investment or money in courts proceedings, or both, in case the respective issuer defaults.

[1020] Tan Wan Yean, 'Sukuk: Issues and the Way Forward' (2008), http://www.iln.com/articles/pub_1674.pdf, 4-5.
[1021] See for instrance, Ahmed Abdirahman Herzi, 'A Comparative Study of Asset Based and Asset Backed Sukuk from the Shariah Compliance Perspective' (2016) 13(1) JMFIR 25; Mohammed W. Alswaidan et. al., 'Understanding and Evaluation of Risk in Sukuk Structures' (n.d.) University of Portsmouth, https://pdfs.semanticscholar.org/5b2d/11e18e4125ebf64560b7004093886ff70a6f.pd accessed 25th August 2019.
[1022] Mohammed Khnifer, 'Lex Islamicus: When Sukuk Default - Asset Priority of Certificate-holders vis a vis Creditors' (2010) http://www.opalesque.com/OIFI181/Lex_Islamicus_Sukuk_Default_Asset_Priority81.html accessed 3rd July 2019.
[1023] Ibid.

In contrast, investors in asset-backed *sukuk* have the right, in time of financial distress or at other times (apart from the time of the initial purchase undertaking), to cause sales of other assets belonging to the SPV or trust.[1024] This becomes particularly relevant on liquidation, as the process will give precedence to asset-backed *sukuk* holders to those holding asset-based *sukuk* certificates. Although the legal transfer of title, which an asset-backed *sukuk* entails, makes the instrument more expensive for the issuer, it is a measure intended to protect investors' interests. However, as was seen above, this mechanism for investor protection is not particularly fool-proof.

It is clear that even if there were no *Shariah* objections to the asset-based *sukuk*, its potential to create credit risk makes it undesirable not just for the *Shariah* but also for the conventional financial environment. This is the case because, from a conventional finance point of view, an asset-backed *sukuk* investor should be more resilient in times of bankruptcy, subject however to its conceptual weaknesses being fine-tuned beforehand.

The negative tone of the analysis should not take away from the *sukuk* instrument that its set-up is geared to protect investors from the potential insolvency of the issuer. The "bankruptcy remoteness" of issuers is achieved through resort to a SPV.[1025]

The tactic to use a SPV for protection from bankruptcy purposes is not new and is not limited to the Islamic market. Consider the following explanation, which highlights that the way SPVs are applied to bankruptcy remoteness purposes in the US resembles their usage in Islamic finance:

> *The remote structure must consist of a single purpose company ("SPC") borrower that owns a single asset generating a stream of income used to pay the credit facility. The SPC is "remote" in two ways. First, it is separated from the other entities of the borrowing group, which may own numerous assets and have significant other debt. Second, the provisions of the facility and the constitutional documents of the SPC make it difficult for the SPC to enter into bankruptcy.*[1026]

1024 Khnifer (n 1022).

1025 Watson Farley & Williams, ' An Overview of Bankruptcy Remote Structures' (2017) http://www.wfw.com/wp-content/uploads/2017/01/WFW-Maritime-Bankruptcy-Remote-Structures-January-2017-1.pdf accessed 3rd July 2019.

1026 Watson Farley & Williams (n 544). See *Paloian v. LaSalle Bank Nat'l Assn (In re Doctors Hospital of Hyde Park, Inc.)*, 507 B.R. 558, 701, 702 (N.D. Ill. 2013) for an example of a SPV, 'formed to hold a defined group of assets and to protect them from being administered as property of a bankruptcy estate.' In Sarah K. Kam, 'The not-so-remote possibility of the bankruptcy of a bankruptcy remote entity' (2013) Reed Smith LLP, https://www.lexology.com/library/detail.aspx?g=235ecab9-67c6-43c8-b62c-16954a210d7a accessed 2nd September

Such SPVs have been used in the States during the last 25 years for real estate transactions. Notably, SPVs have similarly been used by *sukuk* issuers working in the real estate market, for example mortgage providers. (Non)Incidentally, the case study on default discussed below concerns a real estate developer based in Dubai.[1027]

The SPV's bankruptcy remoteness works by isolating the underlying assets for the benefit of the *sukuk* holders. Isolation takes place through the sale of certain assets to the respective SPV. The rationale is that due to the lack of exposure of the SPV to the liabilities of the originator, it will be less vulnerable to the originator's bankruptcy or insolvency.[1028] The SPV remains exposed, however, to the liabilities of the underlying assets,[1029] which suggests that investors are not entirely protected.

Furthermore, it is evident that given the focus on bankruptcy remoteness and isolation of assets, the SPV tool has been introduced into the *sukuk* structure for the benefit of holders of asset-backed *sukuk*. In this sense, the purpose of the SPV is to hold the securitized and separated from the originator assets on trust for the benefit of the beneficiaries, which are the asset-backed *sukuk* holders. This set-up will be fine in jurisdictions where trust law is well-developed. However, as mentioned earlier, the trust mechanism has not yet been properly developed in the Middle East. In addition to that, *sukuk* issuances operating in different countries are likely to get exposure to different rules on bankruptcy remoteness. In the best case scenario, these rules can support the independence of the SPV from the originator. For example, there could be instances (such as in the Cayman Islands) where remoteness is assisted by legislation through measures eliminating potential liability for newly formed SPV (including tax liability) over a substantial span of years.[1030] In some cases, however, bankruptcy courts may give a permission to the SPV to file for

2019. Furthermore, consider that the corporate documents 'may impose limitations on the directors ability to authorize a bankruptcy filing', reducing but not eliminating 'the risk that the SPV will file for bankruptcy, be forced into bankruptcy, or otherwise be adversely affected by a bankruptcy of its affiliates', in Sarah K. Kam (n 1026).
[1027] Bloomberg, 'Tamweel PSC' (n.d.) https://www.bloomberg.com/profile/company/TAMWEEL:UH accessed 3rd July 2019.
[1028] Michael J T McMillen, 'Securities Laws, Enforceability and Sukuk' in Islamic Finance: Global Legal Issues and Challenges, Simon Arches & Rifaat Ahmed Abdel Karim, eds (2008).
[1029] Khnifer (n 1022).
[1030] Khnifer (n 1022).

bankruptcy over its lenders' objections, which has happened on a few occasions in the US.[1031] For example, the US courts allowed a SPV to file for bankruptcy when they were satisfied that the interests of the enterprise justified it.[1032] However, it must be noted that on this occasion the court held that the SPV's directors owe their loyalty to shareholders rather than debtors. In a *sukuk* scenario, therefore, it is not entirely clear how this issue will be decided, considering that *sukuk* holders are neither only lenders, nor are they *prima facie* shareholders in the enterprise.

Another, albeit rare possibility, is that bankruptcy courts use their equitable power to force the SPV to go 'into bankruptcy, through substantive consolidation with the bankruptcy estates of affiliated entities.'[1033] To this end, courts can proceed to consolidate the assets and liabilities of, for instance, issuer and originator, in order to obtain a single entity, which would allow for 'a more equitable distribution of property among creditors.'[1034]

Furthermore, section 363 of the US Bankruptcy Code authorizes the bankruptcy court to sell some of the assets of the SPV 'free and clear of the lender's liens'.[1035] This measure could be taken if the court is satisfied that by doing so the bankruptcy sale will obtain the highest value for the SPV's assets.[1036]

Lastly, US law (as most other jurisdictions) recognises the concept of a true sale, which refers to establishing of whether the financial assets now held by the SPV have indeed been sold to them or that the purported sale has the characteristics of a loan. The US courts decided such matter on a case by case basis, looking at the specific circumstances and the substance of the transaction. In the US courts' view, if the seller appears to have parted with the risks and benefits inherent in ownership of the assets subject to the sale, the transaction constitutes a true sale. Furthermore, the existence of recourse to these assets tentatively indicates that the transaction is a loan rather than

[1031] Sarah K. Kam (n 1026).
[1032] *General Growth Properties Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009).
[1033] Sarah K. Kam (n 1026). Section 105 of Title 11 of the United States Code (the Bankruptcy Code).
[1034] Sarah K. Kam (n 1026). See, *Westlb AG v. Kelley*, 514 B.R. 287, 291 (D. Minn. 2014); see also *Bank of N.Y. Trust Co. v. Official Unsecured Creditors Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009).
[1035] Sarah K. Kam (n 1026).
[1036] Sarah K. Kam (n 1026).

a sale. The courts will take the intention of the parties in consideration but will not consider them a controlling factor in their determination.[1037]

In comparison to the US, the UK framework on bankruptcy remoteness of SPVs appears more beneficial to the *sukuk* instrument. On the matter of consolidation of assets, it has been established that English courts will be reluctant to conflate the identities of the originator and the issuer in an insolvency of either of them, because doing so will force the court to pierce the corporate veil. The exception to that would be fraud or proving that the issuer had no real commercial purpose for the transaction.[1038]

As to the concept of true sale, the courts will likely to look at how the parties have described the transaction in their documents in order to decide whether a transaction purporting to be a sale of goods should be re-characterized as a secured loan.[1039] If the court has a reason to believe that the transaction was a sham, it would not be deemed a true sale. Note that English law considers a sham those transactions, from which transpires that 'the parties must have intentionally executed documents that give the appearance of creating legal rights and obligations different from those which the parties intended to create.'[1040]

The respective legislative position in France is even more investor friendly, provided that the SPV has been established in France. Most importantly, the provisions of French law on bankruptcy do not apply to French securitisation entities.[1041] With regard to whether a transaction is a true sale, French law requires that its relevant provisions are abided by. French law requires the execution and remittance of the transfer deed on the transfer date and payment of the agreed price. Furthermore, existence of recourse against the originator is not deemed as invalidating the transaction. Although there is some risk of clawback under French law, related to the originator undergoing restructuring or liquidation, it is remote and can be challenged on a number of grounds. The exception to this would be if there is evidence that the sale was for an inadequate

[1037] Robin Parsons, Phillip Taylor and Alex Rovira, 'Asset securitisation and the effect of insolvency on special purpose vehicles' (n.d.) Sidley Austin Brown & Wood LLP, http://www.europeanrestructuring.com/05intro/036_041.htm accessed 2nd September 2019.

[1038] Ibid.

[1039] *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148, UK Court of Appeal. See also, Lloyds and Scottish Finance v Cyril Lord Carpet Sales Ltd and Re George Inglefield Ltd

[1040] Robin Parsons, Phillip Taylor and Alex Rovira (n 1037).

[1041] Article L214-175 III of the MFC.

price or that the fund had actual or constructive knowledge of the insolvency of the seller at the time of the transaction. [1042]

With respect to the risk of consolidation, French law provides that this can take place under strictly defined circumstances, including *de facto* management or comingling of assets. However, the former is unlikely to be proven due to the French law requirement that a SPV is managed by a licensed management company.[1043] Last but not least, the security interests of bond holders could be enforced by their representative, if such has been appointed and crucially, if the bonds were governed by French law.[1044]

It could be concluded that the way bankruptcy remoteness of the SPV is approached by the US courts and legislation should concern *sukuk* investors. In comparison, UK and French courts appear more likely to support a claim that the sale of assets to the SPV was a true transaction and should not be reclassified as a loan. Furthermore, these courts are unlikely to decide in favour of consolidation of the assets of the SPV with assets of another, possibly indebted company. These findings suggest that if a defaulted *sukuk* case reaches either the English or French courts as a consequence of arbitration or because of a nexus between the parties and the respective jurisdiction, investors have a better chance to obtain satisfactory results, compared to having this proceeding taking place in the US. However, it should not be forgotten that although investor-friendly, English law is more stringent than its French counterpart and British courts will subject the transaction to a much greater scrutiny than their French colleagues would.

Last but not least, it is possible that even if British courts decide the point on bankruptcy remoteness favorably for investors, they will still be challenged by the hybrid structure of the *sukuk* instrument.

A very interesting point to consider is that although the discussion on bankruptcy remoteness suggested that *sukuk* investors would not be well-served by the US justice system, case law demonstrates that this has so far not been the case. The comparison, which will be presented below, between the approaches to defaulted *sukuk* of the US and GCC countries courts indicates

[1042] Article D214-219 of the MFC.
[1043] Olivier Hubert, 'Getting the Deal Through', (2017) in 'Structured Finance & Securitisation', Patrick D Dolan Ed., Law Business Research, https://www.vda.pt/xms/files/v1/Publicacoes/2017/Artigo_PGF_MPR_-_Getting_the_deal_through_Structured_Finance___Securitisation.pdf accessed 25th August 2019, 25.
[1044] Ibid.

that the problems facing *sukuk* investors grow greater the closer they are to home. The next section will outline a number of cases of defaulted *sukuk* in order to give a better understanding of the practical implications of defaulted *sukuk* for investors.

10.5.2. Outcome for investors in defaulted sukuk: case law comparison between the US and the GCC countries

Post the global financial crisis period, there have been a number of cases of defaulted *sukuk*. This offers a chance for a glimpse at resolution procedures in a situation of distress.

One of these cases involved East Cameron Partners (ECP) from Louisiana and the first *sukuk* issued in the US (rated CCC+ by Standard & Poor's). As the analysis below will show, the law in the US was sufficiently adequate in protecting the *sukuk* investors. This is hardly the case with investors in defaulted *sukuk* issued in the Gulf Cooperation Council (GCC) countries. The comparison is worrying and merits a closer look.

The underlying contract in the ECP case was *musharakah* (co-ownership/joint venture) – the investments were funneled into the SVP jointly by the originator ECP and the *sukuk* holders. The *sukuk* was vested in royalty interests in oil and gas revenues from two companies (Overriding Royalty Interest (ORRI)), sold to, in a true *Shariah*-compliant sale, and held by an offshore SPV. The assets were secured by a mortgage over the assets of the originator. The SPV, called East Cameron Gas Company (ECGP), was incorporated in the Cayman Islands. It acted as a trustee for the *sukuk* holders. In 2008, the distressed originator attempted to engulf the *sukuk* assets into its estate, while filing for protection under Chapter 11 of the US bankruptcy code. This was contrary the undertakings of the issuer who had advertised the *sukuk* assets as bankruptcy remote. The Court held that the transaction concerning the *sukuk* assets was a true sale which meant that the investors were protected on this occasion.[1045]

ECP opted to seek financing through placing of *sukuk* because at the time this seemed to them a good alternative of conventional financing, all the more that they had some difficulties raising the

[1045] Islamic Markets, 'East Cameron Partners' Sukuk' (2019) https://islamicmarkets.com/education/east-cameron-partners-sukuk accessed 16th July 2019. See also, Sweder van Wijnbergen and Sajjad Zaheer , 'Sukuk Defaults: On Distress Resolution in Islamic Finance' , (July 2013) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2293938 accessed 16th July 2019.

funds that they needed at the material moment. The ECP had a choice between issuing *ijarah sukuk* and a *musharakah sukuk*. They elected the latter option because it provided them with complete control with respect to their shares post the maturity date. Another relevant consideration was that the returns on *ijarah sukuk* would have been lower than that on the *musharakah* alternative, which would have made the issuance more unattractive to investors.

The *sukuk* issuance in the instance was considered fully *Shariah* compliant because it abided by the relevant 2008 AAOIFI's requirements. Firstly, the *sukuk* was asset-backed. The underlying *musharakah* assets, with respect to which the *sukuk* holders were conferred ownership, were claims on the oil and gas reserves through registered ownership of ORRI. Such claims are deemed real property in the US jurisdiction.[1046] The originator provided credit enhancement through a $9.5 million reserve account. This too was in accordance with the relevant *Shariah* principles, as discussed by AAOIFI in 2008.[1047] In addition, the issuance was hedged (through a backup offtake agreement with Merril Lynch) against the risk related to demand for gas production. Hedging of risk is in principle accepted by *Shariah*. Furthermore, the company bought put options for the right to sell the oil and gas at the strike price, in order to avoid selling at prices below this level.

Despite the well-thought out *sukuk* structure, the company defaulted on the periodic payments due on the *sukuk*. This was caused by a hurricane in the area in September 2008, which inflicted damage, resulting in a shortfall in oil and gas production. Following this, in October 2008 the ECP filed a petition for bankruptcy under the relevant law in the United States Bankruptcy Court (USBC) in Louisiana to reorganize their debts and operations.[1048] The ECP asked the USBC to hold that the transfer of assets to the SPV was "secured loans" rather than a true sale.[1049] If the court had agreed with that, in the case of liquidation the *sukuk* holders would have been placed alongside the other creditors of the company *vis-a-vis* receiving redress from the company's assets. This is to say that they would not have had a preferential claim on these assets. This was rejected by the USBC, which stated that "[sukuk] holders invested in the sukuk certificates in

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[1046] John Lowe, 'Defining the Royalty Obligation' (1997) 49(2) SMU Law Review, SMU Dedman School of Law Legal Studies Research Paper No. 306, https://ssrn.com/abstract=2807139 accessed 16th July 2019.
[1047] Islamic Markets (n 1045).
[1048] *East Cameron partners L.P, v. Louisiana offshore holding, LLC. & Ors* [2009].
[1049] Ibid.

reliance on the characterisation of the transfer of the royalty interest as a true sale"[1050] The case had been subjected to multiple analyses, including by Islamic scholars who largely agreed with the court's stance, deeming it aligned with the *Shariah* maxim "Muslims are bound by their contractual agreement".[1051]

The 2009 case of The Investment Dar (TID) *sukuk* turned on the default of the issuer TID. The $100m issuance was of asset-based *sukuk*, governed by English law, and the relevant underlying assets were located in Kuwait. Due to the location of the assets, the case was decided under the new financial stability law of Kuwait. The court considered that TID's investors held certificates of asset-based *sukuk* and according to the prospectus, 'were to present a put option to TID, with the accompanying risk to rank pari passu with other unsecured creditors.'[1052] The decision of the court was to issue a protection order halting all insolvency-related lawsuits against TID. In practice this meant that the investors were prevented from being compensated by the issuer in an adequate and timely matter. Instead, following the conclusion of the proceedings, TID agreed with the *sukuk* investors to restructure the debt over the course of the following six years.[1053]

Another 2009 case concerned the default of a $650m *sukuk*, issued in Bahrain by the Saad Group (a Saudi conglomerate). The default came as a result of a financial crisis following the freezing of the assets of the Group by the Saudi Arabian Monetary Authority. While it was reported at the time that the Group reached a settlement with its Saudi investors and they were subsequently repaid, foreign investors claimed to have been entirely ignored by the Saad Group 'and in 2013 a settlement had yet to be agreed.'[1054]

The fourth case concerns the $4bn Nakheel *sukuk* issued by Dubai World. The *sukuk* was governed and structured according to English trust law. In 2009 the issuer ran into financial difficulties and took steps to restructure its $26bn debt. This created panic among Nakheel *sukuk*'s investors. Fortunately for lenders, although the rights held by them were leasehold rights

[1050] East Cameron (n 1048); See also, Fawaz Elmalki & Dennis Ryan, 'The Untested Waters of Default in Islamic Finance' (2010), Eurekahedge, Conyers Dill & Pearman http://www.eurekahedge.com/Research/News/477/The_Untested_Waters_of_Default_in_Islamic_Finance accessed 25th June 2019.

[1051] Saheed Abdullahi Busari, 'Juristic Analysis of Ṣukūk default: East Cameron Gas United States of America' (2019) 2(1) Al Hikman Journal 109, 109.

[1052] Steven Friel and Silke N. Kumpf, 'Sukuk default' (2015) Financier Worldwide, https://www.financierworldwide.com/sukuk-default accessed 23rd June 2019.

[1053] Ibid.

[1054] Steven Friel and Silke N Kumf (n 1052).

and the ownership of the underlying assets only beneficial (as per English law) and in addition, they were not recognised as real rights under UAE law, the default was prevented by the government which was the indirect owner of the assets. What made it easier was that the underlying assets were located in the UAE.[1055]

As has been argued,

> *These case studies make clear that in most cases, the problems can be traced back to clauses and structures that made the sukuk more like conventional bonds. Furthermore, once default happened, most of the sukuk discussed did not transfer the underlying assets to the sukuk holders. So, in the event of default, due to limited recourse provisions, sukuk holders often had nothing to resort to, as effectively there were no underlying assets in their ownership. The case studies highlighted the importance of the legal institutions of the country where the collateral is likely to be contested.*[1056]

In any case, such disparity in the law is bound to create some obstacles in the smooth operation of the global *sukuk* market, if for no other reason, then for reason that many investors use investment platforms, which are trading cross-border. The issue is likely to become more noticeable in the future, with the increasing influence of financial technologies on the Islamic markets.

This section was an attempt to illuminate the possible challenges linked to *sukuk* investments from a technical point of view. Note that a completely different set of challenges may come to being if *sukuk* is altogether banned by religious authorities due to its *Shariah*-problematic nature or if its rules are heavily changed, in order to make them more compatible with *Shariah*. This aspect of the instrument merits a more thorough discussion and will be discussed later in the book. However, even before such a discussion has taken place, it is evident that *sukuk* is potentially risky for investors (despite being good for businesses). The expected problems may

[1055] Steven Friel and Silke N Kumf, 'Sukuk default' (2015) Financier Worldwide https://www.financierworldwide.com/sukuk-default accessed 3rd July 2019.

[1056] Sajjad Zaheer and Sweder J.G. van Wijnbergen, 'Sukuk Defaults: on Distress Resolution in Islamic Finance' (2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2293938 accessed 16th July 2019, 2.

not arrive tomorrow but they will arrive soon enough. It is arguable that once this happens, despite the costs, it would be harder to reestablish investors' trust in Islamic finance than it is now to calibrate the instrument and make it safer for all parties concerned.

10.6. The sufficiency of the Islamic financial instruments

"Comparison with the same should not be based on the name alone".[1057]

Substance in law has been described in the following way: "A matter of substance, as distinguished from a matter of form, with respect to pleadings, affidavits, indictments, and other legal instruments, entails the essential sufficiency, validity, or merits of the instrument, as opposed to its method or style."[1058]

The analysis in this work suggests that while the Islamic finance instruments remain largely true to form, the genuine compliance with *Shariah* law of their substance is often questioned. This work made no exception to this tendency but it so far attempted critical analysis from either a technical or a religious-jurisprudential point of view. While the author has discussed the specific weakness of one or another instrument, these have not yet been bundled and analysed together in order to detect a trend or to guess an outcome. While Islamic financial instruments have already been analysed in this work against the markers of validity and merits, it would be quite useful to examine how they would fare against the requirement of "sufficiency". This would help us draw some conclusions as to the instruments' jurisprudential purity and their potential viability in a moderate or radical legal environment.

Sufficiency is a quality needing a point of reference. It could for instance be asked: sufficient for whom or sufficient to achieve what. The analysis of this work suggests that practitioners currently deem the pool of Islamic finance instruments sufficient to allow the carrying out of most commercial transactions. For example, Islamic finance offers contracts of exchange (e.g. *ijarah*, *murabahah*, *istisna'*) or contract of participation (for example, *musyarakah* and

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[1057] Fatawa Al Islam Su'aal wa Jawaab, Bab 47651 Al Bunuk Al Islamiyyah, juz 1 p. 4707 under the supervision of Sheikh Muhammad Soleh Al Munjid; in www.islam-qa.com

[1058] The Free Dictionary, 'Substance' (n.d.) https://legal-dictionary.thefreedictionary.com/substance accessed 12th June 2019.

mudarabah), as well as debt-based arrangements such as the Islamic bond, which allows the funding of major, including governmental, projects. Furthermore, with the exception of futures, the Islamic market utilises the most common forms of derivatives, namely forwards, options and swaps.

However, the ability to simply carry out a financial transaction is hardly sufficient, without a focus on efficiency and sophistication. It transpires from the current research that Islamic financial instruments lack the former to some and the latter to a bigger extent. The lack of efficiency is linked largely to the overwhelmingly complex structure of these instruments. In order to build a *Shariah* compliant Islamic transaction, the parties must conclude a series of smaller transactions and to enter into a series of contracts. Not only does this necessitate more human hours and effort, it exponentially increases the risk of transaction failure since it allows for a greater possibility of actionable breaches to take place at many turns of the deal. The practical outcome of this is higher administrative costs, which are being passed on to the end customer (usually the weaker party to the transaction) and possibly litigation costs and loss of opportunity costs in case that the contract breaks down.

Another practical consideration related to the structuring of Islamic financial transactions is to do with speed. Since the area of derivatives trading is speed sensitive, the overcomplicated way of transacting characteristic for Islamic finance should be held responsible for a percentage of losses. For example, it is common knowledge that speed is essential in the price discovery process. To this end, aggressive high-speed trading has increasingly become the norm on exchanges, which is expected, considering that putting in an aggressive order brings in an inherent advantage.[1059]

The lack of sophistication, on the other hand, should arguably be held responsible for the loss of numerous advantages. For example, due to the interconnectedness of modern finance, Islamic derivatives operate in a very competitive and sophisticated environment, which operates with much more sophisticated instruments. Limiting Islamic finance's operation to the currently available derivative contracts limits the respective benefits attached to derivative trading,

[1059] Joe Parsons, 'Eurex begins test run of speed bumps in derivatives market' (2019) The Trade, https://www.thetradenews.com/eurex-begins-test-run-speed-bumps-derivatives-market/ accessed 3rd September 2019.

ultimately hurting Muslim investors. 20 years ago it has been argued that this trend would lead to a welfare loss for the Muslim world, which may be big enough to justify factoring in of the issue in the discussion on the future of Islamic finance.[1060] It is up to the current scholars to conclude whether this is still the case and act accordingly.

In addition, even if this negative prognosis turns out to be incorrect, one must question whether instruments have already been utilised to the best of their abilities or if there is room for improvement in this regard. For example, the *sukuk*, which is a popular Islamic finance alternative to conventional bonds, has been stagnating on a few occasions during the last decade and particularly around the latest financial crisis,[1061] due to various reasons. It has been noted that among such reasons are 'lack of standardization of Shariah rules, high issuance costs, low liquidity in the secondary sukuk market, and low foreign participation.'[1062]

Chapter 11: What conclusions can be made from the revivalist developments in Islam and how this would impact on the Islamic finance framework?

11.1. The concept of jahiliyyah

Chapter Four presented the historical background of the revivalist movement, as well as the main philosophical and religious concepts espoused by *Sunni* and *Shia* Muslims respectively. Chapter Eleven will continue discussing the topic, this time placing it closer to the modern times and the area of finance, while tracing the ways in which radicalism manifested itself in the Islamic

[1060] Obiyathullah Ismath Bacha, 'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration' (1999) (1(1)International Journal of Islamic Financial Services 1, 15.
[1061] Rahail Ali and Imran Mufti, 'Sukuk – Back to the future' (2008) IFR Middle East Report 2008, Reuters, http://www.ifre.com/sukuk-back-to-the-future/566049.fullarticle accessed 17th June 2019.
[1062] Abdullah Alawi and Saleh Al-Quati, 'Sukuk: The Sharia Fixed Income Alternative Strategy' (2014) Strategy Report, AlJazira Capital, http://webcache.googleusercontent.com/search?q=cache:qpJsdQPkzScJ:www.aljaziracapital.com.sa/report_file/ess/spe-171.pdf+&cd=3&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 17th June 2019, 1.

political life throughout the 20th and in the early 21st centuries. For the sake of completeness, references will be drawn to the material discussed in Chapter Four. As will be seen below, the continuity characteristic of Islam has allowed the transfer and absorption of concepts from the early Islam to modernity. The notion of *jahiliyyah* makes no exception to this.

The concept of *jahiliyyah* (ignorance) could be an important starting point for understanding radical Islam. Amalgamation of the notions of renewal, condemnation and striving, the term was used in reference to the period prior to the time when Mohammad received the revelations.

In the 20th century's early contemporary revivalism, Mawdudi adopted a different use of the word. For him *jahiliyyah* was those forces which strived to corrupt the Muslim society and it was the duty of the revivalists to fight such forces. Building upon this, Qutb labeled as *jahiliyyah* those who he deemed enemies of true Islam.[1063] For Qutb *jahiliyyah* had pervaded the entirety of modern life, and even its 'material comforts and high-level inventions cannot rescue modernity [and] do not diminish this ignorance.'[1064] Specifically, Qutb preaches that 'the whole world, including that part of it that calls itself Muslim, is in a state of jahiliyyah.'[1065] In his narrative, *jahiliyyah* now 'takes the form of claiming that the right to create values, to legislate rules of collective behaviour…rests with man, without regard to what God has prescribed.'[1066] In his Manifesto *Milestones*, Qutb claimed that:

> *We are also surrounded by Jahiliyyah today, which is of the same nature as it was during the first period of Islam, perhaps a little deeper. Our whole environment, people's beliefs and ideas, habits and art, rules and laws – is Jahiliyyah, even to the extent that what we consider to be Islamic culture, Islamic sources, Islamic philosophy and Islamic thought are also constructs of Jahiliyyah!*[1067]

The concept, now perceived as referring to "secular modernity"[1068] has enjoyed renewed prominence in this century as an ideological foundation for the activities of both ISIS and Al Qae'da. For instance, both groups based their denouncement of the civil and religious leaders of

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[1063] See in general, Mark A. Menaldo, 'Sayyid Qutb's political and religious thought: the transformation of jahiliyyah and the implications for Egyptian democracy' (2014) 2(1) Leadership and the Humanities 64.
[1064] Sayyid Qutb, *Milestones* (1964) (Islamic Book Service 2006).
[1065] Sayyid Qutb, *Milestones* (1964) (Islamic Book Service 2006).
[1066] William E Shepard, 'Sayyid Qutb's Doctrine of Jahiliyyah' (2003) 35 International Journal of Middle-Eastern Studies 521, 521.
[1067] Sayyid Qutb, Milestones (1964) (Islamic Book Service 2006).
[1068] Oxford Islamic Studies Online, *Jahiliyyah* (2019) http://www.oxfordislamicstudies.com/article/opr/t125/e1157 accessed 10th August 2019.

modern Islam on *jahiliyyah*.[1069] However, the connection of these two groups to Qutb's philosophy ran deeper.

After the execution of Qutb, the Muslim Brotherhood split into a more moderate and more radical fraction. The latter, known as Egyptian Islamic Jihad was headed by a former Muslim Brother, Ayman al-Zawahiri.[1070] Al-Zawahiri left Egypt after the assassination of the Egyptian President Anwar Sadat. In the following years he traveled to Pakistan where he met Osama bin Laden, leading to the eventual merging by 1998 of the Egyptian Islamic Jihad with the organisation then headed by bin Laden. This was how Al Qae'da was created.[1071] After the death of bin Laden in 2011, al-Zawahiri became Al Qae'da's leader. As known, Al Qae'da worked with a number of affiliated organizations. One of them, Al Qae'da in Iraq, eventually separated and became an independent organisation, known as the Islamic State (ISIS). Importantly, the ideological connection between the radical wing of the Muslim Brotherhood, Al Qae'da and ISIS has been provided to a big extent by the writings of Qutb, (and indirectly the writings of Mawdudi)[1072] and particularly his reading of the concept of *jahiliyyah*.[1073]

Another very pertinent notion is that of *tawhid*, the oneness of God.[1074] While *tawhid* has traditionally been seen as a belief or a concept, in the last decades of the 20th century it came to be perceived as a process and more specifically, as the process of Islamic transformation of a society or an individual.[1075] Once again, it is Mawdudi who transformed the concept into something broader and farther reaching by claiming that *tawhid* has basic implication for political, social and economic life.[1076] *Tawhid* is therefore instrumental to the process of active transformation of society aspired to by revivalists. In some more radical interpretation, *tawhid* may therefore become the ideological platform for the reshaping of the current framework into

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[1069] James Hess, 'How Jahiliyyah Provides an Ideological Platform for Islamic Terrorists' (2016) https://inpublicsafety.com/2016/04/jahiliyyah-provides-ideological-platform-islamic-terrorists/ accessed 10th August 2019.
[1070] Abdel Monem Said Aly, 'The Truth about the Muslim Brotherhood' (2018) The Cairo Review of Global Affairs, https://www.thecairoreview.com/essays/the-truth-about-the-muslim-brotherhood/ accessed 10th August 2019.
[1071] James Hess (n 1069) ibid.
[1072] Asyraf Hj. A.B. Rahman and Nooraihan Ali, 'The Influence of Al-Mawdudi and The Jama'at Al Islami Movement On Sayyid Qutb Writings' (2012) 2(4) World Journal of Islamic History and Civilization 232.
[1073] James Hess (n 1069). See also, National Commission on Terrorist Attacks Upon the United States, 'The foundation of the New Terrorism' (2004) (https://www.9-11commission.gov/report/911Report_Ch2.htm accessed 10th August 2019.
[1074] The *Qur'an* (n 109), Chapter 112:1-4.
[1075] Yvonne Yazbeck Haddad (n 67), 28.
[1076] Yvonne Yazbeck Haddad (n 67), 28.

one that is aligned to a purer form of Islam. This tendency has already been observed in the activities of the early Muslim Brotherhood, as well as in its latest iterations.

Sayyid Qutb himself placed a great emphasis on *tawhid*, treating it as an irreplaceable part of the structure of the revived Islam. While this is understandable because a concept based 'on the principle of total submission to God alone'[1077] seems to fit right in a revivalist doctrine, *tawhid* started penetrating the parlance of the more moderate Muslim intellectual elite. For example, al-Faruqi argues in favour of "Islamisation of knowledge", considering that a holistic Islamic approach must be applied to all spheres of life, including the economic one.[1078] Significantly, the ideologist of the Iranian revolution Ali Shariati contributed significantly to the conceptual development of *tawhid*, thus confirming that dissemination of the ideals of revivalists transcends the borders of denominations and the overarching, *de facto* pan-Islamic connection among modern day revivalists.

11.1.2. What exactly is the modern Islamic radicalism?

The first significant writings on Islamic radicalism started appearing in the 1950s, non-coincidentally around the end of the colonisation era. These ideas came more prominently to the surface, or rather received a more physical manifestation, in the late 70s, coincidently close to the time when the concept of Islamic finance was born and started taking its first steps. It is easy to conclude that such stirring of ideas occurred because the newly independent nation states needed to self-identify, with respect to their former colonial rulers and with respect to their newly formed neighbouring countries. As will be seen further below, this need for self-identification proved to be instrumental for the development and relative success of the so-called Islamic State (ISIS).[1079]

The case of ISIS was a particularly interesting one from a variety of points of view –historical, anthropological, sociological, psychological and not just political. As with all revolutionary movements, the process of self-identification of its followers necessitated internalisation of and identification with the idea of a reform and its consequent signalling to the outer world.

[1077] Sayyid Qutb, *Milestones* (1964) (Islamic Book Service 2006).
[1078] Tasnim Abdul Rahman et al., 'The Works and Contributions of Isma'ilRaji al-Faruqi in Islamization of Knowledge' (2015) 5(1) Journal of Islamic Thought and Civilization 33.
[1079] Trevor Hawkins, 'A Theoretical Analysis of ISIS Indoctrination and Recruitment' (12-2016) Capstone Projects and Master's Theses. 7.
https://digitalcommons.csumb.edu/caps_thes_all/7 accessed 14th Septemberc 2019, 20, 27-29.

Furthermore, while ISIS may arguably be the culmination of the ideas of revival and radicalism, this narrative would not be complete without giving its due to the distinction in the ideological movements originating in *Sunni* and *Shia* countries respectively. These distinctions are culturally-sensitive, yet relevant to the current discussion and will be explored below despite the fact that Islamic Finance as discussed prior in this work applies solely to traditional *Sunni* Islam (because of specificities applicable to *Shia*, which will be looked at in detail further below).

The *Shia* discussion has been included for two main reasons.[1080] Firstly, as will be seen below, the ideas of Islamic radicalism largely coincide with respect to their diagnosis, goals and cures, regardless of whether they belong to a *Shia* or a *Sunni* thinker. Secondly, while most extremist movements, including ISIS, were driven by *Sunni* Muslims, Iran (the country with the largest *Shia* population in the world) has already succeeded in carrying out an Islamic Revolution. In that, Iran (the Islamic Republic of) may provide a good case study on the potential outcomes for radicalised States. Even more importantly, its 40 years of experience under the Islamic Republic could support a hypothesis about the economic viability of an entirely religious regime, specifically with regard to the financial markets.

11.2. Shia and the narrative of radicalism

11.2.1. The road to the Revolution

A country, which is predominantly *Shia*, Iran gave birth to a fundamentalist and politically active movement known as *Fidaiyan al-Islam* as early as the late 40s of the last century. The *Fidaiyan* movement had a momentous and continuous impact on the development of the Iranian State and as such it deserves to be looked into in some detail. Its beginnings were laid down by Sayyed Mojtabā Mīrlawḥī, following the arranged by him assassination of the anti-*Shia* Persian historian and intellectual, Aḥmad Kasrawī.

At first glance, this assassination encapsulated the clash between secular and religious, which had permeated the recent history of the Muslim states. Kasrawī was targeted because, as a lawyer with anti-cleric and reformatory convictions,[1081] he envisioned and propagated for a secular

[1080] For an illuminating discussion on *shi'a* see in general Laurence Louer, Transnational Shia Politics: Religious and Political Networks in the Gulf (Columbia University Press 2008), 5.
[1081] Lloyd Ridgeon, *Sufi Castigator: Ahmad Kasravi and the Iranian Mystical Tradition*, (Routledge 2006), 47.

Iranian State, contributing to it by writing the influential books "History of the Iranian Constitutional Revolution" and "Eighteen Years History of Azerbaijan". The latter gave a detailed account of the Persian Constitutional Revolution (1905-1911) which led to the establishment of a Parliament in Iran (then Persia) for the first time. Despite the controversy surrounding Kasrawī – mainly due to the perceived weakness of his academic research and his alleged bias towards pre-determined conclusions, he was influential in the discourse on Iranian post-colonial identity.[1082]

The main reason why Kasrawī was targeted by *Fidaiyan al-Islam* was rooted in their belief that Islam needs to be purified from internal and external threats. To their mind Kasrawī represented both because of his harsh criticisms of many traditional Islamic practices, as well as his fondness for the West. In that, Kasrawī's philosophy and conduct encapsulated the two main objections that historically have taken a strong hold within Islamic radical movements.

Note that fitting with the logic of such movements, the organisation that presented itself as *Fidaiyan al-Islam*'s politically more digestible alternative, the National Front (*Jebha-ye mellī*), was supported by the same Ayatollah Kāšānī, who in the period of 1946-1951 was closely linked to *Fidaiyan al-Islam*.[1083] However, despite this ideological connection, the National Front and *Fidaiyan* had a number of major differences, which culminated after the Front's advent to power. Relevantly, the Front was secularist, which *Fidaiyan* was clearly not. As a result, although the latter was instrumental to the Front's winning the election, soon after the former took power, their paths diverged. Instrumental to this separation were claims that *Fidaiyan* was linked or contributed with its activities to an 'atmosphere that promoted political violation and vigilantism'.[1084]

Admittedly, much of this conduct was caused by initial real concerns about the distribution of national resources, mainly oil, and in particular, about the integrity of the contracts concluded or attempted to be concluded with the British.[1085] However, after the nationalization of the oil (which alleviated these concerns) and the transition of Ayatollah Kāšānī towards an alliance with

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[1082] Ibid.
[1083] Y Richard, 'Ayatollah Kashani: Precursor of the Islamic Republic?' in N Keddie, ed., *Religion and Politics in Iran: Shiism from Quietism to Revolution*, (New Haven 1983), pp. 101-24.
[1084] Farhad Kazemi, 'FEDĀʾĪĀN-E ESLĀM' (2012) Encyclopeadia Iranica, http://www.iranicaonline.org/articles/fedaian-e-esla accessed 3rd June 2019.
[1085] Ibid.

the National Front, *Fidaiyan* became politically isolated and experienced a downfall, including the arrest, conviction and execution of its main leaders in 1956.[1086]

Nevertheless, the ideas of the organisation remained attractive to different parts of the population. For example, some of them were espoused by the Coalition of Islamic Associations (*Hayʾathā-ye moʾtalefa-ye eslāmī*) in 1963. The Coalition was known with the radical stance they took on the Shah's reforms, including on women's right to vote. To this end, it is notable that the leftist *Fidaiyan*'s Guide to truth (*Rāhnemā-ye ḥaqāʾeq*) as published in Tehran in 1950, was reissued after the 1978-79 revolution.[1087] It included the entire ideological statement of the movement and how they see the future Islamic State and society. Importantly, the Guide calls for an entirely *Shariah* ruled society, across all sectors of life. The document envisions that all non-Islamic laws would be abolished and the same harsh policy will apply to immoral practices such as gambling.[1088] More specifically:

> *The Fedāʾīān's program calls for the creation of an essentially egalitarian society, where wealth is distributed fairly and the needs of the poor are met. It values labor and thrift and stresses the importance of legitimate business activity. It praises the simple grocery shop as the exemplar of proper economic behavior, where hard work, fairness, and thrift guide its operations. The program particularly spares no harsh words for those who engage in usury, bribery, and corruption.*[1089]

Usury being another (more extreme) form of imposing interest on money was of a particular importance for this paper. Furthermore, the elevation of ordinary trade with tangibles (the reference to a grocery shop) and the opposition to gambling, as opposed to that of the more sophisticated capital market (where one added underlying problem is the use of money as commodity) arguably foreshadows (albeit by way of simplification) the current troubling state of

[1086] Farhad Kazemi, 'FEDĀʾĪĀN-E ESLĀM' (2012) Encyclopeadia Iranica, http://www.iranicaonline.org/articles/fedaian-e-esla accessed 3rd June 2019.
[1087] Ibid.
[1088] A Rahnema and F Nomani, *The Secular Miracle: Religion, Politics, and Economic Policy in Iran*, London, 1990, pp. 73-96, 81.
[1089] Farhad Kazemi, 'FEDĀʾĪĀN-E ESLĀM' (2012) Encyclopeadia Iranica, http://www.iranicaonline.org/articles/fedaian-e-esla accessed 3rd June 2019.

the Iranian economy with its many problems, among them a raging inflation, a Central Bank which lacks independence from the government and a 'fragile banking and financial sector'.[1090]

Despite the nearly utopian shade of the *Fidaiyan*'s ideology and that the practices of its members were disavowed by a number of Iranian governments, the movement's fundamentals are very much present in the politics of modern Iran.[1091] This was made possible because of the sufficient degree of popular support for the movement's ideas, including by the Iranian government.

Furthermore, this *de facto* ideological closeness between outright radicals and governments could underpin an argument that how strict the application of Islamic law will be, will very much depend on factors outside of a political discourse recognisable for Westerners. For example, Islam's big emphasis on the common wealth and the wellbeing of society rather than on the prosperity of its individual members makes for a deeply internalised link between Muslims and their religion. This link thrives on the idea that the poor, the weak and the helpless will be taken care of, subject to their devotion to Islam. While the idea of protection of the meek could be found in other religions, more specifically in Christianity, Islam arguably goes further in the practical protection of its devotees' rights by adopting a political framework where equality and fairness in wealth distribution takes a prominent role. Crucially, this sentiment was instrumental for the success of the Iranian Revolution, an uprising fuelled by the Iranian people's dissent to 'the Shah's increasingly authoritarian measures' and 'outrage against government extravagance, corruption, brutality, and the suppression of individual rights.'[1092]

11.2.2. The Iranian Revolution: a geo-political approach to revivalism

The Iranian Revolution is of significance to the focus of this work and as such, it deserves a more thorough explanation. Although bringing a drastic change to the order of the Iranian society, the

[1090] Stratfor, 'Iran's Frail Banking Sector Poses a Threat From Within' (2019) https://worldview.stratfor.com/article/irans-frail-banking-sector-poses-threat-within accessed 10th August 2019.
[1091] Ahmad Ashraf, 'Theocracy and Charisma: New Men of Power in Iran' (1990) 4(1) International Journal of Politics, Culture, and Society 113.
[1092] Jeremy Bender and Melia Robinson, '25 photos show what Iran looked like before the 1979 revolution turned the nation into an Islamic republic' (2019) Business Insider Spain, https://www.businessinsider.es/iran-before-the-revolution-in-photos-2015-4?r=US&IR=T&fbclid=IwAR2PYnjAYd9cVw-Fak9S3dLLBXuzXCjRcjeuvuux2ArQJU-yCOVuWzEm6xo accessed 10th August 2019.

Revolution was the result of a gradual process of disenfranchising for ordinary Iranian people. This process began as far back as the middle of the 19th century, with the formal colonisation of India by the British – an act, which arguably initiated the process of disintegration of the last Islamic Caliphate. Following the demise of the Ottoman Empire in 1918, almost the entire Muslim world fell under European colonisation. This prompted an intensive Muslim anti-colonial movement in the first half the 20th century, led by secular-nationalist, western-educated elites.[1093] The goal of these secular movements was to establish a progressive, secular political order, aligning Muslim states with the modern European secular states. Somehow, however, this drive to aligning with the West and separating politics from religion caused grave concern among ordinary people and religious scholars, who started, at first unassumingly and more and more prominently after that, to advocate the idea of returning to Islamic moral and religious values. This was the start of the Islamic revivalist movement.[1094] Although non-political at their beginning, these movements gained prominence because in times of profound change they delivered the social solace and support much needed by ordinary Muslims.[1095] The transformation into a political movement came later, with the adoption of a clear socio-political agenda, informed by socialist and nationalist ideals, which started circulating the Muslim populated public space.

The next period of the development of Muslim revivalism came after the Second World War and was a result of the attempt of the US and Russia to divide the world into the capitalist and communist camps respectively. Iran, as well as the other Muslim nations, was caught into this narrative, eventually siding with the US and turning into a secular, democratic country. Mohammad Mosaddeq's National Front government maintained the balance between secularity and religion. The government united the Iranian nation, which resented the Iranian Shah and the British exploitation of the national oil reserves.

The latter issue caused great struggle for the Iranian Government and the Iranian people because attempts by Iran to nationalise the previously British-owned Anglo-Iranian Oil Company (AIOC), led to devastating for the Iranian economy British and US economic sanctions. Soon

[1093] Mehmet Ozalp, 'World politics explainer: the Iranian Revolution' (2018), The Conversation, https://theconversation.com/world-politics-explainer-the-iranian-revolution-100453 accessed 16th August 2019.
[1094] Ira M Lapidus, 'Islamic Revival and Modernity: The contemporary Movements and the Historical Paradigms' (1997) 40(4) Journal of the Economic and Social History of the Orient 444.
[1095] Mehmet Ozalp (n 1093).

after that, a coup engineered by the British MI6 and the CIA took place in Iran, overthrowing Mosaddeq's government and consolidating the Shah's rule for the next 26 years.

Following the nationalisation attempts, the British 'regarded Mosaddeq as a serious threat to its strategic and economic interests…[and the coup] was aimed at making sure the Iranian monarchy would safeguard the west's oil interests in the country.'[1096] After the coup, the AIOC became BP and the division of profits between the Iranian State and the British was set at 50-50 as opposed to the 20% which the Iranians were able to receive under the previous agreement.

The national sentiments were and still very much are that the US prioritises its economic interests over the democratic governance of Iran, causing great distrust and negative feelings across all walks of life. As one author has put it, 'Not only did this intervention leave Iranians with a sense of bitter humiliation, betrayal and impotence, its impact also reverberated within the wider Muslim world.'[1097] The equalisation in the minds of ordinary Iranians, between the politics of the West and Western values, increased the distrust in the secular policies introduced by Reza Pahlavi, and his politics of modernisation of the Iranian society. It did not help that a corollary of the White Revolution of the Shah was an increasing inequality in the distribution of wealth among Iranian citizens and the creation of an underclass of marginalised people.

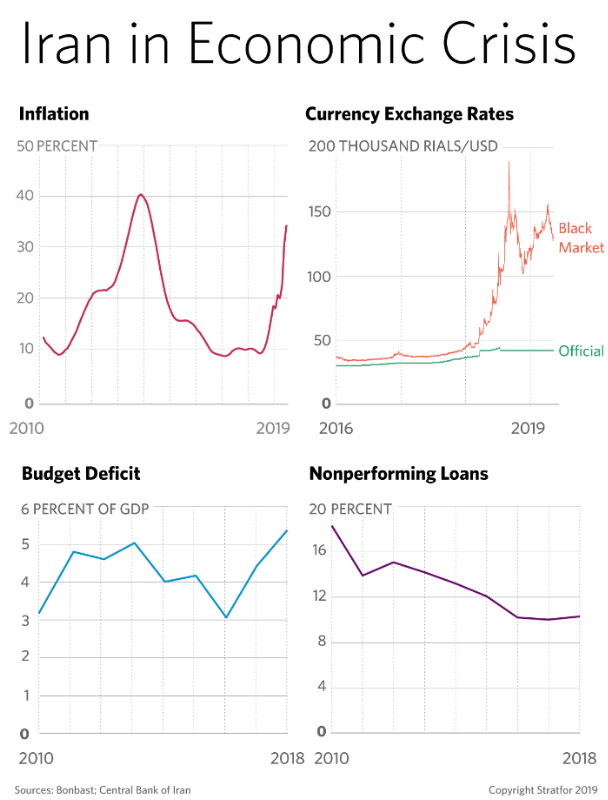
This brought dissent, which was in turn supressed by the government. The common theme of the resistance was the idea, promoted and developed by Islamic scholars that following 'the top-down imposition of a Western lifestyle, believing Islam was being completely removed from society.'[1098] This societal turmoil eventually gave rise to the 1978-79 Islamic Revolution, which was hoped to put an end to Western imperialism and create a true Islamic State, based on the accepted sources of Islamic law.

40 years later, the Revolution is still standing, as a reminder that the idea of progress of the secularist movements of the 20th century had a better alternative. The revolution impacted on the socio-political developments in the Muslim world because its success caused the resurgence of political Islam throughout the Muslim populated territories. More importantly, in an ideological

[1096] Saeed Kamali Dehghan and Richard Norton-Taylor, 'CIA admits role in 1953 Iranian coup' (2013) The Guardian, https://www.theguardian.com/world/2013/aug/19/cia-admits-role-1953-iranian-coup accessed 16th August 2019.
[1097] Mehmet Ozalp (n 1093).
[1098] Mehmet Ozalp (n 1093).

sense Iran inspired similar radical movements towards the establishment of an Islamic state, contrary to the interests of Western imperialism. In the 1980s and 90s, this led to the creation of a number of Islamic political parties across the Muslim world. Their agenda was the (re)introduction of a religious governance model as a response and the only alternative to the alleged by them failure of the secular model 'to deliver progress and full independence'. This narrative was based on a concept of "progress", which fundamentally differed from those espoused by secularist reformers.

Semantics notwithstanding, the current condition of the Iranian economy is concerning, bringing analysts to predict that Iran faces no other alternative in the 21st century but to follow the path to a moderate rather than Radical Islam.[1099] As a visual of the problems facing Iran, the following Table, compiled by the US geopolitical intelligence platform and publisher Stratfor[1100] gives a summary of Iran's performance in the period 2010-2019 along the main economic indicators:



[1099] Mehmet Ozalp (n 1093).
[1100] As an example, see also, Central Bank of the Islamic Republic of Iran, 'CPI and Inflation' data for 2018, https://www.cbi.ir/Inflation/Inflation_en.aspx accessed 10th August 2019.

The Table points out at raising inflation, budget deficit and non-performing loans, as well as a thriving black market for currency exchange. This paints a bleak picture for Iran despite the relatively good performance in the country's GDP.

11.2.3. Current state of (and trends in) the Iranian economy

In an interesting move, the spring of 2019 marked a significant change in the Iranian banking market. Following the developments in the rest of the financial world, the Iranian Central Bank appears set to explore the possibilities of Blockchain.[1101] Furthermore, as recently announced, '[T]he Money and Credit Council, Iran's top financial decision-making body, allowed the central bank on April 16 to engage in open market operations (OMOs) for the first time in the country's history.'[1102] Given that the country's financial markets are subject to both the Riba-Free Banking Act (RFBA) and Iranian Criminal Law Codex, the securities traded on the open market will remain Islamic in character with a focus on treasury bonds. The move has been discussed to have been prompted by the desire of the Iranian Central Bank to rein in interest rates, albeit indirectly, and to assist Iranian banks against the high rate of non-performing loans (NPLs), necessitating huge overdrafts from the Central Bank. Ultimately, the OMO move is hoped to diminish the crippling inflation in the country.[1103]

Furthermore, the current developments, as well as the indications that the Central Bank may soon revise its currency policy, signal to a climate change in Iranian internal policy. Whether this will bring about a bank reform in Iran, and in particular, more independence for the Iranian Central Bank, is still early to say. What could be taken away is that after 40 years of consistent Islamic rule, the financial system in Iran is slowly opening up to modern influences. To a big extent this was necessitated by persistent and grave economic troubles, originating from the period even

[1101] Financial Tribune, 'Iran's CB to Tap Blockchain Technology' (2019) https://financialtribune.com/articles/business-and-markets/96107/irans-cb-to-tap-blockchain-technology accessed 5th June 2019.
[1102] Maziar Motamedi, 'Will open market operations signal new chapter in Iran's financial leadership?' (24th May 2019) https://www.al-monitor.com/pulse/originals/2019/05/iran-open-market-operations-central-bank-reform-inflation.html accessed 5th June 2019.
[1103] Ibid.

prior to the Revolution and crippling the development of the country.[1104] The question which now faces the Iranian government is what version of Islamic finance it will adopt and even more importantly, how it would make the Islamic securities participation in the Iranian market attractive to both Western and *Sunni* financial operators. From the point of view of the investor, these prospective changes are exciting yet concerning; as Iran prepares to enter the "big unknown" of financial innovation and modernisation, it is not yet clear how this will reconcile the desire for a healthy market with the traditional for *Shia* governance lack of independence from religious authority. It is suggested that this peculiarity should warrant the adoption of a careful and culturally sensitive approach not only to actual commercial relations between Western companies and Middle Eastern counterparties but also with respect to any prognoses that could be made regarding future long-term investments in the area.

In addition, it should not be overlooked that due to the centuries-long division between *Shia* and *Sunni* Islam, whatever types of Islamic finance have been adopted in Iran have not been easily accepted or even accepted at all in the *Sunni* market. While the emerging in the last quarter of the 20th century of the huge oil revenues of the Gulf countries put the issue of a compliant with Islam financial framework in focus, as much for *Shia* as it did for *Sunni*, the Iran-specific approach to this has so far been met with distrust by *Sunni* financiers.[1105] Particularly, there have been accusations from the *Sunni* financial camp that the 1983 Iranian Riba-Free Banking Act (RFBA)[1106] remained the only significant reform of the Government towards a truly compliant with *Shariah* banking framework. Whether this accusation is justified or not,[1107] the fact remains that the very few banking products issued by Iranian entities do not demonstrate attractiveness to the *Sunni* investor.[1108] As for the Western investor, the existing framework of the Iranian government (entirely ruled by *Shariah* law) and the on-going sanctions regime[1109] does not instil

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[1104] Esfandyar Batmanghelidj, 'Investors Have Always Struggled in Iran' 2019) Bloomberg, https://www.bloomberg.com/opinion/articles/2019-02-12/why-investors-have-always-struggled-in-iran accessed 5th June 2019.

[1105] Jacopo Dettoni, 'Iran and the Islamic Finance Crown' (2015) The Diplomat, https://thediplomat.com/2015/06/iran-and-the-islamic-finance-crown/ accessed 5th June 2019.

[1106] For an analysis of the RFBA for the period of 1983-2014 see Farhad Nili, 'Iran: Islamic Banking and Finance' in *The Islamic Finance Handbook*, Sasikala Thiagaraja, Andrew Morgan, Andrew Tebbutt & Geraldine Chan Eds, (John Wiley & Sons Singapore Pte. Ltd. 2014).

[1107] Ibid.

[1108] Dettoni (n 1105).

[1109] The Nuclear Threat Initiative, 'Iran Nuclear' (2018) https://www.nti.org/learn/countries/iran/nuclear/ accessed 5yh June 2019.

sufficient investor confidence. However, things appear to have started to slowly change, even before the spring of 2019, as data collected by Bloomberg in 2016 suggests potential increase in the number of foreign companies investing in Iranian Islamic bonds.[1110]

11.3. The political positions of Sunni and Shia radicals: a second look

Despite the deep differences in the political theory embraced by *Sunni* and *Shia*, radical Muslims from either denomination agree that "revolution is justified as well as urgently needed".[1111] It is meaningful that Khomeini was able to justify the Iranian Revolution by claiming that relinquishing sovereignty to foreigners, diminishing the role of Islam and introducing culture that is inconsistent with the Islamic traditions, delegitimises State power. Furthermore, despite Iran's populace's long-standing tradition of accommodating (for various pragmatic reasons) those Iranian governments that were not entirely legitimate, Khomeini considered the further accommodation of the Shah's government to be unsustainable from a pragmatic point of view.[1112]

Considering that despite religious differences and historical clashes, the main political ideas of Muslim radicalism have proved able to penetrate the Islamic world regardless of denomination, it is possible that Khomeini's narrative could underline a critique of Islamic finance, at least at the level of concepts, with a relative ease. As Aarabi concludes, 'Western policymakers have underestimated Iran's commitment to upholding and exporting 1979's revolutionary ideology. That commitment is held by leaders across the spectrum, from those perceived by the West as hardliners to those seen as moderates.'[1113]

The export of revolution purportedly takes place, at least according to Western analysts, by sponsoring militarised dissidents in the Islamic world. Among the key findings of the Tony Blair Institute's Report, the following three deserve attention as particularly relevant to this research:

[1110] Dettoni (n 1105). For an opinion on why political framework is not determinative to Iranian economic success or failures see Esfandyar Batmanghelidj, 'Investors Have Always Struggled in Iran' 2019) Bloomberg, https://www.bloomberg.com/opinion/articles/2019-02-12/why-investors-have-always-struggled-in-iran accessed 5th June 2019.
[1111] Sivan (n 85), 8.
[1112] Sivan (n 85), 8-9.
[1113] Kasra Aarabi (n 100).

- A state-sanctioned *Shia* Islamist ideology unites Iranian 'hardliners' and 'moderates'.

- Iran is as committed to exporting the Islamic Revolution today as it was in 1979.

- *Shia* Islamism shares key ideological overlaps with *Sunni* Islamism.[1114]

Such consistent tendency towards conversion of beliefs suggests that ideas and particularly radical ones, could circulate the Islamic world without much scholars' opposition (or even with scholar's help as per the *ijtihad* tradition), despite these ideas origination from a different denomination.

Having said that, one must take into consideration that in the traditional *Sunni* understanding, a government can be deposed only if its leader openly rejects Islam. *Sunni* traditionalists value order to the point that the breach of certain rules, even major ones, can be overlooked in order to avoid chaos.[1115] This explains the tolerance of a framework such as the Islamic finance one, despite on-going accusations that it parrots the Western system and surreptitiously introduces forbidden principles, such as *riba* and *gharar* - (c.f. with the *Shia* approach, which was to fight against 'relinquishing sovereignty to foreigners, diminishing the role of Islam and introducing culture that is inconsistent with the Islamic traditions, delegitimises State power'.)

Furthermore, despite the many calls for rapprochement, *Sunni* and *Shia* radicals have proven over the last decades that they remain truly committed to the differences upon which their respective denominations clash. This makes it unlikely that an export of the Iranian Revolution will take place; rather, as it was the conclusion of theorists at the end of the 20th century[1116] and that of more recent analyses,[1117] as well as the experience during the 5 year period of ISIS expansion, *Sunni* and *Shia* radicals 'will each have to pursue its own revolutionary path.'[1118]

[1114] Kasra Aarabi (n 100).
[1115] Sivan (n 85), 9.
[1116] Sivan (n 85), 28.
[1117] Murat Özçelik, 'The Two Radical Sources of Instability in the Middle East' (2014) Council of Councils, https://www.cfr.org/councilofcouncils/global_memos/p33347 accessed 16th August 2019.
[1118] Sivan (n 85), 28.

11.4. The performance of the Islamic finance sector: some practical considerations and statistical overview

The following section will examine the performance of the Islamic finance sector in the context of the opposition it is met with by radicalised or revivalist parts of the population.

It has been noted that

> *[in] these economies, stagnation persists due to the lack of change in a traditional culture where there is no incentive to adapt and grow. Additionally, emerging or underdeveloped economies may be in a state of static equilibrium where it is nearly impossible to raise the aggregate level of income even though there is an active desire to change. Static equilibrium is negative and causes long-term stagnation. In these last two cases, stagnation arises due to external or internal forces that are not necessarily economic factors. War and famine, for example, can be external factors that cause stagnation. In addition, situations where an economy decreases its inherent entrepreneurial vigor or desire to achieve high-growth represent internal factors that can cause stagnation.* [1119]

It is arguable that the drive to development of Islamic entrepreneurs in the Muslim world has been counteracted by considerations of *Shariah* compliance, to create such static equilibrium as described in the above quote. The immediate outcome of this could be that a sector, which could bring a lot more to the economy, routinely underperforms. This section will look into this assertion by analysing selected data on States' economic performance in 2015-2018. The discussion will later move to consider the reasons that may have caused the alleged static equilibrium and/or stagnation observed in Muslim countries.

A word of warning is due however. The following section does not intend to assert that Islamic finance or the Islamic market, or certain Islamic countries are experiencing economic stagnation. Rather, the author will try to explore the idea that due to underutilising of the possibilities inherent in Islamic finance, the relevant countries and markets under-achieve their potential. In this sense, unless specifically clarified, the author will use the term "stagnation" as meaning "under-development" or "under-achievement" of the markers the relevant market has set out to achieve.

[1119] Will Kenton, 'What is Stagnation in Economics? (2019) Investopedia, https://www.investopedia.com/terms/s/stagnation.asp accessed 12th August 2019.

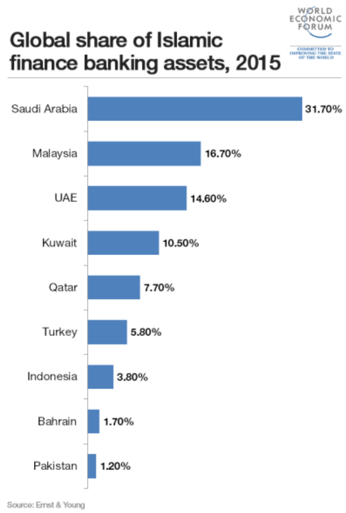
Let us begin by considering the following statistics, which indicate that:

In 2018, the GDP of Malaysia (which is the global leader in Islamic finance) was $354.348 billion (RM1.4 trillion). This was an increase from 2017 when the GDP of the country was $314.5 billion (RM1.353 trillion). For a comparison, this number was $296.5 billion in 2016 and $296.4 billion in 2015 respectively, indicating a stable growth for the country. To put the above numbers in context, the recorded gross output value for Malaysian Financial Services in 2017 was RM138.0 billion (c.f. RM122.4 billion in 2015) – or roughly amounting for 10% of the country's GDP.

According to data provided by the Malaysian Bank Negara, 'the total assets of the Islamic banking industry grew by 8.3% in 2016 (2015: 11.5%) to account for 28% of the overall banking system (2015: 26.8%).The takaful industry also sustained its growth …to account for 14.6% of total industry premiums and contributions.'[1120] This means that on a rough estimation, Islamic banking and *takaful* (Islamic insurance) combined contributed to 4% of the country GDP. Taking in mind the rate at which the Malaysian GDP increases year on year and the ever increasing demand for Islamic finance products, it makes sense that introducing more Islamic finance alternatives will be beneficial for the (Malaysian) economy.

To receive a more circumspect idea of the contribution of Islamic finance to the global economic development of a country, consider that the states with the largest global share of Islamic Assets for 2015 were (in descending order): Saudi Arabia, Malaysia, United Arab Emirates, Kuwait, Qatar, Turkey, Indonesia, Bahrain and Pakistan (fig.3).

[1120] Bank Negara Malaysia, 'Islamic Finance Development' (2016), Financial Stability and Payment Systems Report 2016, 87.



While Malaysia is number 2 in this ranking, it takes a resounding first place in the 2016/2017 ranking of the Global Islamic Economy Indicator (GIEI). The GIEI is intended to 'show the current health and development of the Islamic Economy ecosystem (Halal Food, Islamic Finance, Halal Travel, Modest Fashion, Halal Media and Recreation, and Halal Pharmaceuticals and Cosmetics). The ranking is weighted towards Islamic Finance and Halal Food given that their economic impact is comparatively larger than other sectors.'[1121]

Looking at Saudi Arabia (SA), which ranked first on the Fig.3 list, its GDP increased from $654.3 billion USD in 2015 and with almost no upward change in the following two years ($644.9 billion in 2016 and $683.8 billion in 2017), to $782,483 billion in 2018. This positive development is connected to increased activity in the Islamic banking sector (constituting roughly two-thirds of total bank financing in SA),[1122] as well as in *Shariah* compliant FinTech.

In comparison, the United Arab Emirates (UAE) marked GDP of $358.1 billion in 2015, $357 billion in 2016 and $382.6 billion in 2017, finishing 2018 with $424.635 billion. The UAE Islamic Banking penetration statistics indicate that Islamic finance assets contributed 44% to the

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[1121] Adelaida Salikha, 'Top 15 Countries In Global Islamic Economy' (2018) https://seasia.co/2018/03/06/top-15-countries-in-global-islamic-economy accessed 13th August 2019.

[1122] Consider that: 'In a new report, Fitch Ratings says Islamic finance is a mature and developed industry in Saudi Arabia, representing about two-thirds of total bank financing. About 38% comes from Islamic banks and 28% from the Islamic windows of conventional banks. No special treatment is applied to Islamic products and no additional support is given to Islamic banks. However, as a predominantly Muslim market, and now that similar retail products exist in both conventional and sharia-compliant form, Islamic banking is seeing the fastest growth.' Reuters, 'Fitch: Islamic Banking Is Dominant in Saudi Arabia' (2016) https://www.reuters.com/article/idUSFit947384 accessed 13th August 2019; FitchRatings, 'Saudi Arabia Islamic Banks Dashboard' (2016) https://www.fitchratings.com/site/re/877077 accessed 13th August 2019.

country's GDP in 2016.[1123] Furthermore, UAE is third in the ranking of the 2018 Global Islamic Finance Development Indicator – IFDI, following only Malaysia and Bahrain. A glance at the statistics of Indonesia indicates that the country's GDP was $860.9 billion in 2015 and gradually grew to $932.3 billion in 2016, $1.016 trillion in 2017 and $1.022 trillion in 2018. To put this in context, the market share of Islamic Finance for 2017 was 8.24% of the national financial industry assets.[1124]

Furthermore, Turkey had a GDP in 2015 amounting to $859.8 billion, slightly increasing it to $863.7 billion in 2016 and marking a decrease to $851.1 billion in 2017 and to $766.428 billion in 2018. While Turkey is present on the Fig.3 ranking, it does not rank among the top 15 countries in the GIE indicator and it is neither in the Top 10 ranking for Islamic Finance.[1125] While the recent political turmoil in Turkey impacted negatively on the country's economy, it is arguable that the lesser emphasis on the development Islamic finance also contributed to these statistics.

In comparison, Bahrain, which has ranked 3rd in the Top 10 for Islamic Finance and 3rd among the top 15 countries in the GIE indicator,[1126] demonstrated a gradual increase of its GDP in the period 2015-2018. It achieved a GDP of $31.13 billion in 2015, $32.15 billion in 2016, $35.31 billion in 2017 and $$37,746 billion in 2018.

Furthermore, Pakistan which ranked respectively 6th and 7th in the above rankings increased its GDP from $270.6 billion in 2015 to $312,570 in 2018. However, similarly to Bahrain, the country is at the bottom of the Top 9 ranking for global share of Islamic Finance banking (Fig.3).

As regard those economically developed countries that did not make the above rankings, Egypt demonstrated a decrease in the GDP for the period 2015-2018 (GDP in 2018 $249,559 billion, $ 235.4 billion in 2017, $332.9 billion in 2016, $332.7 billion in 2015). Morocco and Iraq marked a modest but continuous increase in the GDP in the material period: from $100.6 billion in 2015 to

[1123] Reuters, 'Overview of Islamic Finance Development in UAE' (2018) https://webcache.googleusercontent.com/search?q=cache:jVc2zhLSKgwJ:https://repository.salaamgateway.com/images/iep/galleries/documents/20180207051436294 6.pdf+&cd=1&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 13th August 2019.
[1124] OJK, 'Indonesia Islamic Banking Snapshot 2017' (2018) https://www.ojk.go.id/en/berita-dan-kegiatan/publikasi/Pages/Snapshot-of-Indonesia-Islamic-Banking-Development-2017.aspx accessed 13th August 2019.
[1125] Adelaida Salikha (n 1121).
[1126] Adelaida Salikha (n 1121).

$118,495 billion in 2018 for Morocco and from $179.6 billion in 2015 to $225,914 billion in 2018 GDP for Iraq. Since 2006, Morocco have introduced certain aspects of Islamic finance in its financial markets but with caution and sparingly.[1127] Nevertheless, there is indication that its market is opening more widely. For example, the Morocco's central bank announced in the early 2017 that 5 Moroccan banks have been approved to provide *Shariah* compliant products and services. It has also approved the opening of Islamic windows for the subsidiaries of three leading French banks (Société Générale, BNP Paribas and Crédit Agricole's Islamic Development Bank).[1128] The situation in Iraq is more delicate because of the war and the on-going internal conflicts, which turned the country back into a cash economy. For example, research for 2016 indicates that 'Islamic banks currently account for 1.5% of total assets of Iraqi banks'; however, there is interest among Iraqi banks for the development of this area.[1129]

Last but not least, one should consider, in comparison, the GDP performance of Iran; a country which arguably holds the Islamic Finance Crown because its entire financial services industry is governed by *Shariah* law.[1130] In 2015 Iran boasted $385.9 billion in GDP, which increased to $419 billion the following year, to $439.5 billion in 2017 and $452,275 billion in 2018. Considering that the country has been subjected to years of economic sanctions which aimed to weaken its economy,[1131] it is instructive to see its impressive GDP performance. Admittedly, much of this is due to oil revenues. For instance, the country's GDP growth in 2017/18 dropped to 3.8 % because 'the effect of a large surge in oil revenues in the previous year dissipated.'[1132] In this period, the non-oil sectors were responsible for the overwhelming majority of growth, more

[1127] Yasser Errabti, 'Perspectives of Islamic Banking in Morocco' (2018) 2(1) Bingöl Üniversitesi İktisadi ve İdari Bilimler Fakültesi Dergisi 51.

[1128] Erica de la Harpe, 'Morocco launches Islamic banking services' (2017) https://www.worldfinance.com/banking/morocco-launches-islamic-banking-services accessed 13th August 2019. See also, Salma Rhanoui, 'Islamic Banking in Morocco: The Factors of a Promising Future' (2017) https://www.researchgate.net/publication/320179528_Islamic_Banking_in_Morocco_The_Factors_of_a_Promising_Future accessed 13th August 2019.

[1129] Arno Maierbrugger, 'Iraq Islamic banks see opportunity for expansion' (2016) https://www.gulf-times.com/story/510063/Iraq-Islamic-banks-see-opportunity-for-expansion accessed 13th August 2019.

[1130] Jacopo Dettoni, 'Iran and the Islamic Finance Crown' (2015) The Diplomat, https://thediplomat.com/2015/06/iran-and-the-islamic-finance-crown/ accessed 13th August 2019.

[1131] Zein Basravi, 'The economic impact of US sanctions on Iran's streets' (2019) Aljazeera, https://www.aljazeera.com/blogs/middleeast/2019/07/economic-impact-sanctions-iran-streets-190706190053896.html accessed 13th August 2019.

[1132] The World Bank, 'Islamic Republic of Iran' (2018) https://www.worldbank.org/en/country/iran/overview accessed 13th August 2019.

than half of which can be attributed to services growing by 4.4 %.[1133] Given the above, the overall conclusion of observers is that with the exception of Iran, 'Malaysia, Bahrain and the UAE are most developed markets while Saudi Arabia, Malaysia, and the UAE lead in terms of total assets.'[1134]

The discussion highlighted that while other factors should also be taken into consideration (other than the relative size of the Islamic finance sector in a given economy), such as oil reserves, political stability and cultural specifics, it appears that overall, in the course of the last 4 years, countries which have invested in the development of Islamic finance have enjoyed better economic results, at least measured by their GDP. If an argument can be made therefore, that Islamic finance benefits national economies, it is plausible that the greater the size of the sector, the greater the potential benefits.

Such thinking supports the argument advanced earlier, namely that Islamic countries, many of which are either underdeveloped economies or economies that emerged relatively recently (in the post-colonial era) are undergoing a period of secular stagnation. To recall, secular stagnation is caused by the opposition of traditional culture to processes of adaptation and growth. While it can be difficult to argue that there are no incentives for development in the sector of Islamic finance, such incentives lose their attractiveness for a substantial part of the population, due to cultural and religious considerations.

For example, many citizens would not use any sort of banking because of entrenched beliefs that all banking contains *riba* and is therefore contrary to *Shariah* law. Consider also that a study by the World Bank have identified that 'Muslims are significantly less likely than non-Muslims to have an account and save at a formal financial institution… Self-identification as a Muslim is associated with a 6 percent decrease in the probability of having a formal account.'[1135] Such sentiments are both fuelled and internalised by some *Shariah* scholars, who feel that conventional

[1133] Ibid.
[1134] Waheed Abbas, 'UAE among advanced Islamic finance markets' (2018) https://www.khaleejtimes.com/business/banking-finance/uae-among-advanced-islamic-finance-markets accessed 13th August 2019.
[1135] Asli Demirguc-Kunt, Leora Klapper and Douglas Randall, 'Islamic Finance and Financial Inclusion Measuring Use of and Demand for Formal Financial Services among Muslim Adults' (2013) The World Bank Development Research Group Finance and Private Sector Development Team, October 2013, WPS6642, 4.

banking has taken over the purpose of Islamic finance.[1136] While there have been strong arguments that Islamic finance is driven by Western banks rather than by their indigenous Islamic counterparts, Islamic scholars have been known to respond to this trend, in line with the authority vested in them.

A fitting example of this is the ban on organised *tawarruq*, issued by the Islamic Fiqh Academy in 2009 (discussed earlier).[1137] The ban had a profound negative effect on Islamic banks, many of which by the time of its introduction have made *tawarruq* their go to instrument when needing to offer S*hariah*-compliant working capital, to manage their liquidity issues, or to structure larger, more complex Islamic finance transactions.[1138] While all three purposes are of significant importance for banks, using *tawarruq* to manage their liquidity shortages has implications on systemic stability on one hand[1139] and on the preparedness of Islamic banks to conform to the requirements of Basel III. The loss of access to this instrument (at least in its organised version) was concerning for both the conventional and Islamic finance market. Above all, it signalled to the market that a decision by a *Shariah* Advisory Board may halt established business practices or negatively affect billion dollars investments.

Assuming that stagnation has indeed taken place in Islamic economies as a result of certain conflicting practices, it has likely been caused by 'external or internal forces that are not necessarily economic factors'.[1140] However, in so arguing one must remain alive to the specificities of Islamic beliefs and question the importance of economic development when juxtapositioned to Islamic moral values. From a Western philosophical perspective, stagnation is opposed to progress, which is in turn expressed by qualities such as 'freedom, happiness or utility, and the realization of human capabilities.'[1141] For example, philosophers from the French Enlightenment tradition concluded that progress was reinforced and furthered by scientific

[1136] Robin Wigglesworth, 'Scholars: Sharia compliance rulings reverse trend' (2009) Financial Times, https://www.ft.com/content/8ec1abb4-e2be-11de-b028-00144feab49a accessed 15th August 2019.
[1137] Chapter 5.3.5.1.
[1138] Robin Wigglesworth (n 1036).
[1139] For example, liquidity crisis caused the Turkey-based Ihlas Finans bank to closed down in 2001 - see, Muhammad Ayub, 'Liquidity Management by Islamic Banks: An Issue or a Contrivance for Risk-Free Returns ' (2017) 7(1) Journal of Islamic Business and Management 1, 3.
[1140] Will Kenton, 'What is Stagnation in Economics? (2019) Investopedia, https://www.investopedia.com/terms/s/stagnation.asp accessed 12th August 2019.
[1141] Stanford Encyclopedia of Philosophy, 'Progress' (2011) https://plato.stanford.edu/entries/progress/ accessed 15th August 2019.

discoveries and political freedom.[1142] In this narrative, the term "scientific discoveries" may be applied to the innovation of financial instruments and "political freedom" to the possibility to make use of them without the fear of persecution and without uncertainty as to their future legality.

However note that in comparison, wellbeing in the Islamic philosophical tradition is arrived at by the individual aligning himself with his spiritual and religious obligations:

> *According to Islam, worshipping and serving Allah are humanity's ultimate function, the fulfillment of which constitutes well-being. In other words, well-being is living a life in which all one's actions and intentions are organized around the principle of Allah's absolute sovereignty. This view requires absolute submission to the will of Allah in every aspect of life, no matter how small. Detailed guidelines on how to live a proper life are provided in the sharia, which is God's revealed law to govern individual and social life. This notion of well-being underlies all concepts of well-being formulated in all Islamic schools of thought (e.g., Islamic philosophy and Sufism) throughout Islamic history including contemporary islamic conceptualizations of well-being.*[1143]

If wellbeing equals progress (as Western thinkers would have us believe) and if wellbeing in the Islamic tradition is achieved by adhering closely to the principles of *Shariah,* then halting economy and causing stagnation (in other words, causing under-development or under-achievement) is irrelevant because it increases individuals' wellbeing. In the Islamic narrative, such behaviour is rational because it is conducive to progress as understood in the Islamic philosophical tradition.

On a more pragmatic note, however, the Islamic scholars' objections to some or more of the innovative Islamic finance instruments are based on three rather solid arguments.

First, they argue that using structures such as organised *tawarruq* diminishes the credibility of the Islamic finance framework among Muslims and non-Muslims, because it underlines the lack of differences between conventional and Islamic finance. Particularly, in cases where purported *Shariah*-compliant instruments and practices end up being very expensive to consumers, their

[1142] Ibid; See works by Anne-Robert-Jacques Turgot, Baron de Laume (1727-81), and Marie Jean Caritat, Marquis de Condorcet (1743-1794).
[1143] Mohsen Joshanloo, 'Islamic Conceptions of Well-Being', in *The Pursuit of Human Well-Being*, Richard J. Estes and M. Joseph Sirgy eds (Springer 2017), 109.

similarity with the based on interest conventional financial techniques and strategies becomes too much for comfort.

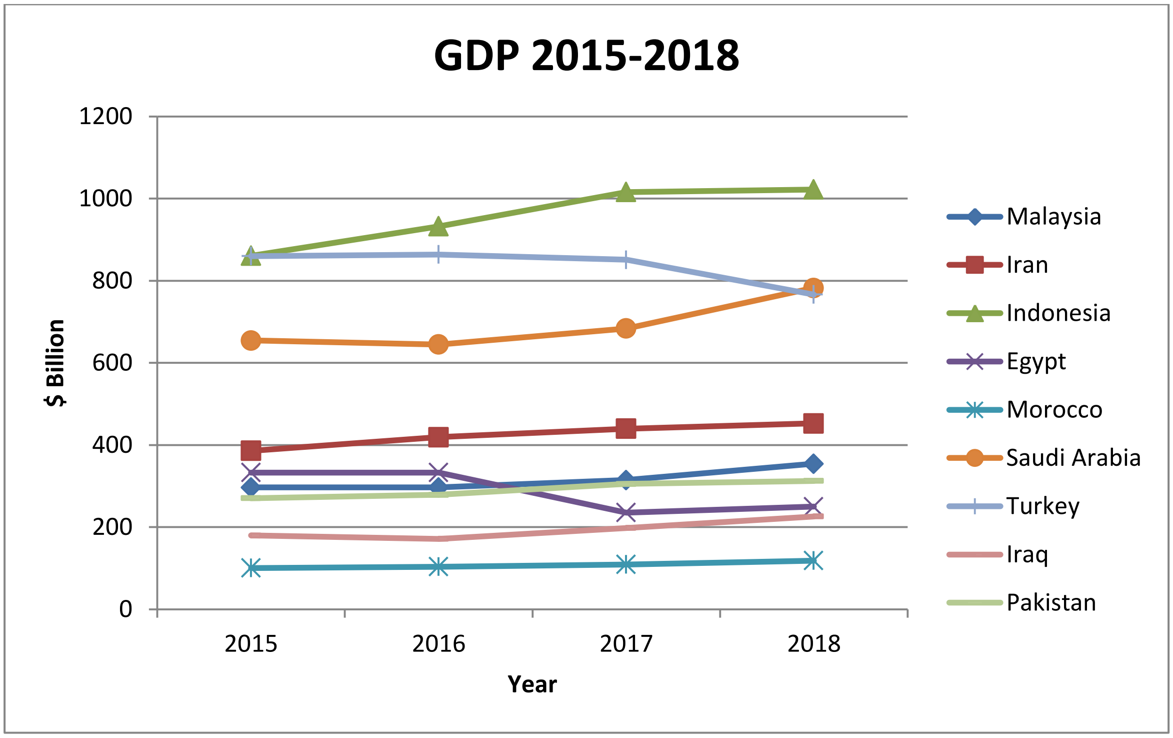
Secondly, the *ulama* often argue that using instruments that mimic conventional financial instruments actually stifles innovation and development in the sector.

Thirdly, scholars bring forward a public interest argument to the effect that a structure that mimics a conventional counterpart hinders the negotiations between Islamic finance institutions and global regulators. Specifically, it diminishes the opportunities to tailor the regulatory framework to suit the Islamic finance framework.[1144]

A fourth argument advanced by the critics of the reforms (particularly targeted at the ban on organised *tawarruq*) is that such transactions usually take place on the international markets and as such they funnel assets outside the internal Islamic market framework.[1145]

These arguments are convincing and placing the *ulama*'s narrative within a more pragmatic context. However, as previously discussed, not only does Islam place high value on one's wellbeing but the individual's relationship with *Allah* is central to Islam. This specificity makes it unlikely that the current equilibrium in the Islamic financial markets, between the more liberal and more conservative strands of Islam, can be preserved over the long term. While there seems to be a (relatively) quiet understanding between the banking sector (internal and external) and the *ulama* (the learned of Islam), the market and investors will be better served by rebuilding the Islamic finance framework with instruments displaying more solid ideological foundations. Until such time, the "soft radicalism" of the purists of Islam will intervene with varied success, perhaps causing unfavourable fluctuations on the market. The most concerning aspect of this, from the point of view of a Western financier, is that fluctuations of the market could be prompted deliberately by those having the power to do so. Western financial system has suffered many a crisis due to manipulation of markets; and global regulators should not remain short-sighted to this potential aspect of the Islamic finance framework.

[1144] Ahmad A Alkhamees, *Critique of Creative Shari'ah Compliance in the Islamic Finance Industry* (Brill | Nijhoff 2017), 79.
[1145]



**Source: Author*

Fig.2 In US Dollar billion

Year	Malaysia	Iran	Indonesia	Egypt	Morocco	Saudi Arabia	Turkey	Iraq	Pakistan
2015	296.4	385.9	860.9	332.7	100.6	654.3	859.8	179.6	270.6
2016	296.5	419	932.3	332.9	103.6	644.9	863.7	171.5	278.7
2017	314.5	439.5	1016	235.4	109.1	683.8	851.1	197.7	305
2018	354.348	452	1022	250	119	783	766.4	226	313

Source: author

11.5. The radicalism vs. normativity narrative

11.5.1. Overview of context

Keeping this context in mind, it is arguable that a transition towards a hardened regime could take place, even if no overt radicalisation has been observed. In fact, while an abrupt change in the system of government will necessarily be noticed, including in advance, halting all normal business activities, what could be potentially more damaging for commerce is a gradual, step-by-step transition in direction of radicalisation. Such a transition need not happen willingly or at least, it need not happen by the will of those immediately involved. Crucially, the transition may not even feel like one.

Almost since their introduction on the market, Islamic financial instruments have been subjected continuously and relentlessly to the critique of many scholars of Islam. The arguments of such critics are repetitive yet difficult to refute with absolute certainty. They bring attention to the lack of originality of these instruments, to their parroting of certain forbidden conventional instruments (now counterparts) and to their logical inclusion of features that are not permitted under the strict law of *Shariah*. While this as a whole does not disturb the application of Islamic financial instruments, it likely diminishes the number of potential investors from within the country-issuer. It is true that, as a rule, the compliance with *Shariah* of any instrument is confirmed and sanctioned by a dedicated *Shariah* Advisory Board. However, it is also the case that ordinary Muslims would seriously consider the opinion of clerics and imams as they carry out their practical life. The negativity of such opinions arguably stifles further innovation and development of the Islamic financial market. Furthermore, it does so without offering a working alternative.

From the point of view of an Islamic scholar, this attitude is understood. After all, if nothing else, the analysis conducted in this book made it clear that the majority of the currently existing Islamic finance instruments are manifestly at odds with Islam in its pure form. Moreover, in their (commendable) desire to bring the Muslim community closer to modern financial practices, the developers of these instruments arguably created them wanting in form and potentially dangerous for both consumers and financial stability. As an unexpected positive result, the scholars' voices of concern serve to contain the unrestricted expansion of novelty instruments. However, the resulting balance is fragile, fluid and uncertain. The lack of constructive dialog between the more radical and more progressive elements of the Islamic society creates, maintains and promotes a climate of uncertainty. The practical outcome of this is the creation of more complex contractual structures. Complexity in this context means higher costs and lesser efficiency, as well as diminished legal certainty, particularly on default. These are most often than not passed on to the end consumer (generally, in terms of fees). While a Muslim investor may feel more at ease with contracts, which have traditionally been part of the Islamic commercial framework, and with concepts firmly rooted in his Islamic faith, conventional investors are somewhat apprehensive of the complex dynamics on this market.

However, since the framework of Islamic finance is emotive, meaning that it is permeated by inspiration, doubts, excitement, critiques, confusion, all of which boils down to legal uncertainty, conventional (and perhaps Muslim) investors must have come to accept that certain measure of risk is unavoidable for this market and should be perceived as a cost for participation.

Whether this is indeed the case will be discussed in the last substantive Chapter; however, two objections to such an acceptant approach should be noted briefly at this junction. The first is that the framework does not benefit from a constant negative feedback, coming on one side from conventional market experts and/or investors and on another, from some Islamic religious scholars. Rather, such feedback has the effect of holding Islamic finance back when this is not justified by socio-economic reasons.[1146]

For example, statistic evidence strongly suggests that Islamic finance has a beneficial effect on the economy with experts stating that 'financial system development stimulated economic growth in the selected MENA countries over the studied period…[and] while Islamic financial development can boost economic growth, this positive effect is hindered by underdeveloped institutional frameworks.'[1147] The second objection is a more general one and focuses on the

[1146] The positive effect of a developed Islamic finance framework is discussed elsewhere in this paper.
[1147] Jamel Boukhatem and Fatma Ben Moussa, 'The effect of Islamic banks on GDP growth: Some evidence from selected MENA countries' (2018) 18(3) Borsa Istanbul Review 231, 231.

premise that lack of development causes stagnation of economic growth. The type of stagnation that is envisioned here can afflict underdeveloped or emerging economies.

11.5.2. The (un)predictable phenomenon of ISIS[1148]

The group known as ISIS went through three distinct iterations, beginning as the Islamic State of Iraq (ISI, October 2006–April 2013), then becoming the Islamic State of Iraq and Sham (ISIS, April 2013–June 2014), and culminating as the Islamic State (IS or ISIS, June 2014–present). This section will not delve into the reasons of why ISIS went on to operate undetected for so many years and neither will it discuss the military successes and losses attributed to this organisation. The inclusion of ISIS in this work is justified by a desire to unpack a real-life example of an Islamic state, established by a radical *Sunni* group. Furthermore, the ISIS experience will be evaluated only with respect to ISIS' ideological underpinning and their proposed or expected government policies regarding their internal financial market.[1149] In addition, because evidence in this respect is scarce, most of the analysis will take the form of a hypothesis, based on the facts currently accessible for research.[1150]

ISIS belongs to the *jihadi*-salafist branch of Salafism. A brief introduction to Salafism is necessary in order to understand the ideological context within which the group operated and still operates.

[1148] Graeme Wood, 'What ISIS's Leader Really Wants' (2014) https://newrepublic.com/article/119259/isis-history-islamic-states-new-caliphate-syria-and-iraq accessed 5th June 2019. See also, Robin Wright et al., 'The Jihadi Threat: ISIS, al-Qaeda, and Beyond' (2017) United States Institute of Peace; See also, Cole Bunzel, 'From Paper State to Caliphate: The Ideology of the Islamic State', Center for Middle East Policy at Brookings, The Brookings Project on U.S. Relations with the Islamic World Analysis Paper No. 19, March 2015. See also, Daniel Byman, 'ISIS Goes Global' (2016) Foreign affairs, https://www.foreignaffairs.com/articles/middle-east/isis-goes-global accessed 5th June 2019.
[1149] Discussed in Chapter 11: [11.6.1.].
[1150] See Chapter 11: [11.6.1.2.].

11.5.3. Understanding the salaf

Salafism is perceived as a trend in Islam rather than one of its Schools.[1151] The name originates from the word "*salaf*", meaning "pious". It is connected to an utterance by the Prophet Mohammed, "the best of my community" (*khayr ummatī*) or "the best people" (*khayr al-nās*) are "my generation [*qarnī*] and then the ones who follow them [*thumma lladhīna yalūnahum*] and then the ones who follow them [*thumma lladhīna yalūnahum*]."[1152] These words have been interpreted by some Muslims to mean that the first three generations Muslims were "the pious predecessors" (*al-salaf al-ṣāliḥ*).[1153]

During the centuries, a number of Islamic thinkers have espoused ideas that the Muslim society must return to the values of the Golden age of Islam, emulating the early generations Muslims in all areas of life. This ideological movement culminated in the 18th century Arabic Peninsula in what is now known as Wahhabism. The Wahhabism disseminated the Salafi ideas beyond the Peninsula and across the Muslim world. The 20th century Salafists endeavour to emulate the first three generations Muslims 'as closely and in as many spheres of life as possible'.[1154]

Salafism is distinct from other movements in Islam in the detail in which its followers believe the *salaf* must be emulated. The theological basis for their credo brings new-Salafists close to the so-called *Sunni* "traditionalists" (*ahl al-ḥadīth*). The traditionalists, strongly influenced by the writings of Aḥmad b. Ḥanbal (780–855 – who went on to become the founder of the *Hanbali* School), believe that the Muslim community should only consider guidance derived from the *Qur'an* and the *Sunnah*. The Hanbali School view is in opposition to the orthodox *Sunni* view (i.e. the Shāfiʿī school, founded by Muḥammad b. Idrīs al-Shāfiʿī (767–820)), which holds that opinions of scholars should be accepted as a source of law, in addition to the *Qur'an* and the *Sunnah*.[1155]

1151 Joas Wagemakers, 'Salafism' (2016) Oxford Research Encyclopedias, https://oxfordre.com/religion/view/10.1093/acrefore/9780199340378.001.0001/acrefore-9780199340378-e-255 accessed 17th August 2019.

1152 Ṣaḥīḥ al-Bukhārī, book 57 ("Kitāb Faḍāʾil Aṣḥāb al-Nabī"), chapter 1 ("Faḍāʾil Aṣḥāb al-Nabī"), nos. 2–3.

1153 Joas Wagemakers (n 1051).

1154 Joas Wagemakers (n 1051).

1155 N J Coulson, *A History of Islamic Law* (Edinburgh University Press, 1999); Wael B Hallaq, *Sharīʿa: Theory, Practice, Transformations* (Cambridge University Press, 2009); and Joseph Schacht, *An Introduction to Islamic Law* (Oxford University Press, 1982).

Another important trend that started in the early years of Islam and was taken on by the new-Salafists was the rejection of the doctrine of *taqlid*. The concept of *taqlid* refers to one's obedience to the decisions and pronouncements of the *ulama* (the religious teachers of Islam). On a more granular level, *taqlid* means 'the unquestioning acceptance of the legal decisions of another without knowing the basis of those decisions'.[1156] Judging by the writings of Ibn Ḥazm (died 1064) and many Hanbali and Shafiʿī School adherents, it appears that the act of *taqlid* was not perceived positively by scholars. For example, the former 'argued that any jurist who belongs to a school and does not disagree with any of its positions thereby engages in taqlīd.'[1157] This was opposed by the latter who believed that as long as the jurist knows the reasons why a certain decision with which he agrees has been taken, he is free of *taqlid*.[1158] The above suggests that orthodox *Sunni* jurists placed value on independent thinking although they did not go as far as to become proactively critical of the ulama's pronouncements.

Most of these jurists accepted that the greatest minds of the early centuries of Islam have deliberated successfully on all matters that have been left unanswered or not clear enough in the *Qur'an* and the *Hadith*. The deliberations of the early scholars were held in such a high regard because they were deemed superbly qualified for their contribution, largely for their temporal proximity to the initial point of Islam. Furthermore, as these scholars used the accepted in the *Sunni* tradition *ijtihād* (independent interpretation of the sources) and used analogical reasoning (*qiyas*) in their interpretations, they were deemed to have followed the correct legal procedure in arriving at their respective decisions. For the above reasons the *Sunni* community largely accepted that the most important questions of faith have already been settled and that not only was there no need to raise them again but even that 'the right of independent interpretation had been withdrawn for future generations.'[1159]

Taqlid was, for this reason and in this context, expected by believers. Importantly, the issue of *taqlid* was dealt with differently by the *Shia*, who, as discussed earlier, hold the belief that every *Shia* Muslim is obliged to show *taqlid* to the modern day *ulama*. In contrast to the orthodox view on *taqlid*, traditionalists, thinkers from the 19th and 20th centuries, members of the Hanbali School

[1156] Encyclopedia Britannica, 'Taqlid' (n.d.) https://www.britannica.com/topic/taqlid accessed 18th August 2019.
[1157] Ibid.
[1158] Encyclopedia Britannica, 'Taqlid' (n 1056).
[1159] Encyclopedia Britannica, 'Taqlid' (n 1056).

and the Wahhābī reform movement felt that Muslims needed to return to the sources and make an independent judgment of their message.

Opposing *taqlid* towards the early ulama was therefore seen as encouraging the renewal of Islam and the progress of the Muslim community. To a great extent, the modernists' approach to *taqlid* was more democratic and inclusive than that of the traditionalists. This democratisation manifested in the modernists' beliefs that lay Muslim could choose between exercising *taqlid* and following the path of *ijtihad*. Scholars, in particular, were encouraged to apply independent reasoning when interpreting the *Qur'an* and the *Sunnah*. This position on interpretation of sources is largely followed by the new-Salafists,[1160] including ISIS.

It should be emphasised, however, that both orthodox *Sunni* and new-Salafists display an attitude of reverence to the Prophet and his companions, and endeavour to lead their lives in accordance with the example set by them. The difference is in the much greater focus placed on the *salaf* by the new-Salafists. To this end, it might be correct to assume that when the difference is just one of degree rather than substance, the more moderate *Sunni* may transit to a more hardened theological and legal interpretation than their current creed suggests.[1161] Thinking along these lines, Joas Wagemakers aptly summarises the process of penetration of the Salafist creed in the wider Muslim world, setting it in a historical context. His explanation of this phenomenon merits quoting in full:

> *The spread of Salafism in the 20th century and its emergence as a worldwide trend (rather than an ideology espoused by individuals or local movements such as Wahhabism) should be explained in this context of general Sunni proclivity toward the salaf. Although indigenous Salafi scholars and movements in various places have undoubtedly contributed to the rise of Salafism, the most important factor in the trend's spread has been the influence of Wahhabism since the 1950s. This influence has been due to three factors. First, there was the rise of the oil industry in Saudi Arabia and the rest of the Gulf. Because of the booming oil business since the second half of the 20th century, many Arabs emigrated to Saudi Arabia or other Gulf countries to find jobs there. Apart from employment, they also often found Wahhabi ideas there, influencing their own beliefs, which they subsequently took with them when they returned to their home countries, sometimes even resulting in the founding of Salafi organizations. Second, in response to the anti-monarchical rhetoric from socialist Egypt in the 1950s and 1960s and revolutionary post-1979 Iran, Saudi Arabia actively started pursuing a policy of*

[1160] Bernard Haykel, "On the Nature of Salafi Thought and Action," in Global Salafism: Islam's New Religious Movement, ed. Roel Meijer (Hurst, 2009), 33–57.
[1161] Joas Wagemakers (n 1051).

> *spreading Wahhabism as a conservative counter-narrative, backed up by money made in the oil industry. Third, the defeat of several Arab states in the June 1967 war with Israel and, by extension, the de-legitimization of Arab socialism, as espoused by Egyptian President Jamāl ʿAbd al-Nāṣir (Nasser; r. 1954–1970), led to a search for an alternative discourse, which provided fertile ground for Wahhabism. As such, Salafism was spread across the Muslim world and even beyond when Middle Eastern Salafis moved to European countries and elsewhere to preach their message there.*[1162]

Earlier in this Chapter, an argument was made that in the foreseeable future the modern Islamic finance framework may undergo (or perhaps is undergoing already) a process of soft radicalisation. To the extent it does, this transition is fluid because the intensity of the critique of revivalists and traditionalists depends on evidence that the Islamic finance structures are indeed breaching the principles of *Shariah*. While this book has so far suggested that such evidence would be easy to provide, the matter of *Shariah* compliance of Islamic finance is far from simple and even farther from settled. It is arguable, furthermore, that what compelled critics to voice their concerns was not a particular radicalism in their convictions, but a sense that the Islamic finance structures were too far removed from the traditional Islamic doctrine. Thus, some scholars would inevitably feel in a position where they could no longer justify the progress in the area, all the while remaining unaccepting of ISIS' salafism.

Without a stable point of reference and without consensus in the *ulama*, scholars are reduced to being reactive (rather than pro-active) to breaches, which they perceive as a trend inherently destructive for Islam. Understandably, the more objectionable the stimulus, the greater the indignation of the scholar and the closer his rhetoric takes him to what can be defined as a Salafist perspective. This may explain why such critiques could be perceived as filling the gap between moderate *Sunni*, which framework arguably used to be but was no longer convincing for the masses, and the ISIS' promises. Arguably, it is the fluidity of this response, which should trouble analysts the most, for it makes it hard to identify the convictions and allegiance of the speaker. The process of recognition is further made difficult by the New-Salafism's (from now, just "Salafism") split into three main branches: quiet Salafism, political Salafism and jihadi-Salafism.

[1162] Joas Wagemakers (n 1051).

Quiet Salafism is followed by those who believe that political activism should be rejected and they should concentrate instead on "cleansing" and teaching the pure values of Islam. Political Salafism is focused on political commitment, perceiving it to be an integral part of Islam. This commitment is expressed by participation in the Parliament, in contentious debates and by founding of political parties. The Jihadi-Salafism's adherents conceive of their religion as a call to overthrow regimes in the Muslim world, which they view as apostate, by waging violent jihad.[1163]

It is the last branch to which ISIS belongs.[1164]

The jihadi-salafism represented by ISIS was inspired, in addition to the salafist tradition discussed above, by the early Muslim Brotherhood's writings. While the beginnings of the Muslim Brotherhood were on the radical end of the Islamic revivalism, its ideology was never so hostile to other denominations and sects of Islam such as *Shia* or Sufism (Islamic mysticism) respectively. However, inspired by nationalistic and anti-imperialistic sentiments, the Brotherhood embraced the idea of the caliphate.[1165] Since ISIS rose from the Brotherhood's most radical wings, it is conceivable that its idea of a pan-Islamic Caliphate was adopted from or inspired by the movement.[1166] The difference was that ISIS took a pro-active approach to the establishment of the Caliphate while the Muslim Brotherhood remained confined within the framework of ideology and discussions, perceiving it as a long-term rather than immediate objective of their work.[1167]

Salafism, as the second source of inspiration for ISIS, was instrumental to their rejection of democratic power, including legislation. Let us recall that the two major theological focuses of Salafism were the oneness of God (*tawhid*) and eradicating idolatry (*shirk*). The former aligns ISIS and all jihadi-Salafists with the main denominations of Islam and with other monotheistic

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[1163] Joas Wagemakers (n 1051).
[1164] Abū H. amza al-Muhājir, 'Qul mūtū bi-ghayz. ikum,' Mu'assasat al-Furqān, 5 May 2007. Transcript in Majmū', 147–152. See also, Daniel Lav, Radical Islam and the Revival of Medieval Theology (Cambridge University Press, 2012), and Joas Wagemakers, A Quietist Jihadi: The Ideology and Influence of Abu Muhammad al-Maqdisi (Cambridge University Press, 2012).
[1165] Madawi Al-Rasheed, Carool Kersten, and Marat Shterin, "The Caliphate: Nostalgic Memory and Contemporary Visions," in Demystifying the Caliphate, ed. Al-Rasheed, et al (Hurst & Co., 2013), 1–30.
[1166] Cole Bunzel, 'From Paper State to Caliphate: The Ideology of the Islamic State', Center for Middle East Policy at Brookings, The Brookings Project on U.S. Relations with the Islamic World Analysis Paper No. 19, March 2015, 8.
[1167] Richard Mitchell, *The Society of the Muslim Brothers* (Oxford University Press, 1969), 235.

religions. As respect the latter however, in addition to declaring apostates all those who exhibit excessive reverence to saints, tombs and other physical objects of veneration (such as practices characteristic of *Shia*), ISIS sees democrats as apostates because they 'err in assigning "partners" to God in legislation, deemed the prerogative of the Divine Legislator.'[1168]

Since fighting *shirk* (the sin of idolatry or polytheism) is the second pillar of jihadi-Salafism, its rejection of established legislative (and with that, regulatory) framework is nothing short of logical. It is conceivable that despite the obvious benefits that trading within a Western-orientated, Western-dominated regulatory framework brings, a jihadi-salafist order could proceed to first sever all existing commercial relationships with the West and with apostate Muslim States and secondly, to establish an internal system of trade, which would comply with the ideals of Islamic purists.

Furthermore, if a movement similar to ISIS succeeds in establishment of a Caliphate, it is possible that this will excite Muslims living in other Muslim States, or in the West, to join in. To this end, it is worth mentioning that according to *Hizb ut-Tahrir* (Party of Liberation), a pan-Islamic organisation, aiming to re-establish the Caliphate and the Islamic way of life in the Muslim populated world, the bringing of at least one Muslim country under its control will create a "domino effect" leading to the establishment of a new caliphate.[1169]

While such a prognosis may seem too far-fetched at the moment, particularly considering the 2018 defeat of ISIS, one should not neglect three major pieces of evidence that give some food for thought in this regard. First, although the Muslim Brotherhood, which provided the ideological foundation for most of modern Salafism, purports to have recast itself in a moderate shade of Islam, there are suggestions that extremists sentiments persist among the Brothers. Some of these ideas have even been discussed publicly – for example, by speaking in the 2012 edition of the Muslim Brotherhood Supreme Guide of the reestablishment of "the Muslim State".[1170]

[1168] Cole Bunzel (n 1166), 8.
[1169] World Almanac of Islamism American Foreign Policy Council, 'Hizb ut-Tahrir', (2018) http://almanac.afpc.org/hizb-ut-tahrir accessed 18th August 2019.
[1170] Cole Bunzel (n 1166), 8, referring to Muhammad Ismā'īl and Muhammad Hajjāj, 'Badī': al-khilāfa al-rāshida wa-ih. yā' dawlat al-Islām wa'l-sharī'a hadaf al-Ikhwān,'
al-Yawm al-Sābi', 29 December 2011, http://www.youm7.com/news/newsprint?newid=565958.

Secondly, there is evidence that ISIS started to resurface and regroup itself, despite the heavy losses sustained by the group in the 2018 Western-led campaign.[1171] Just in April 2019, in a video address by ISIS leader Abu Bakr al-Baghdadi 'ISIS claimed responsibility for the Easter Sunday attacks in Sri Lanka that killed at least 250 people.'[1172] This re-emergence of the elusive leader of the group has been interpreted by terrorism experts as a 'way for him to say that even without the land, the message of the Islamic State lives on.'[1173] More importantly, the reappearance of al-Bagdadi reassured ISIS followers that their leader is indeed alive and that the fight for the Islamic State goes on.

As commentators have noted, since the beginning of the ISIS expansion, their leadership was in no doubt that the current ISIS forces would be defeated in an immediate clash with a Western and coalition military forces. It was suggested that this was the reason why, since the very beginning, 'Baghdadi has sought to lay the groundwork for a guerrilla insurgency in Iraq and Syria, hoarding resources, including weapons and money, while moving from conventional military operations to more asymmetric tactics.'[1174]

The third point to be made is that due to politico-social, cultural and religious specificities, a substantial part of the Muslim populace holds conservative beliefs and is prone to a conservative application of the faith. Furthermore, due to the strong emphasis the *Qur'an* places on the wellbeing of the Muslim community (including a very big emphasis on its spiritual wellbeing), the *ulama* (the religious scholars of Islam) is not only a leader and educator of the masses but it must consider the people's attitudes, beliefs and practices, particularly so when these are carried out in accordance with the sources of Islamic law.

An example of this is the attempt of Muhammad Hussain Fadlallah (who was a Grand Ayatollah, a prominent *Shia* cleric and one of the alleged leaders of Hezbollah) to prohibit the practice of self-mutilation during the 1985 celebration of Ashura in Beirut. This action was intended to achieve rapprochement between the *Sunni* and the *Shia*, the former looking with repugnance at

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[1171] See John Haltiwanger, 'Experts say that ISIS' leader is taking a big risk to capitalize on the Sri Lanka attacks — and that it's a 'big middle finger' to counterterrorism forces' (2019) https://www.businessinsider.com/isis-al-baghdadi-resurfaced-to-recruit-after-sri-lanka-experts-say-2019-4?IR=T accessed 19th August 2019.
[1172] Ibid.
[1173] John Haltiwanger (n 1171).
[1174] Colin P Clarke, 'Baghdadi Resurfaces: What It Means for ISIS's Global Terror Campaign' (2019) Rand Corporation, https://www.rand.org/blog/2019/05/baghdadi-resurfaces-what-it-means-for-isiss-global.html accessed 19th August 2019.

the *Shia* rituals surrounding Ashura. But Fadlallah's prohibition was met with even more zealous self-flagellation by the young members of Hezbollah, which in Sivan's view suggests that rapprochement between the two denominations would be challenging to achieve.[1175]

Such crisis of authority becomes more meaningful considering that infallibility of the ulama is an important aspect of *Shia*'s faith. As history has demonstrated, particularly but not exclusively in the ISIS example, *Sunni* Muslims are theologically better prepared, compared to their *Shia* counterparts, to question their religious and political leaders' suitability for the role, purity of faith and adherence to the main sources of Islamic law. On a broader note, however, this episode demonstrates that even prominent religious leaders must have their finger on the pulse of the Muslim community; or else, they risk outcomes which they may not have been prepared for.

In this particular example, the timing of the prohibition was perhaps unfortunate, given that just a few months before Ashura, in June 1985, Israel withdrew and officially ended the 1982 Lebanon War.[1176] Incidentally, this war was one of the catalysts for the creation of Hezbollah, who, prior to ISIS was credited as being 'the most successful case study in the exporting of the Iranian Revolution.'[1177] Furthermore, the incident feeds in a larger discussion concerning Hezbollah's subsequent adherence to the pan-Islamic religious identity that was so salient in their origins. In some analysts' view, this initial mostly religious identity 'has been replaced by an increased political pragmatism,[1178] which makes it necessary to analyse the group through 'political conceptions of cultural and religious identities.'[1179]

To this end, it is worth comparing the political bent of the *Shia* revolutionary organisation with some historical events surrounding the origins of the *Shia* faith in Iran. This could be significant for many reasons, only one of which is connected to the leaders of the Iranian Islamic

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[1175] Sivan (n 85), 28.
[1176] Jessica Zhanna Malekos Smith, 'A Victory for Whom? Lessons from the 1982 and 2006 Lebanon Wars' (2018) Small Wars Journal, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3190488 accessed 18th august 2019. See also, BBC News, '1982 Lebanon invasion' (2008) http://news.bbc.co.uk/2/hi/middle_east/7381364.stm accessed 18th august 2019.
[1177] Pol Morillas, 'Hezbollah's Identities and their Relevance for Cultural and Religious IR' (December 2011). ICIP Working Paper No. 2009/4, https://ssrn.com/abstract=1884127 or http://dx.doi.org/10.2139/ssrn.1884127 accessed 18th August 2019, 8. Also see, Martin Kramer, (1990). 'Redeeming Jerusalem: The Pan-Islamic Premise of Hizballah' in David Menashri, (ed.) *The Iranian Revolution and the Muslim World* (Westview Press 1990); Hala Jaber, *Hezbollah. Born with a Vengeance*, (Columbia University Press 1997).
[1178] Pol Morillas, ibid.
[1179] Pol Morillas, (n 1177).

Revolution, who provided Hezbollah with financial, political, and logistical support.[1180] Although it is presently the country with the biggest *Shia* majority in the world, Iran was not a *Shia* country from the beginning of its conversion to Islam. Rather, the transition from a *Sunni* dominated (mostly of the *Sunni Sufism* branch) to the *Shia* denomination took place in the early 16th century, after the conquest of Persia by Ismail I.

When arriving in Persia, Ismail initiated an extremely intolerant to *Sunni* Muslims campaign of conversion, aiming to eradicate *Sunni* Islam from the land. The conversion of the *Sunni* Persians into *Shia*, which slowly but steadily took place between the 10th and the 15th century CE, was motivated by the geopolitical interests of the Safavid dynasty and mostly by the desire to establish a Persian identity, which would be distinct from that of their main political enemies – the Ottoman Empire and the Central Asian Uzbeks.[1181] These events suggest that religious identity in the context of Islam has traditionally and reliably served, in addition to its spiritual role, as a way of drawing (or re-establishing) the borders within the Muslim community, predominantly in the pursuance of geopolitical objectives. The importance of having control over this identity for ideologists and political leaders could not be overestimated.

Such overtly political bent has indeed been justified by *Shia* revolutionaries and jihadi-salafists through the employment of the apostasy rhetoric, helping reshape their political strife into a religious one. While this approach is aligned with the understanding that all aspects of Muslims' life must be surrendered to Islam, and is therefore not contentious from a religious point of view, it explains the extreme version of jihadi-salafism adopted by ISIS. If the objective is to create an identity of the Caliphate's populace, which would both strengthen the new Caliphate from within and will make it stand out in comparison to its enemies (which are now easy to identify by virtue of not belonging to this identity), it is unlikely that ISIS leaders have (for now) any plans to soften their approach, including and particular in the sphere of legislation.

The more significant conclusion is that any radically-bent organisation with appetite for power, which wishes to remain relevant, should adopt this approach and locate itself within its own unique ideological parameters. Furthermore, until such time that the denominations find a

[1180] Pol Morillas, (n 1177), 8.
[1181] Nikki R. Keddie, Yann Richard, *Modern Iran* (Yale University Press 2003), 11. See also, Nikki R Keddie, *Iran: Religion, Politics, and Society : Collected Essays* (Frank Cass 1980), 91.

consensus on the ideological points of contention, or the Caliphate wins, the drive in the Muslim world will be towards diversion rather than conversion. Where this leaves the area of Islamic finance is far from easy to predict; however, it is likely that the constant uncertainty as to compliance with the *Shariah* will render the sector underperforming (in the best case scenario) or threatening systemic stability within the Muslim markets and perhaps beyond.

11.6. Islamic finance framework in the pursued and existing Islamic States

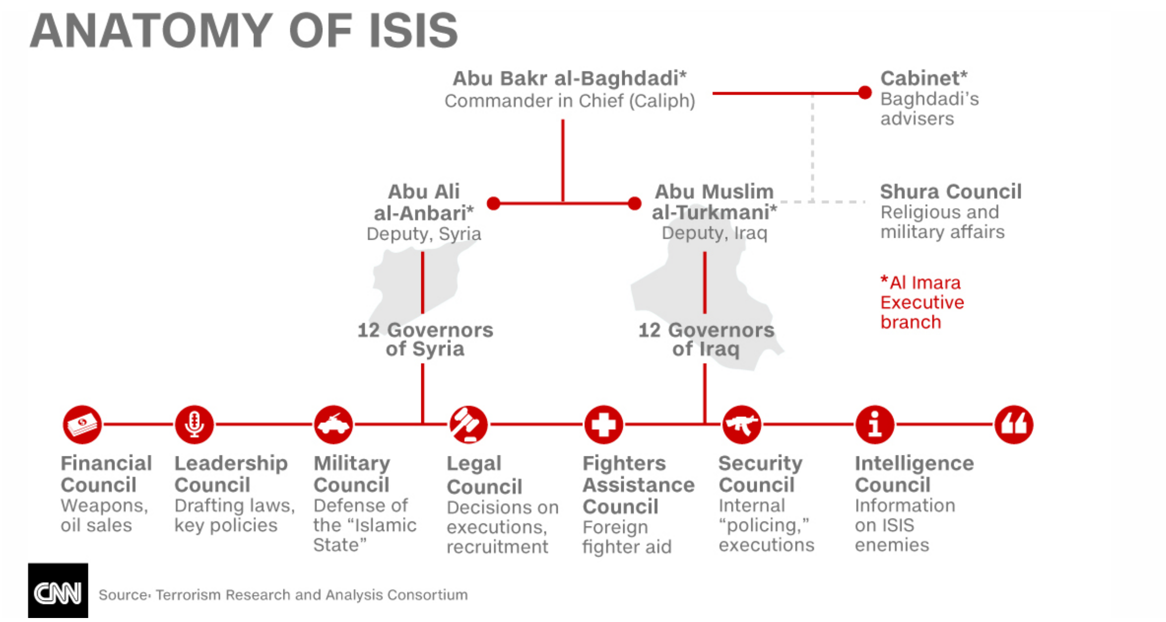
11.6.1. Case study A: ISIS

11.6.1.1. Funding of ISIS and how this relates to the future of Islamic finance

This analysis would be incomplete without trying to examine the connection between ISIS and Islamic finance, including developments in financial technologies. While funding of terrorism is only marginally related to this thesis, although it is indeed perceived as one of the means of establishing an Islamic State, terrorism is only part of ISIS' activities. In addition to it, the organisation engaged in active propaganda, proselytism and even trade. Trade was just one of the funding avenues explored by ISIS. The question of funding and how it was procured is even more intriguing because, as a self-proclaimed State, ISIS needed to build a structure resembling, if not mimicking, a normal State apparatus. Specifically, observers have noted that in their state building endeavor, ISIS follows the US strategy of '"Clear and Hold" to win territory, establish control over the area, then get the locals to help govern it.'[1182]

[1182] Nick Thompson and Atika Shubert, 'The anatomy of ISIS: How the 'Islamic State' is run, from oil to beheadings' (2015) CNN, https://edition.cnn.com/2014/09/18/world/meast/isis-syria-iraq-hierarchy/ accessed 20th August 2019. See also, Eckart Woertz, 'How Long Will ISIS Last Economically?' (2014) CIDOB, https://www.cidob.org/en/publications/publication_series/notes_internacionals/n1_98/how_long_will_isis_last_economically accessed 20th August 2019.

Consider, for example, the following diagram, distributed by CNN in the early 2015:



The diagram shows two structures that are relevant to this work: the Financial Council, which dealt with weapons and oil sales and the Leadership Council, which handled the issue of law and policy. As for the former, oil trade was largely responsible for the massive cash flows collected by ISIS, which were, for example in the early ears, 'secured from the oilfields of eastern Syria, which it had commandeered in late 2012, some of which it sold back to the Syrian regime.'[1183] The Guardian goes on to mention ISIS' propensity to make money 'from smuggling raw materials pillaged in Syria as well as priceless antiquities from archeological digs.'[1184] Although the Guardian's figures could have been exaggerated, ISIS oil revenues were undoubtedly significant.[1185]

Table.6

Source	**Percentage of Revenue**

[1183] Ian Black et al, 'The terrifying rise of Isis: $2bn in loot, online killings and an army on the run' (2014) The Guardian, https://www.theguardian.com/world/2014/jun/16/terrifying-rise-of-isis-iraq-executions accessed 20th August 2019

[1184] Ibid.

[1185] Aymenn Jawad Al-Tamimi, 'The Archivist: Unseen Islamic State Financial Accounts for Deir az-Zor Province' (2015) Jihadology, http://www.aymennjawad.org/17916/the-archivist-unseen-islamic-state-financial accessed 21st August 2019. The critical work of Al-Tamimi has been acknowledged in the book by Brian H. Fishman, *The Master Plan: ISIS, al-Qaeda, and the Jihadi Strategy for Final Victory*, (Yale University Press 2016).

Oil & Gas	27.70%
Electricity	3.90%
Taxes	23.70%
Confiscations	44.70%

The issue of oil trade is relevant to this work for reasons of examining the attitude of an active Islamic State to derivative and sale-purchase contracts.

11.6.1.2. ISIS deployment of Islamic finance: a hypothesis

Crude oil trading is known to offer 'excellent opportunities to profit in nearly all market conditions due to its unique standing within the world's economic and political systems.'[1186] Setting aside the issue of commandeering of property, it is arguable that the act of selling tangible assets was not incompliant with *Shariah* law. Quite the contrary, provided that the trade of crude oil has comprised of a simple exchange of goods and money, it would have been compliant with the *Qur'an*. What is more, it would have resembled the simple trading practices of the early Islamic period. As such, it would have comfortably fit into the theological jihadi-salafists' narrative.

Due to the difficulty of gathering reliable data, however, it is impossible to state at this point whether ISIS engaged in anything more than that, for example by using Islamic finance derivatives instruments/Islamic contracts and trading them on an over-the-counter (OTC) market. Considering for instance, the popularity of oil futures for the trade of crude oil,[1187] it is conceivable that ISIS has traded into this type of derivative.

Furthermore, as far as the oil deals are concerned, the relevant question is how and when ISIS got paid for the delivery of the commodity (through conventional or shadow banking channels, through cryptocurrencies or any other method), how the contract was structured (by deferred delivery or deferred payment) and whether hedging was involved. The Civil Code of the Ottoman

[1186] Alan Farley, '5 Steps to Making a Profit in Crude Oil Trading' (2019)
[1187] Harry Tchilinguirian, 'Oil price Q&A: What are oil futures and how are they traded?' (2008) The Telegraph, https://www.telegraph.co.uk/finance/newsbysector/energy/2790647/Oil-price-QandA-What-are-oil-futures-and-how-are-they-traded.html accessed 20th August 2019.

Government states: 'The real reason of contracts is for the objectives and not for the literal wordings,[1188] suggesting, in addition to other things, that in Islamic law substance must triumph offer form. It is arguable that whatever form the contracts between the parties took, or whatever the label they put on it, it is its content which would help us determine whether or not ISIS employed the use of Islamic or conventional financial instruments in order to finance their campaign.

For example, considering the price of this commodity and the size of deals, (estimated revenue of $1.5milion a day or slightly less, depending on the source of information)[1189] it is hard to imagine that cash payment has taken place at every instance of the trade. The less cash participates in a deal, the more likely it is that some sort of derivative trading has been involved. At the same time, the use of cash does not, in itself, negate the possibility of trading in derivatives. Rather, it may designate the use of derivatives as sporadic and borne out of the necessity of the war and the peculiarity of the traded commodity.

To this end, there is data suggesting that cash sales of oil may have taken place. For example, consider the RAND Report's findings that:

> *Airstrikes have … targeted ISIL cash storage sites in Iraq. Two airstrikes in January 2016 in Mosul destroyed an uncertain amount of money, while four more airstrikes in February hit cash storage and distribution facilities; estimates have ranged from tens of millions of dollars to a billion dollars, although all estimates are highly uncertain. Further attacks on cash storage sites have occurred since March 2016. In October 2016, the U.S. Treasury estimated that "at least tens of millions, and possibly more than a hundred million dollars" had been destroyed.*[1190]

It is possible that some of this cash was oil money. If, however, ISIS had indeed dealt in cash mostly, it is not impossible that they have since changed their strategies, following the strikes. Furthermore, while dealing in and storing of cash could have been easier when ISIS controlled a large territory, in the current circumstances, whatever recourses ISIS have, it is unlikely that they

[1188] Majallah (the Civil Code of the Ottoman Government) promulgated in 1876.
[1189] Patrick Blannin, 'Islamic State's Financing: Sources, Methods and Utilisation' (2017)9(5) Counter Terrorist Trends and Analyses 13, 15.
[1190] Colin P Clarke et al., 'Financial Futures of the Islamic State of Iraq and the Levant Findings from a RAND Corporation Workshop', (2017) RAND, https://www.rand.org/pubs/conf_proceedings/CF361.html accessed 21st August 2019, 12.

will keep all of them in cash. Since ISIS was known to be the richest terrorist group in the world, accumulating its cash through the described above methods and the 'seizure of resources throughout Iraq, including approximately $500 million to $1 billion from various banks,'[1191] it is possible that a substantial part of this wealth still exists, even after the huge setbacks/defeat experienced by the organisation in 2018/2019.[1192]

Until such time that any evidence is produced to one or another effect, this author's hypothesis is that in the past Islamic finance instruments (for instance, futures) have been made use of by ISIS. Furthermore, the author supports an argument that ISIS may have used the financial markets, either before its defeat, after it or throughout, as an additional way of storing and investing cash. This hypothesis is not supported by concrete evidence, however. In fact, it is well-known that ISIS were low-tech, at least in carrying out terrorist activities,[1193] which made their detection very hard. In addition, they have remained low tech in their financial dealings on the ground in their captured territories.

Consider, in this connection, the use by ISIS of the existing throughout Iraq and Syria Money and Value Transfer Services (MVTS) network. As the 2015 FATF Report suggests, '[s]ince many Iraqis and Syrians do not hold bank accounts, they rely on these often unregulated MVTS companies for sending, or receiving payments from, local or foreign counterparties. ISIL could abuse this system of transferring money.'[1194] The relevant point here is that MVTS companies work by sending a message through novel communication channels (often Telegram or

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[1191] Ibid.

[1192] Bethan McKernan , 'Isis defeated, US-backed Syrian Democratic Forces announce' (23 Mar 2019),The Guardian, https://www.theguardian.com/world/2019/mar/23/isis-defeated-us-backed-syrian-democratic-forces-announce accessed 21st August 2019. C.f. with articles claiming that ISIS is getting ready to reemerge: Kurdistan24, 'Canadian Commander warns of ISIS re-emergence in Iraq unless causes addressed '(February 2019) https://www.kurdistan24.net/en/news/29ad5122-5297-4e99-8957-e9d4bd5183ea accessed 21st August 2019; Joshua A. Geltzer, 'Why Baghdadi Risked a Video Appearance' (May 2019) The Atlantic, https://www.theatlantic.com/ideas/archive/2019/05/baghdadi-video-announces-rebirth-isis/588421/ accessed 21st August 2019; John Ubaldi, 'The Rise, Fall and Possible Re-Emergence of ISIS' (May 2019) In Homeland Security, https://inhomelandsecurity.com/possible-re-emergence-isis/ accessed 21st August 2019.

[1193] Daniel R DePetris, 'ISIS is Using Low-Tech Means to Inflict Large-Scale Terror' (2017) https://nationalinterest.org/feature/isis-using-low-tech-means-inflict-large-scale-terror-22190 accessed 21st August 2019.

[1194] FATF, 'Financing of the Terrorist Organisation Islamic State in Iraq and the Levant (ISIL)' (2015), 28.

WhatsApp but also via email, fax, or telephone) to a local or foreign associate to pay or receive payment from the counterparty to a transaction.[1195]

This approach notwithstanding, it is doubtful that the same approach could have been taken by ISIS in their larger deals, which supports a hypothesis that a more high-tech avenues have been pursued by the organisation.

This ability to make progress in some, while neglecting other fields, is further buttressed by observations that ISIS 'made most of its technological progress in the field of drone technology.'[1196] Compared to other terrorist organisations, the development of ISIS has been described as "striking",[1197] particularly in their ability to weaponise drones.[1198] Another field where ISIS demonstrated aptitude was the Internet; and the last years of ISIS coincided with a rapid technological advancement on the Internet, through a vast range of applications and platforms, which ISIS could have made use for different (not limited to propaganda and recruitment) purposes.[1199] This supports an argument that the organisation may have or could in the future utilise such applications and platforms for financing purposes. There is some evidence that this could have been carried out via cryptocurrencies.

11.6.1.3. ISIS' forays into cryptocurrencies

As discussed, out of all trade that took place, selling oil was 'believed to be the largest single source of ISIS income.'[1200] However, measures taken by the Western forces towards the last years of the anti-ISIS offensive prevented ISIS from selling oil as easily as they did at the beginning of their campaign.[1201] With the progression of time, ISIS started losing control over much of their conquered territory and importantly, over the oil fields. This made it necessary for

[1195] Ibid.
[1196] Truls Hallberg Tønnessen, 'Islamic State and Technology – A Literature Review' (2017)11(6) Perspectives on Terrorism 101, https://www.jstor.org/stable/26295959?seq=6#metadata_info_tab_contents accessed 21st August 2019, 103.
[1197] Ibid.
[1198] Truls Hallberg Tønnessen (n 1196), 104.
[1199] Truls Hallberg Tønnessen (n 1196), 105.
[1200] Rachel Kreisman, 'Raqqa and the Oil Economy of ISIS' (2017) Atlantic Council, https://www.atlanticcouncil.org/blogs/syriasource/raqqa-and-the-oil-economy-of-isis accessed 20th August 2019.
[1201] Ibid.

them to procure other methods of funding. One such method employed the use of cryptocurrencies.

Cryptocurrencies lend themselves to use in the regulated and unregulated space. There is data indicating that ISIS has continuously utilised this opportunity, mostly through Bitcoin and Zcash, to purchase website domains,[1202] obtain funding from supporters or directly finance its operations.[1203] Despite the drastic drop in the market share of Bitcoin during the last few years (from 80% to 35%), it is still deemed preferred by cybercriminals and other players, due to the privacy it offers[1204] but also because it is the cryptocurrency easiest to exchange or cash out.[1205] As to whether ISIS indeed uses Bitcoin, it has recently become known that the organisation funded the April 2019 Sri Lanka Easter bombings (for which it formally took responsibility),[1206] with Bitcoin donations.[1207] It has been further alleged that ISIS has used CoinPayments, a Canadian based platform, 'which allows its customers to receive cryptocurrency payments and convert them into dollars.'[1208] Furthermore, commentators alleged that ISIS has discovered a way of anonymising itself on the Bitcoin Blockchain which, if true, would solidify the position Bitcoin takes with respect to their fundraising policies.[1209] Even now, however, this way of funding is popular among radical groups. For example, there is evidence that the militant Palestinian group Hamas' wing Qassam Brigades has set up a website where prospective donors are each given a unique Bitcoin address where to send their charity donations to the group. Any doubts in their targeted audience were alleviated with the publication of a video, posted on-line,

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[1202] David Canellis, 'Europol: Criminals are still using Bitcoin, but ISIS loves Zcash' (2018) https://thenextweb.com/hardfork/2018/09/19/europol-cryptocurrency-cybercrime/ accessed 20th August 2019.
[1203] David Carlisle, 'Cryptocurrencies and Terrorist Financing: A Risk, But Hold the Panic' (2017) RUSI.org, https://rusi.org/commentary/cryptocurrencies-and-terrorist-financing-risk-hold-panic accessed 20th August 2019.
[1204] Europol, 'Internet Organised Crime Threat Assessment (IOCTA) 2018' (2018) https://www.europol.europa.eu/activities-services/main-reports/internet-organised-crime-threat-assessment-iocta-2018 accessed 20th August 2019.
[1205] Brenna Smith, 'The Evolution Of Bitcoin In Terrorist Financing' (2019) https://www.bellingcat.com/news/2019/08/09/the-evolution-of-bitcoin-in-terrorist-financing/ accessed 20th August 2019.
[1206] Michael Safi and Jason Burke, 'Sri Lanka bombings: Islamic State claims responsibility for attacks' (2019) The Guardian, https://www.theguardian.com/world/2019/apr/23/sri-lanka-bombings-first-burials-take-place-on-day-of-mourning accessed 21st August 2019.
[1207] Elaine McCahill, 'ISIS 'funded Sri Lanka Easter bombings with Bitcoin donations'' (2019) The Mirror, https://www.mirror.co.uk/news/world-news/isis-funded-sri-lanka-easter-14982949 accessed 20th August 2019.
[1208] Roy Katsiri, 'Bitcoin donations to ISIS soared day before Sri Lanka bombings' (2019) https://en.globes.co.il/en/article-exclusive-isis-funded-sri-lanka-bombings-with-bitcoin-donations-1001284276 accessed 20th August 2019.
[1209] Brenna Smith (n 1205).

where a leading sheikh explained the origins of Bitcoin and confirmed that it was permissible to use the currency for charity donations to the organisation.[1210]

Considering that ISIS has been prevented from using the international financial system, including the banking system, [1211] it is possible that the organisation will continue to finance its activities by over and underground deals carried out with cryptocurrencies.

However, the lifetime of this scenario is limited to two possible outcomes – the full defeat of ISIS or its establishment as a "normal" state. In the latter, ISIS will have to first, give a historical account of the way it financed its way to victory and secondly, create a lasting framework allowing the normal operation of the state. Such framework will have to include financial legislation. Rigorous research by this author has produced little evidence that, with exception of taxes, ISIS have contemplated how the economic framework of their state would look like. As to their third biggest source of revenue, taxation, which was claimed to have generated 'as much as $360 million per year'[1212] ISIS have adhered to, in addition to normal quasi-state taxes, a religious tax known as *khums*. *Khums*, along with *zakat* is a traditional obligation for business and individuals. In the circumstances, ISIS imposed up to 50%[1213] (the traditional approach being up to 20%) *khums* tax on businesses involved in petroleum distribution and antiquities smuggling. Historically, *khums* have been levied on the spoils of war and on excavated artifacts,[1214] which means that ISIS had religious justification for commercial taxation.[1215] Another clue as to how a potential future Islamic State might look like (in the interpretation of ISIS) is seen in RAND's Report, where it has been noted that ISIS 'maintains a penchant for

[1210] Nathaniel Popper, 'Terrorists Turn to Bitcoin for Funding, and They're Learning Fast' (2019) The New York Times, https://www.nytimes.com/2019/08/18/technology/terrorists-bitcoin.html?rref=collection/timestopic/Islamic%20State%20in%20Iraq%20and%20Syria%20(ISIS) accessed 21st August 2019.

[1211] Colin P Clarke et al., (n 1131), 13.

[1212] Patrick Blannin (n 1107), 17-18; see also, Anan Swanson, 'How the Islamic States makes its money', The Washington Post, (November 18, 2015), https://www.google.com.sg/?gfe_rd=cr&ei=GM39WJPsOIiFogOa7q3oCg&gws_rd=ssl#q=Anan+Swanson,+%E2%80%98How+the+Islamic+States+makes+its+money%E2%80%99,+The+Washington+Post accessed 21st August 2019.

[1213] Brigadier General (Ret.) Russell Howard, Marc Elliott, and Jonathan Prohov, 'Digging In And Trafficking Out: How The Destruction Of Cultural Heritage Funds Terrorism' (2015) 8(2) CTC Sentinel 14, 16, https://www.ctc.usma.edu/v2/wpcontent/uploads/2015/02/CTCSentinel-Vol8Issue27.pdf in Patrick Blannin (n 1130).

[1214] Jessica Stern, 'ISIL and the Goal of Organizational Survival', Center for Complex Operations, (2016) Prism, National Defense University, The Journal of Complex Operations https://cco.ndu.edu/BCWWO/Article/980822/9-isil-and-the-goal-of-organizational-survival/ accessed 21st August 2019, 198.

[1215] Patrick Blannin (n 1212), 18.

retaining technical expertise from previous government and private sector regimes, promotes limited state ownership of industry beyond regulatory and taxation roles, and boasts an ability to balance expenditures and revenues (debits and credits).'[1216] This allows a tentative guess that a state run by ISIS will not be against private initiative, and could even have rightwing tendencies. This is not surprising, considering that the state is envisioned as a Caliphate, therefore, it would be non-democratic by default. In comparison, the two main political parties inside post-revolutionary Iran are the conservative Principlists, known in the West as the hard-liners in Iranian politics. The other camp belongs to the Reformists, who lean towards the center and support a change towards greater democracy and freedom in the country.

In addition, the analysis of RAND suggests that a future ISIS state would be technocratic and aiming for efficiency. This presupposes a financial services framework of some *Shariah*-compliant sort built-up within the governmental organisation.

11.6.2. Case study B: Iran

11.6.2.1. Background

Following the Islamic Revolution, Iran underwent a deep change affecting all of its economic and social structures, including the financial market system. The Revolution happened at a moment when the country's economy was in stagflation (inflation and a decline in the GDP). Iran experienced a run on the banks, which threatened closures and bankruptcies. The solution of the new government was to nationalise the state's 34 banks and to merge them into 9, 6 of which were commercial and 3 specialised.[1217]

Unlike other Islamic countries, Iran permits the trade of *sukuk* on both the primary and secondary markets.[1218] However, Iran has a legal framework which purports to protect the

[1216] Colin P Clarke et al., (n 1131), 33.
[1217] Muhammad Anwar, 'Islamic Banking in Iran and Pakistan: A Comparative Study' (1992) 31(4) The Pakistan Development Review 1089, 1090.
[1218] Ebrahim Abdipour Fard, 'Legal Requirements of Financing by Issuance of Islamic Financial Instruments (Iranian Case Study)', (2017) Chapter 4, http://uncitralrcap.org/wp-content/uploads/2017/03/3.-Ebrahim-Abdipour-Fard.pdf, accessed 18th August 2019, 82.

interests of investors and *sukuk* holders. In broad lines, the Iranian Islamic finance market resembles its *Sunni* counterpart, for example, in the proscription of *riba* (interest);[1219] however, instruments are structured with regard to the spirit of the *Shia Immamieh* jurisprudence.[1220]

For example, although Iran shuns *riba*, it introduced, immediately after nationalisation, the concept of "guaranteed minimum profit", which could be between 4-8%, depending on the economic activity. The concept applies also to deposits.[1221] Furthermore, the new regulation replaced interest on assets with a "maximum service charge" of 4%. In the years immediately after the Revolution, a prevalence of short term vs. medium and long-term financing was observed in the activities of banks. This has been seen as insufficiently compliant with the *Shariah* principles, which favour long term cooperation between banks and investors, leading to the promulgation in 1984 of the Law for the Usury-Free Banking.[1222] Furthermore, the "guaranteed minimum profit" was seen as akin to interest. The new law allowed modes of banking such as *qard al-hasan* (loans), *mudharabah*, civil and legal partnerships, term investment deposits, which 'shall be used in joint venture, *mozarebeh* (agency contract), *ijarah-be-shrte tamlik* (hire-purchase), instalment transaction, *mozara-ah*, *mosaqat*, direct investment, forward dealings and *joaalah* transactions.'[1223] Furthermore, the new law substituted the fixed "guaranteed minimum profit" applicable to deposits with non-fixed bonus for depositors.[1224] In a nutshell, the most profound novelty of the new legislation was the replacement of the quasi-interest-based business practices with a profit-and-loss sharing model. This however, did not take away from the pragmatism characteristic of the Iranian banking system. For instance, in case of defaulting debtors, banks are allowed to charge a fixed penalty of 12% a year imposed on the unpaid proportion of a loan.[1225] In addition, the banks are allowed to impose a rate of interest up to the rate of inflation. Last but not least, because Iranian banks are state property, the payment

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1219 Muhammad Anwar, 'Islamic Banking in Iran and Pakistan: A Comparative Study' (1992) 31(4) The Pakistan Development Review 1089, 1090.

1220 Fard (n 1218), 82.

1221 Ali Asghar S Hedayati, 'Theoretical and philosophical aspects of Islamic banking' (1991) Paper presented in the Second International Course on Islamic Banking, Babolsar, Central Bank of the Islamic Republic of Iran, October 5-20, 17-32.

1222 Central Bank of the Islamic Republic of Iran, Law for the Usury (Interest) Free Banking, https://www.cbi.ir/page/2235.aspx accessed 21st August 2019.

1223 ibid, p.2-3, Chapter II, Article3 (B); see also, Muhammad Anwar (n 1219), 1090.

1224 Law for the Usury (Interest) Free Banking (n 572), Article 6(A).

1225 Hossein S Mahdavi , 'Fundamental and Uniqueness Features of Islamic Banking in Iran', (1991) Paper presented in the Second International Course on Islamic Banking, Babolsar, Central Bank of the Islamic Republic of Iran, October 5-20, p.6.

and receipt of extra amount in addition to the principal is allowed in the context of government borrowings (it is not deemed *riba*).[1226]

Analyses of the achievements of the Iranian banking system has rendered them unimpressive, due to slow growth, relatively narrow range of products and services, and a large portfolio of non-performing assets. Even more crucially, the Iranian system is perceived as permitting interest as part of the authorised under its laws transactions.[1227] Furthermore, the Iranian banking system guarantees the deposits of its customers, as well as permits a services charge of 2%. In addition, the system allows buy-back arrangements and the sale of goods which the bank is not in possession of. This has brought the Iranian banking system under a barrage of criticism for its alleged incompliance with *Shariah*.[1228] However, as a side effect of the fact that banks are owned by the state, their policies reflect governmental long-term planning and are, therefore, intended to increase of the well-being of the Iranian nation.

11.6.2.2. Current framework

The Iranian financial system is currently under the supervision of the Iranian Ministry of Economic Affairs and Finance, to which belong the Money and Credit Council, the Securities and Exchange High Council and the Insurance High Council. The Councils govern the Central Bank of Islamic Republic of Iran (CBI), the Securities and Exchange Organization (SEO) and the Central Insurance of Islamic Republic of Iran (CII), respectively.[1229]

The current legislative framework, governing the financial markets of Iran consists of the Law for Development of New Financial Instruments and Institutions 2009,[1230] the Iranian Anti-Money

[1226] Muhammad Anwar (n 1219), 1094.
[1227] Mondher Bellalah and Omar Masood edts., *Islamic Banking and Finance*, (Cambridge Scholars Publishing 2013), 167.
[1228] Andrew Cunningham, *Islamic Banking and Finance* (Middle East Economic Digest 1997), 37.
[1229] Majid Pireh, 'An Overview of Islamic Financial Instruments/Institutions in Iran' (2015) 7th International Course on Islamic Capital Markets Tehran; Islamic Republic of Iran May 2015, 5.
[1230] Law for Development of New Financial Instruments and Institutions 2009, http://cic.tccim.ir/images/Docs/The_Law_for_Development_of.pdf accessed 22nd August 2019.

Laundering Act 2008,[1231] the Securities Market Act of the Islamic Republic of Iran 2005[1232] and the Commercial Code of Iran 1932.[1233]

The Securities and Exchange High Council determines the general policies of the Iranian capital market and oversees the Securities and Exchange Organization, which in turn provides the Iranian capital market's rules and regulations. The SEO oversees the Tehran Stock Exchange, the Farabourse Company, the Iran Mercantile Exchange and the Energy Exchange which on their part are responsible for a number of markets for trading of financial instruments.[1234] In addition to the Tehran Exchange which deals with regulated by the SEO securities, the Farabourse Company deals with, inter alia, the Iranian *sukuk* market. The Commodity Exchange is tasked with the admission of industrial, mineral and agricultural commodities and the based on them securities. The Energy Exchange was formed in 2011, in order to supply the market with, among other things, oil and petroleum derivatives.

The procedure of approving new securities includes the following. First, the SEO drafts the new instrument, which it then presents to the *Shariah* Board of the SEO. The Board deliberates on the *Shariah* compliance of the instrument and upon reaching a conclusion that the new product does not contradict the religious rules, it hands it over to the High Council. The later bears the ultimate responsibility for the approval of new instruments. Should the High Council decide to give a go-ahead in such a situation, the responsibility for the rules and regulations, concerning the new instruments, is handed back to the SEO.[1235]

The *Shariah* Board of the SEO is in place to provide examination of and comments on financial instruments, markets and institutions. The review of the Board is carried out from a jurisprudential perspective. Should the board conclude that the instrument, market or institution are lacking in compliance with *Shariah*, they provide recommendations for reform.[1236]

[1231] Money Laundering Law in I.R. of Iran 2008, https://www.sb24.com/en/footer/pdf/Money_Laundering_Law_in_I.R._of_Iran.pdf accessed 22nd August 2019.
[1232] Securities Market Act of the Islamic Republic of Iran 2005, http://www.tse.ir/cms/Portals/0/int/_Securities_Market_Act4.pdf accessed 22nd August 2019.
[1233] Commercial Code of Iran 1932, http://www.ilo.org/dyn/natlex/natlex4.detail?p_lang=en&p_isn=79503&p_country=IRN&p_count=168&p_classification=01.03&p_classcount=15 accessed 22nd August 2019.
[1234] Majid Pireh (n 1229), 6.
[1235] Majid Pireh (n 1229), 13.
[1236] Majid Pireh (n 1229), 14.

11.6.2.3. Financial instruments in the Iranian capital market

The Iranian capital Market operates with equity shares, *sukuk*, derivatives and certificates of housing loans priority rights. The *sukuk* market is well-developed. It includes musharakah, ijarah and murabaha, which are regulated, considered tradable and issued. *Mudarabah*, *istisna*, *jo'alah*, *qard*, *manfa`ah* and *muzara`ah* are tradable in principle but, with the exception of *qard*, are not subject to specific rules and regulations and there has been no issuance of them. Lastly, *salam* or *salaf* (forward sale) is subject to rules and regulation, and there has been issuance of this instrument. However, while tradable, it can only be traded on the basis on parallel *salam*. All of the above instruments, with the exception of *musharakah*, benefit from a review by the *Shariah* Board of the SEO.[1237] This has adorned them with extra credibility in terms of their religious compliance.

In terms of trading volume, *musharakah* was first issued in 1994 and by 2015 its issuance exceeded $30 billion. This instrument is mainly issued and traded in the banking system. The first *ijara sukuk* was issued much later - in 2011 – and its volume up to 2015 reached $600 million. *Ijara sukuk* is preferred on the Iranian capital market. *Murabaha* was first issued in 2013 and has generated $60 Million in the first two years, mainly on the capital market. *Salam* was first issued in 2014 as an instrument structured on embedded option contracts.[1238]

Derivatives allowed on the Iranian market include futures and options (note that futures are largely not present on the Sunni financial market due to incompliance with *Shariah*). The *Shariah* Board of the SEO demands that with respect to both, 'the market should keep a rational ratio with the real market and that the underlying assets should be deliverable.'[1239] The most commonly used futures are commodity futures, traded on the Iran Mercantile Exchange (IME) (including gold coin futures, wired copper, copper cathode and gold bullion futures) and equity futures

[1237] Majid Pireh (n 1229), 18.
[1238] Majid Pireh (n 1229), 19.
[1239] Majid Pireh (n 1229), 20.

(single stock futures), traded in Tehran Stock Exchange (TSE). As regard to options, the Iranian capital market offers embedded put options for single stocks. [1240]

A popular for Iran financial institution is the mutual fund where investors' funds are pooled together and then invested in different securities, for instance stocks, *musharakah sukuk* or short-term instruments of the money market. The Law for Development of New Financial Instruments and Institutions defines mutual fund as 'a financial institution which invests the financial resources derived from issuance of investment units in its designated area of activity.'[1241] This means that the units of a mutual fund can be traded. Positively for investors, the *Shariah* Board of the SEO approved the third party guarantee for minimal rate of return for unit holders.[1242]

In addition to mutual funds, the Iranian market boasts 8 investment banks, engaged in capital raising through underwriting and/or acting as the client's agent in the issuance of securities, or in trading of securities.

11.6.2.4. Differences (and similarities) with the Sunni market

Although the Iranian market uses many of the instruments already familiar on the conventional and *Sunni* capital markets, the Iranian approach differs in some aspects. This makes it necessary to provide some further explanation on the main pillars of the Iranian financial system and the critiques, which it has endured. Iranian market players are under positive and negative obligations that follow the *Shia* specific interpretation of *Shariah* law. With regard to the former, these affirmative obligations are laid down in acknowledgment that the Islamic financial instruments have a dual nature. They comprise of contractual relationships, while remaining subject to regulations on the financial market (primary and secondary). With respect to *sukuk*, which is by far the most popular instrument on the Iranian market, Iranian jurisprudence underlines that the instrument differs from conventional bonds because it does not create a debt relationship but, depending on the type of *sukuk*, a 'relation of seller and buyer or leaser and leaseholder or agent and principal or investor and entrepreneur as well as a relation between fellow partners in a joint

[1240] Majid Pireh (n 1229), 20-21.
[1241] Law for Development of New Financial Instruments and Institutions (n 580), Article 1(e).
[1242] Majid Pireh (n 1229), 24.

investment project'.[1243] This definition indicates that Iranian financial scholars place the emphasis on the active cooperation of the parties in the pursuance of a productive enterprise, thus distinguishing Iranian *sukuk* from the passive debt-based character of conventional bonds.

Iranian jurists are confident that the state's regulatory system protects the interests of investors, for example by introducing a permission-based system regarding *sukuk*, whereby permission is granted subject to the issuer and originator providing documents, which demonstrate that capital market norms relating to custody, payment and administration, have been followed, as well as that contractual provisions for the provision of a periodic return and payment have been put in place. Above all, the entire structure of the *sukuk* must be compliant with *Shariah*, which in itself would guarantee fairness and justice for all parties concerned.[1244] The presence of such protections in varied *Sunni* jurisdictions would very much depend on the particular state; in any case, it was a lot easier for Iran to introduce a closed loop regulatory system, because of its political structure.

Similarly to partnership-based *sukuk* issued in *Sunni* jurisdictions, Iranian-based issuance necessitates a *nehade-vaset* (special purpose vehicle (SPV) or in some cases, special purpose company (SPC)), intended to act as intermediary between originator and investors. In addition, the Iranian version of *sukuk* is subjected to more rigid rules compared to the *Sunni* framework, because it demands that issuer and originator are the same entity (which is not necessarily the case in the *Sunni* market). As a result of this, Iranian *sukuk* adopts characteristics akin to asset-based (as opposed to its asset-backed *sukuk*), which may raise doubts about the state of protection of investors. Such doubts would be largely misplaced, however, because of the measure of state control in the country, as well as the fact that the majority of Iranian banks are State owned.

Furthermore, Iranian jurisprudence treats *sukuk* as a means to finance a project rather than any other commercial activity (although in theory, the *sukuk* could have a commercial transaction as a subject of the partnership). This somewhat rigidity is connected to the understanding that while the financial system must promote the well-being of the people, this must be done with moderation and modesty in mind. Consider in this context that the Law for Usury Free Banking

[1243] Fard (n 1136), 84.
[1244] Fard (n 1136), 84.

states that ‘banks are by no means entitled to invest in the production of luxury and non-essential consumer goods.’[1245]

Other types of *sukuk* (non-partnerships, such as purchase and sale (*sukuk-murabaha* and *sukuk-istisna*, purchase and lease (*sukuk-ijarah*) or hire-purchase (*sukuk-ijarah be sharte tamlik*) or sale-purchase (*sukuk-mudarabah*) allow that originator and issuer are two different entities. In this case, the intermediary (SPV) acts as the issuer and investors become co-partners of the collected funds. Investors enter a legal relationship with the issuer (and not with the originator) and it is the issuer, which is authorised to contract or generally deal with the collected funds.

Last but not least, Iranian *sukuk* issuance is subject to the same rules (as its *Sunni* counterpart) on *riba*, meaning that money is not allowed to make more money itself. Furthermore, investments must be made in real commercial activities, which could include trade, lease or investments. This guarantees that all profit generated by the *sukuk* is generated by the effort and skills of the investor and financier rather than just by virtue of the invested capital.[1246]

As discussed elsewhere in this work, managing of credit and market risk should be of serious consideration in the context of *sukuk* issuance. To this end, the Iranian regulatory framework has taken some positive steps by providing that ‘holders of sukuk have proportionate ownership in an underlying asset and are co- partners on the return of the asset.’[1247] However, their title is only beneficial and their interest in the asset – equitable. Therefore, the legal title to the relevant assets rests with the SPV, which is entitled and entrusted to operate with respect to these assets on its own behalf and on behalf of the respective *sukuk*-holders. In case of a shortfall in payment, *sukuk*-holders must seek redress from the legal owner of the assets, i.e. the SPV. In another example, *sukuk-istisna*, ownership in the asset to be manufactured is transferred to the *sukuk*-holder only when the entire payment obligation has been met.[1248]

This arrangement suggests that Iranian *sukuk* is asset-based rather than asset-backed, with all the investor protection ramifications attached to this.

[1245] Law for Usury Free Banking (n), Article 8.
[1246] Fard (n 1218), 85.
[1247] Fard (n 1218), 86-87; See, the Regulations Governing the Issue of Ijarah Sukuk 2008, s 1.
[1248] See, Directive on Manufacture Order Instruments" (directive on sukuk-ol-istesna) 2013, Section 10 in Fard (n 1218), 87.

The protections envisioned by the law are very well seen in the *ijara* regulatory framework. In this connection, note that the Law for Development of New Financial Instruments and Institutions has established, that the SEO exercises control of the process of establishment of a SPV. For example,

> *[t]he funds raised shall be pooled in a special account and any withdrawal from such account shall take place under the supervision and with the approval of SEO. A different SPV is specified for each issuance/project. The opening, closing, withdrawal and transfer of monies from the account in which the funds derived from Sukuk issuance is done according to the standards approved by the SEO.*[1249]

Furthermore, the Regulations Governing the Issue of Ijarah Sukuk (the Regulations) state that a different SPV must be specified for each issuance/project and that 'the opening, closing, withdrawal and transfer of monies from the account in which the funds derived from Sukuk issuance is done according to the standards approved by the SEO.'[1250] To this end, the SVP is only allowed to use the proceeds derived from the sale of securities in the project or purposes for which they have been collected or a project related to it. In such a scenario, cash flow may be invested 'solely in the securities which shall bear the guarantee of repaying the principal amount and its accrued interest as well as in the bank deposits.'[1251] To reiterate that investor protection is paramount for the legislators, the Regulations go on to state that management of funds by the SPV should always be done with protection of the interests and rights of investors in mind. Considering that *ijara sukuk* is currently one of the most popular forms of sukuk on the Islamic market,[1252] it can be concluded that the Iranian regulator aims to achieve a transparent and efficient market. This is commendable and demonstrates awareness of the way the *sukuk* market may influence the interest of investors and the general stability of the financial system.

As regard the prohibition on *riba*, Iranian *sukuk* follows the same pathway as its *Sunni* counterpart, namely, it involves the principle of profit and loss sharing instead of guaranteed

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[1249] Fereshteh Rahimi Almasi, 'Iran's Experience in Ijarah Sukuk' (2012), ehttp://www.tkbb.org.tr/Documents/Yonetmelikler/Irans.Experience.in.Ijarah.sukuk18.pptx accessed 22nd August 2019.

[1250] Ibid.

[1251] Fereshteh Rahimi Almasi (n 1249).

[1252] Faiza Nahar, Mufti Alam Adha and Dyah Titis Kusuma Wardani, 'Issues of Sukuk Ijarah' (2018) https://www.researchgate.net/publication/330413498_Issues_of_Sukuk_Ijarah accessed 22nd August 2019.

return. Furthermore, as is the case with *Sunni sukuk* issuance, profit cannot be fixed *a priori* and it usually is determined *pro-rata* to the investment. The same principle applies to distribution of losses.

However, certain classes of *sukuk* offer more predictable return, compared to others. *Sukuk-murabaha*, *sukuk-salam*, *sukuk-ijara* and *sukuk-istisna* fall in the former group. The latter comprises of *sukuk-musharakah* and *sukuk-muzarabah*.[1253] This division is logical, considering that the first group contains purchase and sale, manufacturing and lease agreements, as well as forward sales. The second group is more volatile because the profit derived from the *sukuk* is more closely related to the performance of the asset.[1254]

To this end, note that Iranian law obliges issuers of *sukuk-musharaka* (partnership instruments) to annually pay a fixed sum to the respective *sukuk*-holders as payment on account. Although this may be interpreted as payment of *riba*, it is allegedly justified by a requirement that a pre-condition of issuance of *sukuk-musharakah* is that the issuer presents a proposal, demonstrating the expected profitability of the project. Before issuance can be authorised, the profitability of the project must be confirmed by experts. In this scenario, the issuer has 'guaranteed the profitability of his project and investors have relied on his statements'.[1255] In addition to guaranteeing that resources will not be wasted in poor business initiatives, this would allow the issuer to arrive at the basis upon which the percent of predictable profit could be determined.[1256] Furthermore, types of *sukuk musharakah*, which replicate an asset ownership venture, provide for the issuer the option to call the originator on the repurchase undertaking on behalf of the investors. The basis of this venture is parity between the issuer (who provides the capital) and the originator (who

[1253] See the definition of *muzarabah* (commercial) *sukuk* in Ali Askari and Morteza Mollanazar. 'Islamic Financial Mechanisms: A Study of the Methods, Instruments and relevant Tax Treatments' (2018) http://ataic28.org/wp-content/uploads/2018/10/IRAN-English-Article-ATAIC-Lecture-Shahrivar-12-1393.pdf accessed 22nd August 2019: 'According to the standards of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Muzarabah Sukuk consists of certificates indicating projects or activities managed under a Muzarabah contract whereby one of the two parties is selected as the Mozareb in order to manage the operation. Such a financial instrument is applied to huge investment schemes where there is a need to attract the public partnership. This type of Sukuk is based on the foundation of distributing Muzarabah capitals by publishing units of equal value to be owned by the holders. Muzarabah Sukuk certificates specify the assets owned through Muzarabah investment. Each Muzarabah Sukuk certificate refers to the undistributed profitable ownership of a particular asset acquired through a Muzarabah investment and is not adventurous over other Muzarabah Sukuk certificates. When a person buys Muzarabah Sukuk, he will be entitled to all ownership rights including the sale or transfer of the asset to his heirs.'

[1254] Capital Market Central Asset Management.co., 'Musharakah Sukuk' (2016) http://sukuk.ir/en/about-sukuk/sukuk-differences/musharekaha-sukuk accessed 22nd August 2019.

[1255] Fard (n 1218), 92.

[1256] Fard (n 1218), 89.

provides the expertise, management as well as specific assets relevant to the project).[1257] In reality, however, in the Iranian framework issuer and originator in *sukuk-musharakah* are the same entity. What is deemed crucial by the legislator is whether the project has indeed obtained the profit estimated in the proposal. If this is the case, then honouring the rights of the investors is what is expected from the issuer. However, 'if the project failed, according to one Sharia principle, one who was deceived, has a right of recourse against the deceiver (*almaghrour yarjeo ela man gharrahu*).'[1258]

11.6.2.5. Justifications for redemption of principal and return

From the perspective of *Sunni* Islam, one of the controversial points of the Iranian framework is that the Iranian legislator has guaranteed redemption of the principal and return on *sukuk-murabaha* and *sukuk-istisna*, *sukuk-ijara* and *salam*. With respect to the first two, redemption 'will be paid from the sale of asset to the originator and the issuer must take both personal security and proprietary security from the originator in order to guarantee the performance of obligations of the originator (obligor). The guarantor must be a bank or financial institution.'[1259] Furthermore, the originator is bound to insure the underlying assets through an insurance company.[1260] To recall, insurance is largely unacceptable by *Sunni* Islam. In distinction, *immamieh* (*Shia*) jurists have established that commercial insurance is valid and does not contain *gharar*. Rather, insurance is there to provide the parties with legal certainty and peace of mind as to the outcome of the transaction.[1261]

While admitting that this may be a point of contention, Iranian jurists are confident that their approach is justified for reasons. First, for *murabaha*, *salam* and *istisna sukuk*, profit is predictable, therefore it is not against *Shariah* law to guarantee redemption of principal and return. Furthermore, Iranian jurists rely on a 2008 AAOIFI's pronouncement that with the exception of *mudarabah* and *musharakah sukuk*, purchase undertakings at face value may be

[1257] IFSB, Capital Adequacy Requirements for Sukuk, Securitizations and Real Estate Investment, (January 2009) 5 www.ifsb.org/standard/ifsb7.pdf accessed 23rd August 2019.
[1258] Fard (n 1218), 92.
[1259] Fard (n 1218), 91. See Regulations Governing the Issue of Murabaha Sukuk 2012, s 5.
[1260] Regulations Governing the Issue of Ijarah Sukuk 2008, s 12.
[1261] Morteza Motaheari A Study About Insurance on Islamic Jurisprudence (Mighat, 1983) 81-82.

permissible.[1262] In this connection, a subtle point, raised by Iranian scholars, is that it is a contractual obligation of the issuer to deliver profit – because he collected the investments on the basis of a proposal, pre-agreed and approved by a financial expert. In their view, it would be inequitable to investors not to guarantee redemption on their investment. It is arguable that while this approach takes inspiration from the *Shariah*'s objective of achieving a fair and just social system, it also strives to ensure that entrepreneurs will not approach irresponsibly the money entrusted to them. Generally speaking, considering that most of the Iranian banks are still owned by the State (although since 2001 there is a slow movement towards privatisation in the sector), this may be interpreted as the State's way of guaranteeing efficient use of resources and promotion of development.

Further to this topic, as far as arrangements on redemption in *sukuk ijara* are concerned, in the opinion of Iranian jurists 'where the contract in the form of hire purchase or lease contract incorporated the condition that the leaseholder is obliged to purchase the asset for a nominated price, this agreement and obligation will be valid.'[1263] This understanding is founded on the Prophet's words that all Muslims are bound by their contractual terms.[1264]

11.6.2.6. Iranian jurists' approach to riba

While Iranian jurists subscribe categorically to the proscription on usury, they demonstrate some flexibility as to what would be classified as forbidden interest. To this end, they distinguish between interest and excessive interest, which incidentally is the approach taken by some *Sunni* jurists. One of the reasons why the *immamieh* will seek ways to allow the payment of some premium in excess of the principal is the considerable inflation in the Iranian economy. In reality, if investors do not receive some extra payment on top of the principal, by redemption time they would have incurred losses. This makes investing in the Iranian economy unattractive for investors. Iranian issuers have tackled this problem by declaring fixed return rates, which are, on many occasions, higher than the anticipated inflation rate. In some cases, such as *murabaha*, *istisna*, *salam* and *ijara sukuk* (for the reasons discussed above), this approach appears acceptable

[1262] Fard (n 1218), 90.
[1263] Fard (n 1218), 90.
[1264] Mohammad Alhor Alameli Vasael Alshia Ela Tahsil Masael Alsharia V21 (2nd ed, Allolbeyt, 1996), 276.

to Iranian jurists. It is more surprising when their approval is given in other cases, such as that of *musharakah-sukuk*, where the explanation of jurists is that typically, 'the fixed profit of the project will be definite after profit-and-loss account'.[1265] Perhaps this explanation is meant to indicate that the fixed profit of *musharakah* ventures is not all that fixed after all.

11.6.2.7. Iranian jurists' approach to gharar

Gharar (uncertainty) typically refers to the elements of contracts and quality, quantity, pricing and delivery of assets. As such it is closely related to the issue of risk management of contractual and financial transactions. The *immamieh* distinguishes between the prohibited by default major uncertainty (*gharar fahish*) and the socially acceptable concept of minor uncertainty (*gharar yasir*). To this end, it has been noted that Iranian jurists prohibit only unreasonable risk and unnecessary uncertainty in financial transactions. The prohibition is laid down in the interest of the stability of the capital market.[1266]

11.6.2.8. Selling debt for debt in the Iranian market

In a major divergence from *Sunni* Islam and the traditional understanding that Islamic law prohibits the sale of debt for debt, subject to certain requirements being satisfied, *Shia* jurists consider sale of debt legally valid and enforceable. This is reflected in the initial permissibility to trade *sukuk* on the secondary market. In order for such trade to remain valid, it must be *Shariah* compliant. To this end, the most important *Shariah* requirement, in the view of *Shia* jurists, is that the price of *sukuk* traded on the secondary market should always be in cash and not in debt.[1267]

The *immamieh* justifies the permission by arguing that both *Sunni* and *Shia* jurists accept the sale of debt to the debtor. The reservations had by *Sunni* scholars pertain to selling a debt to a third party, and are largely based on the possibility that the seller fails to deliver the subject matter of

[1265] Fard (n 1218), 93.
[1266] Fard (n 1218), 93.
[1267] Fard (n 1218), 95.

the contract to the buyer. This can potentially create a number of issues with *Shariah* law, such as *gharar*, absence of delivery (*qabadh*) and *riba*.[1268] Iranian jurists trust that they have dealt with this possibility via the obligation that the relevant price be in cash.

11.6.2.9. Other considerations

In another bid to remain commercially flexible, *Shia* jurists allow simulation of contracts when there is a real transaction, which while remaining hidden, is commercial in nature. Furthermore, such contracts are enforceable only if the essential requirements to conclude a valid contract have been met: for example, that there was consent, object and cause for the contract.[1269]Furthermore, such a contract must not prejudice other parties and must not be contrary to *Shariah* law.

In distinction, absolute simulation, where the contractual parties had no intention to be bound by the terms of the contract, would make the contract void. In the case of *sukuk*, because it typically involves third parties, simulation of contract can render the contract valid, subject to two conditions being fulfilled. First, the third party must not have been put on notice about the nature of the contract. Secondly, the contract could be executed as long as its execution would be beneficial to the third party. Third parties that have been put on notice are in the same legal position *vis-à-vis* the contract as the parties to it.

Another rule relevant to Iranian *sukuk* issuance is that the prohibition on certain activities and products applies to both the provenance of the funds used to purchase *sukuk* certificates and the activities into which these funds have been channelled.

Last but not least, Iranian scholars subscribe to the proscription on unjust enrichment.[1270]

[1268] Securities Commission of Malaysia, *Resolutions of The Securities Commission Shariah Advisory Council* (2nd ed, 2006), 17.
[1269] Fard (n 1218), 95.
[1270] Fard (n 1218), 96.

Chapter 12: Towards Shariah compliant FinTech solutions

Back to the future: How FinTech may help reconcile the conflicting objectives of the Islamic markets?[1271]

This research would have been incomplete without a reference to FinTech (Financial Technology) and its impact on Islamic finance. Before dealing in detail with the degree to which FinTech has been introduced in Islamic finance, this work will delve into the many ways the development in financial technology has changed the context in which financial services, including Islamic finance ones, operate.

FinTechs and many of the so-called "traditional" financial services entities rely on innovation to create a more efficient, less costly and more customer-orientated product. The benefits delivered by FinTech could therefore be significant regardless of the degree of sophistication of the host financial market. An argument could be made that financial innovation can be particularly beneficial for under-developed markets. For example, in the sphere of banking, developments in FinTech could have a beneficial impact on the empowerment and inclusion of parts of the population that were previously unable to bank.

In this line of thoughts, it is worth considering what caused the popularity of FinTech payment and investment applications among young Western customers. Undoubtedly, FinTech makes banking and investing easier for the retail investor. It lowers the cost of services,[1272] increases the speed of transactions[1273] and in the case of investors and borrowers, it lowers the cost of capital.[1274] However, FinTech does a lot more for the younger generation in the West and more

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[1271] Antony Peyton, 'Saudi Arabia and UAE unite for digital currency dream' (30th January 2019) https://www.bankingtech.com/2019/01/saudi-arabia-and-uae-unite-for-digital-currency-dream/ accessed 5th June 2019. Antony Peyton, 'UAE and Saudi Arabia trial cross-border payments on blockchain' (13th December 2018) https://www.bankingtech.com/2018/12/uae-and-saudi-arabia-trial-cross-border-payments-on-blockchain/ accessed 5th June 2019. Antony Peyton, 'Saudi Arabian Monetary Authority pilots Ripple payments' (14th February 2018) accessed 5th June 2019. See https://www.bankingtech.com/region/saudi-arabia/ , https://fintechnews.ae/3734/saudiarabia/fintech-saudi-arabia-overview/ , https://www.arabianbusiness.com/banking-finance/421469-saudi-central-bank-grants-licences-to-14-fintech-firms , Basil M.K. Al-Ghalayini 'Progress in the Saudi Islamic finance industry' 13th January 2019) http://www.arabnews.com/node/1434546; Tadawul Launches Derivatives Market in the First Half of 2019 (4th September 2018) https://www.spa.gov.sa/viewfullstory.php?lang=en&newsid=1809448 accessed 5th June 2019.

[1272] KPMG UK, 'Value of Fintech' (2017).

[1273] Ibid.

[1274] KPMG (n 1272).

generally, for all those who share their 'lingering distrust in banks'.[1275] It democratises banking as a process, and undermines banks as a structure, which has traditionally been seen as a part of the establishment.[1276]

This has not come without a trade-off, however. Different studies have shown that microfinancial and macro-financial risks have a potential to increase, due to FinTech, thus having a bearing on financial stability. It is submitted that to the extent FinTech has been and will continue being introduced in Islamic finance, the objectives of the latter may be undermined, particularly with respect to risk management and systemic stability. In addition, FinTech raises a number of other issues that have bearing on the jurisprudential aspects of Islamic finance.

For example, an overly enthusiastic introduction of FinTech may facilitate an even more entrenched "conventionalization" of the *Shariah* compliant instruments. Alternatively, it could provide the opportunity to avoid some of the jurisprudential compromises that have been necessary to date in order to maintain a competitive, compared to the Western model, market. Last but not least, updating the framework of *Shariah* compliant financial services may solve a host of technical issues, which are till plaguing the Islamic financial markets system.

The following Chapter will be structured with a view of tentatively answering these questions and, in particular, discerning how the new trend may steer the direction of the Islamic derivative market. The below analysis will consider the most notable *Shariah* compliant FinTech developments while before everything looking at the wider context in which these developments operate.

[1275] Kate Rooney, 'After the crisis, a new generation puts its trust in tech over traditional banks' (2018)CNBC https://www.cnbc.com/2018/09/14/a-new-generation-puts-its-trust-in-tech-over-traditional-banks.html accessed 4th July 2019.

[1276] See the brilliant paper by Thorsten Beck, Asli Demirgüç-Kunt and Ross Eric Levine, 'Law, Politics, and Finance' (April 12, 2001), World Bank Policy Research Working Paper No. 2585. https://ssrn.com/abstract=269118 accessed 4th July 2019.

12.1. What is FinTech and how it came to change the landscape of financial services?

The term "FinTech" stands for financial technologies. In its last FinTech report, 'FinTech and market structure in financial services: Market developments and potential financial stability implications',[1277] the Financial Stability Board (FSB) defines it as: 'technology-enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on the provision of financial services.'[1278] The potential benefits of FinTech have been summarized in the same Report as including 'decentralisation and increased intermediation by non-financial entities; greater efficiency, transparency, competition and resilience of the financial system; and greater financial inclusion and economic growth, particularly in emerging market and developing economies.'[1279] With respect to potential risks arising from FinTech, the Board includes among them 'both microfinancial (e.g. credit risk, leverage, liquidity risk, maturity mismatch and operational risks, especially cyber and legal) and macro-financial (e.g. non-sustainable credit growth, increased interconnectedness or correlation, incentives for greater risk-taking by incumbent institutions, procyclicality, contagion and systemic importance).'[1280] This section will discuss this statement in some length.

Before doing so though, a bracket should be opened to remind the reader that the term "FinTech" should not be confused with the term "FinTechs". The latter denotes firms (usually start-ups), which provide consumers with cutting edge financial services through employment of technology and reliance on technology developments. FinTechs operate in many areas of finance such as '(i) payments, clearing and settlement; (ii) deposits, lending and capital raising; (iii) insurance; (iv) investment management; and (v) market support.'[1281] This chapter will try to outline the ways

[1277]Financial Stability Board, 'FinTech and market structure in financial services: Market developments and potential financial stability implications' (14th February 2019). From here on, "the Report".
[1278] Financial Stability Board, 'FSB report assesses FinTech developments and potential financial stability implications' (14th February 2019) http://www.fsb.org/2019/02/fsb-report-assesses-fintech-developments-and-potential-financial-stability-implications/ accessed 6th March 2019, 7.
[1279] Ibid, 3.
[1280] Financial Stability Board (n 1278), 3.
[1281] Financial Stability Board (n 1278), 8. See also, World Economic Forum, 'The Future of Financial Services How disruptive innovations are reshaping the way financial services are structured, provisioned and consumed' (2015) http://www3.weforum.org/docs/WEF_The_future__of_financial_services.pdf accessed 19th March 2019.

FinTechs can contribute to financial instability, more specifically by positioning them against the backdrop of the larger financial markets context.

Definitions aside, FinTech has a quality about it that arouses people's interest. Some hail it as the means to solve the majority of the problems plaguing the global financial system, such as money laundering and corruption, tax evasion, lack of transparency, lack of inclusion and the excessive costs due to the money and time spent in the carrying out of financial transactions.[1282] If FinTech was able to do away with the above issues (without any negative trade-offs), it would have been an agent of financial stability and indeed this is what FinTech proponents are arguing.[1283] There have been other voices however, initially not too loud but gradually gaining prominence, arguing that while FinTech's indisputable benefits must be harvested, its ability to pose a serious risk to global financial stability should not be underestimated.[1284]

The most recent account of what this risk is perceived to be is found in the FSB's February 2019 Report, where the FSB maps out the following key considerations, relevant to financial innovation:

-That incumbent financial institutions and FinTech firms work together successfully and in symbiosis, where the former provides the latter with large customer base and the latter gives the former access to financial innovation. The result of this cooperation is that the incumbents become more competitive and the FinTechs' operational capabilities increase.

[1282] Douglas W. Arner, Ross P. Buckley and Dirk A Zetzsche, 'Fintech for Financial Inclusion: A Framework for Digital Financial Transformation', (29 Oct 2018) UNSW Law Research Paper No. 18-87, University of Hong Kong Faculty of Law Research Paper No. 2019/001, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3245287 accessed 20th January 2019; David Lee Kuo Chuen and Ernie G. S. Teo, 'Emergence of Fintech and the Lasic Principles' (2015) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2668049 accessed 20th January 2019.

[1283] Rory Van Loo, 'Making Innovation More Competitive: The Case of Fintech'(2018) 65 UCLA Law Review 232, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2966890 accessed 20th January 2019; Douglas W. Arner, Ross P. Buckley, Dirk A Zetzsche and Janos Nathan Barberis, 'Fintech and Regtech: Enabling Innovation While Preserving Financial Stability' (2017) 18(3) Georgetown Journal of International Affairs 47 UNSW Law Research Paper No. 18-41 University of Hong Kong Faculty of Law Research Paper No. 2018/036 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3211708 accessed 21st January 2019.

[1284] Jamie Lee, 'Fintech can pose systemic risks: report' (2017) https://www.businesstimes.com.sg/banking-finance/fintech-can-pose-systemic-risks-report accessed 19th January 2019; Global Sign, 'An Introduction to Economic Risks by FinTech Companies' (October 2018) https://www.globalsign.com/en/blog/economic-risks-of-fintech-companies/ accessed 19th January 2019; c.f. The World Bank, 'The Fintech Revolution: A Threat to Global Banking?' http://documents.worldbank.org/curated/en/516561523035869085/The-Fintech-Revolution-A-Threat-to-Global-Banking accessed 18th February 2019 and ESMA (Patrick Armstrong), 'Financial Technology: ESMA's Approach 4th Luxembourg FinTech Conference (10 October 2018)

-That this symbiosis apply to some but not all institutions as there are already FinTechs that have made inroads in the provision of credit and payments. While this is still done on a small scale, it is argued that with the development of technologies, which will allow further unbundling of some financial products that are traditionally offered by incumbent financial institutions, the market share of FinTechs will increase. [1285]

The above points made by the FSB drive a conclusion that the Board is wary of the implications of FinTech on competitiveness and competition in the financial market. Given the interconnectedness of the global financial market, the conclusions of the Board apply to innovative technologies utilised by Islamic finance as well.

12.2. Outline of the FinTech related risks relevant to financial stability

Financial stability could be undermined by increasing both microfinancial and macro-financial risks. The former become an issue when separate firms or sectors, or financial market infrastructures (FMIs) become vulnerable to financial distress. Occasionally, such risks crystalize in a way which increases the actor's sector-wide importance, for example by triggering distress or having negative implications for critical services or functions, markets or counterparties.[1286]

Such risks may have financial and operational sources. With respect to the former, there are concerns that FinTech may cause maturity mismatch (linked to non-performing loans) and liquidity mismatch (linked to run risks and fire sale with the corresponding market chaos). Lastly, FinTechs with high leverage may contribute to systemic instability. This may be the case if the firm adopts unsafe borrowing policies, meaning unrealistic equity – borrowing ratio. In this scenario if certain risks come to pass, the firm will be unable to absorb the ensuing losses.[1287] Fortunately for *Shariah* compliant markets, high leverage is a very distant risk for them, due to the traditionally conservative policies on lending, adopted by Islamic credit institutions.

[1285] Financial Stability Board (n 1278), f.n.1.
[1286] Financial Stability Board (n 1278), 14.
[1287] Financial Stability Board (n 1278), 14.

Regarding the operational sources for microfinancial risk, these include poor governance/ process control, too much reliance on the same third parties, openness to cyber-attacks, legal and regulatory uncertainty, particularly with respect to liability for losses and lastly business risks of critical financial market infrastructures.[1288] Of this, legal and regulatory uncertainty, particularly with respect to liability for losses could picked up as particularly relevant to the Islamic finance environment.

Macro-financial risks include risk of contagion (cross-sectorial or cross-institutional transmission of distress), procyclicality (linked to market behaviour supporting current trends such as low pricing of risk in financial markets during good times, and the high risk premia demanded by investors during bad times[1289]), excessive volatility (specifically to news; usually prompted by homogeneity on the market) and systemic importance (linked to moral hazards such as predatory pricing or taking of irresponsibly high risk).[1290] The Islamic finance system appears well-insulated from most of these risks, with the exception perhaps of excessive volatility to news. As the analysis on defaulted *sukuk* made clear, there have been instances where news of financial distress of the originator has caused panic among the company's *sukuk* investors. On the facts of the case, it was largely due to the indirect participation of the UAE government in the issuance, which helped take the situation back under control.[1291]

12.2.1. Micro-financial risks in the FinTech context

The FSB's Report suggests that the financial risks outlined above (maturity and liquidity mismatch as well as leverage risk) are not typically associated with FinTechs. This is not the case with operational risk, however. With respect to governance and process control, FinTechs are an obvious risk factor because they are either outside the regulatory oversight or are not currently regulated as stringently as incumbents. This is particularly the case in the digital currencies environment.[1292] With respect to issuance of digital currencies in the Islamic world, this is not

[1288] Financial Stability Board (n 1278), 14. See CPMI-IOSCO (2012), "Principles for Financial Market Infrastructures" (PFMI), Principle 15.
[1289] Financial Stability Board (n 1278), 15.
[1290] Financial Stability Board (n 1278), 15.
[1291] Steven Friel and Silke N Kumf (n 1055).
[1292] Financial Stability Board (n 1278), 18-19.

such big of a challenge, due to this area being almost entirely developed by Muslim governments rather than private companies. Examples of this are the joint effort of Saudi Arabia and the UAE[1293] and the gold-backed cryptocoin developed by Iran.[1294] As far as regulation of incumbent cryptocurrency is concerned, Muslim States' governments appear to react in a timely manner with a host of legislation promulgated in Indonesia,[1295] Pakistan,[1296] Saudi Arabia,[1297] UAE, Bahrain, Kuwait and Qatar, to name just a few.[1298] Furthermore, in 2019, Malaysia, which is one of the biggest players on the market, imposed harsh new ICO and cryptocurrency laws.[1299]

Secondly, FinTechs increase the possibility of cyber risk i.e. the possibility that a systemically important financial institution or a group of institutions will fall victim to a cyber-attack through a weakness in the system. The FSB notes further that 'some FinTech activities may spread data across a larger number of institutions, for example, via increased use of digital wallets and e-aggregators' and that the greater the use of digital technology, the higher the number of entry points vulnerable to cyber-attacks.[1300] The issue is relevant to Islamic finance because of cross-border and cross-systemic operations. Due to draconic legislation on data protection in most of

[1293] The Block, 'Saudi Arabia and UAE announce joint digital currency trial' (2019), https://www.theblockcrypto.com/tiny/saudi-arabia-and-the-uae-announce-new-digital-currency/ accessed 3rd September 2019.

[1294] Simon Chandler, 'US Sanctions on Iran Crypto Mining — Inevitable or Impossible?' (2019)Cointelegraph, https://cointelegraph.com/news/us-sanctions-on-iran-crypto-mining-inevitable-or-impossible accessed 3rd September 2019. Avi Mizrahi, 'Global Crypto War Is Heating up - Iran Next in Line With Its Own Gold-Backed Coin' (2019) Bitcoin.com, https://news.bitcoin.com/global-crypto-war-is-heating-up-iran-next-in-line-with-its-own-gold-backed-coin/ accessed 3rd September 2019.

[1295] Yogita Khatri, 'Indonesia Passes Rules for Trading of Cryptocurrency Futures' (2019) Coindesk, https://www.coindesk.com/indonesia-passes-rules-for-trading-of-cryptocurrency-futures accessed 3rd September 2019.

[1296] Yogita Khatri , 'Pakistan Introducing Regulations, Licensing Scheme for Crypto Firms' (2019)Coindesk, https://www.coindesk.com/pakistan-introducing-regulations-licensing-scheme-for-crypto-firms accessed 3rd September 2019.

[1297] Marie Huillet, 'Saudi Arabia Warns of Crypto Scammers Posing as Gov't Projects' (2019)Cointelegraph, https://cointelegraph.com/news/saudi-arabia-warns-of-crypto-scammers-posing-as-govt-projects accessed 3rd September 2019;

[1298] Library of Congress, 'Regulation of Cryptocurrency Around the World' (2019) https://www.loc.gov/law/help/cryptocurrency/world-survey.php#saudi accessed 3rd September 2019.

[1299] Yessi Bello Perez, 'Malaysia set to impose harsh new ICO and cryptocurrency laws' (2019) Hard Fork, https://thenextweb.com/hardfork/2019/01/14/malaysia-set-to-impose-harsh-new-ico-and-cryptocurrency-laws/ accessed 3rd September 2019. See, "Capital Markets and Services Digital Currency and Digital Token Order, 2019, Malaysia. See also, Asia Blockchain Review, 'Malaysia Implements new Regulations for Cryptocurrency Trading' (2019) https://www.asiablockchainreview.com/malaysia-implements-new-regulations-for-cryptocurrency-trading/ accessed 3rd September 2019.

[1300] Financial Stability Board (n 1278), 19.

the major players of international trade (the EU, the USA and China),[1301] this is not an issue Muslim lawmakers should consider lightly.

With regard to risk caused by third-party reliance, there is a possibility that if a FinTech based operation, which is critical to an incumbent's activities (such as cloud computing) become disrupted, this could affect systemic stability, particularly if the entity in question is systemically important or is interconnected with other systemically important institutions.[1302] Furthermore, some FinTech activities, such as robo-advice and lending, rely on data and respectively, on data providers which could be non-financial actors, such as BigTechs in telecommunication, and importantly, which could provide the service in a very concentrated, almost monopolistic manner. In that case, overreliance on third parties may create unhealthy dependencies, particularly exacerbated if or when the respective data provider also enters the financial services business. Business risk could also potentially impact financial stability but only with respect to FinTechs growing into substantial financial market infrastructures. As the current data suggests, this is not a very pressing concern, because most FinTechs are still relatively small to cause a serious disruption if they experience business failures. The more worrying scenario arises if one considers the possibility of a FinTech partnering with a bank or the possibility of a bank becoming excessively reliant on FinTech in its business model. In such a case, business failures could have contagious effect, particularly if the entity in question is systemically important. Admittedly, this scenario seems too remote for the reality of the current Islamic finance market.

The last point to consider is the legal and regulatory risk posed by FinTech. The main problem that has been identified in the FSB Report is the problematic lack of regulation and particularly of regulation which is consistent across the globe. There is a cross jurisdictional lack of legal certainty regarding a number of FinTech related issues such as ownership, cross-border activities and their regulation, particularly in the sphere of robo-advice or smart contracts (which validity is deemed particularly uncertain in a cross-border context). Considering that the countries of the

[1301] Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation); United States Privacy Act, the Safe Harbor Act and the Health Insurance Portability and Accountability Act; China National Standards on Information Security Technology – Personal Information Security Specification GB/T 35273-2017.
[1302] Jordan Novet, 'Amazon scrambles to fix cloud networking issue affecting companies like Atlassian, Twilio' (2018) https://www.cnbc.com/2018/03/02/amazon-cloud-networking-outage-affecting-atlassian-twilio-slack.html accessed 19th March 2019.

Islamic finance area experience significant regulatory challenges due to lack of harmonisation in their respective regimes, FinTech is likely to exacerbate this trend. This is certainly going to be a work in progress for the respective regulators, bearing in mind that technology always advances with a faster pace compared to the legislation governing it. At present, however, it could be argued that governments across the Muslim world have taken measures to at least warn their citizens of the dangers of trading in crypto currencies and their approaches appears to be consistent in this sense. Furthermore, a number of *Shariah* consultancies have declared crypto currencies *halal* (permitted), which gave a significant boost to the internal Islamic finance market in crypto currencies.[1303]

12.2.2. Macrofinancial risk related to FinTech

Analysis shows that FinTech could create exposure to a number of macro-financial risks, each of which will be considered in turn.

The risk of contagion, caused by FinTech, is expected to materialize in terms of reputational contagion and contagion through over-reliance on automation. While the former is more relevant to retail users, the latter may have more challenging consequences, particularly if it leads to the creation of weak entry points.[1304]

In addition, FinTech seems to be particularly prone to increase the risk of procyclicality. This is the case, because users are expected to be more sensitive (than they will be in normal circumstances) to the unpredictable dynamics of FinTech lending or investing platforms. This tendency could be worsened by the fact that FinTech based investing or lending is often preferred by retail investors, who are unfortunately more prone to herding behaviour. To this end, the issue of sourcing of capital could become particularly sensitive for FinTechs, as sudden fluctuation on a FinTech platform (for example rise in non-performing loans) may cause drying up of the capital

[1303] Although, note that there have been warnings that crypto currencies may conceal pyramid schemes; see, Al Jazeera, 'Islam and cryptocurrency, halal or not halal?' (2018) https://www.aljazeera.com/news/2018/04/islam-cryptocurrency-halal-halal-180408145004684.html accessed 3rd September 2019.

[1304] ECB, 'Algorithmic trading: trends and existing regulation' (February 2019) https://www.bankingsupervision.europa.eu/press/publications/newsletter/2019/html/ssm.nl190213_5.en.html accessed 13th March 2019.

provided to borrowers by retail investors. Other procyclicality risks include underpricing of risk and entering a race to the bottom, often together with incumbents, lowering of lending standards and failing to accurately assess credit quality.[1305] With respect to the area of Islamic finance, the risk of procyclicality is tangible. Suffices to recall the example of Malaysia, which is one of the biggest players on the Islamic finance market, and which has retained only national credit ratings providers. The potential problems derived from this were discussed earlier in this work; it stands to reason that the lack of stringent credit quality assessment (or at least the lack of internationally recognised credit quality assessment) may further exacerbate the risk of procyclicality inherent in FinTech.

Furthermore, FinTechs are deemed particularly prone to excessive volatility because of the speed with which decisions are taken and deals are executed. In addition, the behaviour of algorithmic traders may adversely affect the markets and assets price as they tend to exit the market *en mass* in times of great volatility. Another way in which FinTech can play a role here is in the context of aggregators – the facilitated by aggregators fast switching between providers may cause liquidity problems for banks and make the system too vulnerable to news. This aspect of FinTech-related risks is interesting. Due to the structural and transactional complexity of the Islamic finance instruments, investors are unable to operate on the market in a speedy manner. FinTech is supposed to increase this speed and make Islamic finance more competitive in this regard. However, due to FinTech in Islamic finance still being in its nascent period, it remains to be seen whether the increase will be such as to cause excessive volatility.

Last but certainly not least, while systemic importance is still not an issue at the moment, it can become one in the future, particularly if we are to consider the possibilities of trading in digital currencies. To this end, it is possible to imagine the creation of an Islamic finance market infrastructure reliant on digital currencies (for example for payment services), or on aggregators (for bank loans or opening of bank accounts) or of a market infrastructure specifically dealing with data provision services. Such data could be collected from customers in a non-financial setting and then utilized for financial services. Whatever it is that the future holds, it appears that FinTech is here to stay, which would place a heavier burden on regulators, including those regulating the Islamic finance market.

[1305] Financial Stability Board (n 1278), 20.

12.3. FinTech in Islamic finance context

As already discussed, Islamic finance is based on the practice of profit and loss sharing. This makes it relatively more resilient to risks, compared to its conventional counterpart. While this may sound very convincing in theory, the reality is that many Islamic Finance lenders abstain from following the rules strictly,[1306] and this is particularly the case in Malaysia and to extent, in Pakistan.[1307] Furthermore, the majority of credit institutions in the Muslim world would choose conventional rather than *Shariah* framework for its operations. This choice is informed by concerns about competitiveness, loss of market share and perhaps even insolvency. Statistics indicate that around 20-30% of all credit institutions in the Muslim world work in a *Shariah*-compliant manner. The rest operate as conventional banks. As to Muslim customers, while a big part of them would choose the bank which gives them a higher rate (particularly Muslims living in the West), a very significant proportion of the population either refrains from banking or elects to bank with a *Shariah*-compliant institution.

The struggle of Islamic financiers is manifested across the sector. For example, to guarantee to their customers that their financial objectives will be met, Islamic financial institutions often resort to implicit or explicit promises for nonnegative return on deposits.[1308] The introduction of novel financial instruments, such as *wa'd/murabaha* are another instance of practices that could be potentially problematic.

The examples should help the reader appreciate that Islamic Finance faces a number of challenges, the majority of them due to context – Islamic financial institutions do not operate in a vacuum and in order to survive, they must consider their conventional finance competitors. The advent of FinTech has created many opportunities for old players on the market (conventional and otherwise) to be sidestepped and for new operators to reach their prospective customers directly. The implications of this could be many and some of them may have an effect on how

[1306] Zamir Iqbal, 'Islamic Financial Systems', (1997) 34(2) Finance and Development 42.
[1307] Albaraka 2012, Statement of Financial Position as at 31 December 2011, Albaraka Bank (Pakistan) Limited, <http://albaraka.com.pk/downloads-documents/FinancialStatements/Annual/Annual-Financial-Statements-for-year-2011.pdf >accessed on 14th June 2018.
[1308] Serhan Cevik and Joshua Charap, 'The Behaviour of Conventional and Islamic Bank Deposit Returns in Malaysia and Turkey', IMF Working Paper No 11/156.2011.

much or less stricter *Shariah* law's observance will be in the future, as far as derivatives are concerned, within and without the area of financial technologies.

The trend is to introduce financial technologies in some of the more traditional sectors of the Islamic finance market. For example, the Dubai-based fintech startup Wethaq, which is a "platform-as-a-service" firm, has entered a partnership agreement with R3 Corda's blockchain with the aim to manage the pre-sale, issuance, management and financialization of *sukuk*.[1309] The ambition of the blockchain platform is to digitize sukuk, thus decreasing both the cost and time of issuance. As the discussion on *sukuk* highlighted, issuance involves input from a number of entities – in this number banks, clearing houses and trustee entities. The purpose of the project would be to streamline this process and enable wider distribution, attracting more issuers and investors, 'by standardizing the digital assets with global financial architecture.'[1310]

12.3.1. FinTech in Islamic finance: taking a practical perspective

FinTech has introduced a new context for the operation of financial services, quickly becoming a game changer for traditional credit institutions in the conventional banking area. The impetus for change should be credited to FinTechs, typically start-ups, which combine technical and industry knowledge in the pursuance of a customer-centered, efficient and low-cost financial services ecosystem.

Due to their inclusive nature, FinTechs are able to enjoy a similar rate of success within both conventional and *Shariah* compliant finance. This section will argue that FinTech's mobile applications may become an organic solution for the needs of personal finance market in the Islamic world and for Muslims globally. This is due on one hand to the high level of non-represented members of the population within Muslim countries and on another, to the number of Muslims living in the West. In the first scenario, there are many marginalized or under banked individuals, who would, if they could, elect to manage their personal and small business finances via a *Shariah* compliant mobile banking application.

[1309] Daniel Kuhn, 'R3 Partners With Dubai Firm to Tap $120 Billion Sukuk Market' (August 29 2019) Coindeskhttps://www.coindesk.com/r3-partners-with-dubai-firm-to-tap-120-billion-sukuk-market, accessed 10th September 2019.
[1310] Ibid.

This application of FinTech does not exhaust the benefits of financial innovation though. The section below will discuss the (few) possibilities to make a meaningful use of FinTech's innovations, while remaining compliant with *Shariah* law.

12.3.2. Robo advice in Islamic finance

FinTech has increasingly become a part of everyday parlance. Although heavily underpinned by religious considerations, Islamic Finance has remained no stranger to this trend. Why has this been the case?

As mentioned at the beginning of this Chapter, the moniker FinTech stands for technologies facilitating finance. Although having become popular in the last couple of years, it is arguable that it has been around ever since man started applying technologies to (or used them to facilitate) financial transactions. FinTech, therefore, does not belong to a specific financial system and it does not come with any specific ideological connotation. As argued elsewhere, [1311] FinTech and Islamic Finance mesh well, the former having the potential to revive Islamic banks, lower the price of banking, including for ordinary people and close the credit gap existing in many Muslim countries.

The disfranchising of a great number of Muslims in countries in the Middle East, caused by lack of means to access banking and other essential financial services is problematic in itself for a number of reasons; FinTech offers the means for improving this situation and adopting it more widely is doubtlessly something to consider. Furthermore, making FinTech part and parcel of Islamic Finance, of course within the confines of *Shariah* law, can be particularly relevant for young Muslims living in the West. It is this demographics, which is the easiest to lose to conventional finance. Using technological advancements in order to cater to their needs appears, therefore, to be a rational solution.

[1311] Maria Todorof, 'Shariah-compliant FinTech in the banking industry' (2018) 19(1) ERA FORUM 1 (Springer) https://link.springer.com/article/10.1007/s12027-018-0505-8 accessed 28th September 2018.

A quick look at the available *Shariah* compliant FinTech services indicates that the potential of the above has been appreciated by the industry.[1312] In terms of reaching Muslim Millennials living in the West and Muslims living in the Middle East for whom accessing financial services has proven to be challenging, the two FinTech areas proven to be most suitable to their needs are those of peer-to peer lending (P2P)[1313] and Robo Advice. The latter will be discussed below due to its connotations for the *Shariah* compliant derivative market.

12.3.2.1. What is robo advice and how it compares to advice provided by humans?

Robo Advice or Robo Adviser (RA) is a software product, which could be used for investment management purposes. This software operates as a digital platform with algorithm-driven services and therefore almost no human input, as far as substantial advice is concerned. In addition to not having human input, RA may or may not include human supervision. It functions by way of collecting and analyzing personal financial data, analyzing the existing investments market trends and matching the specific client to the most suitable to him or her investment solution.[1314] The result of this analysis is either advice or investment service, depending on the kind of agreement the firm running the RA service has with its clients. A RA platform can be launched by a stand-alone Robo-Advisor such as the pioneer in this field Betterment,[1315] or by dedicated financial services and asset management firms. The two options differ in that the former can be more accessible to investors with lower means.[1316]

[1312] L Cosseboom, Shariah-compliant P2P lending is the 'Wild West' in Indonesia (2017). https://www.salaamgateway.com/en/story/shariahcompliant_p2p_lending_is_the_wild_west_in_indonesia-SALAAM01082017053423/ (accessed 30 September 2018).
[1313] Discussed in M Todorof (n 1311).
[1314] Investopedia, 'Robo-Advisor (Robo-Adviser)' (2018) https://www.investopedia.com/terms/r/roboadvisor-roboadviser.asp accessed 09 September 2018.
[1315] Arriele O"Shea and Andrea Coombes, 'Betterment Review 2018' (2018) https://www.nerdwallet.com/blog/investing/betterment-review/ accessed 30 September 2018.
[1316] Trevir Nath, 'Betterment Review 2016: Fees and Investment Facts' (2017) https://www.investopedia.com/updates/betterment-review/ accessed 09 September 2018.

12.3.2.2. Benefits of robo advice

Robo Advice can be attractive to the unsophisticated investor because of a number of reasons, one of the most important of which is that the advent of this technology eliminates the need of a middleman and brings investment advice services directly to the client. Additionally, one of the distinct features of Robo Advice platforms is that they place no limit on the size of funds to be invested. For example, Betterment platform is by far the best in this respect as it does not demand any funds in order to open an account with them. However, a typical Robo Advisor will require (only) between $500[1317] -$2000 for these purposes.[1318] In comparison, human advisors will start with $5000[1319] and go as high as $50 000 account minimum.[1320] Notably, because human advisers will typically require substantial investable assets, they will therefore work only for the wealthy and high net worth individuals (HNWI).

With respect to fees, Robo Advisors charge substantially less than a human advisor would with the rates typically being within the 0.2% -0.5% range for the former and the 1%-2% for the latter. The rate difference is justified by the substance of the provided service. A particularity of the more wealthy customers is that they have a specific need for dedicated wealth management, which includes, in addition to providing them with financial and investment advice, management of their accounting and tax, retirement planning, and legal or estate planning needs.[1321] In order to cater for this, the service provided by the wealth management services provider is treated as a bundle and is done for a set fee.[1322] In distinction, Robo Advice firms offer a limited set of services (although tax-loss harvesting and retirement planning[1323] has recently been added to the

[1317] Wealthfront, 'Live the life you want. We've got your back' (2018) https://www.wealthfront.com/ accessed 10th September 2018.
[1318] SigFig, 'Wealth Advisor' (2018) https://www.sigfig.com/site/#/home/am accessed 10th September 2018.
[1319] See Schwab Intelligent Portfolios, 'Investing made easier' (2018) https://intelligent.schwab.com/ accessed 10 September 2018.
[1320] Vanguard Personal Advisor Services, 'Advice for real life' (2018) https://investor.vanguard.com/advice/personal-advisor accessed 10th September 2018.
[1321] Investopedia, 'Wealth Management' (2018) https://www.investopedia.com/terms/w/wealthmanagement.asp accessed 09 September 2018.
[1322] Ibid.
[1323] OECD, 'Robo-Advice for Pensions' (2017) https://www.oecd.org/pensions/Robo-Advice-for-Pensions-2017.pdf accessed 12th June 2019.

investment services traditionally provided by them), which justifies the lower fee and their greater accessibility by a larger pool of potential customers.[1324]

Importantly and apart from lowering the cost of service, RAs are more accessible to customers than a human advisor would be also because of their availability around the clock.

Furthermore, and as the narrative goes, relying on an algorithm-based investment decision (i.e. on a Robo Advisor) is arguably more rational than the investor taking the decision by themselves, because an investor can be influenced by excitement and competitiveness, and could become a victim of cognitive, including informational, deficiency and/or of poor decision-making capacity. With respect to human advisors, the above mentioned pitfalls would largely be avoided. Human advisors' rationality and integrity are as a whole undisputed,[1325] as well as strongly encouraged by legislation.[1326] The only area where they may fail in comparison to their automatized counterpart is perhaps that of the speed at which investment decisions are being taken – Robo Advisors operate at an incomparably higher speed, which can generate much greater profits *should* the correct investment decision have been made. However, this is subject to the platform remaining operational, including during high-volume traffic. Furthermore, system breakdowns could prevent the execution of a transaction in a crucial moment, leading to significant losses.[1327]

12.3.2.3. Robo advice: what should we be wary of?

It has been seen that Robo Advice can be very useful in certain circumstances with a few caveats. Elaborating on this, it should be noted that some of the advantages of Robo Advice (mainly that of eliminating the middle man) may present a disadvantage in certain circumstances. For example, the need of human contact may be more pronounced or even indispensable when dealing with a larger investment portfolio and greater wealth in general, as well as in times of

[1324] Investopedia (n 1321).
[1325] Juhani T Linnainmaa, Brian Melzer and Alessandro Previtero, 'The Misguided Beliefs of Financial Advisors' (May 16, 2018), Kelley School of Business Research Paper No. 18-9, https://ssrn.com/abstract=3101426 or http://dx.doi.org/10.2139/ssrn.3101426 accessed 10th September 2018.
[1326] Although far from exhaustive, for the EU see MiFIDII/MiFIR; for the US see the U.S. Investment Advisers Act of 1940.
[1327] Boomberg News, 'Robo-adviser websites crashed as market slid' (2018) http://www.investmentnews.com/article/20180205/FREE/180209960/robo-adviser-websites-crashed-as-market-slid accessed 17th September 2018.

emergency and/or a financial crisis. In such circumstances, if automated advice is needed, a HNWI should seek it as a part of a bundle service, provided by a dedicated financial services and asset management firm. Robo Advice in times of emergency and particularly in the case of inexperienced and/or young investors can still provide an inferior service and should not be elected.

Another related downside of Robo Advice is its relative unreliability in times of financial instability, particularly when the markets become volatile.

Last but not least, although the decisions taken by Robo Advisors are generally rational, they are not capable of knowing their customer as well as their human counterparts. To this end, despite that a client will necessarily be taken through the obligatory questions determining his risk appetite and profile, it is arguable that clients can be unclear about their own financial circumstances, needs and goals or of the effect of one or another investment outcome. A Robo Advisor would not be able to make a sophisticated decision on whether or not this is the case, leading to potentially harmful investment decisions.[1328]

12.3.2.4. Who is or could become the typical customer of robo advice?

In addition to potential investors with little to mid-size investment assets, Robo Advice is said to be particularly attractive to Millennials who typically match the profile of being financially less well informed, having relatively low value net worth[1329] and being inclined to use (time saving) technologies to manage their finances.[1330]

Despite that, a recent study by Charles Schwab found that of all interviewed Millennials:

[1328] Wolf-Georg Ringe and Christopher Ruof, 'A Regulatory Sandbox for Robo Advice' (2018), European Banking Institute Working Paper Series 2018 - no. 26, https://ssrn.com/abstract=3188828 or http://dx.doi.org/10.2139/ssrn.3188828 accessed 10th September 2018, 2.

[1329] MoneyGoody, 'How Much Are Millennials Worth?' (2018) https://moneygoody.com/millennials-net-worth/ 10th September 2018; Bartie Scott, 'Millennials' Money Troubles Are Worse Than You Think' (2018) https://www.inc.com/ilya-pozin/billionaires-like-warren-buffett-oprah-winfrey-mark-cuban-use-these-counterintuitive-strategies-to-manage-their-money.html accessed 10th September 2018.

[1330] Marianne Chrisos, 'How Technology is Helping Millennials with Finance Management' (2018) https://www.techfunnel.com/fintech/technology-helping-millennials-finance-management/ accessed 10th September 2018.

31% have a written financial plan compared to 20 percent of Gen X and 22 percent of Boomers

36% have specific savings goals compared to 25 percent of Gen X and 17 percent of Boomer

Nearly three-quarters regularly rebalance their investment portfolios compared to 66 percent of Gen X and 64 percent of Boomers

Millennials are almost as likely as Boomers to work with a financial advisor (22% and 25%, respectively) while Gen X lags (16%)[1331]

Furthermore, while not all Millennials prefer to invest through a Robo Advisor, over half of them do and this number is set to increase.[1332]

A different target group altogether is that of affluent (but not HNW) Muslim investors living in Western countries, for whom relying on traditional investing platform to accommodate their need for *Shariah* permissible investment is either impossible or too costly. Research by the *Shariah* compliant US Robo Advisor Wahed Invest suggests that most of their clients have never before invested with another platform.[1333] Importantly, Wahed targets Muslim Millennials in the US who, in the words of Wahed's CEO 'have been interested in digital investment services and computer-generated, wealth management advice for some time'.[1334] To such clients, platforms such as Wahed offer a solution reconciling their investment needs with their beliefs.[1335]

Wahed works by using a panel populated by humans to review whether certain stocks, commodities and other investment types are socially responsible or *Shariah* compliant. Upon screening those that are applicable, they feed them into the algorithm-based Robo Advice.

[1331] Charles Schwab, '2018 Modern Wealth Index' (May 15, 2018) https://www.aboutschwab.com/modern-wealth-index-2018 accessed 10th September 2018.
[1332] Donna Fuscaldo, 'Charles Schwab: Millennials Like Robo-Advisors' (2018) https://www.investopedia.com/news/charles-schwab-millennials-roboadvisors/ accessed 10th September 2018.
[1333] Bernardo Vizcaino, 'Robo-adviser Wahed targets Muslim investors in U.S. and beyond' (2018) Reuters UK https://uk.reuters.com/article/us-islamic-finance-fintech/robo-adviser-wahed-targets-muslim-investors-in-u-s-and-beyond-idUKKBN18X1GS accessed 28th September 2018.
[1334] Crowdfund Insider, 'New Robo-Advisor Provides Access to Shariah Compliant Investments' (2017) https://www.crowdfundinsider.com/2017/06/101527-new-robo-advisor-provides-acces-shariah-compliant-investments/ accessed 28th September 2018.
[1335] Ibid.

Wahed's Muslim clients are then advised, depending on their risk tolerance, on investing into *sukuks* and gold.[1336]

Prior to Robo Advice becoming a feature for Muslims living in the West, the technology has been offered to Muslims living in Asia by a number of dedicated platforms. One such platform that caters for both *Shariah* and conventional investments is the recently launched platform Algebra[1337] from Malaysia. Algebra appears to be doing well for now and its success is based on the platform's owners careful appreciation of what is permissible by *Shariah* law. For example, their Muslim-orientated investments do not include any forbidden products such as alcohol, weapons, erotic entertainment or excessive or baked-in risk (for example hedging).

However, one of the outcomes of this policy is that the amount of investment vehicles they can offer to their clients diminishes. Furthermore, because their investment products do not involve interest the process of investing becomes very complicated. Considering that according to the Malaysia Islamic Financial Centre and Thomson Reuters, the assets under management (AuM) of 'the global Islamic fund and wealth management market… at the end of the first quarter of 2017 stood at $70.8 billion',[1338] the effort to create *Shariah*-compliant investments appears to be well worth it. This has been appreciated by governments in the region. For example, the Malaysian Security Commission recently published their Islamic Fund and Wealth Management Blueprint, which focuses on creating more value in the Islamic investment services industry, expanding the role of Malaysia in the Islamic financial market and ensuring the sustainability of the investment sector.[1339]

The above reinforces an argument that investment in *Shariah*-compliant FinTech has a potential for positive impact on both population and economy. This aspect of financial technology has been acknowledged by the leaders in Islamic finance. What remains is to ensure that the sector

[1336] Crowdfund Insider, 'New Robo-Advisor Provides Access to Shariah Compliant Investments' (2017) https://www.crowdfundinsider.com/2017/06/101527-new-robo-advisor-provides-acces-shariah-compliant-investments/ accessed 28th September 2018.
[1337] See Algebra, 'Asia's Leading Robo-Adviser@ (2017) https://algebra2u.com/app/home/hello accessed 27th September 2018.
[1338] Beatrice Low, 'Robo-advisors ready to morph Malaysia's Islamic finance industry' (2017)' https://www.salaamgateway.com/en/story/roboadvisors_ready_to_morph_malaysias_islamic_finance_industry-SALAAM08082017055055/ accessed 28th September 2018.
[1339] Malaysian Security Commission, 'Islamic Fund and Wealth Management Blueprint' (2017) https://www.sc.com.my/wp-content/uploads/eng/html/icm/ifwm_blueprint_170112.pdf accessed 28th September 2018.

will find the balance between introducing instruments that are genuinely *Shariah*-compliant and utilizing them in a way, which do not stifle the potential commercial outcome.

Chapter 13: Conclusion

13.1. Remarks on the research question

The work on this thesis was undertaken out of fascination with a culture and a religion, so full of mystery and contradictions, despite its overwhelming focus on simplicity. These qualities of Islam were magnified in the area of finance; hence they did for a potentially fruitful research topic.

Finance is as much a product of society's political choices as of its economic ones, both of which would shape the respective framework in different, ever fluid, proportions. Looking closely at Islamic finance makes us realize, however, the presence of a third source of influence – that of religion, or, of course, the lack of it.

By doing so, Islamic finance ushers spirituality and indeed, morality, into a framework, which often appears to forget principles such as charity, forgiveness and genuine care for the fellow human being. It would be wrong to assume, however, that considerations of morality do not enter the narrative on conventional finance. Evidence that they do and do so often is seen in the number of legislative provisions aimed at guaranteeing more generally the rule of law and more specifically, consumer and investor protection within conventional jurisdictions.

Naturally, conventional finance does not provide for the religious underpinning of these consumer-orientated provisions.[1340] Rather, while Islamic finance justifies its broader principles by referring to religious sources, conventional finance is governed by considerations of what would be the rational choice in a particular set of circumstances, how should the (occasionally) clashing interests of market participants be balanced against each other and ultimately how the

[1340] For reasons of keeping the focus on the comparison between the conventional and Islamic systems clear, the analysis has deliberately omitted references to other forms of ethical finance such as Christian (catholic) finance and ethical and communal investment in Judaism. Another reason for this omission is the much stronger impact of Islamic finance on global economy.

pursuit of economic growth may continue without jeopardizing the health of the financial system. Above all, however, conventional finance has embraced the objective of value maximization as opposed to the Islamic, wellbeing of the community-focused model.

With this notable exception, conventional and Islamic finance pursue similar goals: to ensure the supply of funds for the efficient operation of commerce, investment and long-term financial planning. Both systems recognise that finance is the engine, which moves forward enterprise, creating jobs and paying taxes in the process, thus indirectly supporting successful state governance. It would not be far-fetched to say that these objectives form the fundamental *raison d'etre* of finance as a discipline, Islamic finance included.

The basic similarities in the objectives of the two systems do not however diminish the differences between them, neither do they hide the fact that each system derives its rulebook from a fundamentally different source. To this end, the fact that Islamic finance sources its principles from religion, as opposed to secular regulation, would suggest that any increase in the religious observance in a particular country would influence the rules regulating finance, in direction of making it more compliant with *Shariah* law.

Considering this, it would matter that one of the main conclusions of this thesis was that the majority of the currently utilised Islamic finance instruments are deficient in terms of *Shariah* compliance.

Such considerations lead us back to the question, underpinning this research; namely, how viable would conventional and Islamic derivatives be, in conditions of radical Islam. The surprising answer, at which it was arrived at, was that while the viability of the current Islamic financial instruments will likely be affected by a transition towards extremism, Islamic finance as a sector of the economy will persist.

The author proposed that an extremist (*jihadi*-salafists) government would go in one of two possible directions. Either (akin to Iran) it will preserve a very narrow version of the existing framework, using just these instruments that are strictly necessary for trade and commodity-based funding, or it will create a unique *Shariah*-compliant system, which will be populated by centrally governed *novel* financial instruments. To this end, central governance would guarantee that issues of *Shariah*-compliance will not be raised and would ensure the development of financial instruments and trade. It is suggested that the current investor protection issues of the Islamic finance framework would likely be resolved in such states due to State issued regulation or by the State backing the transactions, whichever appropriate. This author would argue that the former is more likely to happen, due to the right-wing tendencies of *jihadi*-salafists movements.

The above strongly points towards a conclusion that conventional derivatives will be largely obsolete in a *jihadi*-salafist state.

Outside of the scenario of extremist rule, this research supports a conclusion that the viability of the current Islamic finance instruments is under a far greater threat from within; namely, a threat due to their structural deficiencies, leading to inefficiencies and a lack of adequate protections for investors in the case of default. As the discussion in the relevant chapters made it clear, the Islamic financial instruments are hybrid products, in which a conventional financial arrangement is transposed to the *Shariah* compliant financial framework through the use of traditional Islamic contracts. However, this transposition appears to have been made hurriedly, with attention to the final goal rather than to detail. The result is a contractual arrangement, which would function sufficiently well until such time that it does so no longer. Unfortunately, for the event of such occurrence, the Islamic finance framework offers no adequate protections for the parties concerned. What is even more concerning is that due to the specifics of these instruments, finding a solution outside the Islamic finance framework would also be hard to achieve.

This could have the effect of both undermining the trust in Islamic finance and eroding the population's confidence in the respective governments, developing the sector. The author concluded that, if not addressed by making changes in the structure of the offending instruments, the process of "soft radicalism" prompted by such grass-root discontent may transition into hard-line economic policies, affecting the viability of the instruments (and contractual arrangements) used at present. To the extent, however, this process takes place in a secular state, the viability of conventional derivatives will not be adversely impacted.

13.2. Reflecting on the research

It was the intention of this author to provide an honest and impartial account of Islamic finance and how it fits within the broader financial legislative context.

The structure of this work was affected by the fact that this small morsel of the Islamic jurisprudential output is so much affected and dependent on religious principles. To remain true to its name, Islamic finance had to be borne entirely out of the premises of Islam. One of the questions which this research indirectly asked, therefore, was whether there has indeed been no contamination with outside influences, more specifically that of conventional finance.

Naïve as this question sounds, it had to be asked for how could we properly identify anything unless we put it to comparison with something else? How can we talk about purity of concepts, unless we juxtaposition them along their negation?

13.3. Overview of Islamic finance

The historical overview of the development of Islamic finance suggested that, at least at the beginning, it overlapped as a concept with that of Islamic banking. Despite its relative immaturity, the sector grew in popularity, which was further affirmed by Islamic banks' stable performance during the 2007-2008 global financial crisis. The apparent resilience to financial shocks, demonstrated by Islamic banks, attracted the attention of analysts and helped introduce this alternative method of financing more widely within the conventional financial framework. Examination of *Shariah* banks' performance suggested that despite their lesser profitability compared to conventional banks, the former are more conducive to stability than the latter. The framework's approach to interest payment and the choice of product portfolio were credited as main reasons for this success.

The operational choices made by the Islamic banks were informed by the Islamic finance's dependency on *Shariah* law principles. This justified a broad introduction of the relevant premises in this work.

The starting point of the inquiry was to acknowledge that *Shariah* is the "path", and what Muslims consider an overarching guidance, leading them towards a pious life. This guidance permeates all dimensions of the devotee's life: the spiritual as well as the secular, infusing both with the ethical and moral principles espoused by Islam. Because of this, *Shariah* law governs the area of finance both from a technical but also religious perspective, imposing varied proscriptions and prescriptions, including considerations of the impact of community's actions on social justice and fairness in the broad Muslim world.

This approach suggests that the framework of Islamic finance law is seen as directly connected to other areas of life. For instance, the ban on interest is not just a financial devise; it serves to guarantee that Muslims will inhabit an interest-free economic system where there is no exploitation and improper accumulation of capital. Ultimately, despite acknowledging that finance has its objectives and limitations, *Shariah* paves the way for Islamic finance to make the *Ummah* a more community-friendly society. The ideological importance and sincerity of this pursuit appears to distinguish the Islamic framework from the Western alternative. Despite of these lofty ideals, however, due to globalisation, the last few decades bore witness to an ever increased cross-fertilisation between Islamic and conventional finance. The impact of this will be discussed shortly.

As the analysis in this work highlighted, the principles of *Shariah* law are derived from the *Qur'an* (the Islamic holy book) and the *Sunna* (the accumulated lifetime wisdom of Muslims), as well as from the *Fiqh* – the body of jurisprudence produced by Islamic scholars. Importantly, it was noted that the wisdom of the *Qur'an* is deemed immutable and applied by governing through broad concepts and abstract ethical and moral principles. Together with the *Sunna*, the *Qur'an* influences *Fiqh*, which is, however, mutable and detailed, bridging the gaps that have been left in Islamic jurisprudence. This division is relevant to Islamic finance because it allows the introduction and their prior and subsequent scrutiny of novel concepts and instruments into the framework. To this end, *Fiqh* serves as a constantly updated source of knowledge against which such innovations are being tested.

Furthermore, the interaction of different sources of law contributes to a strong bias towards the good of the community as opposed to that of the individual. This approach applies also in Islamic finance. In this context, the interests of the larger community are perceived as aligned with those of the financial institution, helping the sector to achieve its overarching macro and micro prudential objectives.

13.4. Prohibitions in Islamic finance

The *Shariah* law prohibitions, relevant to finance, include a ban on interest, prohibition on excessive risk taking, speculation and gambling, unearned income and trading in forbidden products and industries. While not all prohibitions are of equal standing, they are intended to work in a holistic whole. Among them, the ban on *riba* (interest) is perhaps the most important proscription imposed by Islamic law. While the meaning of *riba* refers to imposition of excessive interest, namely "usury", the current situation is that all *riba* is forbidden on the Islamic finance market. The practical outcome of this ban is that lenders are not allowed to charge interest on loans. The same applies to investments, contracts of sale and the like. *Shariah*'s justification for *riba* is that charging interest on money comprises of 'unjustifiable increase of capital'. As noted, the theme of justness is particularly strong in Islam and the attitude to *riba* is an essential part of its philosophy. Furthermore, the ban addresses the act of making money from money, this way turning money into a commodity, which is strictly forbidden in Islam. This rejection of one of the fundamental principles related to the use of money by conventional finance is explained by arguments that money has no time value. Furthermore, turning money into a commodity would detach finance from the real economy and it is the latter, which Islam promotes.

The apparent impracticality, from a conventional finance point of view, of not being able to obtain interest on money lent, has been somewhat counteracted by Islamic finance through the introduction of the rule on profit and loss sharing between the parties to a transaction. This principle is seen as fundamental for the sector and enforced across the framework. As just one example of this, recall the discussions on perpetual *sukuk*, which listed as one of the weaknesses of the instrument the practice of originators guaranteeing the receipt of periodic payments.

From a religious point of view, *riba* is forbidden because it corrupts society. For instance, the *Qur'an* views *riba* as *zulm* (fundamentally unjust) and destructive. The ill-effect of *riba* is understood to arrive as a result of the appropriation of the counterparty's property, which the practice of interest is perceived as helping normalise. To this end, the *riba* effect is deemed misappropriation, because the extra wealth generated by the interest is interpreted to be due to multiplication of money and not to effort. This quality of *riba* is said to demean people and diminish their personality, eventually transcending into the financial system and leading to negative growth, financial instability and ultimately, to the financial demise of society. Finally, in the *Qur'an*'s view, the technical disadvantages of *riba* are due to its disconnect from the real economy with its simple and predictable transactions.

The difference with conventional finance is striking since interest is fundamental to conventional banking. Relevantly to this discussion, precisely because of its fundamentality to the process of value creation, interest has been institutionalized and closely regulated in the conventional finance framework, turning it into a stable source of income. This is an important point because, as will be seen later, the lack of acceptance of interest in the Islamic finance framework (along with other factors), led to a lack of comprehensive regulation with respect to instruments, which are only purportedly *Shariah*-compliant. Furthermore, the ban on interest results in the lack of pre-determined rewards for customers transacting with Islamic financial institutions. This is expectable for Muslim customers, because the opposite would have breached the rule of profit and loss sharing. However, from the perspective of the conventional investor such behaviour is unacceptable because it interferes with his ability for a long-term management of his finances.

The negatives borne out of *riba* for the real economy are seen by Islamic scholars in the inequality between transacting parties, which the detached from the real economy financial markets tend to create. In their view, this inequality is prompted, *inter alia,* by informational asymmetries. Despite the above, there have been voices that the prohibition should be relaxed because it impacts negatively on the development of the financial industry and consequently, that of the Muslim community. Critics of the ban have pointed towards the ability of interest to promote equilibrium between the supply and demand of capital and to facilitate its efficient allocation. Furthermore, it has been noted that receiving interest on savings would incentivise savers to deposit their money with Islamic rather than conventional banks (and would prevent them from not depositing them at all, which would be the most unattractive option). The proponents for relaxation of the ban have argued that while the exploitation argument was a valid one at the early centuries of Islam, this is no longer the case due to changes in society. This suggests that for some scholars the prohibition on interest has outlived its social usefulness.

The existence of critiques directed towards the *riba* ban is meaningful for a number of reasons. First, it demonstrates that Islam is not entirely closed to the future development of its principles and that voices of the minority will be heard. After all, *Fiqh* is about a discussion and exchange of ideas and importantly, the practice of *ijtihad* (independent reasoning) is supported in the more radical quarters of Islam (for example, in salafism and within the larger *Shia* environment). Secondly, the critiques reflect, although they do not always overtly mention, the fact that Islamic finance instruments are generally vulnerable to accusations of committing *riba* because much of their practices appear to include interest, albeit disguised in a *Shariah*-palatable form.

The ban on games of chance (*al-qimar*) is also of interest to this analysis. The prohibition justifies the proscription on betting and gambling with the argument that they would necessarily create a winner and a loser – something, which Islam sees as inherently unfair. In the area of Islamic finance *al-qimar* prohibits investments in excessively risky ventures, excessive profits or abnormal price manipulation as well as all immoral trading practices. Linked to *al-qimar*, the ban on *maysir* (gambling) prohibits the taking of risk which would involve the unlawful appropriation and gain of one at the expense of another. Due to the strictness of this prohibition, the mere engaging in *maysir* is prohibited, even if the financial outcome is negative for the transacting party. As regard Islamic finance, these two bans preclude it from utilizing particularly risky derivatives such as synthetic derivatives or conventional futures.

Perhaps the most interesting prohibition, after that of *riba*, *gharar* forbids the taking of excessive risk and uncertainty in financial transactions. Furthermore, *gharar* operates with respect to unsavory conducts such as deceiving of one's contracting parties and entering deals which are marred with uncertainty. In contrast to the Western, based on risk model, the broadly interpreted ban on *gharar* demands that transacting parties are not deceived due to uncertainties in the contractual terms or the quality of the product, subject to the contract. Importantly, *gharar* applies to uncertain or insufficient information regarding the transaction. For example, the proclivity of Islamic finance to operate *via* complex transactions may be seen as breaching the *gharar* prohibition because it precludes customers (particularly retail investors) from properly identifying the transactional risk. In practical terms, breaching *gharar* may give rise to a call of default due to inherent legal uncertainty – for example, uncertainty as to the *Shariah* compliance of the contract. As has been seen, this has already happened in practice.

13.5. Issues of property and ownership in a comparative perspective

In addition to looking at the prohibitions and their effect on Islamic finance, this work focused on two important philosophical aspects of Islamic finance. The first was a comparison between the Islamic and common law approaches to the issue of property and ownership. The second was the application of the social justice theory in Islamic law. Both points were discussed due to their impact on the application of the Islamic finance regime.

With respect to the former, the author compared definitions of what is perceived as "ownership" in each respective system. To this end, the Western view that ownership is "a set of relationships, granting to a person or to a group control over a specific resource *vis à vis* other persons"), and property is "the legally recognised relationships we have with each other with respect to things" were contrasted to the approach of the civil law. In the latter's view, the concept of ownership is contained within the thing itself. The right, which is treated as enforceable against all persons, is in the thing and this is what establishes the direct link between the right-holder and the thing.

In comparison, the *Sunni* Schools offer four different interpretations of property. For the Hanafi School, this could only be "things" existing in reality, which in addition have the following qualities: desirability, durability, being beneficial for people and abiding by the law of scarcity and expenditure. The Shafie School sees property as a thing with *exchangeable* value, which value must, in addition, benefit people. This is in contrast to the common law, which does not require that a "thing" should have a specific *exchangeable* value in order to be designated a "property".

The Hanbali School focuses on whether the thing can legally benefit the Muslim owner and the legality of the thing is measured with respect to *Shariah* law. The School makes one exception to the requirement for legality – this is circumstances of extreme need or necessity (such as, hunger or extreme poverty).

Finally, the Maliki School perceives "property" in a way, which is most similar to that of the common law. Namely, it views property as a thing that could be owned with the corresponding right to exclude others from enjoying it.

While the Schools differ on the interpretation of what constitutes "property", they all agree with *Shariah* law's postulate that *Allah* is the absolute owner of all property, and that all property is held on trust for *Allah*. Human owners are deemed, therefore, to be mere beneficiaries of the property. This indicates that Islamic law differentiates between the concepts of property and ownership, unlike the common law. Rather, the latter recognises the concept of property rights (as opposed to ownership) existing in relation to a thing. This distinction helps explain the attachment of Islamic finance to the real economy, which is perceived as the only sector providing real value and true property incidents.

Notice that, in line with the common law's position, *Shariah* law accepts the idea of "bundling" of property rights. The author suggested that because of the fragmentation of rights theory persistent in the Anglo-Saxon tradition, the fragmented character of derivatives rights' and derivatives' dependency on an underlying asset resemble the bundle of rights concept of the common law of property, thus making the concept of derivative trading particularly attractive to the Anglo-Saxon investor.

However, the approach of *Shariah* law to derivatives is fundamentally different. Since Islam sees property as contained in the thing and not expressed through a property right, Islamic law does not perceive bundling of rights the way the common law does. This different understanding is linked to the fundamental belief that the choices of the individual and the range of actions as regard one's property, is limited by the beneficial character of humans' ownership of things.

13.6. The application of the Islamic social justice theory in Islamic finance

The application of the Islamic social justice theory in Islamic finance law was equally important because of its comprehensive reach. One such example is the profit and loss sharing model, which aimed, in addition to avoiding the *riba* ban and attempting to promote careful entrepreneurial practices, to limit exploitation of the poor. This principle was further informed by the belief that it is better to relieve the hardship of someone than create wealth for someone else. Despite the *prima facie* similarities with the Western welfare system, the purpose of the Islamic social justice theory is fundamentally different for it endeavors to create a system empowering the poor to take an active part in the process of wealth creation rather than remain a passive recipient of welfare or charity. This strategy, adopted by Islamic law, aims to diminish the inequality between rich and poor. In the context of Islamic finance, the profit and loss sharing principle is intended to diminish the relative disparity between parties to financial transactions. To this end, the protections and incentives created by the Islamic finance framework target the course of financial dealings and strive to achieve greater participation and inclusivity, even if they come at the expense of sophistication.

This idea of Islamic finance is clearly born out of leftist political tendencies, which remain in stark contrast to the capitalist underlay of conventional banking. For example, banks in the conventional system make the bulk of their profit by playing with debt and equity. Debt is used by banks to procure assets, thus contributing to the profitability of the institution. Logically, this is not characteristic for Islamic banks, not only because of the non-capitalistic tendencies found in Islamic philosophy but also because trade in debt is forbidden by *Shariah* law. Interestingly, while this harmonisation of objectives in Islamic law suggests a consistent bent towards the left of the political spectrum, the lack of provision for true democratic choices being made places the Islamic narrative firmly in the territory of the political right. Fittingly, this hybridisation of the political identity of Islam is reflected in practice – for example Iran, which is the only official Islamic state, imposes the leftist ideals of *Shariah* law through a rightist government. As the case study of Iran highlighted, the two most popular parties in modern Iran are right wing (the party in power) and the centre-right (their opponents).

On a more technical level, the distinction between the capitalistic and the Islamic financial systems (and credit institutions) has a direct relevance to the matter of risk and its management in each respective system. While capitalism rewards entrepreneurship, it does not let the community assume responsibility for entrepreneurial risk. In the case of banks, theoretically speaking the risk of loss caused by the actions of the bank's managers is borne by the bank itself (meaning, as a corporation and without sharing it with its customers). In the Western narrative, shouldering the entrepreneurial risk entitles the bank to the reward in times of positive financial outcomes. In contrast, Islamic banks share profits and losses with their customers, meaning that their risk management strategy is based on sharing entrepreneurial risk with the larger community.

A more recent reference to conventional banks reminds that they were put in a not so different position after the crisis – when a heavily regulated framework resulted in banks sharing of the assumed risk with a larger group of stakeholders. The important distinction with Islamic finance is that first, this change applied to sharing of risk only as opposed to profit and loss and secondly, it was confined to the banking sector.

However, the often-heard critiques targeting Islamic finance issuers that they sidestep this principle suggest that the industry is struggling to adhere to it. There could be a valid argument that issuers& originators are better prepared and in a better position than investors to assess the risk of the investment and to this end, to insist on the latter shouldering the responsibility on equal footing with the former, would be unfair. To the point that investors are aware of this disparity, the principle of profit and loss sharing is likely to serve as a deterrent for their participation. Perhaps it could be suggested that this principle is relaxed as regard *sukuk* and is preserved for undertakings where the borrower is a lay person and not an institution. Applying the profit and loss sharing principle in this way will arguably be truer to the intentions of *Shariah* because it will guarantee that no nominal oversight over the project will take place and that investments will be made only if they can satisfy the requirement for profitability and efficient use of resources. From the perspective of viability of Islamic financial instruments, relaxing the principle of profit and loss sharing with regard to *sukuk* will make the instrument less likely to fail because it will guarantee the interests of both investors and issuers. The inherent fairness of this outcome, coupled with the usefulness of the instrument will be an argument for its preservation even in a more extreme regulative environment.

However, the above suggestion should be considered in light of the fact that, in addition to the sharing of risk principle, the Islamic finance risk management strategy includes the active imposition of the prohibitions on *riba, gharar* and *maysir*. This is justified with a perceived immorality inherent in the acts of deception and illusion (including self-illusion). By the combined impact of these three principles, the system achieves two objectives. First, it deals with the issue of spiralling debt, thus preventing the worsening of poor people's financial situation and on a larger scale, by restraining financial speculation, supports a sound micro and macro prudential framework.

Consider, nevertheless, that this success comes with certain negative trade-offs. For example, *gharar* together with *maysir* creates a prohibition, preventing the introduction of conventional insurance in Islamic finance law. While this appears justified under *Shariah* law, due to the prohibition to take money up front for something that is not certain to take place in the future and the prohibition on paying in advance in order to protect from or reduce financial risk, this ultimately renders the Islamic finance sector less sophisticated than its conventional counterpart (and its participants more open to the adverse effects of risks). The conflicting arguments make arriving at a conclusion a challenging task but one that nevertheless, must be attempted by the respective authorities.

13.7. Risk management techniques in Islamic finance: derivatives and securitization

The review of the *Shariah* law prohibitions highlighted that a big part of the rationale for their insertion in the Islamic finance framework is their contribution to the system-wide management of risk. Another way to manage this problem is to use derivatives contracts to hedge risk and speculation.

In the definition of *Shariah* experts, derivatives are rights over receivables which the owner-originator transfers to a special purpose vehicle (the so-called, issuer), which in turn issues certificates sold to investors. This definition fits closely the *sukuk* instrument which would not be, strictly speaking, classified as a derivative in conventional finance. The conventional view of derivatives is that of a product, the value of which is dependent or derived from the underlying asset. Admittedly, this is a very broad definition, which could arguably accommodate *sukuk*.

More importantly than the issue of semantics, in addition to derivatives, financial experts utilise a process called securitisation to effectuate risk and benefit transfer, as well as to achieve value optimization. In this arrangement, derivatives are the means through which the securitisation process delivers on its risk transfer objectives. The process helps the originator manage his credit risk, by preserving the securitised exposures on his balance sheet (keeping the legal title to assets while transferring their risk to a SPV).

Securitization was introduced in Islamic finance under the influence of the West and as a result of trade with conventional financial partners. The Islamic finance sector has traditionally displayed increased resort to securitization, which was considered one of the reasons for the stable performance of Islamic financial institutions during the latest financial crisis.

While derivatives are used to protect against price movements, increase exposure to price movements for speculative purposes, assist with markets penetration and with the movement of more illiquid assets, Islamic finance does not approve of their application for speculative purposes, due to the ban on *gharar* and *maysir*.

From a *Shariah* perspective, the most uncontroversial application of derivatives is to use them as a strategy to hedge (protect) profits against the risk of loss. Investments in pursuance of this objective are deemed to be risk reducing. Note however, that while risk management is not controversial under the *Shariah* framework, some aspects of hedging could be. For example, hedging is defined as a behaviour which helps mitigate against adverse price movements. The connotation to insurance could be problematic because, as mentioned above, *Shariah* does not accept insurance against losses. On another, more controversial, interpretation, hedging may be perceived a risk-reward strategy. This would be unacceptable under *Shariah* law because being rewarded for taking a risk in a commercial transaction, particularly in a speculative context (which is often the case of derivative trading), is deemed unsustainable. Nevertheless, the consensus among practitioners and scholars appears to be that hedging is allowed, as long as it is done in compliance with the main requirements of Islamic law.

While Islamic finance has come to accept most conventional derivatives, this has not been done without some reservations. For example, forward contracts ("deferred" contracts) in which goods and money are agreed to be exchanged at a future date while the price of the goods is agreed upon at the time of signing of the contract, entail the risk of non-delivery of either the goods or the money. In addition to the risk of loss, which *Shariah* law endeavors to avoid, this kind of contract is based on trading in what one does not yet own. *Shariah* law forbids such practices due to the connotation to speculation (*maysir*). Nevertheless, as the analysis of forwards highlighted, these derivatives are adopted in the Islamic finance framework, which, in addition offers an Islamic version of the forward contract, structured on the basis of *murabaha*, *bai muajjal*, *bai salam*, *bai istisna*, *arbun* and *wa'd*. The permission of this construct is conditioned on the possibility to make an inference (which must be supported by part upfront payment) that the parties intend to honour their commitments.

The *Sunni* approach to Islamic finance does not accept futures contracts since they conflict with the requirement that financial transactions must bring benefits to the real economy and the rule that transacting parties must share the risk between them. Additionally, futures entail no real exchange; they comprise of a payment of the difference between the price agreed to be paid and the market price of the goods at maturity. Furthermore, the outcome of futures transactions always is that one party loses and the other wins. Nevertheless, as has been seen, as futures could be very useful for commodity trading, the Crude Palm Oil Futures is approved for use in *Sunni* Islam, most notably in Malaysia. Significantly, futures are acceptable in the *Shia* Islamic finance framework.

Conventional options are used to speculate or to hedge current holdings, or to generate income. This derivative is broadly divided in call options and put options. *Shariah* allows options under the condition that they are used to protect against risk (for example, against adverse price movements) or for arbitrage (benefiting from the different prices of the product in different markets). Due to the ban on speculation and gambling, Islamic finance does not accept options trading for speculative purposes, namely when exposures to risk are undertaken with the sole purpose of profiting.

A sub-division of options, swaps should in principle be permitted in Islamic finance because they can protect businesses against interest rate and currency rate fluctuations, thus indirectly serving as stabilizing factor for the market. To recall, swaps are contracts for the simultaneous delivery of periodic payments in exchange of two different cash flows streams. When they are used for hedging and speculative purposes (in the case of interest rate swap and asset swap), they are not permitted in the Islamic market framework. However, the commodity swap is accepted in the Middle Eastern market, albeit in a *Shariah* compliant form.

Because swaps are used as exchange of value or exchange of risk tool, they become subject to great scrutiny by *Shariah* law experts as to the way risk is managed through them. To this end, the compliance of this derivative has been ensured by basing them on contracts or contractual undertakings such as *tawarruq*, *wa'd* or commodity *murabaha* (for instance, *murabaha* based currency swaps, *murabaha* profit rate swaps or Islamic total return swaps). The *Shariah* compliant use of these derivatives is currently governed by the Hedging (Tahawwut) Master Agreement issued by the International Swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM).

In addition to conventional derivatives, Islamic finance operates with instruments (*quasi*-derivatives), which have been structured specifically for the purposes of the *Shariah* compliant market. As mentioned above, the forwards *bai'salam'* and *istisna* are generally accepted across the Islamic Schools. Nevertheless, the analysis has demonstrated that some of the features of the contracts upon which the Islamic derivatives are based render the resulting product incompatible with *Shariah* law.

Broadly speaking, the Islamic contract (*akad*) follows similar to the common law contract pathways. *Akad* is concluded between two or more parties and its validity is dependent on the simultaneous declaration of offer and acceptance (*ijab* and *kabul*). However, as has been seen from the analysis in the relevant chapter, the structure of many Islamic derivatives relies on the premise of *wa'd* to ensure religious compliance. This was seen by this author as problematic for reasons that will be enumerated below.

13.8. Use of wa'd in Islamic financial contracts

The concept of *wa'd* (unilateral promise) has traditionally been understood as a morally binding promise, not entailing legal obligations and legal sanctions, following from a possible breach of the *wa'd*. To this end, the concept bears some resemblance to the civil law, which treats promises as binding or otherwise, depending on the promisor's intentions.

The modern understanding of *wa'd* is that the promisor in a contractual transaction commits to undertake or abstain from one or another course of action. For example, the Islamic Fiqh

Academy considers that *wa'd* pertaining to commercial transactions should be legally binding. The justification of the Academy was that if the unilateral promise has caused the promisee to incur liabilities but the promisor has gone back on his promise, the former was entitled to claim actual damages from the latter.

Despite this, it could be argued that *wa'd* is distinct to an actual *akad* in that it is not *prima facie* legally binding. Its binding force depends on the interpretative authority. What seems uncontroversial is that *wa'd* is religiously and morally binding on the promisor, without this, however, entitling the promisee to anything more than a moral right to enforce the promise.

In addition, while it could be argued that *wa'd* bears some similarities with the common law concept of unilateral contract, the latter requires a degree of reciprocity in order to be enforceable, which is not the case in *wa'd*. For example, the common law places equal weight on the rights of promisor and promisee, whereas *wa'd* (for instance in the approach of the Maliki School) is more concerned with the position of the promisee. More specifically, if the promisee has incurred costs or have endured detriment in reliance of the promise, the *wa'd* would be treated as binding. While the Maliki School approach resembles the common law doctrine of consideration, it differs exactly in the aspect of reciprocity.

It is arguable that the Islamic School preferred to focus on the promisee for two reasons. First, Islamic contract law posits that contracts are to be performed. Secondly, *Shariah* endeavors to alleviate detriment rather than to grant benefit. Furthermore, *Shariah*'s understanding of a contractual promise is that it comprises of "offer" and "acceptance", which should, in principle, make it binding at the moment the promisee fulfills the conditions or requirements of the promisor. Furthermore, Islamic law treats contractual promises as commitments to deliver *benefit* to the promisee.

Due to the relative independence in the approaches of the four *Sunni* Schools, the interpretation of *wa'd* remains fractured across jurisdictions applying Islamic contract law. It was concluded by this author that although *wa'd* has absorbed some influence from the common law and the civil law traditions, its fundamental premises cannot be transposed into conventional contract law (to an extent, also because of the divergence between the respective common law and civil law approaches to the subject matter). It has been suggested that this, together with the lack of unification in the approach within the Muslim scholarship, gives a serious cause for concern.

The main challenge linked to the uncertain status of *wa'd* is that Islamic derivatives rely on the assumption that *wa'd* is binding to structure a product both suitable to market and compliant with *Shariah*. Currently, the market tends to accept *wa'd* as binding, if the following conditions are fulfilled (as per the opinion of the Islamic Fiqh Academy): the promise is unilateral, the promisee incurs a loss or expense in an effort to meet the promise and the actual sale is completed. The last conditions is however slightly confusing because it does not inform what would the legal situation be prior to completing the sale.

13.9. Potential issues in the murabaha contracts

Another often used concept of Islamic contract law, which contains potential controversial features is the *murabaha* (cost plus) contract. *Murabaha* is one of the many Islamic contracts which allow future repayment of the advanced sum in the form of a deferred payment sale (in addition to instalment sale and *bay'mu'ajjal*) or in the form of leasing contracts (*ijarah*). The challenge of such arrangements is that due to the ban on *riba* (interest) the imposition of extra payment as a compensation for the delay, would not be *Shariah* compliant (of course, conventional finance allows this practice). The main issue here is that the cost plus suggests that money has time value, which is rejected by *Shariah*. Nevertheless, scholars justify the imposition of cost plus in *murabaha* exactly with the passage of time.

Perhaps, this apparent flexibility was due to the extreme usefulness of the *murabaha* arrangement, which has been used as a basis for many complex transactions. However, for the contract to be allowed, the following conditions must be satisfied: the object of the sale (*mabi*) should be certain and identified, of a *Shariah* compliant nature and for a legitimate use. Furthermore, the value of the *mabi* should be substantial and determinable. It must be noted that the conditions related to the *mabi* reflect the idea of the *Sunni* Schools that to constitute a "property", a thing must be identifiable, legitimate and of a certain value. Unwittingly, such organic matching of concepts and application reinforces the sense of continuity prevalent in the *Shariah* legal framework.

Further to this line of thoughts, note that a failure to adhere to the above conditions regarding the *mabi* renders the contract void. In addition, *mabi* should be deliverable both at the time of contract and at the time of sale. This condition arguably takes care of *Shariah*'s requirement that one cannot sell that which one does not yet possess. Lastly, *murabaha* contract, in which the price is not indicated precisely, is considered voidable (*fasid*).

It could be concluded that while *murabaha* is indeed a debt creating transaction, which in addition does not comply with the principle of profit and loss sharing, it is useful as a source of funding, which justifies its place in Islamic finance.

Another controversial instrument is *tawarruq*: a version of *murabaha* that could be used in Islamic finance as an alternative to the conventional model of retail commerce financing by bank credit. Also known as commodity *murabaha*, the instrument is used predominantly in the Gulf Cooperation States. Many other jurisdictions either do not accept the instrument or accept it only under certain conditions. Note, however, that the commodity *murabaha* is particularly useful for trading in commodities such as oil, which explains its popularity in the GCC area.

There are two types of *tawarruq*: *tawarruq haqiqi* (intrinsic *tawarruq*), which is approved and *tawarruq munazzam* (organized *tawarruq*), which is inadmissible, due to containing three impermissible under *Shariah* law elements:

(1) The bank is involved in the process of a resale and liquidization as an agent of its customer.

(2) This involvement of the Islamic bank makes the transfer of the title of the relevant good unclear.

(3) Providing *tawarruq* is just a stable way for the institution to earn profits.

The main problem with organised *tawarruq* is that all transactions contained within the *tawarruq* are bundled together, including the resale and liquidization process. To this end the bank becomes the party which benefits doubly from the transaction – the first time when it originally purchases the product and later, when the borrower meets his obligations. This renders the transaction nominal and akin to a conventional loan, opening the instrument to accusations of *riba* in disguise.

This accusation is proven by the fact that in organized *tawarruq* all steps are pre-determined and the bank is made an agent of the customer, this way indicating that the borrower has no actual freedom under the contract. Furthermore, there is rarely a physical exchange of the goods and the very quick exchange is more often done by way of warehouse warrants. The result of this is a sequence of speedy exchanges of title, which Islamic finance law, in contrast to conventional finance, is not comfortable with. This suggests that the steps envisioned in the contract are only taken with a view of side-stepping the ban on *riba*.

With a view of the above, and in order to avoid invalidation of the transaction on the basis of *Shariah* incompliance, *tawarruq* must be staged in the way proposed by the Islamic Fiqh Academy, namely the instrument must retain some degree of transparency and it should have to demonstrate that there is a legally binding contract between two distinct parties. Above all, the bank must not act as an agent of its customer because this would invalidate the offer and acceptance upon which the contract hinges. This approach aligns Islamic finance with the common law, arguably making intrinsic *tawarruq* more attractive to Western investors.

The popularity of *murabaha* (including *tawarruq* (commodity *murabaha*)) among investors justified a closer look at the benefits and challenges of this instrument.

As the research highlighted, one of the most lauded features of *murabaha*, compared to conventional loans is the lack of penalty (extra charge, added to the existing obligation) provided by the instrument in the event of late payments or defaults. This results in less consumer debt than under the traditional credit purchase model, ultimately rendering *murabaha* contracts less risky than their conventional alternative and therefore safer for the financial system. Furthermore, *murabaha* contracts are presumed fairer than conventional loans because the latter share only the profit and *not* the potential loss of the borrower. It is arguable that the Islamic finance approach to loans could therefore stimulate enterprise at a higher rate than conventional finance would.

However, as touched upon above, the *murabaha* contract is open to accusations that it includes interest, dressed up in a *Shariah* compliant form. Furthermore, trading in what the parties do not yet own is a big challenge for *murabaha* based transactions. While this has been resolved by structuring *murabaha* contracts through the help of *wa'd*, the analysis on the *wa'd* concept suggested that the solution is hardly fool-proof. In this connection, the review of case law, reaching the English or Malaysian courts suggested that the *murabaha* contract needs to be reworked in order to better guarantee the rights and obligations of the parties in situation of default.

In addition, it should be mentioned that the majority of contracts, which are ostensibly *Shariah* compliant, achieve this compliancy by bundling two or more contracts together. However, combining two transactions onto one and combining of contracts for sale and contract of debt is not permitted by Islam. Furthermore, *Shariah* law requires that if contracts must nevertheless be combined, each contract must be able to operate independently and without binding the other. In practice, this is not observed: as noted, most of the *murabaha* structures rely on *wa'd* in order to ensure legitimacy; however, the underlying contracts are always dependent on each another to establish legitimacy and to promote performance. Furthermore, considering that the most relaxed of the practices are typically observed in Malaysia, which is a leader in Islamic finance, it could be tentatively suggested that a more radical framework would reconsider the existing arrangements regarding complex transactions.

13.10. The sukuk framework: structural basis and investor protection issues

As emphasised throughout this thesis, the main focus of Islamic finance law is to ensure compliance with the sources of Islamic law. From a pragmatic perspective, this translates in achieving fairness for the contracting parties and a sound, beneficial to the wellbeing of the community outcome of contracts. Informed by these considerations, the author dedicated a lot of the discussion in this thesis on the Islamic bond (*sukuk*). In addition, this choice was influenced by the popularity of *sukuk* and the role it performs in the relevant sector and more importantly, by the desire to question certain aspects of the bond's structure.

The author approached the discussion on *sukuk* looking at the instrument's provisions on investor protection, particularly in the event of default by the issuer. This was done deliberately, due to real concerns and considerations that consistent underperformance of the instrument with regard to investor protection would render it *Shariah* incompliant and/or inadequately prepared for the market. While the former could be of relevance in a regime of radical or more conservative *Shariah* rule, in the worst case scenario prompting the abolition of the concept, the latter could render *sukuk* too risky to use in any jurisdiction. Furthermore, even if a radically-bent government would hesitate to remove the instrument from use on religious grounds, it could be convinced to do so more easily if arguments for its market unsustainability abound. The importance of this point necessitated an in-depth analysis of *sukuk*, examining it in the context of the conventional instruments, which it was based on.

Importantly, although *sukuk* are known as Islamic bonds and conventional bonds are not derivatives (rather, they (along shares) are assets which underlie derivatives), *sukuk* are deemed Islamic derivative instruments, demonstrating the efficiency of conventional derivatives while applying similar securitization principles.

The introduction of *sukuk* intended to provide Muslim investors with the benefits of a bond while escaping the operation of the *riba* ban. Like conventional bonds, it is a means for businesses to finance their projects by receiving capital from the public. The parties in a *sukuk* arrangement are known as investor and issuer, in distinction to bonds where the terminology refers to lenders and borrowers. The main distinction between the Islamic and conventional bond is that bonds are debt instruments whereas *sukuk* are a fusion of debt and equity.

Sukuk is defined as tradeable, asset-backed, medium term notes, structured on the basis of a contract of exchange or contract of participation. It is an instrument combining features of conventional bond, more specifically, covered bonds, Asset-Backed Securities (ABS) and shares (most notably, preferred shares). Each of these conventional instruments was discussed in turn in order to make the Islamic bond more familiar to the reader.

The comparison between bonds and *sukuk* highlighted that, similarly to conventional bonds, *sukuk* are issued with the purpose to fund the economy and are offered mostly to institutional investors. (However, note that the *sukuk* market is gradually opening up to retail investors too.) Just as covered bonds, *sukuk* are backed by a pool of assets, which is (at least in theory) accessible to investors to make a preferential claim in case of insolvency of the issuer. The arrangements related to the pool of asset, the role of the SPV and the bankruptcy remoteness rules of the two instruments are largely the same. While the current EU regime on covered bonds is not yet harmonised, analysis of the proposed new EU regime on covered bonds highlighted that the new legislative package will provide for repaying investors as per the respective contractual schedule, including on default of the issuer. Furthermore, events of insolvency or resolution will not shorten the maturity of the bond. It should be noted, in this context, that *sukuk* are not deemed covered bonds under the EU legislation, and a similar regime of protection is missing from the *sukuk* originators' states, including Malaysia.

Furthermore, the discussion underlined that some similarities existing in the structures of *sukuk* and ABS respectively, and more specifically, the relevant differences between ABS and covered bonds. For example, while in the case of covered bonds interest payments are paid out of the originator's account, in the case of ABS, they are paid on the basis of the performance of the assets in the pool. Compared to *sukuk*, ABS resemble asset-backed *sukuk*, while covered bonds are similar to the asset-based variant of the instrument. Notably, in the ABS scenario, the income of the performance of the assets goes straight into a securitization trustee account. The outcome of this is that the asset-liabilities mismatch is passed on to investors, thus allowing ABS to provide investors with a more detached from the originator performance.

However, while a similar devise, resembling a trust is used in the context of *sukuk*, there is no trust law framework developed in Islamic countries, which makes the application of the trust concept challenging. Furthermore, the bankruptcy remoteness of the SPV in an ABS context is ensured in the EU by the Securitisation Regulation, which requires that the transfer of title to the SPV should be done by means of a true sale or in any other legal way, ensuring that the transfer will be enforceable against the seller or a third party. The Regulation provides that in the event of the seller's insolvency the sale could not be subject to severe clawback provisions. As indicated, there are no corresponding provisions on *sukuk* in the Muslim market.

As already intimated, in addition to bonds, *sukuk* bears resemblance to shares. The research in this work has established that *sukuk* is most akin to preferred shares, which, although not providing most of the benefits inherent in common stock (such as voting rights or appreciation), guarantee the payment of dividends at regular intervals. This makes preferred shares less risky than the rest of stock. Another relevant distinction is that in the event of a bankruptcy, shareholders holding preferred shares are paid prior to their common shares counterparts.

Note that due to the prohibition on trading of debt, there is a requirement that the *sukuk* structure represents clearly the link between the returns and cash flows of the financing and the underlying assets, or the returns generated from them (akin to coupon payments in bonds). This underlines that if assets cannot be identified, they could not be used for the purposes of raising *Shariah*-compliant financing. This point could become particularly relevant on default, which, at the very least, could be called by any of the parties if it becomes aware that there was fraud as to the *Shariah* compliance of the instrument.

Relevant to this is the AAOIFI's definition of *sukuk* which suggests that *sukuk* are certificates of equal value, representing undivided shares, and that a link to an identifiable tangible asset is needed in order for certificate holders to have a valid claim. This work suggested that despite that indivisibility of shares is a fundamental feature of the conventional share instrument, the reference to undivided shares may create problems for investors in the event of default of asset-backed *sukuk*.

The issue of definition was used as a starting point to exemplify the lack of clarity in the current regime on *sukuk*. The argument of the author was that as far as default of the issuer is concerned, the instrument presented the common law jurisdictions with a problem caused by the hybrid character of the product. Adding to that the lack of suitable regime back home, the smooth operation of *sukuk* issuances hinged on the chance that default will not, after all, happen. However, as the analysis of the many case study demonstrated, this hope did not come to pass.

In order to unpack the problem to its essential components, the issue of undivided shares was discussed by reference to the English common law for reasons of the instrument's provenance and the conceptual similarities between Islamic contract law and the common law of contract. This analysis was further prompted by considerations related to the hybrid structure of *sukuk*, which, it was suggested, made for potential *Shariah* compliance challenges as well as for difficulties adapting the instrument to the common law context.

The discussion affirmed that the *sukuk* structure is weak from an investor protection perspective. For example, the author made a strong argument that holders of asset-backed *sukuk* certificates for issuances outside the UK jurisdiction (and perhaps locally issued too) would find it challenging to assert their rights satisfactorily on the assets in the UK and/or in jurisdictions applying similar insolvency and company law provisions (for example, Malaysia). These difficulties could be caused by uncertainties as to the certificate holders' exact legal position and to the liberal fusion of concepts, borrowed from the common law. As will be clarified below, the reference to difficulties envisions the actual satisfaction of the claim, i.e. the matter of division of assets, rather than the matter of bankruptcy remoteness of the SPV.

For example, reference to the practice of the English courts, as well as the applicable regulatory framework, indicated that *sukuk* is regulated only at the level of the issuer and the courts have not yet had the opportunity to decide on *sukuk* defaults, formally caused by the insolvency of the issuer. The very few examples that have reached UK courts established that in case *Shariah* law provisions have been intended to be binding on the parties, a very clear reference to this must be introduced in the contract. Even in that case though, English courts are solely competent to apply English law, which means that *sukuk* holders claiming at a UK court must bear this in consideration. Furthermore, to the extent English law has provisions on default, they provide for redress in damages (which is arguably inacceptable under the AAOIFI's 2000 guidance on default).

Moreover, it is not clear how an English court or a court referring to English law would decide the issue of asset division because while English law gives precedence to bondholders over shareholders (and will treat *sukuk* holders akin to bondholders), the definition of *sukuk* refers to undivided shares. At the very least, unless this is clarified, a decision of the court (whatever it is) may open the doors to further litigation.

Furthermore, in the case of asset-backed *sukuk*, the court will most likely interpret the claim as referring to the equity contained in the SPV. It remains to be seen how the indivisibility of the units to which the definition refers will be applied to the asset division of the SPV. It was suggested that the court may decide that the claims should be satisfied through physical division or a division of the proceeds of the assets held by the SPV. However, should the asset be a chattel, which could be the case, English law is unclear as to the direction it may take. Case law suggests that the law relating to joint tenancy and tenancy in common over chattels is less established, leading to uncertainty in the event of disputes over the division of assets.

As mentioned earlier, asset-based and asset-backed *sukuk* contain different credit risk: the former would render investors exposed to the insolvency of the originator, whereas the latter would not. The reason for the, at least in theory, more beneficial position of the asset-backed *sukuk* is that holders of certificates are in a possession of a legal title for the assets in the asset pool. While in the event of distress, the losses will be passed on to investors, the pool will continue paying until there are assets left. Since the asset-based *sukuk* has no direct link to the assets in the pool, holders effectively have rights over a portion of the cash flows, as opposed to equity. Unfortunately, this places holders of asset-based *sukuk* in a disadvantaged position on default.

The thesis highlighted that the position on bankruptcy remoteness in the UK and France regarding asset-backed *sukuk* investors, holding certificates in a locally issued *sukuk*, benefit from a clearer regulatory approach and a more investor-friendly rules on bankruptcy remoteness.

Note that as regard asset-backed *sukuk*, the SPV's purpose is to guarantee bankruptcy remoteness of the assets in the pool by holding them on trust for the benefit of *sukuk* holders, away from the reach of the originator. While this could work well in jurisdictions with developed trust law, to date this mechanism has not been properly developed in the Middle East. It could be argued furthermore, that the right of asset-backed holders to cause sales of the assets (and generally , to rely on them) at times of insolvency could be curbed by legislation in some relevant countries.

For example, bankruptcy courts may permit the SPV to file for bankruptcy despite the objections of its lenders. This has happened on a number of times in the US. Another possibility is for the bankruptcy court to use its equitable power and force the SPV to go into bankruptcy, by triggering substantive consolidation with the bankruptcy estates of the originator or the affiliated entities. The court's purpose in such a situation would be to consolidate all assets and liabilities in a single entity, in order to bestow the creditors of the entity with a more equitable distribution of property. Furthermore, the bankruptcy court could be authorized under section 363 of the US Bankruptcy Code to sell some of the assets of the SPV unencumbered by the lender's liens. This measure could be justified by considerations of achieving the highest value for the SPV's assets. Lastly, the concept of a true sale allows the US courts to decide whether the financial assets contained in the asset pool have been sold to the SPV or rather, they have been loaned.

This suggests that the matter of bankruptcy remoteness of the SPV could be decided in a not so investor friendly way by the US courts, due to legislation which should concern *sukuk* investors. In comparison, the European approach and more specifically UK and French law are far more likely to acknowledge that the sale of assets to the SPV was a true sale as opposed to a loan. In addition, it would be unlikely for the courts in the UK or France to hold in favour of consolidation between the assets of the SPV and those of another, possibly indebted company. This suggests that electing the UK or France as jurisdiction for arbitration or because of a nexus between the parties and certain clauses of the contract to the respective jurisdiction, investors are likely to obtain satisfactory result. However, deciding on the point of bankruptcy remoteness in favour of investors would not solve the problem with asset division related to the structure of *sukuk* (discussed earlier).

Although the discussion on remoteness suggested that some jurisdictions outside the Middle East could have a more issuer-friendly as opposed to investor-friendly approach, analysis of case law of the US and the GCC countries suggests that *sukuk* holders are better provisioned on default abroad than they are in their own jurisdiction. In fact, in all discussed cases, apart from the US one, some or all of the *sukuk* holders were prevented from being compensated appropriately and timely. Unfortunately, on the occasion when the claims of some investors were satisfied, the ones that were not originated from foreign investors. This approach is hard to explain because the *sukuk* structure does not provide for an additional division between investors, based on nationality.

13.11. The effect of defaults on the viability of the Islamic financial instruments

The focus on the treatment of defaulting debtors under Islamic finance law is not misplaced. To begin with, the more evidence there is that the aspect of investor protection of the bond has been overlooked by its engineers, the easier it would be to assume that Islamic finance instruments are unfair and tend to place the weaker party in a disadvantaged position. The outcome would be an increased opposition on behalf of Islamic scholars to the ongoing application of the offending instruments in investment and project financing. Such approach would be in-line with the premises of Islam, relating to social justice and more specifically, to those of them demanding fairness and regulating the attitude to and conduct of debtors. As repeated throughout the work, the *Qur'an* requires that debts should be paid, particularly when the debtor is wealthy.

The current position of Islamic law on defaulting debtors, and particularly those in difficulties, is that debtors are enjoying a period of grace. This is due to the traditional view that debts are a relatively relaxed obligation. Nevertheless, as per the position in the *Qur'an*, creditors have freedom to decide whether to seek the outstanding payment of the depth or not. It should be noted that the exact meaning of the two key concepts related to defaults, namely "difficulty" and "ease" are not defined, which leaves the discussion open as to when is a debtor in an adequate position to be expected to return his debt.

It is further arguable that the current lack of adequate Islamic finance provisions for default could be traced back to various culturally-specific and geo-political factors. As to the former, the *Qur'an* imposes strict moral demands on Muslims, requiring the performance of contractual obligations and the payment of debts. It is possible that to the extent these moral expectations have functioned well in the context of simple trade structures, they are not entirely applicable to the complexity of the novel Islamic financial instruments and particularly, to the modern, including global, financial market environment.

To this end, the possible negative attitudes of Islamic scholars could be supported by findings that the structure of many Islamic finance instruments is weakened by certain deficiencies, potentially able to cause investor-protection and market stability issues. As a result, the religion-based opposition to Islamic instruments can support or alternatively be supported by industry experts and law makers. This would be made easier by statistics that defaults and pre-default events have already been observed across the Muslim markets. Their relatively small number, compared to conventional defaults is nevertheless worrying because while still young, Islamic finance continues growing, which will increase the possibilities for further defaults. Furthermore, Islamic finance has a global reach. Defaulting instruments could affect the ability of Islamic investors to invest in the Western markets and vice versa, could lower the confidence of foreign investors in the Islamic markets. Most importantly, however, such events could erode the trust of ordinary Muslims in a system, which promised to provide the *Ummah* with ethical yet viable alternative of conventional finance. In this context, the failure of Islamic finance to deliver on this promise would reach beyond the financial system into the post-colonial narrative on Muslims' national and cultural identity.

Furthermore, even if these deficiencies are overcome in separate jurisdictions, the lack of consistent application of *Shariah* law across the entire pertinent demographics would make harmonisation of the framework on default a challenging task. Apart from the obvious religious implications, as the discussion on EU covered bonds and ABS demonstrated, failure to harmonise would contribute to inefficient allocation of resources, including high cost of capital, investor protection issues and some prudential points of concern. Conversely, greater harmonisation would have the effect of increasing investor confidence, including for cross-border investment. This would help finance the economy through funding sources that are both cost-effective and sustainable.

13.12. The religious legitimacy of sukuk: some remarks

In addition to the discussion on default, the topic of the religious legitimacy of *sukuk* merits some elaboration. *Sukuk* has been critisised for being inconsistent with the Islamic values, because of accusations of commitment of *riba* and breach of the risk-sharing principle. The former has been based on the argument that the discount on the bonds could be perceived as interest return and the latter on suggestions that guaranteeing the profit ex-ante takes away the investment risk.

Indeed, the *sukuk* instrument has adopted a number of devises which helps guarantee that investors will receive the correct PDA even if the profit does not allow for this amount to be distributed. The argument of critics is that by embedding these devises into the structure, the *sukuk* effectively disconnects the performance of the investment from that of the asset. In reality, such practices manage risk through risk transfer; however, this time the risk is moved from investor to originator.

A novel form of *sukuk* added particular force to the arguments of the critics of Islamic finance. While new for the Islamic finance environment, perpetual *sukuk* has been utilised in conventional finance for a long time. Because of its lack of maturity date, this instrument is closer to shares than to bonds and is treated as *quasi* equity from accountancy perspective, forming part of the capital of the company.

In order to be recognised as equity, the instrument must contain a profit deferral feature and in addition, its issuer must be able to defer profit without being called in default. In the event of insolvency, perpetual *sukuk* ranks higher than preferred shares and is subordinated to bonds and other liabilities. Importantly, holders cannot redeem their certificates unless redemption has been triggered, since there is no redemption date for this *sukuk*. On the other hand, the issuer is entitled to a call option, which is the right but not the obligation to redeem the *sukuk* once the initial non-call protection period has passed. The typical non-call period is 5 years.

Because perpetual *sukuk* is under the obligation to be structured on the basis of non-exchange-based underlying Islamic contracts, it manifests various *Shariah* compliance related issues. This includes its perpetuity, and more specifically the lack of maturity date and the unilateral ability of the issuer to dissolve the contract, which renders the underlying *mudarabah* and *musharakah* contracts invalid. The issue is caused by the requirement under these two contracts that the parties retain equal participation in the management of the venture.

Furthermore, experts agree that due to increase of inflation over time, issuers benefit from the longer duration of the bond to a greater extent than investors. The only benefit for investors is the higher yield obtained by the investment. In addition, while perpetual *sukuk* investors could sell the certificates on the secondary market, the price and ability to do that will depend largely on the liquidity of the bond market.

Another *Shariah* compliance issue could be found in the deferral of Periodic Distribution Amount (PDA) feature of perpetual *sukuk*. Due to requirements of the Basel III framework, issuer may be prompted to defer the PDA in order to comply with the relevant minimum capital requirement. Nevertheless, in the event that the *sukuk* is structured on the basis of a *musharakah*, the deferral of the PDA breaches religious provisions requiring strict observation of the profit distribution date at which all partners to the venture would receive their profit. Furthermore, the rule that the issuer may decide to withhold the payment of the PDA at all (non-cumulative profit deferral) without this amounting to a default would breach the rules on *mudarabah*, which entitle all parties to the contract to receive their share of the venture’s profit.

Nevertheless, this practice is currently deemed acceptable by AAOIFI and independent experts who claim that as long as the parties agree to the offending conditions prior to entering the agreement, the feature is not incompliant with *Shariah*.

Such innovative justifications have been applied to other controversial aspects of perpetual *sukuk*, for example the practices of deferral of unrealized return and capitalization of return, which are suspect on basis of accusations of *riba* (interest arising from deferment) and/or debt rollover, both not permitted by *Shariah*. For example, the justification for allowing capitalization under *Shariah* is based on the argument that the increase in the payment amount is additional investors' capital, generated by the reinvestment activity.

While such arguments may suffice in the particular example, the broader analysis of the *sukuk* instrument suggested that the Islamic bond is deficient on the point of investor protection as well as on the issue of its *Shariah* compliance. Furthermore, the analysis in this work suggested that while the Islamic finance instruments preserve their overt legitimacy, their genuine compliance with *Shariah* law is often questioned by experts, institutions and Islamic law scholars.

As a broader point, while the Islamic market utilises a wide array of derivatives, research indicates that the framework lacks efficiency and sophistication. This is due to a highly complex way of structuring of instruments intended to convince that a *Shariah* compliant transaction has taken place. However, the many smaller transactions cost additional human hours and effort, thus increasing transaction costs and the risk of transaction failure. As a result, transacting in Islamic finance accumulates costs and risks, which are in most cases passed down to the end customer (usually the weaker contracting party).

13.13. Islamic revivalism

The extensive analysis of Islamic finance law would not be complete without examining its connection to politics and most of all, the Islamic revival (*tajdid*). The latter is perceived as a force aiming to revolutionize the masses and replace the established order without regard to whether its character is authoritarian or democratic. This indicates that the movement is religiously, rather than politically motivated, which can result in a hybrid governmental structures.

The term revival refers in this context to the values of the early Islam and the fundamentals of the Islamic religion. In the view of revivalists, the early years of Islam constituted the golden age of the religion; its example, therefore, could not be improved upon. In this context, let us recall that Islam places great value on continuity, including that of ideas, and the link to the past. This facilitates ideas which have circulated from the time of the early Islam to remain influential till modernity.

Although revivalists' ideas go back centuries, modern ideologists have developed their narrative inspired by the allegedly ideologically failing secular governments, which inherited the colonial order. Revivalists perceived the main failure of such rulers to be their betrayal of the sense of national identity and the cultural and spiritual heritage of the Muslim community.

The three basic principles defining a *Shariah* compliant political system are consistency with the teachings of Islam, obedience of the masses to the political authority of their rulers and mutual consultation of the participants in the political discourse.

Apart from having a consensus on the above, Islamic revivalism was never uniform. Like Islam, it benefited from the contribution of the many philosophical, cultural, national and ultimately, denominational iterations of the religion. Nevertheless, the idea that the true Islamic State was not yet achieved permeated the lines of revivalists, uniting them in the belief that the main political ideologies of the modernity (capitalism and communism) failed and that it was better for the world to undergo Islamisation than it was for Islam to incorporate modern notions and developments.

The first and most conservative strand of the ideology has sought to preserve the main concepts of pre-modern Islamic revivalism. Adoption of this approach should leave little room for Islamic finance as we now know it, for the majority of the currently used Islamic financial instruments are unlikely to withstand the scrutiny of a true revivalist. This was not so much the case with the second category of revivalism, which sought to infuse older concepts with modernity and make them relevant to the changing times. It is arguable that the current state of Islamic finance represents, willingly or not, this exact tendency. The third revivalist strand was the most radical – giving rise to new concepts, reflecting the changing conditions of our modernity.

The second important theme in the narrative of Islamic revivalism (the first being the purification of Islam from evil), historically present in Islamic ideology, is the call to judge contemporary societies, which are identified as nonbelieving (*kafir*) and the process of judgment, passed on to them, as *takfir*. Notably, *takfir* has historically been practised only by the more militant strands of revivalism.

The third strand of Islamic revivalism is the theme of holy war (*jihad*). Although *jihad* could be inner, spiritual and military (extremist), of interest to this discussion is the latter. Its theoretical foundation is based in the 'Milestones', written in 1960s by Sayyid Qutb, and the medieval work 'Provisions of the Hereafter', compiled in the 13-14th century BC. While on a detailed view the three forms of *jihad* appear disconnected, some theorists argue that the inner war should be waged against corrupt and impious Muslim rulers and governments, turning this into the foundation of *jihad*'s proper, physical manifestation. This proactive nature of *jihad* made it instrumental in the Muslim anti-colonial movements, which prompted a struggle for national and cultural identity. This struggle developed at the backdrop of uncertainty as to the desirability of the nation-state. While some intellectuals supported this notion, others argued that the nation-state ideal was introduced by the former colonialists in order to further undermine the *Ummah*.

Another important concept that could serve understanding radical Islam is that of *jahiliyyah* (ignorance). At first the word was used in reference to the period of pre-Muslim Arabs. Later, it absorbed the notions of renewal, condemnation and striving, paving the way for the modern understanding of *jahiliyyah* introduced by Mawdudi - which was a fusion of a diagnosis of the illness and the cure – a call for Muslim revivalist to fight those forces which strived to corrupt the Muslim society. Gradually, the term became a label for those that opposed the ideals of revivalism. *Jahiliyyah* was detected in all iterations of modern life, which were deemed ignorant despite all comforts and inventions. In Qutb's understanding, it was ignorant to believe that man can create legitimate rules of collective behaviour, irrespective of those prescribed by God. These radical writings and particularly the elaboration of the concept of *jahiliyyah* provided the ideological connection between Al Qae'da and ISIS.

Tawhid, or the oneness of God, was another major concept transformed by Mawdudi in the 20^{th} century ascribing it to the process of Islamic transformation at the level of society or at that of the individual, a process having basic implication for the Islamic political, social and economic life. The development of *tawhid* turned it into a holistic Islamic concept which revivalists strived to apply to all spheres of life, including the economic one. The concept was so convincing that it transcended the boundaries of the separate denominations, confirming the pan-Islamic beliefs of modern revivalists.

This analysis would not be complete, however, without delving into the distinctions in the ideological movements ascribed to *Sunni* and *Shia*.

The modern Iranian *Shia*'s first serious brush with extremism happened in the 1940s, with the growing Fidaiyan movement. While the Fidaiyan ideology was almost utopian, their activities revolved around unrest, promoting political violation and even political assassinations. Although influential at first and enjoying popular support, the group gradually fell out with the powerful political players of the day. Despite that, its ideology still permeates the politics of modern Iran. For example, the Fidayan's leftist Guide to truth was first published in Tehran in 1950, and republished after the Iranian revolution. The Guide is significant because it outlines what the future Islamic State and society should be, calling for an entirely *Shariah* ruled society. The document argues for the abolishment of all non-Islamic laws, including immoral practices, such as gambling and usury.

The success of this ideology can be explained with its focus on the common good, society's wealth and the wellbeing of society rather than that of its individual members. This rejection of individuality has the effect of unifying Muslims into a community by affirming the deeply internalized link between devotees and religion. This ideology suggests that the disadvantaged will be given a chance to contribute, that the weak will be supported and the poor will be helped out of their situation. The populism of these ideas cannot take away from their genuine importance to the Islamic narrative. In comparison to other religions, Islam strives to adopt a political framework institutionalizing the notions of equality and that of fair wealth distribution. In the context of Iran, these sentiments proved to be decisive for the success of the Revolution.

After the fall of the Ottoman Empire in 1918, almost the entire Muslim world was colonized by European powers. This was not a long occupation but it was a period which put in motion the intensive Muslim anti-colonial movement, which at that time was led by the nations' elites: secular-nationalists, educated in the West. While the objective of these elite was to create a West-emulating state, this was met with a suspicion by ordinary people, who could not identify with the new policies. What started as grass-roots protests, gradually turned into stronger voices of disagreement with the official policies, promoting the idea of returning to the moral and religious values of Islam and forming the beginning of the Islamic revivalist movement. The influx of socialist and nationalist ideals further informed revivalism, transforming it into a full-fledged political movement.

The end of the Second World War saw the division of the states between the US and Russia. Although Iran chose the side of the US, becoming a democratic and secular country, it was not long until tensions with the UK and the US took place. Mostly, this was due to disagreements over oil, of which Iran was very rich. The coup organized by the MI6 and the CIA overthrew the legitimate secular government and solidified the rule of the Iranian Shah.

Despite the desire of the Shah to modernize the country, he was distrusted by ordinary people. The societal turmoil increased towards the end of the Shah's rule, eventually leading to the 1978-79 Islamic Revolution. In addition to defying what was perceived as Western imperialism, the ideologists of the revolution aspired to create the first truly Islamic State, based on *Shariah* law. To the extent that they succeeded in doing so, the Iranian revolution influenced the agenda of several radical movements and the creation of a number of Islamic political parties across the Muslim world. Notably, these parties' objective to reintroduce a religious governance model was perceived as the only path to progress and full independence.

The differences between the *Shia* and the *Sunni* are rooted in their historical disagreement over who was the rightful heir of the Prophet. While the *Shia* believe that the Prophet was chosen to receive the revelations because of his personal virtues and the qualities of his family and tribe, and the following rulers must therefore be chosen among the Prophet's heirs, *Sunni* hold that leadership should fall on the most capable to lead. Furthermore, for *Sunni* leadership of Islam belongs to those earthly domains, which should be decided on the basis of political realities.

It is arguable that *Shia*’s understanding of what constitutes legitimate rule could create disregard to allegedly illegitimate norms, including in commerce. In comparison, *Sunni* would accept the legitimacy of a Muslim government as long as it demonstrates respect to Islam.

The *Sunni* idea of state and governmental power was developed slowly, reflecting the deliberate fluidity of the construct found in the sources of Islamic law. Similarly, the concept of caliphate adopted the meaning of ‘the normative model of the Islamic state’ in the course of time. Importantly, “caliphate” is both a structure of governance and manifestation of Islamic political power, called upon to rule over chaos. To this end, *Sunni* accept despotic power, if this would be the price of order.

In the Islamic belief, all supreme power in the Islamic State belongs to *Allah*. This applies to political power as well. To this end, the sovereignty of the State is not absolute and its government is divided between *Shariah* and the *Ummah*. While the community has an inalienable right to choose a leader and to delegate to him its exclusive rights, its legislative authority (of the *Ummah*) reaches only those areas that have not been legislated upon in the sources of *Shariah* law. The conclusion could be that leaders’ more radical interpretation of the *Qur’an* may diminish the power of the *Ummah* to legislate. This happened in practice in the period of 2014-2018.

Although *Sunni* and *Shia* interpret Islam in a different way, they agree on two important points: the diagnosis of the illness pervading the Islamic world and its cure. The former was identified as the persistent Westernisation of Islamic countries, with the attached to it Western values of democracy, liberalism, economic development, socialism and nationalism. One recurring theme in this ideology is that of the illusion of “good life”, created by Westernisation and innovation. The cure for the pervading ignorance is the winning of the masses, of the younger generations through violence, including overthrowing of governments. In their narrative revolution was urgently needed, as well as justified. For example, the justification of the Iranian Revolution used by Khomeini was to claim that giving up sovereignty to foreigners, adopting culture that is inconsistent with the Islamic values and diminishing the role of Islam renders the power of the incumbent State illegitimate.

Considering that the Iranian revolution succeeded, it was necessary that this work examines the degree to which the post-revolutionary Iranian government applied in practice their concept of the cure. As appropriate, the analysis referred to Iranian Islamic governance in the area of finance.

One of the first things Khomeini's regime attempted in this regard was nationalization of the banks. Banks nationalization permitted the Government to carry out centralized economic policies where risk exposure, following some controversial practices, could easily be absorbed by the State. Among such practices was the permission to trade *sukuk* on both the primary and secondary markets. Note that despite the traditional prohibition on selling of debt, *Shia* jurists consider the practice legally valid and enforceable, even arguing that sale of debt to the debtor is not illegal either in *Shia* or in *Sunni* Islam.

While *Shia* jurists acknowledge that sale of debt to a third party, which trading *sukuk* on the secondary market in reality is, is controversial, they argue that the *Sunni* jurists' reservations are triggered by a concern that the seller will fail to deliver the subject matter of the contract to the buyer, potentially marring the transaction with uncertainty, imposition of interest and absence of delivery. Nevertheless, the *Shia* argument is that on this occasion the interests of investors are protected by the Iranian legal framework because of a requirement that the price of the debt is in cash.

Furthermore, while the Iranian framework is subject to the same *Shariah* prohibitions as its *Sunni* counterpart, the instruments used in the Iranian financial market are structured in the tradition of the *Shia* Immamieh jurisprudence. It is notable that while Iran started off in a rather liberal way – allowing "guaranteed minimum profit" of 4-8%, depending on the economic activity and including on deposits, it revised its policies towards a more conservative take on the prohibitions. After the Law for the Usury-Free Banking came in operation in 1984, interest on assets was replaced with a "maximum service charge" of 4%. Furthermore, the fixed "guaranteed minimum profit" applicable to deposits was replaced with non-fixed bonus for depositors. The new legislation replaced the *quasi*-interest based model with the aligned with *Shariah* profit-and-loss sharing model.

Nevertheless, the Iranian system preserved its pragmatic nuances. For instance, banks were allowed to charge defaulting debtors with a fixed penalty of 12% a year, imposed on the unpaid proportion of a loan. In addition to that, Iranian banks charge a service charge of 2%. Furthermore, interest as such is not completely banned because banks are allowed to impose a rate of interest up to the inflation rate. This is justified by the substantial inflation in the country, which would render it unfair to deny depositors recourse against it. In practical terms, if Iranian banks did not offer this rate, they would have struggled to find depositors. In addition to the above, the Iranian banking system guarantees the deposits of its customers. This practice arguably goes again the principle of risk sharing, embedded in the *Sunni* tradition.

Another controversial practice of Iranian banks is the permitted by the Iranian legislation buy-back arrangements and the sale of goods which the bank is not in possession of. This goes against the prohibition to sell that which one does not own as well as against the requirement that the subject matter of a contract should be identifiable. In addition, it leaves Iranian banks open to accusation of *gharar* (uncertainty). The main critiques aimed at Iranian banks, however, focus on the imposition of interest, which in the opinion of *Sunni* scholars, renders the system incompliant with *Shariah*. The justification often used by proponents of the Iranian system is that the policies of the Iranian banks reflect governmental long-term planning which makes them instrumental to the increase of the well-being of the Iranian nation.

To the extent that the Iranian banking system has been performing in an unimpressive way, exhibiting slow growth, relatively narrow range of products and services, and a large portfolio of non-performing assets, the achievement of these objectives seems doubtful. In addition, the Iranian capital Market demonstrates similar characteristics, i.e. some controversial practices and a relatively narrow range of traded instruments.

Regardless, the Iranian *sukuk* market is well-developed, offering three regulated, considered tradable and issued sukuk: *musharakah*, *ijarah* and *murabaha*. Among the permitted on the Iranian market derivatives are options and futures. The latter is contrary to the practice of the *Sunni* market which disallows futures, due to *Shariah* issues. The justification of the *Shariah* Board of the *SEO* for the inclusion of options and futures is that there are requirements that a rational ratio with the real market should be preserved and the underlying assets should be deliverable.

As regard Iranian *sukuk*, it is more stringently regulated compared to its *Sunni* alternative. For example, Iranian jurists have introduced a permission-based system, which is hoped to protect the interests of investors. Permission is granted only if the issuer and originator provide documents, demonstrating that they have followed capital market norms relating to custody, payment and administration, and that they have embedded contractual provisions for the provision of a periodic return and pay.

Some of these requirements are, however, controversial under *Shariah* law. For example, the attempt to guarantee periodic returns clashes with the principles of sharing of risk (although, admittedly, this is a general problem with the *sukuk* instrument, not limited to *Shia* law). Furthermore, pursuant to the Iranian legislation's requirement that issuer and originator are the same entity (unlike the *Sunni* example), Iranian *sukuk* adopts characteristics akin to asset-based (as opposed to its asset-backed sukuk). For example, *sukuk* holders have proportionate ownership in an underlying asset and are entitled therefore to proportionate return of the asset. However, the title they hold is beneficial and the interest vested in the asset equitable. The discussion on the alleged investor protection failures of the *sukuk* instrument highlighted that the asset-based variety is particularly challenged in this aspect (although, in practice, the asset-backed *sukuk* is also risky from the point of view of receiving redress on default). In the case of Iran, however, due to the extremely high measure of state control and ownership, such fears remain largely unfounded.

Another interesting point is that issuers of *sukuk musharaka* (partnership instruments) are under an obligation to pay annually the respective *sukuk*-holders a fixed sum as payment on account. On a first glance, this constitutes payment of interest. However, jurists justify the practice with the pre-condition of the issuance of *sukuk-musharakah* that the issuer is required to present a proposal, demonstrating the expected profitability of the project. The critique this arrangement faces is based in the argument that a *Shariah*-compliant issuance cannot contain profit that has been fixed in advance. In addition, *sukuk musharaka* does not fall in the classes of *sukuk* which offer more predictable return (such as *sukuk murabaha*, *sukuk salam*, *sukuk ijara* and *sukuk istisna*).

Broadly speaking, the guaranteed redemption of the principal and return on the above instruments is controversial from the perspective of *Sunni* Islam. The justification offered by Iranian jurists is that since profit for these instruments is predictable, it is not incompliant with *Shariah* to guarantee redemption of principal and return. Furthermore, in their opinion the contractual obligation of the issuer to deliver profit should not be neglected since the investments were collected on the basis of a proposal that has been pre-agreed and approved by financial experts. As the argument goes, not guaranteeing redemption on their investment, would be inequitable to investors.

With respect to accusation of committing *riba*, Iranian law distinguishes between the imposition of ordinary and excessive interest, which coincides with the view of some *Sunni* jurists. In addition, as regard accusations of committing *gharar*, Iranian jurists differentiate among major uncertainty (*gharar fahish*), which is prohibited by default and minor uncertainty (*gharar yasir*), which is socially acceptable. In the same vein, Iranian jurists prohibit only unreasonable risk and unnecessary uncertainty in financial transactions. It could be concluded that the Iranian regulator endeavors to build a transparent and efficient market, shaped by considerations of pragmatism rather than excessive religious strictness.

A separate point that could be made is that this original approach is the outcome of the preserved in the *Shia* tradition practice of *ijtihad* (legal reasoning). While the *Sunni* Muslims largely believe that all that was worth saying has already been said, thus effectively restricting *ijtihad* to those who are exceptionally qualified to practice it, *Shia* have left the doors of the dialog open.

Indeed, the *Shia* have supported *ijtihad* through their history, which is reflected in the revered status of their *Ulama*. In distinction, *Sunni* radicals, Islamic modernists, revivalists and salafists have resumed the application of *ijtihad* only recently. However, the permissive approach to legal reasoning demonstrated at present by most (admittedly large) factions of the Muslim community, demonstrating close linkage to revivalism, is arguably instrumental to their revolutionary strategies. To this end, *ijtihad* is used by such factions as a tool to reason through preconceived notions and to shape them according to the respective political aims. Foreshadowing the discussion on *jihadi*-salafism, the inclusion of everyone in the process of *ijtihad*, even those not traditionally qualified to pass a judgment on legal issues, supports the above conclusion.

This work discussed *jihadi*-salafism as a way of understanding the rationale and relevance of ISIS, an organisation, which recently aspired to establish a legitimate Islamic Caliphate. Salafism is a trend in the Muslim faith, which places great weight on the pursuance of piety. Similar to revivalism, it calls for returning to the golden age of Islam and emulating the early generations Muslims across all aspects of life. In the 18th century this ideology penetrated into the doctrine of Wahhabism, currently dominant in Saudi Arabia. Through the Wahhabism, which disseminated it across the Muslim world, salafism reached greater prominence.

Similarly to the *Sunni* traditionalists, salafists believe that one should derive guidance only from the *Qur'an* and the *Sunnah*. However, they reject the doctrine of *taqlid*, which demands one's obedience to those early religious teachers of Islam who have made successful pronouncements on the matters not addressed or not explained fully in the *Qur'an* and the *Hadith*. Salafists reject 'the unquestioning acceptance of the legal decisions of another without knowing the basis of those decisions', believing that one must return to the sources of Islamic law and independently decide on the substance of the religious message. This attitude to *taqlid* was shared by 19th and 20th centuries' members of the Hanbali School and the Wahhābī reform movement. The democratic character of such an approach to *taqlid* cannot be understated.

The form of *jihadi*-salafism embraced by ISIS amalgamated the salafist tradition with ideas derived from the early writings of the Muslim Brotherhood. Even though the beginnings of the Brotherhood were far more overtly radical than how they are currently known, the movement was more moderate than the *jihadi*-salafists. This was displayed in their lack of hostility to other Islamic denominations and sects, and in the fact that although the movement embraced the idea of the Caliphate, it perceived it as a long-term goal rather than an immediate aspiration. As history demonstrated, ISIS, which rose from the most radical wings of the Brotherhood, diverged from this by adopting a pro-active approach to the establishment of the Caliphate and engaging in a direct conflict with those who identified in a different denominational way.

While it has been argued above that the rejection of *taqlid* demonstrates a democratic aspect of the *jihadi*-salafist's credo, it cannot be denied that salafism inspired ISIS to reject political and legislative democratic power. For instance, armed with the salafists' understanding that anyone who revers saints and their tombs is an apostate, ISIS used analogy (*qiya*) to declare democrats apostates too on the basis of their desire to legislate (which they deemed an infraction, because legislation is prerogative of the Divine Legislator). In contrast to the approach of the *Shia* revolutionaries, theirs justified the replacement of existing systems of governance with *Shariah* law without having to provide evidence for the transgressions of the respective secular governments they have come to topple. The distinction in the respective strategies is very significant and speaks volumes, among other things, about the organization's drive for efficiency. *Prima facie*, this makes it possible to suggest that should ISIS' caliphate has been successful, they would have wiped out the indigenous financial system, replacing it with simple trade of goods and commodities. However, it is possible that they choose another avenue, for example, a more pragmatic one, and restrict its financial system to just a few Islamic derivatives, perhaps those which would facilitate their trade with commodities.

This possibility is supported by the thesis' analysis of ISIS funding strategies, arguing that, depending on how the transaction for the sale of oil was structured, oil futures may have been used. Whether this would have been the case would have very much depended on how and when ISIS got paid for the delivery of the commodity, whether there was deferred delivery and/or deferred payment and whether crypto currency was involved. Furthermore, considering that ISIS is known to retain technical expertise from previous government and private sector regimes and promote limited state ownership of industry beyond regulatory and taxation roles, it is not impossible that a successful ISIS metamorphoses in a technocratic, right wing government, which would inevitably preserve some of the most efficient aspects and instruments of the Islamic finance framework.

Whichever way they would choose, it would be imperative for them to adhere to the identity, which they helped create over the course of their advent. As pointed out in this thesis, Islamic religious identity has been applied reliably for the purposes of delineating political power. To this end, the ever increasing extremism of ISIS had not just the purpose to shock in order to assert, but also, to create a common identity of the subjects of the caliphate. While this identity would be incomplete at the beginning, its simplicity would help detect those who did not belong to (the ever fluid caliphate) in an ideological and political sense. This suggests that even if the radical organisation styles itself as a technocratic right-wing government, it would be openly non-democratic and ideologically extreme albeit perhaps sufficiently advanced in a technological sense. This would not exclude ISIS devising their unique Islamic finance version, more efficient and investor friendly than the one discussed in this work. Arguably, in a state where governmental power is centralised, both objectives could be delivered on more easily - as pointed out on numerous occasions, one of the greatest weaknesses of the current Islamic finance framework is the lack of harmonisation between the many jurisdictions.

As a last point, which relates to the above, it is conceivable that part of what caused the complexity of *Sunni* financial instruments is the constant need of the industry to appease not just the *Shariah* boards responsible for the approval of the respective instruments but also the many *Shariah* scholars discussing on the issue of religious compliance. Arguably, a centralized government would help in this regard too – albeit undemocratic – because instruments would benefit from a single rule book, covering the technical and *Shariah* elements of the transactions.

An argument that this could be the possible path of an extremist technocratic government is supported by data, discussed in the thesis, that in addition to other beneficial factors, such as oil reserves and political stability, countries with a developed Islamic finance sector measured better in terms of GDP. However, the research also suggested that the development of Islamic finance appears stagnated as a result of *Shariah* compliance considerations. More specifically, this author argued that the post-colonial Muslim economies are currently experiencing a period of secular stagnation, which could occur when the traditional culture opposes processes of adaptation and growth. In the Islamic finance context, this opposition takes the form of the distrust of revivalists and perhaps even more so, of traditional *Sunni* scholars of the modern Islamic finance.

To recall, the objections of these scholars are based on three fundamental arguments.

- that structures, such as organised *tawarruq*, undermine the credibility of Islamic finance across the Muslim and non-Muslim industry and customer base, because it demonstrates that Islamic finance often simply mimics conventional finance. This tendency becomes particularly unjustified, where such suspect practices are ultimately more expensive to the contracting parties.
- that simply mimicking conventional financial instruments actually stifles innovation and development in the Islamic finance sector.
- that structures mimicking their conventional counterparts hurt the public interest by hindering the negotiations between Islamic finance institutions and global regulators. Specifically, this would provide fewer opportunities to tailor the global regulatory framework to suit that of Islamic finance.

The stagnation in the Islamic finance sector referred to earlier could therefore be caused by non-economic factors. From the point of view of Western philosophy, stagnation is the opposition of progress, which is manifested through ‘freedom, happiness or utility, and the realization of human capabilities.’ In this narrative, progress equals wellbeing. However, to label the processes developing in the Muslim world as lagging behind in progressive developments would equate ignoring the specificities of Islamic beliefs. These beliefs fundamentally question the importance of economic development when juxtapositioned to Islamic religious and moral values. In their understanding, the wellbeing of the *Ummah* would best be achieved by adhering closely to *Shariah*’s premises.

This suggests that, on a strict reading of *Shariah* law, causing under-development or under-achievement would be irrelevant as long as it increases individuals’ wellbeing. In the Islamic religious narrative, this would be the only rational behaviour because it promotes progress as understood in the Islamic philosophical tradition.

The importance of this conclusion is significant. The analysis of this work suggested that the Islamic world exhibits a tendency of conversion of beliefs which is particularly evident in the sphere of radicalism. Furthermore, such ideas tend to circulate successfully without meeting with serious scholarly opposition. This impacts the development of Islamic finance in two principal ways.

First, the “soft radicalism” of the purists constantly criticizing the current Islamic finance framework intervenes with the market with varied success, perhaps causing unfavorable fluctuations due to legitimacy concerns.

Secondly, the flexibility exhibited by the *Sunni* traditionalists in their pursuance of order over chaos explains their tolerance of a framework which is often accused of parroting conventional finance and surreptitiously introducing forbidden by *Shariah* law principles. While at present this flexibility allows the *Sunni* world to open to ostensibly modern economic practices, it could eventually shift in direction of hard-lining and consolidation behind a more uncompromising entity. Such outcome is more likely to be arrived at if Islamic finance fails to solidify its ideological foundation in a way accepted across the Islamic world.

13.14. FinTech in Islamic finance

As a last point this work considered the impact of FinTech on objectives of risk management and development. The author considered the report of the Financial Stability Board (FSB), which summarised the potential benefits of FinTech, which were said to contribute to the 'decentralisation and increased intermediation by non-financial entities; greater efficiency, transparency, competition and resilience of the financial system; and greater financial inclusion and economic growth, particularly in emerging market and developing economies.'

Parallel to that, the Board noted the microfinancial and macro-financial (e.g. non-sustainable credit growth, increased interconnectedness or correlation, incentives for greater risk-taking by incumbent institutions, procyclicality, contagion and systemic importance) risk related to financial technologies. It is significant that the analysis on *sukuk* highlighted that much of the micro financial risks inherent in FinTech (e.g. credit risk, leverage, liquidity risk, maturity mismatch and operational risks, especially cyber and legal) are applicable to investments in *sukuk* issuance. This would be particularly the case as regard credit risk and maturity mismatch. To this end, it could be suggested that from a micro prudential perspective, the introduction of technology in *sukuk* issuance, which has started taking place, could increase the existing *sukuk*-specific challenges and must be watched closely.

It is encouraging that with respect to cryptocurrency, which is arguably the most risky element introduced by FinTech, Muslim States' governments appear to react in a timely manner with a host of legislation promulgated in Indonesia, Pakistan, Saudi Arabia, UAE, Bahrain, Kuwait and Qatar, to name just a few. Furthermore, in 2019, Malaysia, which is one of the biggest players on the market, imposed harsh new ICO and cryptocurrency laws.

Also of interest is the issue of legal and regulatory risk posed by FinTech. As identified in the FSB Report, there is a problematic lack of regulation and most specifically globally consistent regulation. The suggested cross jurisdictional lack of legal certainty regarding FinTech related issues, including regulation of cross-border trading and ownership, particularly as regard smart contracts and robo-advice, brings an analogy to the framework of *sukuk*, which was seen to display similar issues. Since the area of the Islamic finance experiences significant regulatory challenges which are due to lack of harmonisation, it is arguable that any introduction of financial technology in the incumbent activities must be done carefully and with attention to the already identified challenges.

Failure to do so would likely realize the risk of contagion, entailed in FinTech, bringing to the market the issues of reputational contagion and contagion through over-reliance on automation. The research suggested that although the former is more likely to operate among retail users, increasing the risk of procyclicality, the latter may have stronger micro prudential consequences, particularly if its outcome would be the creation of weak entry points.

Procyclicality could be a significant problem on the crossroad between FinTech and Islamic finance. As noted, retail customers, including investors, are typically more sensitive to market panic and prone to herding behaviour. This consequence could only be exacerbated by the unpredictable dynamics of FinTech enabled lending or investing platforms. While it has been identified that sourcing of capital is a particularly sensitive issue for FinTechs, which are heavily dependent on investors' confidence in them, it has not been examined how this problem will play out when FinTechs venture into instruments, such as *sukuk*. The uncertainty as to the outcome of this partnership would be increased if other relevant risks enter the equation, such as the risk of lowering of lending standards and failing to accurately assess credit quality.

The above should not take the attention away from the undoubted benefits which FinTech could bring to Islamic finance. The ability of FinTech to promote inclusion and efficiency through higher speed and lowering of the costs cannot be overlooked. Furthermore, the challenged faced by Islamic Finance include competition from the sector of the conventional finance. To this end, FinTech could create many opportunities for Islamic financiers and Islamic finance firms to become and remain competitive in an ever changing market.

Nevertheless, the points of concern raised above should not be overlooked because combining the risks presumed to be inherent in FinTech with those already identified in the Islamic finance framework, most notably *sukuk* issuance but also in the area of Islamic contracts more broadly, may contribute to a potentially unsustainable regime.

13.15. Recommendations

13.15.1. Overview

This research established that the Islamic financial instruments display structural deficiencies, which render them potentially problematic from an investor protection point of view. These deficiencies are due to the hybrid structure of the relevant instruments, which comprises of features borrowed from their conventional counterparts, incorporated to work in a *Shariah* compliant manner. The problem of this arrangement is that the hybridization of the instruments inevitably changes their nature. What occurs at the end is an instrument which is neither truly compliant with *Shariah*, nor is it sufficiently recognizable under the conventional and more specifically, English law framework. Furthermore, to the point certain English law features have been absorbed in Islamic finance, this has been done without having the robust prudential and investor protection framework of English and EU law in place.

In addition, the currently used Islamic financial instruments suffer from weaknesses due to their complexity and lack of transparency. These problems were highlighted in the discussion on *wa'd* and particularly in the discussions on structuring of complex arrangements, such as Islamic derivatives and *sukuk*. This results in costly transactions, with cost here being measured in terms of invested time, money and legal expenses. These arrangements are, in addition, very risky. Unfortunately, the risk is borne by the weaker party, which is contrary to what *Shariah* law preaches.

To this end, two sets of recommendations could be made.

13.15.2. With respect to Islamic derivatives

First, transactions could be stripped of their complexity by the introduction of novel terms and approaches. For example, there could be a preamble to each contract, the signing of which would confirm that the stage of *wa'd* (and all other stages of transaction, which are there solely for the purposes of rendering the contract *Shariah*-compliant) is assumed to have taken place. This could be done in the case of *tawarruq*, *wa'd-murabaha* or the like. As Islamic contract law holds the intentions of the parties in high esteem, the suggested approach would not diverge from the parties' intentions, as stated in the current *wa'd murabaha* or *tawarruq* contracts, or in the current *wa'd* based Islamic options. The same approach could be applied to other complex structures, where the complexity is due to *Shariah* compliance issues.

Secondly, completely novel, *Shariah*-compliant, instruments could be devised, the structure of which would incorporate the above suggestion, therefore skipping completely the phase where small transactions are piled up in order to demonstrate compliance. To guarantee that interest has not been improperly accrued, any amount above the administrative expenses should be diverted to charity – for example, in the creation of a framework for further financial inclusion of the population, financial education or similar avenues. These instruments should preserve the principle of profit and loss sharing in order to guarantee that both parties are incentivized to participate in the transaction.

13.15.3. With respect to sukuk

The *sukuk* arrangements could benefit from a revision of the *sukuk* structure towards making it more palatable for the conventional regulator (which would positively affect conventional financiers' investment in *sukuk* issuance). However, this appears challenging to do, considering the issues of *Shariah*-compliance. With this in mind, it is suggested that the best solution for the framework would be to introduce stricter local regulation of the product, particularly concerning the aspect of default.

Alternatively, investor protection in the case of asset-based *sukuk* could be achieved by setting a fund, held on trust by the respective government, where every issuer or originator is obliged to invest a certain amount of money, guaranteeing that in the event of default, its investors would be repaid. Issuers could be licensed subject to this conditions (in addition to other applicable conditions) being satisfied. While very onerous, this measure would guarantee that only commercially viable projects will be offered for funding by the public or that alternatively, originators will revert to the practice of asset-backed *sukuk*. To ensure that the money in the fund are applied in an efficient way, they could be invested in other commercially viable and *Shariah*-compliant projects.

A more issuer-friendly solution would be to follow the German example and request that assets from the asset pool be registered in a refinance register and deemed assets belonging to the beneficiary, thus allowing to be claimed by him in case of the originator's insolvency.

Appendixes

Appendix A[1341]

Adoption of AAOIFI Shariah Standard No. 17 pertaining to 'Investment Sukuk''
In order to standardize and harmonize Shariah practices in IBIs, AAOIFI Shariah Standard No. 17 related to 'Investment Sukuk' has been adopted. The Standard is applicable subject to clarifications/amendments as mentioned hereunder:

1. "The word 'certificates' used in the Standard may be read interchangeably for 'Sukuk'.
2. **Clause 1:** The following clarification is added as footnote to the clause: "As the standard covers various types of Sukuk, in case of any query, the provisions/rulings of relevant mode may be referred. For example, in case of query on Ijarah Sukuk, the Shariah Standard on Ijarah may be referred. Further,
AAOIFI Resolution on Sukuk issued in February 2008 which provides necessary explanation to the subject Standard is also adopted with this standard.
3. **Clause 2:** The following is added as footnote to the clause: The phrase 'undivided shares' appearing in the clause may be read as 'undivided share'.
4. **Clause 3/2/2:** The following is added as footnote to the clause which defines Ijarah Mowswoofa fi

[1341] Adoption of AAOIFI Shariah Standard No. 17 pertaining to 'Investment Sukuk' https://webcache.googleusercontent.com/search?q=cache:xpbUbfoIEjoJ:https://www.sbp.org.pk/ibd/2013/C3-Annex-A.pdf+&cd=11&hl=en&ct=clnk&gl=es&client=firefox-b-d accessed 12th June 2019.

Zimmah certificates: ‘The Ijarah Mowsoofa fi Zimmah’ referred to in the clause means Ijarah of described but unidentified assets or services.’

5. **Clause 3/2/3:** The following footnote is added to the clause: “The phrase ‘subscription income’ used in the clause may be read as ‘subscription revenue’.”

6. **Clause 4/3:** The following is added as footnote to the clause: “The term ‘Sharia-nominated’ used in the clause may be read as ‘Shariah-compliant’.”

7. **Clause 4/4:** The following clarification is made with respect to the clause: “The clause may be read as ‘The trading of investment Sukuk is subject to the terms that govern trading of the assets they
represent.”

8. **Clause 5/1/5/2 (c):** The following is added as footnote to the clause: “The holders of these Sukuk listed at a, b, and c of the clause are entitled to the revenue generated by onward sale of these services”.

9. **Clause 5/1/5/10 & 5/1/5/11:** The following is added as footnote to the clause: “The phrase ‘maintaining cost’ in these clauses may be read as ‘maintenance cost’.

10. **Clause 5/1/8/4:** The following is added as footnote to the clause: ‘Islamic bank investing in such Sukuk shall put in place a mechanism to satisfy itself regarding the Shariah compliance of the Sukuk during its entire duration’.

11. **Clause 5/1/8/7**: The following is added as footnote to the clause: “The clause pertains to Sukuk based on Shirkatul Aqd and not on those based on Shirkatul Milk”.

12. **Clause 5/2/2:** The following is added as footnote to the clause: “The impermissibility of undertaking by the issuer to purchase the sukuk at nominal value is not applicable on sukuk based on ‘Shariktul Milk’ or ‘Ijarah’. Further, the term ‘negotiable sukuk’ used in the clause may be read as ‘tradable sukuk’.

13. **Clause 5/2/5:** The following is added as footnote to the clause: “This clause is applicable on sukuk issued on the basis of portfolio of already leased assets only.”

14. **Clause 5/2/7:** The following is added as footnote to the clause: “In cases of sukuk based on sale-andlease-back, the issuer shall not repurchase the leased asset from the sukuk holders before the
completion of one calendar year.”

15. **Clause 5/2/14:** The following is added as footnote to the clause: “However, trading of Salam sukuk is permissible only after taking delivery of the goods and before their onward sale.”

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Resumen de la disertación

Maria B Todorof

VIABILIDAD DE DERIVADOS EN EL ISLAM RADICAL

Introducción

Las finanzas son tanto un producto de las elecciones políticas de la sociedad como de las económicas, las cuales darían forma al marco respectivo de diferentes maneras. Sin embargo, mirar de cerca las finanzas islámicas nos hace darnos cuenta de la presencia de una tercera fuente de influencia: la religión o, por supuesto, la falta de ella.

Al hacerlo, las finanzas islámicas introducen la espiritualidad y, de hecho, la moral, en un marco, que a menudo parece olvidar principios como la caridad, el perdón y el cuidado genuino del prójimo. Sin embargo, sería un error suponer que las consideraciones de moralidad no entran en la narrativa de las finanzas convencionales. La evidencia de que lo hacen y lo hacen a menudo se ve en el número de disposiciones legislativas destinadas a garantizar de manera más general el estado de derecho y, más específicamente, la protección de los consumidores e inversores dentro de las jurisdicciones convencionales.

Naturalmente, las finanzas convencionales no prevén la base religiosa de estas disposiciones orientadas al consumidor. Por el contrario, si bien las finanzas islámicas justifican sus principios más amplios al referirse a fuentes religiosas, las finanzas convencionales se rigen por consideraciones de lo que sería la elección racional en un conjunto particular de circunstancias, ¿cómo deben equilibrarse los intereses (ocasionalmente) enfrentados de los participantes del mercado contra cada uno de ellos? otro y, en última instancia, cómo puede continuar la búsqueda del crecimiento económico sin poner en peligro la salud del sistema financiero. Sin embargo, sobre todo, las finanzas convencionales han abrazado el objetivo de maximizar el valor en oposición al bienestar islámico del modelo centrado en la comunidad.

Con esta notable excepción, las finanzas convencionales e islámicas persiguen objetivos similares: garantizar el suministro de fondos para la operación eficiente del comercio, la inversión y la planificación financiera a largo plazo. Ambos sistemas reconocen que las finanzas son el motor, que impulsa la empresa, crea empleos y paga impuestos en el proceso, apoyando indirectamente una gobernanza estatal exitosa. No sería descabellado decir que estos objetivos forman la razón fundamental de las finanzas como disciplina, incluidas las finanzas islámicas.

Sin embargo, las similitudes básicas en los objetivos de los dos sistemas no disminuyen las diferencias entre ellos, ni ocultan el hecho de que cada sistema deriva su libro de reglas de una fuente fundamentalmente diferente. Con este fin, el hecho de que las finanzas islámicas se basan en sus principios de la religión, en oposición a la regulación secular, sugeriría que cualquier aumento en la observancia religiosa en un país en particular influiría en las normas que regulan las finanzas, con el fin de hacerlo más compatible con la Shariah. ley.

Cuerpo sustantivo de la investigación

La intención de este autor era proporcionar una descripción honesta e imparcial de las finanzas islámicas y cómo encaja dentro del contexto legislativo financiero más amplio.

La estructura de este trabajo se vio afectada por el hecho de que este pequeño bocado de la producción jurisprudencial islámica está muy afectado y depende de los principios religiosos. Para permanecer fiel a su nombre, las finanzas islámicas tuvieron que ser enteramente extraídas de las premisas del Islam. Una de las preguntas que esta investigación hizo indirectamente, por lo tanto, fue si realmente no ha habido contaminación con influencias externas, más específicamente la de las finanzas convencionales.

La visión histórica del desarrollo de las finanzas islámicas sugiere que, al menos al principio, se superpuso como un concepto con el de la banca islámica. A pesar de su relativa inmadurez, el sector creció en popularidad, lo que fue confirmado por el desempeño estable de los bancos islámicos durante la crisis financiera global de 2007-2008. La aparente resistencia a los shocks financieros, demostrada por los bancos islámicos, atrajo la atención de los analistas y ayudó a introducir este método alternativo de financiación más ampliamente dentro del marco financiero convencional. El examen del desempeño de los bancos Shariah sugirió que, a pesar de su menor rentabilidad en comparación con los bancos convencionales, los primeros son más propicios para la estabilidad que los segundos. El enfoque del marco para el pago de intereses y la elección de la cartera de productos se acreditaron como las principales razones de este éxito.

Las elecciones operativas hechas por los bancos islámicos fueron informadas por la dependencia de las finanzas islámicas de los principios de la ley islámica. Esto justificó una amplia introducción de las premisas relevantes en este trabajo.

El punto de partida de la investigación fue reconocer que Shariah es el "camino", y lo que los musulmanes consideran una guía general que los lleva a una vida piadosa. Esta guía impregna todas las dimensiones de la vida del devoto: tanto espiritual como secular, infundiendo tanto los principios éticos como morales propuestos por el Islam. Debido a esto, la ley Shariah gobierna el área de las finanzas desde una perspectiva técnica pero también religiosa, imponiendo diversas prescripciones y prescripciones, incluyendo consideraciones sobre el impacto de las acciones de la comunidad en la justicia social y la equidad en el amplio mundo musulmán.

Este enfoque sugiere que el marco de la ley financiera islámica se considera directamente relacionado con otras áreas de la vida. Por ejemplo, la prohibición de intereses no es solo un dispositivo financiero; sirve para garantizar que los musulmanes habitarán un sistema económico libre de intereses donde no hay explotación ni acumulación inadecuada de capital. En última instancia, a pesar de reconocer que las finanzas tienen sus objetivos y limitaciones, Shariah allana el camino para que las finanzas islámicas hagan de la Ummah una sociedad más amigable con la comunidad. La importancia ideológica y la sinceridad de esta búsqueda parecen distinguir el marco islámico de la alternativa occidental. Sin embargo, a pesar de estos elevados ideales, debido a la globalización, las últimas décadas fueron testigos de una fecundación cruzada cada vez mayor entre las finanzas islámicas y las convencionales. El impacto de esto se discutirá en breve.

Como se destacó en el análisis de este trabajo, los principios de la ley islámica se derivan del Corán (el libro sagrado islámico) y la Sunna (la sabiduría acumulada de por vida de los musulmanes), así como de la Fiqh, el cuerpo de jurisprudencia producido por eruditos islámicos. Es importante destacar que la sabiduría del Corán se considera inmutable y se aplica mediante el gobierno a través de conceptos amplios y principios éticos y morales abstractos. Junto con la

Sunna, el Corán influye en Fiqh, que es, sin embargo, mutable y detallado, y cierra las brechas que han quedado en la jurisprudencia islámica. Esta división es relevante para las finanzas islámicas porque permite la introducción y su escrutinio previo y posterior de conceptos e instrumentos novedosos en el marco. Con este fin, Fiqh sirve como una fuente de conocimiento constantemente actualizada contra la cual se prueban tales innovaciones.

Además, la interacción de diferentes fuentes de derecho contribuye a un fuerte sesgo hacia el bien de la comunidad en oposición al del individuo. Este enfoque se aplica también en las finanzas islámicas. En este contexto, los intereses de la comunidad en general se perciben como alineados con los de la institución financiera, lo que ayuda al sector a lograr sus objetivos generales macro y micro prudenciales.

Prohibiciones en las finanzas islámicas

Las prohibiciones de la ley Shariah, relevantes para las finanzas, incluyen la prohibición de intereses, la prohibición de tomar riesgos excesivos, la especulación y el juego, los ingresos no ganados y el comercio de productos e industrias prohibidos. Si bien no todas las prohibiciones son iguales, están destinadas a funcionar en un todo holístico. Entre ellos, la prohibición de riba (interés) es quizás la prohibición más importante impuesta por la ley islámica. Si bien el significado de riba se refiere a la imposición de un interés excesivo, es decir, "usura", la situación actual es que toda riba está prohibida en el mercado financiero islámico. El resultado práctico de esta prohibición es que los prestamistas no pueden cobrar intereses sobre los préstamos. Lo mismo se aplica a las inversiones, contratos de venta y similares. La justificación de Shariah para riba es que cobrar intereses sobre el dinero comprende el "aumento injustificado de capital".

Como se señaló, el tema de la justicia es particularmente fuerte en el Islam y la actitud hacia riba es una parte esencial de su filosofía. Además, la prohibición aborda el acto de ganar dinero con dinero, de esta manera convertir el dinero en una mercancía, que está estrictamente prohibido en el Islam. Este rechazo de uno de los principios fundamentales relacionados con el uso del dinero por las finanzas convencionales se explica por los argumentos de que el dinero no tiene valor temporal. Además, convertir el dinero en una mercancía separaría las finanzas de la economía real y es lo último lo que promueve el Islam.

La aparente impracticabilidad, desde el punto de vista financiero convencional, de no poder obtener intereses sobre el dinero prestado, ha sido contrarrestada de alguna manera por las finanzas islámicas a través de la introducción de la regla sobre la distribución de ganancias y pérdidas entre las partes en una transacción. Este principio se considera fundamental para el sector y se aplica en todo el marco. Como solo un ejemplo de esto, la tesis discutió el caso del sukuk perpetuo. Una de las debilidades del instrumento, en términos de su cumplimiento con la Shariah, fue la práctica de los creadores de garantizar la recepción de pagos periódicos.

Desde un punto de vista religioso, riba está prohibido porque corrompe a la sociedad. Por ejemplo, el Corán ve a riba como zulm (fundamentalmente injusto) y destructivo. Se entiende que el efecto nocivo de riba llega como resultado de la apropiación de la propiedad de la contraparte, que la práctica de interés se percibe como una ayuda a la normalización. Con este fin, el efecto riba se considera apropiación indebida, ya que la riqueza adicional generada por los intereses se interpreta como una multiplicación de dinero y no un esfuerzo. Se dice que esta calidad de riba degrada a las personas y disminuye su personalidad, eventualmente trasciende en el sistema financiero y conduce a un crecimiento negativo, inestabilidad financiera y, en última instancia, a la desaparición financiera de la sociedad. Finalmente, desde el punto de vista del Corán, las desventajas técnicas de riba se deben a su desconexión de la economía real con sus transacciones simples y predecibles.

La diferencia con las finanzas convencionales es sorprendente ya que el interés es fundamental para la banca convencional. De manera relevante para esta discusión, precisamente por su fundamentalidad en el proceso de creación de valor, el interés ha sido institucionalizado y estrechamente regulado en el marco financiero convencional, convirtiéndolo en una fuente estable de ingresos. Este es un punto importante porque, como se verá más adelante, la falta de aceptación del interés en el marco financiero islámico (junto con otros factores), condujo a una falta de regulación integral con respecto a los instrumentos, que supuestamente solo cumplen con la Shariah. .

Además, la prohibición de intereses resulta en la falta de recompensas predeterminadas para los clientes que realizan transacciones con instituciones financieras islámicas. Esto es previsible para los clientes musulmanes, porque lo contrario habría infringido la regla de compartir ganancias y pérdidas. Sin embargo, desde la perspectiva del inversor convencional, tal comportamiento es inaceptable porque interfiere con su capacidad para una gestión a largo plazo de sus finanzas.

Los estudiosos islámicos ven los aspectos negativos para la economía real, que fluye de riba, en la desigualdad entre las partes que realizan transacciones, que tienden a crear los desapegados de los mercados financieros de la economía real. En su opinión, esta desigualdad es provocada, entre otras cosas, por asimetrías informativas. A pesar de lo anterior, ha habido voces de que la prohibición debe ser relajada porque impacta negativamente en el desarrollo de la industria financiera y, en consecuencia, en el de la comunidad musulmana. Los críticos de la prohibición han apuntado hacia la capacidad de interés para promover el equilibrio entre la oferta y la demanda de capital y para facilitar su asignación eficiente. Los defensores de la relajación de la prohibición han argumentado que si bien el argumento de la explotación era válido en los primeros siglos del Islam, este ya no es el caso debido a los cambios en la sociedad. Esto sugiere que para algunos académicos la prohibición del interés ha sobrevivido a su utilidad social.

La existencia de críticas dirigidas a la prohibición de riba es significativa por varias razones. Primero, demuestra que el Islam no está completamente cerrado al desarrollo futuro de sus principios y que se escucharán las voces de la minoría. Es importante destacar que la práctica de ijtihad (razonamiento independiente) se apoya en los barrios más radicales del Islam (por ejemplo, en el salafismo y en el entorno chiíta más amplio). En segundo lugar, las críticas reflejan, aunque no siempre mencionan abiertamente, el hecho de que los instrumentos financieros islámicos son generalmente vulnerables a las acusaciones de cometer riba porque muchas de sus prácticas parecen incluir interés, aunque disfrazado en una forma sabrosa de la Shariah.

La prohibición de los juegos de azar (al-qimar) también es de interés para este análisis. La prohibición justifica la prohibición de apostar y apostar con el argumento de que necesariamente crearían un ganador y un perdedor, algo que el Islam considera inherentemente injusto. En el área de las finanzas islámicas, al-qimar prohíbe las inversiones en empresas excesivamente riesgosas, ganancias excesivas o manipulación anormal de precios, así como todas las prácticas comerciales inmorales. Vinculada a al-qimar, la prohibición de maysir (juegos de azar) prohíbe asumir riesgos que implicarían la apropiación ilegal y la ganancia de uno a expensas de otro. Debido a lo estricto de esta prohibición, se prohíbe la mera participación en maysir, incluso si el resultado financiero es negativo para la parte que realiza la transacción. Con respecto a las finanzas islámicas, estas dos prohibiciones le impiden utilizar derivados particularmente riesgosos como los derivados sintéticos o los futuros convencionales.

Quizás la prohibición más interesante, después de la de riba, gharar prohíbe asumir riesgos excesivos e incertidumbre en las transacciones financieras. Además, gharar opera con respecto a conductas desagradables como engañar a las partes contratantes y entablar acuerdos que se ven afectados por la incertidumbre. A diferencia del modelo occidental, basado en el modelo de riesgo, la prohibición ampliamente interpretada de gharar exige que las partes en la transacción no sean engañadas debido a incertidumbres en los términos contractuales o la calidad del producto, sujeto al contrato. Es importante destacar que gharar se aplica a la información incierta o insuficiente con respecto a la transacción. Por ejemplo, la propensión de las finanzas islámicas a operar a través de transacciones complejas puede verse como una violación de la prohibición gharar porque impide que los clientes (particularmente los inversores minoristas) identifiquen adecuadamente el riesgo transaccional. En términos prácticos, el incumplimiento de gharar puede dar lugar a una llamada de incumplimiento debido a la incertidumbre legal inherente, por ejemplo, incertidumbre sobre el cumplimiento de la Sharia del contrato. Como se ha visto, esto ya ha sucedido en la práctica.

Cuestiones de propiedad y propiedad en una perspectiva comparativa

Además de analizar las prohibiciones y su efecto en las finanzas islámicas, este trabajo se centró en dos aspectos filosóficos importantes de las finanzas islámicas. El primero fue una comparación entre los enfoques islámico y de derecho consuetudinario sobre el tema de la propiedad y la propiedad. El segundo fue la aplicación de la teoría de la justicia social en la ley islámica. Ambos puntos fueron discutidos debido a su impacto en el régimen financiero islámico.

Con respecto a lo primero, el autor comparó las definiciones de lo que se percibe como "propiedad" en cada sistema respectivo. Con este fin, la opinión occidental de que la propiedad es "un conjunto de relaciones, otorgando a una persona o a un grupo el control sobre un recurso específico frente a otras personas"), y la propiedad es "las relaciones legalmente reconocidas que tenemos entre nosotros con respecto a las cosas ”se contrastaron con el enfoque del derecho civil. En opinión de este último, el concepto de propiedad está contenido dentro de la cosa misma. El derecho, que se trata como ejecutable contra todas las personas, está en la cosa y esto es lo que establece el vínculo directo entre el titular del derecho y la cosa.

En comparación, las escuelas sunitas ofrecen cuatro interpretaciones diferentes de la propiedad. Para la Escuela Hanafi, esto solo podría ser "cosas" existentes en la realidad, que además tienen las siguientes cualidades: deseabilidad, durabilidad, ser beneficioso para las personas y cumplir con la ley de escasez y gasto. La Escuela Shafie ve la propiedad como algo con valor intercambiable, cuyo valor debe, además, beneficiar a las personas. Esto contrasta con el derecho consuetudinario, que no requiere que una "cosa" tenga un valor intercambiable específico para ser designada como "propiedad".

La Escuela Hanbali se centra en si la cosa puede beneficiar legalmente al propietario musulmán y si la legalidad de la cosa se mide con respecto a la ley islámica. La escuela hace una excepción al requisito de legalidad: se trata de circunstancias de extrema necesidad o necesidad (como hambre o pobreza extrema).

Finalmente, la escuela Maliki percibe la "propiedad" de una manera, que es muy similar a la del derecho consuetudinario. Es decir, ve la propiedad como algo que podría ser propiedad con el derecho correspondiente de excluir a otros de disfrutarla.

Si bien las Escuelas difieren en la interpretación de lo que constituye "propiedad", todas están de acuerdo con el postulado de la ley islámica de que Alá es el dueño absoluto de toda la propiedad, y que toda la propiedad se confía en Allah. Los propietarios humanos se consideran, por lo tanto, meros beneficiarios de la propiedad. Esto indica que la ley islámica diferencia entre los conceptos de propiedad y propiedad, a diferencia del derecho consuetudinario. Más bien, este último reconoce el concepto de derechos de propiedad (en oposición a la propiedad) existentes en relación con una cosa. Esta distinción ayuda a explicar el apego de las finanzas islámicas a la economía real, que se percibe como el único sector que proporciona valor real y verdaderos incidentes de propiedad.

Además, el carácter beneficioso de los derechos de propiedad de los humanos, que son vistos como vicerregentes de Allah, impide el desarrollo de un sofisticado mecanismo de ley de confianza. Esto afecta la capacidad de algunos de los instrumentos financieros islámicos, por ejemplo sukuk, para proporcionar protección suficiente a los inversores en caso de incumplimiento del emisor.

En línea con la posición del derecho consuetudinario, la ley islámica acepta la idea de "agrupar" los derechos de propiedad. El autor sugirió que, debido a la teoría de la fragmentación de los derechos persistente en la tradición anglosajona, el carácter fragmentado de los derechos derivados y la dependencia de los derivados de un activo subyacente se asemejan al concepto de conjunto de derechos del derecho consuetudinario, lo que hace que concepto de negociación de derivados particularmente atractivo para el inversor anglosajón.

Sin embargo, el enfoque de la ley islámica a los derivados fue fundamentalmente diferente. Dado que el Islam ve la propiedad como contenida en la cosa y no expresada a través de un derecho de propiedad, la ley islámica no percibe la agrupación de derechos como lo hace la ley común. Esta comprensión diferente está vinculada a la creencia fundamental de que las opciones del individuo y el rango de acciones con respecto a la propiedad de uno, están limitadas por el carácter beneficioso de la propiedad de las cosas por parte de los humanos.

La aplicación de la teoría de la justicia social islámica en las finanzas islámicas.

La aplicación de la teoría de la justicia social islámica en el derecho financiero islámico fue igualmente importante debido a su alcance integral. Un ejemplo de ello es el modelo de reparto de pérdidas y ganancias, que tenía como objetivo, además de evitar la prohibición de las riba e intentar promover prácticas empresariales cuidadosas, limitar la explotación de los pobres. Este principio fue informado además por la creencia de que es mejor aliviar las dificultades de alguien que crear riqueza para otra persona. A pesar de las similitudes prima facie con el sistema de bienestar occidental, el propósito de la teoría de la justicia social islámica es fundamentalmente diferente, ya que trata de crear un sistema que permita a los pobres participar activamente en el proceso de creación de riqueza en lugar de seguir siendo un receptor pasivo de bienestar o caridad. Esta estrategia, adoptada por la ley islámica, tiene como objetivo disminuir la desigualdad entre ricos y pobres. En el contexto de las finanzas islámicas, el principio de participación en las ganancias y pérdidas está destinado a disminuir la disparidad relativa entre las partes en las transacciones financieras. Con este fin, las protecciones e incentivos creados por el marco financiero islámico apuntan al curso de los negocios financieros y se esfuerzan por lograr una mayor participación e inclusión, incluso a expensas de la sofisticación.

Esta idea de las finanzas islámicas nace claramente de las tendencias políticas de izquierda, que permanecen en marcado contraste con la base capitalista de la banca convencional. Por ejemplo, los bancos en el sistema convencional obtienen la mayor parte de sus ganancias jugando con deuda y capital. Los bancos utilizan la deuda para adquirir activos, contribuyendo así a la rentabilidad de la institución. Lógicamente, esto no es característico de los bancos islámicos, no solo por las tendencias no capitalistas que se encuentran en la filosofía islámica, sino también porque el comercio de deuda está prohibido por la ley islámica. Curiosamente, si bien esta armonización de objetivos en la ley islámica sugiere una inclinación constante hacia la izquierda del espectro político, la falta de provisión para tomar verdaderas decisiones democráticas coloca la narrativa islámica firmemente en el territorio de la derecha política. Oportunamente, esta hibridación de la identidad política del Islam se refleja en la práctica, por ejemplo, Irán, que es el único estado islámico oficial, impone los ideales izquierdistas de la ley islámica a través de un gobierno de derecha. Como destacó el estudio de caso de Irán, los dos partidos más populares en el Irán moderno son el ala derecha (el partido en el poder) y el centroderecha (sus oponentes).

En un nivel más técnico, la distinción entre los sistemas financieros capitalistas e islámicos (y las instituciones de crédito) tiene una relevancia directa para la cuestión del riesgo y su gestión en cada sistema respectivo. Si bien el capitalismo recompensa el espíritu empresarial, no deja que la comunidad asuma la responsabilidad del riesgo empresarial. En el caso de los bancos, en teoría, el riesgo de pérdida causado por las acciones de los gerentes del banco es asumido por el propio banco (es decir, como una corporación y sin compartirlo con sus clientes). En la narrativa occidental, asumir el riesgo empresarial da derecho al banco a la recompensa en tiempos de resultados financieros positivos. En contraste, los bancos islámicos comparten ganancias y pérdidas con sus clientes, lo que significa que su estrategia de gestión de riesgos se basa en compartir el riesgo empresarial con la comunidad en general.

Una referencia más reciente a los bancos convencionales recuerda que se colocaron en una posición no tan diferente después de la crisis, cuando un marco fuertemente regulado resultó en que los bancos compartieran el riesgo asumido con un grupo más grande de partes interesadas. La distinción importante con las finanzas islámicas es que, en primer lugar, este cambio se aplicaba a compartir el riesgo solo en contraposición a las ganancias y pérdidas y, en segundo lugar, se limitaba al sector bancario.

Sin embargo, las críticas a menudo escuchadas contra emisores de finanzas islámicos que eluden este principio sugieren que la industria está luchando por adherirse a él. Podría haber un argumento válido de que los emisores y creadores están mejor preparados y en una mejor posición que los inversores para evaluar el riesgo de la inversión y, para este fin, insistir en que este último asuma la responsabilidad en pie de igualdad con el primero, sería injusto. Hasta el punto de que los inversores son conscientes de esta disparidad, es probable que el principio de participación en las ganancias y pérdidas sirva como disuasivo para su participación. Quizás se podría sugerir que este principio se relaja en lo que respecta a sukuk y se conserva para empresas donde el prestatario es un minorista y no un inversor institucional.

La aplicación del principio de participación en las ganancias y pérdidas de esta manera podría ser más fiel a las intenciones de la Shariah porque garantizará que no se llevará a cabo una supervisión nominal del proyecto y que las inversiones se realizarán solo si pueden satisfacer el requisito de rentabilidad y eficiencia. uso de recursos. Desde la perspectiva de la viabilidad de los instrumentos financieros islámicos, relajar el principio de participación en las ganancias y pérdidas con respecto a sukuk hará que sea menos probable que el instrumento falle, ya que garantizará los intereses de los inversores y emisores. La equidad inherente de este resultado, junto con la utilidad del instrumento será un argumento para su preservación incluso en un entorno regulatorio más extremo.

Sin embargo, la sugerencia anterior debe considerarse a la luz del hecho de que, además del principio de compartir el riesgo, la estrategia de gestión del riesgo financiero islámico incluye la imposición activa de las prohibiciones sobre riba, gharar y maysir. Esto se justifica con una inmoralidad percibida inherente a los actos de engaño e ilusión (incluida la auto ilusión). Por el impacto combinado de estos tres principios, el sistema logra dos objetivos. Primero, trata el tema de la espiral de la deuda, evitando así el empeoramiento de la situación financiera de las personas pobres y, a mayor escala, al restringir la especulación financiera, respalda un sólido marco micro y macro prudencial.

Considere, sin embargo, que este éxito viene con ciertas compensaciones negativas. Por ejemplo, gharar junto con maysir crea una prohibición, evitando la introducción de seguros convencionales en la ley de finanzas islámica. Si bien esto parece justificado bajo la ley Shariah, debido a la prohibición de tomar dinero por adelantado para algo que no ocurrirá en el futuro y la prohibición de pagar por adelantado para proteger o reducir el riesgo financiero, esto finalmente genera el El sector financiero islámico es menos sofisticado que su contraparte convencional (y sus participantes están más abiertos a los efectos adversos de los riesgos). Los argumentos en conflicto hacen que llegar a una conclusión sea una tarea difícil pero que, sin embargo, debe ser intentada por las autoridades respectivas.

Técnicas de gestión de riesgos en las finanzas islámicas: derivados y titulizaciones

La revisión de las prohibiciones de la ley islámica destacó que una gran parte de la justificación para su inserción en el marco financiero islámico es su contribución a la gestión del riesgo en todo el sistema.

Otra forma de manejar este problema es usar contratos de derivados para cubrir el riesgo y la especulación.

En la definición de los expertos de Shariah, los derivados son derechos sobre las cuentas por cobrar que el propietario-originador transfiere a un vehículo de propósito especial (el denominado emisor), que a su vez emite certificados vendidos a inversores. Esta definición se ajusta al instrumento sukuk que, estrictamente hablando, no se clasificaría como un derivado en las finanzas convencionales. La visión convencional de los derivados es la de un producto, cuyo valor depende o se deriva del activo subyacente. Es cierto que esta es una definición muy amplia, que posiblemente podría acomodar sukuk.

Más importante que el tema de la semántica, además de los derivados, los expertos financieros utilizan un proceso llamado titulización para efectuar la transferencia de riesgos y beneficios, así como para lograr la optimización del valor. En este acuerdo, los derivados son los medios a través de los cuales el proceso de titulización cumple con sus objetivos de transferencia de riesgo. El proceso ayuda al originador a administrar su riesgo de crédito, al preservar las exposiciones titulizadas en su balance general (manteniendo el título legal de los activos mientras transfiere su riesgo a un SPV).

Si bien los derivados se utilizan para proteger contra los movimientos de precios, aumentar la exposición a los movimientos de precios con fines especulativos, ayudar con la penetración de los mercados y con el movimiento de activos más ilíquidos, las finanzas islámicas no aprueban su aplicación con fines especulativos, debido a la prohibición de gharar y maysir.

Desde la perspectiva de la Shariah, la aplicación más controvertida de los derivados es usarlos como una estrategia para proteger (proteger) las ganancias contra el riesgo de pérdida. Se considera que las inversiones para alcanzar este objetivo reducen el riesgo. Sin embargo, tenga en cuenta que si bien la gestión de riesgos no es controvertida en el marco de la Shariah, algunos aspectos de la cobertura podrían serlo. Por ejemplo, la cobertura se define como un comportamiento que ayuda a mitigar los movimientos adversos de los precios. La connotación al seguro podría ser problemática porque, como se mencionó anteriormente, Shariah no acepta seguro contra pérdidas. En otra interpretación más controvertida, la cobertura puede percibirse como una estrategia de riesgo-recompensa. Esto sería inaceptable según la ley Shariah porque ser recompensado por asumir un riesgo en una transacción comercial, particularmente en un contexto especulativo (que a menudo es el caso de la negociación de derivados), se considera insostenible. Sin embargo, el consenso entre practicantes y académicos parece ser que la cobertura está permitida, siempre que se haga de conformidad con los requisitos principales de la ley islámica.

Si bien las finanzas islámicas han aceptado los derivados más convencionales, esto no se ha hecho sin algunas reservas. Por ejemplo, los contratos a plazo (contratos "diferidos") en los que se acuerdan intercambiar bienes y dinero en una fecha futura, mientras que el precio de los bienes se acuerda en el momento de la firma del contrato, conllevan el riesgo de no entrega de los bienes o del dinero. Además del riesgo de pérdida, que la ley Shariah intenta evitar, este tipo de contrato se basa en el comercio de lo que aún no se posee. La ley islámica prohíbe tales prácticas debido a la connotación a la especulación (maysir). Sin embargo, como se destacó en el análisis de forwards, estos derivados se adoptan en el marco financiero islámico, que, además, ofrece una versión islámica del contrato a plazo, estructurado en base a murabaha, bai muajjal, bai salam, bai istisna, arbun y taco. El permiso de este constructo requiere que se pueda hacer una inferencia (que debe estar respaldada por un pago inicial parcial) de que las partes tienen la intención de cumplir sus compromisos.

El enfoque sunita de las finanzas islámicas no acepta contratos de futuros, ya que entran en conflicto con el requisito de que las transacciones financieras deben traer beneficios a la economía real y la regla de que las partes que realizan transacciones deben compartir el riesgo entre ellas. Además, los futuros no implican un intercambio real; comprenden un pago de la diferencia entre el precio acordado a pagar y el precio de mercado de los bienes al vencimiento. Además, el resultado de las transacciones de futuros siempre es que una parte pierde y la otra gana. Sin embargo, como se ha visto, dado que los futuros podrían ser muy útiles para el comercio de productos básicos, el Crude Palm Oil Futures está aprobado para su uso en el Islam sunita, especialmente en Malasia. Significativamente, los futuros son aceptables en el marco financiero islámico chiíta.

Las opciones convencionales se utilizan para especular o para cubrir las tenencias actuales, o para generar ingresos. Esta derivada se divide ampliamente en opciones de compra y opciones de venta. Shariah permite opciones bajo la condición de que se usen para proteger contra el riesgo (por ejemplo, contra movimientos adversos de precios) o para el arbitraje (beneficiándose de los diferentes precios del producto en diferentes mercados). Debido a la prohibición de la especulación y el juego, las finanzas islámicas no aceptan el comercio de opciones con fines especulativos, es decir, cuando las exposiciones al riesgo se llevan a cabo con el único propósito de obtener ganancias.

En una subdivisión de opciones, los swaps deberían permitirse en principio en las finanzas islámicas porque pueden proteger a las empresas contra las fluctuaciones de los tipos de interés y las tasas de cambio, lo que indirectamente sirve como factor estabilizador para el mercado. Para recordar, los swaps son contratos para la entrega simultánea de pagos periódicos a cambio de dos flujos de efectivo diferentes. Cuando se utilizan con fines de cobertura y especulativos (en el caso del intercambio de tasas de interés y el intercambio de activos), no están permitidos en el marco del mercado islámico. Sin embargo, el intercambio de productos básicos se acepta en el mercado de Oriente Medio, aunque en una forma que cumpla con la Shariah.

Debido a que los swaps se utilizan como herramienta de intercambio de valor o intercambio de riesgo, los expertos en derecho de la Sharia los someten a un gran escrutinio sobre la forma en que se gestiona el riesgo a través de ellos. Con este fin, el cumplimiento de este derivado se ha garantizado basándolos en contratos o compromisos contractuales como tawarruq, wa'd o commodity murabaha (por ejemplo, swaps de moneda basados en murabaha, swaps de tasa de beneficio de murabaha o swaps de rendimiento total islámico). El uso conforme a la Shariah de estos derivados se rige actualmente por el Acuerdo Maestro de Cobertura (Tahawwut) emitido por la Asociación Internacional de Swaps y Derivados (ISDA) y el Mercado Financiero Islámico Internacional (IIFM).

Además de los derivados convencionales, las finanzas islámicas operan con instrumentos (cuasi-derivados), que se han estructurado específicamente para los fines del mercado que cumple con la Shariah. Como se mencionó anteriormente, los delanteros bai'salam 'e istisna son generalmente aceptados en todas las escuelas islámicas. Sin embargo, el análisis ha demostrado que algunas de las características de los contratos en los que se basan los derivados islámicos hacen que el producto resultante sea incompatible con la ley islámica.

En términos generales, el contrato islámico (akad) sigue caminos similares a los del contrato de derecho consuetudinario. Akad se celebra entre dos o más partes y su validez depende de la declaración simultánea de oferta y aceptación (ijab y kabul). Sin embargo, como se ha visto en el análisis en el capítulo correspondiente, la estructura de muchos derivados islámicos se basa en la premisa de wa'd para garantizar el cumplimiento religioso. Esto fue percibido por este autor como problemático por las razones que se enumerarán a continuación.

Uso de wa'd en contratos financieros islámicos

El concepto de wa’d (promesa unilateral) se ha entendido tradicionalmente como una promesa moralmente vinculante, que no implica obligaciones legales y sanciones legales, como consecuencia de una posible violación del wa’d. Con este fin, el concepto tiene cierta semejanza con la ley civil, que trata las promesas como vinculantes o no, dependiendo de las intenciones del promitente.

La comprensión moderna de wa'd es que el promitente en una transacción contractual se compromete a emprender o abstenerse de uno u otro curso de acción. Por ejemplo, la Academia Islámica Fiqh considera que las transacciones comerciales deben ser legalmente vinculantes. La justificación de la Academia fue que si la promesa unilateral ha causado que el prometido incurra en responsabilidades pero el promitente ha vuelto a cumplir su promesa, el primero tenía derecho a reclamar daños reales de la segunda.

A pesar de esto, se podría argumentar que wa’d es distinto de un akad real en el sentido de que no es prima facie legalmente vinculante. Su fuerza vinculante depende de la autoridad interpretativa. Lo que parece poco controvertido es que wad es religiosa y moralmente vinculante para el promitente, sin esto, sin embargo, da derecho al prometido a algo más que un derecho moral para hacer cumplir la promesa.

Además, si bien se podría argumentar que wa’d tiene algunas similitudes con el concepto de derecho común del contrato unilateral, este último requiere un cierto grado de reciprocidad para ser ejecutable, lo cual no es el caso en wa’d. Por ejemplo, el derecho consuetudinario otorga igual peso a los derechos del promitente y del prometido, mientras que wa’d (por ejemplo, en el enfoque de la Escuela Maliki) está más preocupado por la posición del prometido. Más específicamente, si el prometido ha incurrido en costos o ha sufrido un perjuicio en virtud de la promesa, el wad sería tratado como vinculante. Si bien el enfoque de la Escuela Maliki se parece a la doctrina del derecho consuetudinario de consideración, difiere exactamente en el aspecto de reciprocidad.

Es discutible que la Escuela Islámica prefiera centrarse en la promesa por dos razones. Primero, la ley de contratos islámica postula que los contratos deben ser ejecutados. En segundo lugar, la Sharia se esfuerza por aliviar el perjuicio en lugar de otorgar beneficios. Además, la interpretación de Shariah de una promesa contractual es que se compone de "oferta" y "aceptación", que, en principio, debe hacer que sea vinculante en el momento en que el prometido cumple las condiciones o requisitos del promitente. Además, la ley islámica trata las promesas contractuales como compromisos para brindar beneficios al prometido.

Debido a la relativa independencia en los enfoques de las cuatro escuelas sunitas, la interpretación de wad sigue fracturada en todas las jurisdicciones que aplican la ley de contratos islámica. Este autor concluyó que aunque wa'd ha absorbido cierta influencia del derecho consuetudinario y las tradiciones del derecho civil, sus premisas fundamentales no pueden transponerse al derecho contractual convencional (en cierta medida, también debido a la divergencia entre el derecho consuetudinario respectivo y enfoques de derecho civil al tema). Se ha sugerido que esto, junto con la falta de unificación en el enfoque dentro de la erudición musulmana, es motivo de grave preocupación.

El principal desafío relacionado con el estado incierto de wa'd es que los derivados islámicos se basan en el supuesto de que wa's es vinculante para estructurar un producto adecuado para el mercado y que cumpla con la Shariah. Actualmente, el mercado tiende a aceptar wa'd como vinculante, si se cumplen las siguientes condiciones (según la opinión de la Academia Islámica Fiqh): la promesa es unilateral, el prometido incurre en una pérdida o gasto en un esfuerzo por cumplir la promesa y la venta real se completa. Sin embargo, las últimas condiciones son un poco confusas porque no informan cuál sería la situación legal antes de completar la venta.

Posibles problemas en los contratos de murabaha

Otro concepto de derecho contractual islámico utilizado con frecuencia, que contiene características potencialmente controvertidas es el contrato murabaha (costo más). Murabaha es uno de los muchos contratos islámicos que permiten el reembolso futuro de la suma anticipada en forma de venta de pago diferido (además de la venta a plazos y bay'mu'ajjal) o en forma de contratos de arrendamiento (ijarah). El desafío de tales arreglos es que, debido a la prohibición de riba (interés), la imposición de un pago adicional como compensación por el retraso no sería compatible con la Shariah (por supuesto, las finanzas convencionales permiten esta práctica). El problema principal aquí es que el costo más sugiere que el dinero tiene valor de tiempo, lo cual es rechazado por Shariah. Sin embargo, los estudiosos justifican la imposición del costo plus en murabaha exactamente con el paso del tiempo.

Quizás, esta aparente flexibilidad se debió a la extrema utilidad del acuerdo de murabaha, que se ha utilizado como base para muchas transacciones complejas. Sin embargo, para que se permita el contrato, se deben cumplir las siguientes condiciones: el objeto de la venta (mabi) debe ser seguro e identificado, de naturaleza que cumpla con la Shariah y para un uso legítimo. Además, el valor del mabi debe ser sustancial y determinable. Cabe señalar que las condiciones relacionadas con el mabi reflejan la idea de las Escuelas Sunitas de que para constituir una "propiedad", una cosa debe ser identificable, legítima y de cierto valor. Involuntariamente, tal coincidencia orgánica de conceptos y aplicaciones refuerza el sentido de continuidad que prevalece en el marco legal de la Sharia.

Además de esta línea de pensamiento, tenga en cuenta que el incumplimiento de las condiciones anteriores con respecto al mabi invalida el contrato. Además, mabi debe poder entregarse tanto en el momento del contrato como en el momento de la venta. Podría decirse que esta condición cumple con el requisito de Shariah de que uno no puede vender lo que aún no posee. Por último, el contrato de murabaha, en el que el precio no se indica con precisión, se considera anulable (fasid).

Se podría concluir que, si bien murabaha es, de hecho, una transacción de creación de deuda, que además no cumple con el principio de distribución de ganancias y pérdidas, es útil como fuente de financiación, lo que justifica su lugar en las finanzas islámicas.

Otro instrumento controvertido es el tawarruq: una versión de murabaha que podría usarse en las finanzas islámicas como alternativa al modelo convencional de financiación del comercio minorista mediante crédito bancario. También conocido como murabaha de productos básicos, el instrumento se utiliza principalmente en los Estados de Cooperación del Golfo. Muchas otras jurisdicciones no aceptan el instrumento o lo aceptan solo bajo ciertas condiciones. Sin embargo, tenga en cuenta que el producto básico murabaha es particularmente útil para el comercio de productos básicos como el petróleo, lo que explica su popularidad en el área del CCG.

Hay dos tipos de tawarruq: tawarruq haqiqi (tawarruq intrínseco), que está aprobado y tawarruq munazzam (tawarruq organizado), que es inadmisible, debido a que contiene tres elementos de la ley Shariah inadmisibles:

(1) El banco participa en el proceso de reventa y liquidación como agente de su cliente.

(2) Esta participación del banco islámico hace que la transferencia del título del bien relevante no esté clara.

(3) Proporcionar tawarruq es solo una forma estable para que la institución obtenga ganancias.

El principal problema con el tawarruq organizado es que todas las transacciones contenidas en el tawarruq están agrupadas, incluido el proceso de reventa y liquidación. Con este fin, el banco se convierte en la parte que se beneficia doblemente de la transacción: la primera vez que originalmente compra el producto y luego, cuando el prestatario cumple con sus obligaciones. Esto hace que la transacción sea nominal y parecida a un préstamo convencional, abriendo el instrumento a las acusaciones de riba disfrazadas.

Esta acusación se demuestra por el hecho de que en tawarruq organizado todos los pasos están predeterminados y el banco se convierte en un agente del cliente, lo que indica que el prestatario no tiene libertad real bajo el contrato. Además, rara vez hay un intercambio físico de los bienes y el intercambio muy rápido se realiza con mayor frecuencia a través de órdenes de depósito. El resultado de esto es una secuencia de intercambios rápidos de títulos, con los cuales la ley de finanzas islámica, en contraste con las finanzas convencionales, no se siente cómoda. Esto sugiere que los pasos previstos en el contrato solo se toman para evitar la prohibición de riba.

Teniendo en cuenta lo anterior, y para evitar la invalidación de la transacción sobre la base del incumplimiento de la Sharia, el tawarruq debe organizarse de la manera propuesta por la Academia Islámica de Fiqh, es decir, el instrumento debe mantener cierto grado de transparencia y debe tener para demostrar que existe un contrato legalmente vinculante entre dos partes distintas. Sobre todo, el banco no debe actuar como agente de su cliente, ya que esto invalidaría la oferta y la aceptación sobre las que depende el contrato. Este enfoque alinea las finanzas islámicas con el derecho consuetudinario, posiblemente haciendo que el tawarruq intrínseco sea más atractivo para los inversores occidentales.

La popularidad de murabaha (incluido el tawarruq (murabaha de productos básicos)) entre los inversores justificó una mirada más cercana a los beneficios y desafíos de este instrumento.

Como se destacó en la investigación, una de las características más elogiadas de murabaha, en comparación con los préstamos convencionales, es la falta de penalización (cargo adicional, agregado a la obligación existente) proporcionada por el instrumento en caso de pagos atrasados o incumplimientos. Esto da como resultado una menor deuda del consumidor que con el modelo tradicional de compra de crédito, lo que finalmente hace que los contratos de murabaha sean menos riesgosos que su alternativa convencional y, por lo tanto, más seguros para el sistema financiero. Además, los contratos de murabaha se presumen más justos que los préstamos convencionales porque estos últimos solo comparten las ganancias y no la pérdida potencial del prestatario. Es discutible que el enfoque de las finanzas islámicas a los préstamos, por lo tanto, podría estimular a las empresas a una tasa más alta que las finanzas convencionales.

Sin embargo, como se mencionó anteriormente, el contrato de murabaha está abierto a acusaciones de que incluye intereses, vestido con una forma que cumple con la Shariah. Además, negociar lo que las partes aún no poseen es un gran desafío para las transacciones basadas en murabaha. Si bien esto se resolvió estructurando contratos de murabaha con la ayuda de wa'd, el análisis sobre el concepto de wad sugirió que la solución no es infalible.

Además, debe mencionarse que la mayoría de los contratos, que aparentemente cumplen con la Shariah, logran este cumplimiento agrupando dos o más contratos. Sin embargo, el Islam no permite combinar dos transacciones en una sola y combinar contratos de venta y de deuda. Además, la ley islámica exige que si los contratos deben combinarse, cada contrato debe poder funcionar de forma independiente y sin obligar al otro. En la práctica, esto no se observa: como se señaló, la mayoría de las estructuras de murabaha dependen de wa'd para garantizar su legitimidad; sin embargo, los contratos subyacentes siempre dependen unos de otros para establecer legitimidad y promover el desempeño. Además, teniendo en cuenta que las prácticas más relajadas se observan típicamente en Malasia, que es líder en finanzas islámicas, se podría sugerir tentativamente que un marco más radical reconsideraría los acuerdos existentes con respecto a transacciones complejas.

El marco sukuk: bases estructurales y cuestiones de protección de los inversores

Como se enfatizó a lo largo de esta tesis, el enfoque principal de la ley de finanzas islámica es garantizar el cumplimiento de las fuentes de la ley islámica. Desde una perspectiva pragmática, esto se traduce en lograr la equidad para las partes contratantes y un resultado sólido y beneficioso para el bienestar del resultado comunitario de los contratos. Informado por estas consideraciones, el autor dedicó gran parte de la discusión en esta tesis sobre el vínculo islámico (sukuk). Además, esta elección estuvo influenciada por la popularidad de sukuk y el papel que desempeña en el sector relevante y, lo que es más importante, por el deseo de cuestionar ciertos aspectos de la estructura del bono.

El autor abordó la discusión sobre sukuk mirando las disposiciones del instrumento sobre la protección de los inversores, particularmente en caso de incumplimiento por parte del emisor. Esto se hizo deliberadamente, debido a preocupaciones y consideraciones reales de que el bajo rendimiento constante del instrumento con respecto a la protección del inversor haría que la Shariah no cumpliera o estuviera inadecuadamente preparada para el mercado. Mientras que el primero podría ser relevante en un régimen de la Shariah radical o más conservadora, en el peor de los casos que provoque la abolición del concepto, el segundo podría hacer que sukuk sea demasiado arriesgado para usarlo en cualquier jurisdicción. Además, incluso si un gobierno radicalmente inclinado dudara en retirar el instrumento del uso por motivos religiosos, podría convencerse de hacerlo más fácilmente si abundan los argumentos para su insostenibilidad en el mercado. La importancia de este punto requería un análisis en profundidad de sukuk, examinándolo en el contexto de los instrumentos convencionales, en los que se basaba.

Es importante destacar que, aunque los sukuk se conocen como bonos islámicos y los bonos convencionales no son derivados (más bien, ellos (junto con las acciones) son activos que subyacen a los derivados), los sukuk se consideran instrumentos derivados islámicos, lo que demuestra la eficiencia de los derivados convencionales mientras se aplican principios de titulización similares.

La introducción de sukuk tenía la intención de proporcionar a los inversores musulmanes los beneficios de un bono mientras escapaba de la operación de la prohibición de las riba. Al igual que los bonos convencionales, es un medio para que las empresas financien sus proyectos al recibir capital del público. Las partes en un acuerdo de sukuk se conocen como inversionista y emisor, a diferencia de los bonos donde la terminología se refiere a prestamistas y prestatarios. La principal distinción entre el bono islámico y el convencional es que los bonos son instrumentos de deuda, mientras que los sukuk son una fusión de deuda y capital.

Sukuk se define como notas negociables, respaldadas por activos, a medio plazo, estructuradas sobre la base de un contrato de intercambio o de participación. Es un instrumento que combina características de bonos convencionales, más específicamente, bonos cubiertos, Valores respaldados por activos (ABS) y acciones (más notablemente, acciones preferidas). Cada uno de estos instrumentos convencionales se discutió a su vez para que el vínculo islámico sea más familiar para el lector.

La comparación entre bonos y sukuk resaltó que, de manera similar a los bonos convencionales, los sukuk se emiten con el propósito de financiar la economía y se ofrecen principalmente a inversores institucionales. (Sin embargo, tenga en cuenta que el mercado de sukuk también se está abriendo gradualmente a los inversores minoristas). Al igual que los bonos cubiertos, los sukuk están respaldados por un conjunto de activos, que (al menos en teoría) es accesible para los inversores para hacer un reclamo preferencial en caso de que de insolvencia del emisor.

Los acuerdos relacionados con el conjunto de activos, el papel del SPV y las reglas de lejanía de bancarrota de los dos instrumentos son en gran medida los mismos. Si bien el régimen actual de la UE sobre bonos garantizados aún no está armonizado, el análisis del nuevo régimen propuesto de la UE sobre bonos garantizados destacó que el nuevo paquete legislativo permitirá reembolsar a los inversores según el calendario contractual respectivo, incluido el incumplimiento del emisor. Además, los eventos de insolvencia o resolución no acortarán el vencimiento del bono. Cabe señalar, en este contexto, que los sukuk no se consideran bonos cubiertos bajo la legislación de la UE, y falta un régimen similar de protección de los estados de los creadores de sukuk, incluida Malasia.

Además, la discusión subrayó que existen algunas similitudes en las estructuras de sukuk y ABS respectivamente, y más específicamente, las diferencias relevantes entre ABS y bonos cubiertos. Por ejemplo, mientras que en el caso de los bonos cubiertos, los pagos de intereses se pagan de la cuenta del originador, en el caso de ABS, se pagan sobre la base del rendimiento de los activos en el grupo. En comparación con el sukuk, los ABS se parecen al sukuk respaldado por activos, mientras que los bonos cubiertos son similares a la variante del instrumento basada en activos. En particular, en el escenario de ABS, el ingreso del desempeño de los activos va directamente a una cuenta de fideicomisario de titulización. El resultado de esto es que el desajuste de activos y pasivos se transmite a los inversores, lo que permite a ABS proporcionar a los inversores un rendimiento más separado del originador.

Sin embargo, aunque se utiliza un dispositivo similar, parecido a un fideicomiso en el contexto de sukuk, no existe un marco de leyes de fideicomiso desarrollado en los países islámicos, lo que dificulta la aplicación del concepto de fideicomiso. Además, la lejanía de la quiebra del SPV en un contexto de ABS está garantizada en la UE por el Reglamento de Titulización, que requiere que la transferencia del título al SPV se realice mediante una venta real o de cualquier otra forma legal, asegurando que la transferencia será exigible contra el vendedor o un tercero. El Reglamento establece que, en caso de insolvencia del vendedor, la venta no podría estar sujeta a disposiciones severas de recuperación. Como se indicó, no hay disposiciones correspondientes sobre sukuk en el mercado musulmán.

Como ya se ha indicado, además de los bonos, sukuk se parece a las acciones. La investigación en este trabajo ha establecido que sukuk es más similar a las acciones preferentes, que, aunque no proporcionan la mayoría de los beneficios inherentes a las acciones comunes (como derechos de voto o apreciación), garantizan el pago de dividendos a intervalos regulares. Esto hace que las acciones preferidas sean menos riesgosas que el resto de las acciones. Otra distinción relevante es que, en caso de quiebra, los accionistas que poseen acciones preferentes son pagados antes que sus contrapartes de acciones comunes.

Tenga en cuenta que debido a la prohibición de negociar deuda, existe un requisito de que la estructura sukuk represente claramente el vínculo entre los rendimientos y los flujos de efectivo de la financiación y los activos subyacentes, o los rendimientos generados a partir de ellos (similar a los pagos de cupones en bonos) Esto subraya que si los activos no se pueden identificar, no se podrían utilizar con el fin de obtener financiamiento que cumpla con la Shariah. Este punto podría volverse particularmente relevante en caso de incumplimiento, que, como mínimo, podría ser llamado por cualquiera de las partes si se tiene conocimiento de que hubo fraude en cuanto al cumplimiento de la Shariah del instrumento.

Relevante para esto es la definición de sukuk de AAOIFI que sugiere que los sukuk son certificados de igual valor, que representan acciones indivisas, y que se necesita un enlace a un activo tangible identificable para que los titulares de certificados tengan un reclamo válido. Este trabajo sugirió que a pesar de que la indivisibilidad de las acciones es una característica fundamental del instrumento de acciones convencional, la referencia a las acciones no divididas puede crear problemas para los inversores en caso de incumplimiento de los sukuk respaldados por activos.

La cuestión de la definición se utilizó como punto de partida para ejemplificar la falta de claridad en el régimen actual sobre sukuk. El argumento del autor fue que, en lo que respecta al incumplimiento del emisor, el instrumento presentaba a las jurisdicciones de derecho común un problema causado por el carácter híbrido del producto. Además de la falta de un régimen adecuado en casa, el buen funcionamiento de las emisiones de sukuk dependía de la posibilidad de que, después de todo, no ocurra el incumplimiento. Sin embargo, como lo demostró el análisis de muchos estudios de caso, esta esperanza no se cumplió.

Para desglosar el problema en sus componentes esenciales, el tema de las acciones indivisas se discutió por referencia al derecho consuetudinario inglés por razones de procedencia del instrumento y las similitudes conceptuales entre el derecho contractual islámico y el derecho consuetudinario común. Este análisis fue impulsado además por consideraciones relacionadas con la estructura híbrida de sukuk, que, se sugirió, hizo posibles desafíos de cumplimiento de la Shariah, así como dificultades para adaptar el instrumento al contexto del derecho consuetudinario.

La discusión afirmó que la estructura sukuk es débil desde la perspectiva de la protección de los inversores. Por ejemplo, el autor hizo un fuerte argumento de que los titulares de certificados sukuk respaldados por activos para emisiones fuera de la jurisdicción del Reino Unido (y tal vez también emitidos localmente) encontrarían difícil afirmar sus derechos de manera satisfactoria sobre los activos en el Reino Unido y / o en las jurisdicciones aplicando disposiciones similares sobre insolvencia y derecho de sociedades (por ejemplo, Malasia). Estas dificultades podrían ser causadas por incertidumbres en cuanto a la posición legal exacta de los titulares de certificados y a la fusión liberal de conceptos, tomados del derecho consuetudinario. Como se aclarará a continuación, la referencia a las dificultades prevé la satisfacción real de la reclamación, es decir, la cuestión de la división de activos, en lugar de la cuestión de la bancarrota a distancia del SPV.

Por ejemplo, la referencia a la práctica de los tribunales ingleses, así como el marco regulatorio aplicable, indicó que sukuk está regulado solo a nivel del emisor y que los tribunales aún no han tenido la oportunidad de decidir sobre los incumplimientos de sukuk, causados formalmente por La insolvencia del emisor. Los muy pocos ejemplos que han llegado a los tribunales del Reino Unido establecieron que en caso de que las disposiciones de la ley Shariah hayan sido vinculantes para las partes, se debe introducir una referencia muy clara en el contrato. Sin embargo, incluso en ese caso, los tribunales ingleses son los únicos competentes para aplicar la ley inglesa, lo que significa que los titulares de sukuk que reclaman en un tribunal del Reino Unido deben tener esto en cuenta. Además, en la medida en que la ley inglesa tiene disposiciones sobre incumplimiento, prevén la reparación de daños (lo cual es posiblemente inaceptable según la guía 2000 de AAOIFI sobre incumplimiento).

Además, no está claro cómo un tribunal inglés o un tribunal que se refiera a la ley inglesa decidiría la cuestión de la división de activos porque, si bien la ley inglesa da prioridad a los tenedores de bonos sobre los accionistas (y tratará a los tenedores de sukuk como a los tenedores de bonos), la definición de sukuk se refiere a acciones indivisas. Por lo menos, a menos que esto se aclare, una decisión del tribunal (sea lo que sea) puede abrir las puertas a nuevos litigios.

Además, en el caso de sukuk respaldado por activos, el tribunal probablemente interpretará que la reclamación se refiere al patrimonio contenido en el SPV. Queda por ver cómo se aplicará la indivisibilidad de las unidades a las que se refiere la definición a la división de activos del SPV. Se sugirió que el tribunal puede decidir que las reclamaciones deben satisfacerse mediante división física o una división de los ingresos de los activos en poder del SPV. Sin embargo, si el activo es un chattel, que podría ser el caso, la ley inglesa no es clara en cuanto a la dirección que puede tomar. La jurisprudencia sugiere que la ley relacionada con la tenencia conjunta y la tenencia en común de bienes muebles está menos establecida, lo que genera incertidumbre en caso de disputas sobre la división de activos.

Como se mencionó anteriormente, los sukuk basados en activos y respaldados por activos contienen diferentes riesgos de crédito: el primero expondría a los inversores a la insolvencia del originador, mientras que el segundo no. La razón de la posición, al menos en teoría, más beneficiosa del sukuk respaldado por activos es que los titulares de certificados están en posesión de un título legal para los activos en el conjunto de activos. Si bien en caso de dificultades, las pérdidas se transferirán a los inversores, el grupo continuará pagando hasta que queden activos. Dado que el sukuk basado en activos no tiene un vínculo directo con los activos en el grupo, los tenedores tienen efectivamente derechos sobre una parte de los flujos de efectivo, en oposición al patrimonio. Desafortunadamente, esto coloca a los tenedores de sukuk basados en activos en una posición desfavorecida por defecto.

La tesis destacó que la posición sobre la lejanía de la bancarrota en el Reino Unido y Francia con respecto a los inversores sukuk respaldados por activos, que poseen certificados en un sukuk emitido localmente, se benefician de un enfoque regulatorio más claro y normas más amigables para los inversores sobre la lejanía de la bancarrota.

Tenga en cuenta que, en lo que respecta al sukuk respaldado por activos, el propósito del SPV es garantizar la lejanía de la quiebra de los activos en el grupo al mantenerlos en fideicomiso para el beneficio de los titulares de sukuk, lejos del alcance del originador. Si bien esto podría funcionar bien en jurisdicciones con leyes de fideicomiso desarrolladas, hasta la fecha este mecanismo no se ha desarrollado adecuadamente en el Medio Oriente. Además, se podría argumentar que el derecho de los titulares respaldados por activos a realizar ventas de los activos (y, en general, a depender de ellos) en momentos de insolvencia podría verse limitado por la legislación de algunos países relevantes.

Por ejemplo, los tribunales de bancarrota pueden permitir que el SPV se declare en bancarrota a pesar de las objeciones de sus prestamistas. Esto ha sucedido varias veces en los Estados Unidos.

Otra posibilidad es que el tribunal de quiebras utilice su poder equitativo y obligue al SPV a declararse en bancarrota, desencadenando una consolidación sustantiva con los estados de quiebra del originador o las entidades afiliadas. El propósito del tribunal en tal situación sería consolidar todos los activos y pasivos en una sola entidad, a fin de otorgar a los acreedores de la entidad una distribución más equitativa de la propiedad. Además, la corte de bancarrota podría ser autorizada bajo la sección 363 del Código de Bancarrota de los Estados Unidos para vender algunos de los activos del SPV no gravados por los gravámenes del prestamista. Esta medida podría justificarse por consideraciones de lograr el mayor valor para los activos del SPV. Por último, el concepto de una venta real permite a los tribunales estadounidenses decidir si los activos financieros contenidos en el conjunto de activos se han vendido al SPV o, más bien, se han prestado.

Esto sugiere que la cuestión de la lejanía de bancarrota del SPV podría decidirse de una manera no tan amigable para los inversores por los tribunales de EE. UU., Debido a la legislación que debería afectar a los inversores sukuk. En comparación, el enfoque europeo y, más específicamente, las leyes británica y francesa tienen muchas más probabilidades de reconocer que la venta de activos al SPV fue una venta real en lugar de un préstamo. Además, sería poco probable que los tribunales en el Reino Unido o Francia se mantengan a favor de la consolidación entre los activos del SPV y los de otra empresa posiblemente endeudada. Esto sugiere que elegir al Reino Unido o Francia como jurisdicción para el arbitraje o debido a un nexo entre las partes y ciertas cláusulas del contrato a la jurisdicción respectiva, es probable que los inversores obtengan resultados satisfactorios. Sin embargo, decidir sobre el punto de quiebra remota a favor de los inversores no resolvería el problema con la división de activos relacionada con la estructura de sukuk (discutido anteriormente).

Aunque la discusión sobre la lejanía sugirió que algunas jurisdicciones fuera de Medio Oriente podrían tener un enfoque más favorable a los emisores que a los inversores, el análisis de la jurisprudencia de los Estados Unidos y los países del CCG estableció que los tenedores de sukuk están mejor aprovisionados en caso de incumplimiento en el extranjero que están en su propia jurisdicción. De hecho, en todos los casos discutidos, aparte del de EE. UU., Se evitó que algunos o todos los poseedores de sukuk recibieran una compensación adecuada y oportuna. Desafortunadamente, en la ocasión en que las reclamaciones de algunos inversores fueron satisfechas, las que no se originaron en inversores extranjeros. Este enfoque es difícil de explicar porque la estructura sukuk no proporciona una división adicional entre los inversores, basada en la nacionalidad.

El efecto de los impagos en la viabilidad de los instrumentos financieros islámicos

El enfoque en el tratamiento de los deudores morosos bajo la ley de finanzas islámica no está fuera de lugar. Para empezar, cuanto más evidencia haya de que sus ingenieros pasaron por alto el aspecto de la protección del bono por parte de los inversores, más fácil sería asumir que los instrumentos financieros islámicos son injustos y tienden a colocar a la parte más débil en una posición desfavorecida. El resultado sería una mayor oposición en nombre de los eruditos islámicos a la aplicación continua de los instrumentos infractores en la inversión y el financiamiento de proyectos. Tal enfoque estaría en línea con las premisas del Islam, relacionadas con la justicia social y, más específicamente, con aquellos de ellos que exigen justicia y regulan la actitud y la conducta de los deudores.

La posición actual de la ley islámica sobre los deudores morosos, y particularmente aquellos en dificultades, es que los deudores disfrutan de un período de gracia. Esto se debe a la visión tradicional de que las deudas son una obligación relativamente relajada. Sin embargo, el Corán exige que se paguen las deudas, especialmente cuando el deudor es rico. Sin embargo, según la posición en el Corán, los acreedores tienen libertad para decidir si buscan el pago pendiente de la profundidad o no. Cabe señalar que el significado exacto de los dos conceptos clave relacionados con los valores predeterminados, a saber, "dificultad" y "facilidad" no están definidos, lo que deja la discusión abierta sobre cuándo es un deudor en una posición adecuada para esperar que regrese su deuda.

Es más discutible que la actual falta de disposiciones financieras islámicas adecuadas para el incumplimiento se remonta a varios factores culturalmente específicos y geopolíticos. En cuanto a lo primero, el Corán impone estrictas exigencias morales a los musulmanes, que requieren el cumplimiento de las obligaciones contractuales y el pago de las deudas. Es posible que, en la medida en que estas expectativas morales hayan funcionado bien en el contexto de estructuras comerciales simples, no sean completamente aplicables a la complejidad de los nuevos instrumentos financieros islámicos y, en particular, al entorno de mercado financiero moderno, incluido el global.

Con este fin, las posibles actitudes negativas de los eruditos islámicos podrían estar respaldadas por los hallazgos de que la estructura de muchos instrumentos financieros islámicos se ve debilitada por ciertas deficiencias, potencialmente capaces de causar problemas de protección de los inversores y estabilidad del mercado. Como resultado, la oposición basada en la religión a los instrumentos islámicos puede apoyar o, alternativamente, ser respaldada por expertos de la industria y legisladores. Esto se facilitaría con estadísticas de que ya se han observado incumplimientos y eventos predeterminados en los mercados musulmanes. Sin embargo, su número relativamente pequeño, en comparación con los incumplimientos convencionales, es preocupante porque, aunque todavía es joven, las finanzas islámicas siguen creciendo, lo que aumentará las posibilidades de incumplimientos adicionales.

Además, las finanzas islámicas tienen un alcance global. El incumplimiento de los instrumentos podría afectar la capacidad de los inversores islámicos para invertir en los mercados occidentales y viceversa, y podría disminuir la confianza de los inversores extranjeros en los mercados islámicos. Sin embargo, lo más importante es que tales eventos podrían erosionar la confianza de los musulmanes comunes en un sistema que prometía proporcionar a la Ummah una alternativa ética pero viable de las finanzas convencionales. En este contexto, el fracaso de las finanzas islámicas para cumplir con esta promesa llegaría más allá del sistema financiero a la narrativa poscolonial sobre la identidad nacional y cultural de los musulmanes.

Además, incluso si estas deficiencias se superan en jurisdicciones separadas, la falta de una aplicación coherente de la ley islámica en toda la demografía pertinente haría que la armonización del marco de trabajo por defecto sea una tarea difícil. Además de las obvias implicaciones religiosas, como lo demostró la discusión sobre los bonos cubiertos por la UE y ABS, la falta de armonización contribuiría a la asignación ineficiente de recursos, incluidos los altos costos de capital, los problemas de protección de los inversores y algunos puntos de preocupación prudenciales. Por el contrario, una mayor armonización tendría el efecto de aumentar la confianza de los inversores, incluso para la inversión transfronteriza. Esto ayudaría a financiar la economía a través de fuentes de financiación que sean rentables y sostenibles.

La legitimidad religiosa de sukuk: algunas observaciones

Además de la discusión sobre el incumplimiento, el tema de la legitimidad religiosa del sukuk merece alguna elaboración. Sukuk ha sido criticado por ser inconsistente con los valores islámicos, debido a las acusaciones de compromiso de riba y la violación del principio de riesgo compartido. El primero se basa en el argumento de que el descuento en los bonos podría percibirse como un rendimiento de intereses y el segundo en sugerencias de que garantizar las ganancias ex ante elimina el riesgo de inversión.

De hecho, el instrumento sukuk ha adoptado una serie de dispositivos que ayudan a garantizar que los inversores recibirán el PDA correcto, incluso si el beneficio no permite que se distribuya esta cantidad. El argumento de los críticos es que al incorporar estos dispositivos en la estructura, el sukuk desconecta efectivamente el rendimiento de la inversión del del activo. En realidad, tales prácticas manejan el riesgo a través de la transferencia del riesgo; Sin embargo, esta vez el riesgo se traslada del inversor al originador.

Una nueva forma de sukuk agregó una fuerza particular a los argumentos de los críticos de las finanzas islámicas. Si bien es nuevo para el entorno financiero islámico, el sukuk perpetuo se ha utilizado en las finanzas convencionales durante mucho tiempo. Debido a su falta de fecha de vencimiento, este instrumento está más cerca de las acciones que de los bonos y se trata como cuasicapital desde la perspectiva de la contabilidad, formando parte del capital de la empresa.

Para ser reconocido como patrimonio, el instrumento debe contener una característica de diferimiento de utilidades y, además, su emisor debe poder diferir utilidades sin ser llamado por incumplimiento. En caso de insolvencia, el sukuk perpetuo ocupa un lugar más alto que las acciones preferidas y está subordinado a bonos y otros pasivos. Es importante destacar que los titulares no pueden canjear sus certificados a menos que se haya activado el canje, ya que no hay una fecha de canje para este sukuk. Por otro lado, el emisor tiene derecho a una opción de compra, que es el derecho pero no la obligación de canjear el sukuk una vez que haya pasado el período inicial de protección sin llamada. El período sin llamada típico es de 5 años.

Debido a que el sukuk perpetuo tiene la obligación de estructurarse sobre la base de contratos islámicos subyacentes no basados en el intercambio, manifiesta varios problemas relacionados con el cumplimiento de la Shariah. Esto incluye su perpetuidad y, más específicamente, la falta de fecha de vencimiento y la capacidad unilateral del emisor para disolver el contrato, lo que invalida los contratos subyacentes de mudarabah y musharakah. El problema es causado por el requisito de estos dos contratos de que las partes conserven la misma participación en la gestión de la empresa.

Además, los expertos coinciden en que, debido al aumento de la inflación a lo largo del tiempo, los emisores se benefician de la mayor duración del bono en mayor medida que los inversores. El único beneficio para los inversores es el mayor rendimiento obtenido por la inversión. Además, si bien los inversores perpetuos de sukuk podrían vender los certificados en el mercado secundario, el precio y la capacidad para hacerlo dependerán en gran medida de la liquidez del mercado de bonos.

Otro problema de cumplimiento de la Shariah podría encontrarse en el aplazamiento de la característica de Monto de distribución periódica (PDA) del sukuk perpetuo. Debido a los requisitos del marco de Basilea III, se le puede solicitar al emisor que difiera el PDA para cumplir con el requisito de capital mínimo relevante. Sin embargo, en el caso de que el sukuk esté estructurado sobre la base de una musharakah, el aplazamiento de la PDA viola las disposiciones religiosas que requieren una observación estricta de la fecha de distribución de ganancias en la que todos los socios de la empresa recibirían sus ganancias. Además, la regla de que el emisor puede decidir retener el pago de la PDA (aplazamiento no acumulativo de ganancias) sin que esto constituya un incumplimiento violaría las reglas sobre mudarabah, que dan derecho a todas las partes del contrato a recibir su parte de El beneficio de la empresa.

Sin embargo, AAOIFI y expertos independientes consideran que esta práctica es actualmente aceptable, y afirman que mientras las partes estén de acuerdo con las condiciones delictivas antes de firmar el acuerdo, la característica no es incompatible con la Shariah.

Dichas justificaciones innovadoras se han aplicado a otros aspectos controvertidos del sukuk perpetuo, por ejemplo, las prácticas de aplazamiento del rendimiento no realizado y la capitalización del rendimiento, que son sospechosas debido a acusaciones de riba (intereses derivados del aplazamiento) y / o reinversión de deuda, ambos no permitido por Shariah. Por ejemplo, la justificación para permitir la capitalización bajo la Shariah se basa en el argumento de que el aumento en el monto del pago es capital adicional de los inversores, generado por la actividad de reinversión.

Si bien tales argumentos pueden ser suficientes en el ejemplo particular, el análisis más amplio del instrumento sukuk sugirió que el bono islámico es deficiente en el punto de protección de los inversores, así como en el tema de su cumplimiento de la Shariah. Además, el análisis en este trabajo sugirió que si bien los instrumentos financieros islámicos preservan su legitimidad abierta, los expertos, las instituciones y los estudiosos del derecho islámico a menudo cuestionan su cumplimiento genuino de la ley islámica.

Como punto más amplio, mientras que el mercado islámico utiliza una amplia gama de derivados, la investigación indica que el marco carece de eficiencia y sofisticación. Esto se debe a una forma muy compleja de estructuración de instrumentos destinados a convencer de que se ha llevado a cabo una transacción que cumple con la Shariah. Sin embargo, las muchas transacciones más pequeñas cuestan horas y esfuerzos humanos adicionales, lo que aumenta los costos de transacción y el riesgo de falla de la transacción. Como resultado, las transacciones en las finanzas islámicas acumulan costos y riesgos, que en la mayoría de los casos se transmiten al cliente final (generalmente la parte contratante más débil).

Revivalismo islámico

El extenso análisis de la ley de finanzas islámica no estaría completo sin examinar su conexión con la política y, sobre todo, el renacimiento islámico (tajdid). Este último se percibe como una fuerza que tiene como objetivo revolucionar a las masas y reemplazar el orden establecido sin importar si su carácter es autoritario o democrático. Esto indica que el movimiento tiene una motivación religiosa, más que política, lo que puede dar lugar a estructuras gubernamentales híbridas.

El término avivamiento se refiere en este contexto a los valores del Islam temprano y los fundamentos de la religión islámica. En opinión de los reanimadores, los primeros años del Islam constituyeron la edad de oro de la religión; su ejemplo, por lo tanto, no podría mejorarse. En este contexto, recordemos que el Islam le da un gran valor a la continuidad, incluida la de las ideas, y el vínculo con el pasado. Esto facilita que las ideas que han circulado desde la época del Islam temprano sigan siendo influyentes hasta la modernidad.

Aunque las ideas de los revivistas se remontan a siglos atrás, los ideólogos modernos han desarrollado su narrativa inspirada en los gobiernos seculares supuestamente fallados ideológicamente, que heredaron el orden colonial. Los evangelistas percibieron que el principal fracaso de tales gobernantes era su traición al sentido de identidad nacional y al patrimonio cultural y espiritual de la comunidad musulmana.

Los tres principios básicos que definen un sistema político conforme a la Sharia son la coherencia con las enseñanzas del Islam, la obediencia de las masas a la autoridad política de sus gobernantes y la consulta mutua de los participantes en el sistema político.

Además de llegar a un consenso sobre lo anterior, el revivalismo islámico nunca fue uniforme. Al igual que el Islam, se benefició de la contribución de muchas iteraciones filosóficas, culturales, nacionales y, en última instancia, denominacionales de la religión. Sin embargo, la idea de que el verdadero Estado Islámico aún no se había logrado impregnaba las líneas de los revivistas, uniéndolos en la creencia de que las principales ideologías políticas de la modernidad (capitalismo y comunismo) fracasaron y que era mejor para el mundo sufrir la islamización que fue para el Islam incorporar nociones y desarrollos modernos.

El primer y más conservador capítulo de la ideología ha tratado de preservar los conceptos principales del avivamiento islámico premoderno. La adopción de este enfoque debería dejar poco espacio para las finanzas islámicas como lo conocemos ahora, ya que la mayoría de los instrumentos financieros islámicos utilizados actualmente es poco probable que resistan el escrutinio de un verdadero avivamiento. Este no fue tanto el caso con la segunda categoría de revivalismo, que buscó infundir conceptos antiguos con modernidad y hacerlos relevantes para los tiempos cambiantes. Es discutible que el estado actual de las finanzas islámicas represente, voluntariamente o no, esta tendencia exacta. El tercer capítulo revivalista fue el más radical: dio lugar a nuevos conceptos que reflejaban las condiciones cambiantes de nuestra modernidad.

El segundo tema importante en la narrativa del avivamiento islámico (el primero es la purificación del Islam del mal), históricamente presente en la ideología islámica, es el llamado a juzgar las sociedades contemporáneas, que se identifican como no creyentes (kafir) y el proceso de juicio, pasó a ellos, como takfir. Notablemente, el takfir ha sido practicado históricamente solo por los hilos más militantes del revivalismo.

El tercer capítulo del revivalismo islámico es el tema de la guerra santa (jihad). Aunque la yihad podría ser interna, espiritual y militar (extremista), lo que interesa a esta discusión es lo último. Su fundamento teórico se basa en los "Hitos", escritos en la década de 1960 por Sayyid Qutb, y en la obra medieval "Provisiones del más allá", compilada en el siglo XIII y XIV a. C. Si bien desde un punto de vista detallado las tres formas de la yihad parecen desconectadas, algunos teóricos argumentan que la guerra interna debe librarse contra los gobernantes y gobiernos musulmanes corruptos e impíos, convirtiendo esto en la base de la manifestación física adecuada de la yihad. Esta naturaleza proactiva de la jihad la hizo instrumental en los movimientos anticoloniales musulmanes, lo que provocó una lucha por la identidad nacional y cultural. Esta lucha se desarrolló en el contexto de la incertidumbre sobre la conveniencia del Estado-nación. Mientras que algunos intelectuales apoyaron esta noción, otros argumentaron que el ideal de estado-nación fue introducido por los antiguos colonialistas para socavar aún más la Ummah.

Otro concepto importante que podría servir para comprender el Islam radical es el de jahiliyyah (ignorancia). Al principio, la palabra se usó en referencia al período de los árabes pre-musulmanes. Más tarde, absorbió las nociones de renovación, condena y esfuerzo, allanando el camino para la comprensión moderna de jahiliyyah introducida por Mawdudi, que era una fusión de un diagnóstico de la enfermedad y la cura, un llamado al avivamiento musulmán para luchar contra esas fuerzas que se esforzó por corromper a la sociedad musulmana. Poco a poco, el término se convirtió en una etiqueta para aquellos que se oponían a los ideales del avivamiento. Jahiliyyah se detectó en todas las iteraciones de la vida moderna, que se consideraron ignorantes a pesar de todas las comodidades e inventos. En el entendimiento de Qutb, era ignorante creer que el hombre puede crear reglas legítimas de comportamiento colectivo, independientemente de las prescritas por Dios. Estos escritos radicales y particularmente la elaboración del concepto de jahiliyyah proporcionaron la conexión ideológica entre Al Qae'da e ISIS.

Tawhid, o la unidad de Dios, fue otro concepto importante transformado por Mawdudi en el siglo XX atribuyéndolo al proceso de transformación islámica a nivel de la sociedad o del individuo, un proceso que tiene implicaciones básicas para la política social y política islámica. y vida económica. El desarrollo del tawhid lo convirtió en un concepto islámico holístico que los revivistas se esforzaron por aplicar a todas las esferas de la vida, incluida la económica. El concepto fue tan convincente que trascendió los límites de las denominaciones separadas, confirmando las creencias panislámicas de los revivistas modernos.

Sin embargo, este análisis no estaría completo sin profundizar en las distinciones en los movimientos ideológicos atribuidos a sunitas y chiítas.

El primer roce serio del extremismo chiíta iraní moderno ocurrió en la década de 1940, con el creciente movimiento fidaiyan. Si bien la ideología de Fidaiyan era casi utópica, sus actividades giraron en torno a los disturbios, promoviendo la violación política e incluso los asesinatos políticos. Aunque influyente al principio y con el apoyo popular, el grupo gradualmente se enfrentó con los poderosos actores políticos de la época. A pesar de eso, su ideología aún impregna la política del Irán moderno. Por ejemplo, la Guía izquierdista de la verdad del Fidayan se publicó por primera vez en Teherán en 1950 y se volvió a publicar después de la revolución iraní. La Guía es importante porque describe cuál debería ser el futuro Estado Islámico y la sociedad, y exige una sociedad gobernada por la Sharia. El documento aboga por la abolición de todas las leyes no islámicas, incluidas las prácticas inmorales, como el juego y la usura.

El éxito de esta ideología puede explicarse con su enfoque en el bien común, la riqueza de la sociedad y el bienestar de la sociedad en lugar de la de sus miembros individuales. Este rechazo de la individualidad tiene el efecto de unificar a los musulmanes en una comunidad al afirmar el vínculo profundamente internalizado entre los devotos y la religión. Esta ideología sugiere que los desfavorecidos tendrán la oportunidad de contribuir, que los débiles recibirán apoyo y los pobres serán ayudados a salir de su situación. El populismo de estas ideas no puede quitarles su importancia genuina a la narrativa islámica. En comparación con otras religiones, el Islam se esfuerza por adoptar un marco político que institucionalice las nociones de igualdad y la distribución justa de la riqueza. En el contexto de Irán, estos sentimientos demostraron ser decisivos para el éxito de la Revolución.

Después de la caída del Imperio Otomano en 1918, casi todo el mundo musulmán fue colonizado por las potencias europeas. Esta no fue una ocupación larga, pero fue un período que puso en marcha el intenso movimiento anticolonial musulmán, que en ese momento estaba dirigido por las élites de las naciones: nacionalistas seculares, educados en Occidente. Si bien el objetivo de esta élite era crear un estado que emulara a Occidente, la gente común se encontró con una sospecha que no podía identificarse con las nuevas políticas. Lo que comenzó como protestas populares, se convirtió gradualmente en voces más fuertes de desacuerdo con las políticas oficiales, promoviendo la idea de volver a los valores morales y religiosos del Islam y formando el comienzo del movimiento de avivamiento islámico. La afluencia de ideales socialistas y nacionalistas informó aún más el revivalismo, transformándolo en un movimiento político en toda regla.

El final de la Segunda Guerra Mundial vio la división de los estados entre los Estados Unidos y Rusia. Aunque Irán eligió el lado de los Estados Unidos, convirtiéndose en un país democrático y secular, no pasó mucho tiempo hasta que se produjeran tensiones con el Reino Unido y los Estados Unidos. Principalmente, esto se debió a desacuerdos sobre el petróleo, de los cuales Irán era muy rico. El golpe de estado organizado por el MI6 y la CIA derrocó al gobierno secular legítimo y solidificó el gobierno del Sha iraní.

A pesar del deseo del Sha de modernizar el país, la gente común desconfiaba de él. La agitación social aumentó hacia el final del gobierno del Sha, lo que finalmente condujo a la Revolución Islámica de 1978-79. Además de desafiar lo que se percibía como imperialismo occidental, los ideólogos de la revolución aspiraban a crear el primer Estado verdaderamente islámico, basado en la ley islámica. En la medida en que lograron hacerlo, la revolución iraní influyó en la agenda de varios movimientos radicales y en la creación de varios partidos políticos islámicos en todo el mundo musulmán. Cabe destacar que el objetivo de estos partidos de reintroducir un modelo de gobernanza religiosa se percibió como el único camino hacia el progreso y la independencia total.

Las diferencias entre los chiítas y los sunitas están enraizadas en su desacuerdo histórico sobre quién era el legítimo heredero del Profeta. Mientras que los chiítas creen que el Profeta fue elegido para recibir las revelaciones debido a sus virtudes personales y las cualidades de su familia y tribu, y los siguientes gobernantes deben ser elegidos entre los herederos del Profeta, los sunitas sostienen que el liderazgo debe recaer en los más capaces para liderar Además, para el liderazgo sunita del Islam pertenece a esos dominios terrenales, que deben decidirse sobre la base de las realidades políticas.

Es discutible que la comprensión de los chiítas de lo que constituye una regla legítima podría crear un desprecio por las normas supuestamente ilegítimas, incluso en el comercio. En comparación, los sunitas aceptarían la legitimidad de un gobierno musulmán siempre que demuestre respeto al Islam.

La idea sunita del poder estatal y gubernamental se desarrolló lentamente, reflejando la deliberada fluidez de la construcción encontrada en las fuentes de la ley islámica. Del mismo modo, el concepto de califato adoptó el significado de "el modelo normativo del estado islámico" en el transcurso del tiempo. Es importante destacar que el "califato" es tanto una estructura de gobierno como una manifestación del poder político islámico, llamado a gobernar sobre el caos. Con este fin, los sunitas aceptan el poder despótico, si este fuera el precio del orden.

En la creencia islámica, todo poder supremo en el Estado Islámico pertenece a Allah. Esto también se aplica al poder político. Para este fin, la soberanía del Estado no es absoluta y su gobierno está dividido entre la Shariah y la Ummah. Si bien la comunidad tiene el derecho inalienable de elegir un líder y delegarle sus derechos exclusivos, su autoridad legislativa (de la Ummah) llega solo a aquellas áreas que no han sido legisladas en las fuentes de la ley islámica. La conclusión podría ser que la interpretación más radical de los líderes del Corán puede disminuir el poder de la Ummah para legislar. Esto sucedió en la práctica en el período 2014-2018.

Aunque sunitas y chiítas interpretan el Islam de una manera diferente, coinciden en dos puntos importantes: el diagnóstico de la enfermedad que invade el mundo islámico y su cura. El primero fue identificado como la occidentalización persistente de los países islámicos, con los valores occidentales de democracia, liberalismo, desarrollo económico, socialismo y nacionalismo. Un tema recurrente en esta ideología es el de la ilusión de "buena vida", creada por la occidentalización y la innovación. La cura para la ignorancia dominante es ganar a las masas, a las generaciones más jóvenes a través de la violencia, incluido el derrocamiento de los gobiernos. En su narrativa, la revolución era urgentemente necesaria, además de justificada. Por ejemplo, la justificación de la revolución iraní utilizada por Jomeini fue afirmar que ceder la soberanía a los extranjeros, adoptar una cultura que sea inconsistente con los valores islámicos y disminuir el papel del Islam hace que el poder del Estado titular sea ilegítimo.

Teniendo en cuenta que la revolución iraní tuvo éxito, fue necesario que este trabajo examine el grado en que el gobierno iraní posrevolucionario aplicó en la práctica su concepto de la cura. Según corresponda, el análisis se refirió al gobierno islámico iraní en el área de las finanzas.

Una de las primeras cosas que el régimen de Khomeini intentó a este respecto fue la nacionalización de los bancos. La nacionalización de los bancos permitió al Gobierno llevar a cabo políticas económicas centralizadas donde la exposición al riesgo, siguiendo algunas prácticas controvertidas, podría ser fácilmente absorbida por el Estado. Entre tales prácticas estaba el permiso para comerciar sukuk en los mercados primario y secundario. Tenga en cuenta que a pesar de la prohibición tradicional de vender deuda, los juristas chiítas consideran que la práctica es legalmente válida y exigible, incluso argumentando que la venta de la deuda al deudor no es ilegal ni en chií ni en el Islam sunita.

Si bien los juristas chiítas reconocen que la venta de deuda a un tercero, que en realidad es negociar sukuk en el mercado secundario, es controvertida, argumentan que las reservas de los juristas sunitas se desencadenan por la preocupación de que el vendedor no podrá entregar el tema del contrato con el comprador, lo que podría estropear la transacción con incertidumbre, imposición de intereses y ausencia de entrega. Sin embargo, el argumento chiíta es que en esta ocasión los intereses de los inversores están protegidos por el marco legal iraní debido a la exigencia de que el precio de la deuda sea en efectivo.

Además, si bien el marco iraní está sujeto a las mismas prohibiciones de la Sharia que su contraparte sunita, los instrumentos utilizados en el mercado financiero iraní están estructurados en la tradición de la jurisprudencia chiíta Immamieh. Es notable que, si bien Irán comenzó de una manera bastante liberal, permitiendo una "ganancia mínima garantizada" del 4-8%, dependiendo de la actividad económica e incluso de los depósitos, revisó sus políticas hacia una toma más conservadora de las prohibiciones. Después de que entró en vigencia la Ley para la Banca Libre de Usura en 1984, el interés sobre los activos fue reemplazado por un "cargo por servicio máximo" del 4%. Además, la "ganancia mínima garantizada" fija aplicable a los depósitos fue reemplazada por una bonificación no fija para los depositantes. La nueva legislación reemplazó el modelo basado en cuasi intereses con el modelo de distribución de ganancias y pérdidas alineado con Shariah.

Sin embargo, el sistema iraní conservó sus matices pragmáticos. Por ejemplo, a los bancos se les permitió cobrar a los deudores morosos con una multa fija del 12% anual, impuesta a la proporción impaga de un préstamo. Además de eso, los bancos iraníes cobran un cargo por servicio del 2%. Además, el interés como tal no está completamente prohibido porque los bancos pueden imponer una tasa de interés hasta la tasa de inflación. Esto se justifica por la inflación sustancial en el país, lo que haría injusto negar a los depositantes el recurso contra él. En términos prácticos, si los bancos iraníes no ofrecieran esta tasa, habrían tenido problemas para encontrar depositantes. Además de lo anterior, el sistema bancario iraní garantiza los depósitos de sus clientes. Podría decirse que esta práctica repite el principio de riesgo compartido, incrustado en la tradición sunita.

Otra práctica controvertida de los bancos iraníes es la permitida por los acuerdos de recompra de la legislación iraní y la venta de bienes que el banco no posee. Esto va en contra de la prohibición de vender lo que uno no posee, así como contra el requisito de que el objeto del contrato sea identificable. Además, deja a los bancos iraníes abiertos a la acusación de gharar (incertidumbre). Sin embargo, las principales críticas dirigidas a los bancos iraníes se centran en la imposición de intereses, lo que, en opinión de los académicos sunitas, hace que el sistema no cumpla con la Shariah. La justificación a menudo utilizada por los defensores del sistema iraní es que las políticas de los bancos iraníes reflejan una planificación gubernamental a largo plazo que los hace fundamentales para el aumento del bienestar de la nación iraní.

En la medida en que el sistema bancario iraní ha estado funcionando de manera poco impresionante, exhibiendo un crecimiento lento, una gama relativamente limitada de productos y servicios y una gran cartera de activos no productivos, el logro de estos objetivos parece dudoso. Además, el mercado de capitales iraní muestra características similares, es decir, algunas prácticas controvertidas y una gama relativamente limitada de instrumentos negociados.

En cualquier caso, el mercado iraní de sukuk está bien desarrollado y ofrece tres sukuk regulados, considerados comercializables y emitidos: musharakah, ijarah y murabaha. Entre los derivados permitidos en el mercado iraní se encuentran las opciones y los futuros. Esto último es contrario a la práctica del mercado sunita que no permite futuros, debido a problemas de la Shariah. La justificación de la Junta Shariah de SEO para la inclusión de opciones y futuros es que hay requisitos de que se mantenga una relación racional con el mercado real y que los activos subyacentes se puedan entregar.

En lo que respecta al sukuk iraní, está más estrictamente regulado en comparación con su alternativa sunita. Por ejemplo, los juristas iraníes han introducido un sistema basado en permisos, que se espera para proteger los intereses de los inversores. El permiso se otorga solo si el emisor y el originador proporcionan documentos, lo que demuestra que han seguido las normas del mercado de capitales relacionadas con la custodia, el pago y la administración, y que han incorporado disposiciones contractuales para la provisión de una devolución y pago periódicos.

Sin embargo, algunos de estos requisitos son controvertidos según la ley islámica. Por ejemplo, el intento de garantizar retornos periódicos choca con los principios de compartir el riesgo (aunque, es cierto, este es un problema general con el instrumento sukuk, no limitado a la ley chiíta). Además, de conformidad con el requisito de la legislación iraní de que el emisor y el originador sean la misma entidad (a diferencia del ejemplo sunita), el sukuk iraní adopta características similares a las basadas en activos (en oposición a su sukuk respaldado por activos). Por ejemplo, los titulares de sukuk tienen una propiedad proporcional de un activo subyacente y, por lo tanto, tienen derecho a un retorno proporcional del activo. Sin embargo, el título que poseen es beneficioso y el interés otorgado al activo es equitativo. La discusión sobre las supuestas fallas en la protección del inversor del instrumento sukuk resaltó que la variedad basada en activos es particularmente desafiada en este aspecto (aunque, en la práctica, el sukuk respaldado por activos también es riesgoso desde el punto de vista de recibir compensación por incumplimiento) . Sin embargo, en el caso de Irán, debido a la extremadamente alta medida de control y propiedad estatal, tales temores siguen siendo en gran medida infundados.

Otro punto interesante es que los emisores de sukuk musharaka (instrumentos de asociación) tienen la obligación de pagar anualmente a los respectivos titulares de sukuk una suma fija como pago a cuenta. A primera vista, esto constituye el pago de intereses. Sin embargo, los juristas justifican la práctica con la condición previa de la emisión de sukuk-musharakah de que el emisor debe presentar una propuesta, lo que demuestra la rentabilidad esperada del proyecto. La crítica a la que se enfrenta este acuerdo se basa en el argumento de que una emisión que cumple con la Shariah no puede contener ganancias que hayan sido fijadas de antemano. Además, sukuk musharaka no cae en las clases de sukuk que ofrecen un rendimiento más predecible (como sukuk murabaha, sukuk salam, sukuk ijara y sukuk istisna).

En términos generales, la redención garantizada del principal y el retorno de los instrumentos anteriores es controvertida desde la perspectiva del Islam sunita. La justificación ofrecida por los juristas iraníes es que, dado que las ganancias de estos instrumentos son predecibles, no es incompatible con la Shariah garantizar la redención del capital y la devolución. Además, en su opinión, la obligación contractual del emisor de generar ganancias no debe ser descuidada ya que las inversiones se recaudaron sobre la base de una propuesta que ha sido previamente acordada y aprobada por expertos financieros. Según el argumento, no garantizar la redención de su inversión sería injusto para los inversores.

Con respecto a la acusación de cometer riba, la ley iraní distingue entre la imposición de intereses ordinarios y excesivos, que coincide con la opinión de algunos juristas sunitas. Además, con respecto a las acusaciones de cometer gharar, los juristas iraníes diferencian entre la mayor incertidumbre (gharar fahish), que está prohibida por defecto y la menor incertidumbre (gharar yasir), que es socialmente aceptable. En la misma línea, los juristas iraníes prohíben solo el riesgo irrazonable y la incertidumbre innecesaria en las transacciones financieras. Se podría concluir que el regulador iraní se esfuerza por construir un mercado transparente y eficiente, conformado por consideraciones de pragmatismo en lugar de una estricta rigidez religiosa.

Un punto separado que podría hacerse es que este enfoque original es el resultado de la preservada en la práctica chiíta de ijtihad (razonamiento legal). Si bien los musulmanes sunitas creen en gran medida que ya se ha dicho todo lo que valía la pena decir, restringiendo así el ijtihad a aquellos que están excepcionalmente calificados para practicarlo, los chiítas han dejado abiertas las puertas del diálogo.

De hecho, los chiítas han apoyado a ijtihad a través de su historia, que se refleja en el venerado estado de su Ulama. En distinción, los radicales sunitas, modernistas islámicos, revivistas y salafistas han reanudado la aplicación de ijtihad solo recientemente. Sin embargo, el enfoque permisivo del razonamiento legal demostrado en la actualidad por la mayoría de las facciones (ciertamente grandes) de la comunidad musulmana, que demuestran una estrecha vinculación con el avivamiento, es posiblemente instrumental para sus estrategias revolucionarias. Con este fin, ijtihad es utilizado por tales facciones como una herramienta para razonar a través de nociones preconcebidas y darles forma de acuerdo con los objetivos políticos respectivos. Presagiando la discusión sobre el yihadista-salafismo, la inclusión de todos en el proceso de ijtihad, incluso aquellos que tradicionalmente no están calificados para emitir un juicio sobre cuestiones legales, respalda la conclusión anterior.

Este trabajo discutió el yihadista-salafismo como una forma de entender la razón y la relevancia de ISIS, una organización que recientemente aspiró a establecer un Califato islámico legítimo. El salafismo es una tendencia en la fe musulmana, que pone gran peso en la búsqueda de la piedad. Similar al revivalismo, exige volver a la edad de oro del Islam y emular a las primeras generaciones musulmanas en todos los aspectos de la vida. En el siglo XVIII, esta ideología penetró en la doctrina del wahabismo, actualmente dominante en Arabia Saudita. A través del wahabismo, que lo difundió por todo el mundo musulmán, el salafismo alcanzó mayor importancia.

De manera similar a los tradicionalistas sunitas, los salafistas creen que uno debe obtener orientación solo del Corán y la Sunnah. Sin embargo, rechazan la doctrina del taqlid, que exige la obediencia de uno a los primeros maestros religiosos del Islam que han hecho pronunciamientos exitosos sobre los asuntos no abordados o no explicados completamente en el Corán y el Hadith. Los salafistas rechazan "la aceptación incuestionable de las decisiones legales de otro sin conocer la base de esas decisiones", creyendo que uno debe regresar a las fuentes de la ley islámica y decidir independientemente sobre la esencia del mensaje religioso. Esta actitud hacia los taqlid fue compartida por los miembros de los siglos XIX y XX de la Escuela Hanbali y el movimiento de reforma Wahhābī. El carácter democrático de tal enfoque de taqlid no puede ser subestimado.

La forma de salafismo yihadista adoptada por ISIS amalgamó la tradición salafista con ideas derivadas de los primeros escritos de la Hermandad Musulmana. A pesar de que los inicios de la Hermandad fueron mucho más radicales de lo que se conoce actualmente, el movimiento fue más moderado que los salafistas yihadistas. Esto se demostró en su falta de hostilidad hacia otras denominaciones y sectas islámicas, y en el hecho de que aunque el movimiento abrazó la idea del Califato, lo percibió como un objetivo a largo plazo en lugar de una aspiración inmediata.

Si bien se ha argumentado anteriormente que el rechazo del taqlid demuestra un aspecto democrático del credo del yihadista-salafista, no se puede negar que el salafismo inspiró al ISIS a rechazar el poder democrático político y legislativo. Por ejemplo, armados con la comprensión de los salafistas de que cualquiera que invierta a los santos y sus tumbas es un apóstata, ISIS usó la analogía (qiya) para declarar a los demócratas apóstatas también sobre la base de su deseo de legislar (lo que consideraron una infracción, porque la legislación es prerrogativa del Legislador Divino). En contraste con el enfoque de los revolucionarios chiítas, los suyos justificaron el reemplazo de los sistemas de gobierno existentes por la ley islámica sin tener que proporcionar evidencia de las transgresiones de los respectivos gobiernos seculares a los que han llegado a derrocar. La distinción en las estrategias respectivas es muy significativa y dice mucho, entre otras cosas, sobre el impulso de la organización por la eficiencia. Prima facie, esto hace posible sugerir que si el califato de ISIS hubiera tenido éxito, habrían eliminado el sistema financiero indígena, reemplazándolo con el simple comercio de bienes y mercancías. Sin embargo, es posible que elijan otra vía, por ejemplo, una más pragmática, y restrinjan su sistema financiero a solo unos pocos derivados islámicos, quizás aquellos que facilitarían su comercio con productos básicos.

Esta posibilidad está respaldada por el análisis de tesis de las estrategias de financiación de ISIS, argumentando que, dependiendo de cómo se estructurara la transacción para la venta de petróleo, los futuros del petróleo pueden haber sido utilizados. Si este hubiera sido el caso habría dependido en gran medida de cómo y cuándo se le pagó a ISIS por la entrega del producto, si hubo entrega diferida y / o pago diferido y si estaba involucrada la moneda criptográfica. Además, teniendo en cuenta que se sabe que ISIS retiene la experiencia técnica de los gobiernos anteriores y los regímenes del sector privado y promueve la propiedad estatal limitada de la industria más allá de los roles regulatorios y fiscales, no es imposible que un ISIS exitoso se metamorfosee en un gobierno tecnocrático de derecha, que lo haría inevitablemente preservar algunos de los aspectos e instrumentos más eficientes del marco financiero islámico.

De cualquier forma que elijan, sería imperativo que se adhieran a la identidad, que ayudaron a crear en el transcurso de su advenimiento. Como se señaló en esta tesis, la identidad religiosa islámica se ha aplicado de manera confiable con el propósito de delinear el poder político. Con este fin, el extremismo cada vez mayor del ISIS no solo tenía el propósito de conmocionar para afirmar, sino también para crear una identidad común de los sujetos del califato. Si bien esta identidad estaría incompleta al principio, su simplicidad ayudaría a detectar a aquellos que no pertenecían al (califato siempre fluido) en un sentido ideológico y político. Esto sugiere que incluso si la organización radical se presenta a sí misma como un gobierno de derecha tecnocrático, sería abiertamente no democrática e ideológicamente extrema, aunque tal vez lo suficientemente avanzada en un sentido tecnológico. Esto no excluiría que ISIS diseñe su versión única de finanzas islámicas, más eficiente y amigable para los inversores que la discutida en este trabajo. Podría decirse que en un estado donde el poder gubernamental está centralizado, ambos objetivos podrían alcanzarse más fácilmente, como se señaló en numerosas ocasiones, una de las mayores debilidades del marco financiero islámico actual es la falta de armonización entre las muchas jurisdicciones.

Como último punto, que se relaciona con lo anterior, es concebible que parte de lo que causó la complejidad de los instrumentos financieros sunitas es la necesidad constante de la industria de apaciguar no solo a las juntas directivas de la Shariah responsables de la aprobación de los respectivos instrumentos sino también muchos eruditos de la sharia discuten sobre el tema del cumplimiento religioso. Podría decirse que un gobierno centralizado también ayudaría a este respecto, aunque no sea democrático, porque los instrumentos se beneficiarían de un único libro de reglas, que cubra los elementos técnicos y Shariah de las transacciones.

Un argumento de que este podría ser el camino posible de un gobierno tecnocrático extremista está respaldado por datos, discutidos en la tesis, que además de otros factores beneficiosos, como las reservas de petróleo y la estabilidad política, los países con un sector financiero islámico desarrollado se midieron mejor en términos del PIB. Sin embargo, la investigación también sugirió que el desarrollo de las finanzas islámicas parece estancado como resultado de las consideraciones de cumplimiento de la Shariah. Más específicamente, este autor argumentó que las economías musulmanas poscoloniales están experimentando actualmente un período de estancamiento secular, que podría ocurrir cuando la cultura tradicional se opone a los procesos de adaptación y crecimiento. En el contexto de las finanzas islámicas, esta oposición toma la forma de la desconfianza de los revivistas y quizás aún más, de los estudiosos sunitas tradicionales de las finanzas islámicas modernas.

Para recordar, las objeciones de estos estudiosos se basan en tres argumentos fundamentales.

• que las estructuras, como el tawarruq organizado, socavan la credibilidad de las finanzas islámicas en la base de clientes y la industria musulmana y no musulmana, porque demuestra que las finanzas islámicas a menudo simplemente imitan las finanzas convencionales. Esta tendencia se vuelve particularmente injustificada, donde tales prácticas sospechosas son en última instancia más caras para las partes contratantes.

• que simplemente imitando los instrumentos financieros convencionales ahoga la innovación y el desarrollo en el sector financiero islámico.

• que las estructuras que imitan a sus contrapartes convencionales perjudican el interés público al obstaculizar las negociaciones entre las instituciones financieras islámicas y los reguladores globales. Específicamente, esto proporcionaría menos oportunidades para adaptar el marco regulatorio global para adaptarse al de las finanzas islámicas.

Por lo tanto, el estancamiento en el sector financiero islámico mencionado anteriormente podría deberse a factores no económicos. Desde el punto de vista de la filosofía occidental, el estancamiento es la oposición al progreso, que se manifiesta a través de "libertad, felicidad o utilidad, y la realización de las capacidades humanas". En esta narración, el progreso es igual a bienestar. Sin embargo, etiquetar los procesos que se desarrollan en el mundo musulmán como retrasados en desarrollos progresivos equivaldría a ignorar las especificidades de las creencias islámicas. Estas creencias cuestionan fundamentalmente la importancia del desarrollo económico cuando se yuxtaponen a valores religiosos y morales islámicos. En su entendimiento, el bienestar de la Ummah se lograría mejor al adherirse estrechamente a las instalaciones de Shariah.

Esto sugiere que, en una lectura estricta de la ley Shariah, causar subdesarrollo o bajo rendimiento sería irrelevante siempre que aumente el bienestar de las personas. En la narrativa religiosa islámica, este sería el único comportamiento racional porque promueve el progreso tal como se entiende en la tradición filosófica islámica.

La importancia de esta conclusión es significativa. El análisis de este trabajo sugirió que el mundo islámico exhibe una tendencia de conversión de creencias que es particularmente evidente en la esfera del radicalismo. Además, tales ideas tienden a circular con éxito sin encontrarse con una seria oposición académica. Esto impacta el desarrollo de las finanzas islámicas de dos maneras principales.

Primero, el "radicalismo suave" de los puristas que critican constantemente el marco financiero islámico actual interviene en el mercado con un éxito variado, lo que puede causar fluctuaciones desfavorables debido a preocupaciones de legitimidad.

En segundo lugar, la flexibilidad exhibida por los tradicionalistas sunitas en su búsqueda del orden sobre el caos explica su tolerancia a un marco que a menudo se le acusa de criticar las finanzas convencionales e introducir subrepticiamente prohibidos por los principios de la ley islámica. Si bien en la actualidad esta flexibilidad permite que el mundo sunita se abra a prácticas económicas aparentemente modernas, eventualmente podría cambiar hacia una línea dura y la consolidación detrás de una entidad más intransigente. Es más probable que se llegue a ese resultado si las finanzas islámicas no logran solidificar su base ideológica de una manera aceptada en todo el mundo islámico.

FinTech en finanzas islámicas

Como último punto, este trabajo consideró el impacto de FinTech en los objetivos de gestión y desarrollo de riesgos. El autor consideró el informe de la Junta de Estabilidad Financiera (FSB), que resumía los beneficios potenciales de FinTech, que se decía que contribuían a la ‘descentralización y una mayor intermediación por parte de entidades no financieras; mayor eficiencia, transparencia, competencia y resiliencia del sistema financiero; y una mayor inclusión financiera y crecimiento económico, particularmente en los mercados emergentes y las economías en desarrollo ".

Paralelamente, el Consejo destacó el riesgo microfinanciero y macrofinanciero (por ejemplo, crecimiento crediticio no sostenible, mayor interconexión o correlación, incentivos para una mayor toma de riesgos por parte de las instituciones establecidas, prociclicidad, contagio e importancia sistémica) relacionados con las tecnologías financieras. Es significativo que el análisis sobre sukuk destacó que gran parte de los riesgos micro financieros inherentes a FinTech (por ejemplo, riesgo de crédito, apalancamiento, riesgo de liquidez, desajuste de vencimientos y riesgos operativos, especialmente cibernéticos y legales) son aplicables a las inversiones en la emisión de sukuk. Este sería particularmente el caso en lo que respecta al riesgo de crédito y el desajuste de vencimientos. Con este fin, se podría sugerir que desde una perspectiva microprudencial, la introducción de la tecnología en la emisión de sukuk, que ha comenzado a tener lugar, podría aumentar los desafíos específicos de sukuk existentes y debe ser observada de cerca.

Es alentador que con respecto a la criptomoneda, que es posiblemente el elemento más arriesgado introducido por FinTech, los gobiernos de los Estados musulmanes parecen reaccionar de manera oportuna con una gran cantidad de legislación promulgada en Indonesia, Pakistán, Arabia Saudita, Emiratos Árabes Unidos, Bahrein, Kuwait y Qatar, por nombrar solo algunos. Además, en 2019, Malasia, que es uno de los principales actores del mercado, impuso nuevas y duras leyes de ICO y criptomonedas.

También es interesante el tema del riesgo legal y regulatorio que plantea FinTech. Como se identifica en el Informe del FSB, existe una falta problemática de regulación y, más específicamente, una regulación globalmente consistente. La falta sugerida de seguridad jurídica a nivel jurisdiccional con respecto a los asuntos relacionados con FinTech, incluida la regulación del comercio y la propiedad transfronterizos, particularmente en lo que respecta a los contratos inteligentes y el asesoramiento robótico, trae una analogía al marco de sukuk, que se vio que mostraba problemas similares. Dado que el área de las finanzas islámicas experimenta importantes desafíos regulatorios que se deben a la falta de armonización, es discutible que cualquier introducción de tecnología financiera en las actividades establecidas se debe hacer con cuidado y con atención a los desafíos ya identificados.

De lo contrario, es probable que se dé cuenta del riesgo de contagio, implicado en FinTech, que lleva al mercado los problemas de contagio de reputación y contagio a través de la excesiva dependencia de la automatización. La investigación sugirió que, aunque es más probable que el primero opere entre los usuarios minoristas, aumentando el riesgo de prociclicidad, el segundo puede tener consecuencias microprudenciales más fuertes, particularmente si su resultado sería la creación de puntos de entrada débiles.

La prociclicidad podría ser un problema importante en la encrucijada entre FinTech y las finanzas islámicas. Como se señaló, los clientes minoristas, incluidos los inversores, suelen ser más sensibles al pánico del mercado y propensos al comportamiento de pastoreo. Esta consecuencia solo puede ser exacerbada por la dinámica impredecible de las plataformas de préstamos o inversiones habilitadas por FinTech. Si bien se ha identificado que el abastecimiento de capital es un tema particularmente delicado para FinTechs, que dependen en gran medida de la confianza de los inversores en ellos, no se ha examinado cómo se resolverá este problema cuando FinTechs se adentre en instrumentos, como sukuk. La incertidumbre en cuanto al resultado de esta asociación aumentaría si otros riesgos relevantes entran en la ecuación, como el riesgo de bajar los estándares de préstamos y no evaluar con precisión la calidad crediticia.

Lo anterior no debería desviar la atención de los indudables beneficios que FinTech podría aportar a las finanzas islámicas. No se puede pasar por alto la capacidad de FinTech para promover la inclusión y la eficiencia a través de una mayor velocidad y reducción de los costos. Además, los desafíos que enfrenta la financiación islámica incluyen la competencia del sector de las finanzas convencionales. Con este fin, FinTech podría crear muchas oportunidades para que los financieros islámicos y las empresas financieras islámicas se conviertan y sigan siendo competitivos en un mercado en constante cambio.

Sin embargo, los puntos de preocupación planteados anteriormente no deben pasarse por alto porque la combinación de los riesgos presuntamente inherentes a FinTech con los ya identificados en el marco financiero islámico, especialmente la emisión de sukuk pero también en el área de los contratos islámicos en general, puede contribuir a Un régimen potencialmente insostenible.

Conclusión

Teniendo esto en cuenta, sería importante que una de las principales conclusiones de esta tesis fuera que la mayoría de los instrumentos financieros islámicos utilizados actualmente son deficientes en términos de cumplimiento de la sharia.

Tales consideraciones nos llevan de vuelta a la pregunta, apuntalando esta investigación; a saber, cuán viables serían los derivados convencionales e islámicos, en condiciones de Islam radical. La sorprendente respuesta a la que se llegó fue que, si bien la viabilidad de los instrumentos financieros islámicos actuales probablemente se verá afectada por una transición hacia el extremismo, las finanzas islámicas como sector de la economía persistirán.

El autor propuso que un gobierno extremista (yihadista-salafista) iría en una de las dos direcciones posibles. O (similar a Irán) preservará una versión muy limitada del marco existente, utilizando solo estos instrumentos que son estrictamente necesarios para el financiamiento basado en el comercio y los productos básicos, o creará un sistema único que cumpla con la Shariah, que estará poblado por instrumentos financieros novedosos gobernados centralmente. Con este fin, la gobernanza central garantizaría que no se plantearían cuestiones de cumplimiento de la Shariah y garantizaría el desarrollo de instrumentos financieros y comercio. Se sugiere que los problemas actuales de protección de los inversores del marco financiero islámico probablemente se resolverían en dichos estados debido a la regulación emitida por el Estado o por el Estado que respalda las transacciones, según corresponda. Este autor argumentaría que es más probable que ocurra lo primero, debido a las tendencias derechistas de los movimientos yihadistas-salafistas.

Lo anterior apunta fuertemente hacia la conclusión de que los derivados convencionales serán en gran medida obsoletos en un estado yihadista-salafista.

Fuera del escenario del gobierno extremista, esta investigación respalda la conclusión de que la viabilidad de los instrumentos financieros islámicos actuales está bajo una amenaza mucho mayor desde adentro; a saber, una amenaza debido a sus deficiencias estructurales, que conduce a ineficiencias y a la falta de protecciones adecuadas para los inversores en caso de incumplimiento. Como lo dejó claro en los capítulos relevantes, los instrumentos financieros islámicos son productos híbridos, en los que un acuerdo financiero convencional se transpone al marco financiero conforme a la Shariah mediante el uso de contratos islámicos tradicionales. Sin embargo, esta transposición parece haberse hecho apresuradamente, con atención al objetivo final en lugar de a los detalles. El resultado es un acuerdo contractual, que funcionaría suficientemente bien hasta el momento en que ya no lo haga. Desafortunadamente, para el caso de tal ocurrencia, el marco financiero islámico no ofrece protecciones adecuadas para las partes involucradas. Lo que es aún más preocupante es que, debido a los detalles de estos instrumentos, encontrar una solución fuera del marco financiero islámico también sería difícil de lograr.

Esto podría tener el efecto de socavar la confianza en las finanzas islámicas y erosionar la confianza de la población en los respectivos gobiernos, desarrollando el sector. El autor concluyó que, si no se aborda haciendo cambios en la estructura de los instrumentos infractores, el proceso de "radicalismo suave" provocado por tal descontento de base puede pasar a políticas económicas de línea dura, afectando la viabilidad de los instrumentos (y acuerdos contractuales) utilizados en la actualidad. Sin embargo, en la medida en que este proceso tenga lugar en un estado secular, la viabilidad de los derivados convencionales no se verá afectada negativamente.

Recomendaciones

Visión de conjunto

Esta investigación estableció que los instrumentos financieros islámicos muestran deficiencias estructurales, lo que los hace potencialmente problemáticos desde el punto de vista de la protección de los inversores. Estas deficiencias se deben a la estructura híbrida de los instrumentos relevantes, que se compone de características prestadas de sus contrapartes convencionales, incorporadas para trabajar de manera compatible con la Shariah. El problema de este arreglo es que la hibridación de los instrumentos cambia inevitablemente su naturaleza. Lo que ocurre al final es un instrumento que no cumple realmente con la Shariah, ni es suficientemente reconocible bajo el marco legal convencional y más específicamente inglés. Además, hasta el punto de que ciertas características de la ley inglesa se han absorbido en las finanzas islámicas, esto se ha hecho sin contar con el sólido marco prudencial y de protección de los inversores de la legislación inglesa y de la UE.

Además, los instrumentos financieros islámicos utilizados actualmente sufren de debilidades debido a su complejidad y falta de transparencia. Estos problemas se destacaron en la discusión sobre wad y particularmente en las discusiones sobre la estructuración de arreglos complejos, como los derivados islámicos y el sukuk. Esto da como resultado transacciones costosas, con el costo aquí medido en términos de tiempo invertido, dinero y gastos legales. Estos arreglos son, además, muy arriesgados. Desafortunadamente, el riesgo lo asume la parte más débil, lo cual es contrario a lo que predica la ley islámica.

Con este fin, se podrían hacer dos conjuntos de recomendaciones.

Con respecto a los derivados islámicos

Primero, las transacciones podrían ser despojadas de su complejidad mediante la introducción de nuevos términos y enfoques. Por ejemplo, podría haber un preámbulo para cada contrato, cuya firma confirmaría que se asume la etapa de wa'd (y todas las otras etapas de la transacción, que están allí únicamente con el fin de hacer que el contrato cumpla con la Shariah) haber tenido lugar Esto podría hacerse en el caso de tawarruq, wa'd-murabaha o similares. Como el derecho contractual islámico tiene en alta estima las intenciones de las partes, el enfoque sugerido no diferiría de las intenciones de las partes, como se establece en los actuales contratos de waurad murabaha o tawarruq, o en las opciones islámicas actuales basadas en wada. El mismo enfoque podría aplicarse a otras estructuras complejas, donde la complejidad se debe a problemas de cumplimiento de la Shariah.

En segundo lugar, se podrían diseñar instrumentos completamente novedosos, que cumplan con la Shariah, cuya estructura incorporaría la sugerencia anterior, omitiendo por completo la fase en la que se acumulan pequeñas transacciones para demostrar el cumplimiento. Para garantizar que no se acumulen intereses de manera indebida, cualquier monto por encima de los gastos administrativos debe ser desviado a organizaciones benéficas, por ejemplo, en la creación de un marco para una mayor inclusión financiera de la población, educación financiera o vías similares. Estos instrumentos deben preservar el principio de participación en las ganancias y pérdidas para garantizar que ambas partes sean incentivadas a participar en la transacción.

Con respecto a sukuk

Los acuerdos de sukuk podrían beneficiarse de una revisión de la estructura de sukuk para hacerla más aceptable para el regulador convencional (lo que afectaría positivamente la inversión de los financieros convencionales en la emisión de sukuk). Sin embargo, esto parece difícil de hacer, teniendo en cuenta los problemas de cumplimiento de la Shariah. Con esto en mente, se sugiere que la mejor solución para el marco sería introducir una regulación local más estricta del producto, particularmente en relación con el aspecto de incumplimiento.

Alternativamente, la protección del inversor en el caso de sukuk basado en activos podría lograrse mediante la creación de un fondo, mantenido en fideicomiso por el gobierno respectivo, donde cada emisor u originador está obligado a invertir una cierta cantidad de dinero, garantizándolo en caso de incumplimiento, sus inversores serían reembolsados. Los emisores pueden obtener una licencia sujeta a estas condiciones (además de otras condiciones aplicables) que se cumplan. Si bien es muy onerosa, esta medida garantizaría que el público solo ofrecerá proyectos comercialmente viables para su financiación o que, alternativamente, los creadores volverán a la práctica del sukuk respaldado por activos. Para garantizar que el dinero del fondo se aplique de manera eficiente, podrían invertirse en otros proyectos comercialmente viables y que cumplan con la Shariah.

Una solución más amigable para el emisor sería seguir el ejemplo alemán y solicitar que los activos del conjunto de activos se registren en un registro de refinanciamiento y se consideren activos pertenecientes al beneficiario, permitiendo así que él sea reclamado por él en caso de insolvencia del originador.