ISLAMIC FINANCE

By

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PREFACE

Interest *(riba)* is largely responsible for most of the social sufferings. The worst is that it multiplies like nothing else, and the so-called civilised society calls it compound interest. It becomes the proverbial white elephant given to a poor man to ride on.

It is here that Islamic Finance assumes importance as the viable alternative. Yes, to talk of Islamic Finance in a riba-ridden society is like applying a soothing balm to the wounds of a typical modern man, who is writhing on the hot bed of exploitation, inequality and injustice. Islam promises to rid the society of economic exploitation and injustice; for it is the complete system, which encompasses every aspect of man's life fully and perfectly.

There is a crying need to say NO, of course with zeal and determination, to interest in financial markets as well as in the banking system. And no stone should be left unturned to banish it from society lock, stock and barrel.

Mr. Suhail Zubairi as vice-president, Shari'ah structuring, documentation and product development, Dubai Islamic Bank has vast experience of the latest trends and experiments in the field. His writings are marked by clarity of thought and lucidity of expression. We are indeed pleased to present the writings of Mr. Zubairi in a book form with the hope that professionals, teachers, and students of Islamic Finance in general and Islamic Banking in particular will find it highly informative and useful for restructuring the society on healthy grounds.

OPERATION OF INVESTMENT FUNDS

Stock markets have seen stunning developments in recent years in which various major international bourses have been linked and the on-line trading has been made possible.

In this state of the art environment, it has become much easier and safer for an investor to choose from a wide range of securities and trade on-line - without the help of brokers or intermediaries.

An Islamic investor has also benefited immensely from the above technological advancements and can now directly invest in an individual stock from an Islamic securities index from the comfort of home and exit whenever desired.

These developments have helped an Islamic investor to effectively deploy his surplus liquidity without the fear of violating *Shari'ah* regulations.

In addition to *Shari'ah* compliant securities, an investor can also choose from a wide variety of Islamic funds.

An Islamic fund comprises a well-diversified portfolio of various *Shari'ah* compliant securities. The selection of securities in a fund is conducted through a series of screenings under the watchful supervision of *Shari'ah* scholars.

It includes checking on a company's line of business, examination of its debt level, review of its cash and debtors holding and the level of interest bearing deposits and investments.

While investing in an Islamic fund could be a relatively low-risk option in view of its carefully diversified base, there is an attendant cost to it that is in addition to the dividend tax an investor has to bear in any case.

This is the administrative cost at a pre-agreed ratio a fund manager is authorised to charge to the investor in the capacity of a *Mudareb.*

Islamic mutual funds have existed in some form since the mid-1980s. However, they were on small scale and largely localised, serving certain social purposes such as Islamic community welfare.

Islamic funds started becoming popular from the early 1990s; however, they got a shot in the arm with the launch of Islamic securities indices during the late 1990s.

Today, almost every prime bank from the developed world has some or the other role to play in developing, managing or marketing an Islamic fund.

Portfolio of an Islamic fund may typically consist of a mix from the following *Shari'ah* compliant asset classes:

- Equities of the companies whose activities are not *Shari* repugnant
- Spot trading of commodities such as grains, cereals, metals and minerals but excluding gold and silver
- Real estate
- *Sukuk* (Islamic bonds)
- Short-term cash and cash equivalent pending investment but held with Islamic financial institutions
- Finance and operating leases

Islamic fund can be open or close-ended and an investor can buy a stake at its launch or invest later if it is an open-ended fund. The investor receives a certificate testifying to his subscription to the fund and entitling him to receive profit which is distributed pro-rata to the period that his funds remain invested. Distribution of profit could be annual or interim.

The investor must enter into the Islamic fund with a clear understanding that the return on his subscription is tied up with the actual performance of the fund which means the fund could also perform negatively thereby eroding value of the investment partly or fully.

Nevertheless, if the loss is caused by the negligence or mismanagement by the fund manager, the investor will not be responsible and the fund manager will have to make good the loss. As such it is important to examine the credentials of the fund manager while selecting an Islamic fund.

SOME MEASURES TO KEEP A FUND *SHARFAH-COMPLIANT*

How do Islamic funds manage to maintain their identity and what measures are adopted to keep them Shari'ah-compliant? We will have a look at some of the measures.

First of all, it is important to note that an Islamic fund running without *Shari'ah* supervision of any sort does not qualify to receive fund for investment. When an investor opts for Islamic funds, he expects the fund managers to go to great lengths to keep the fund Shari'ah-compliant at all times. Such expectations put enormous pressure on fund managers to remain extra vigilant in order to maintain the integrity of their fund.

The following are various measures adopted to keep the fund Shari'ah-compliant:

***Shari'ah* supervision board**

Retaining the services of a full *Shari'ah* supervisory board with at least three members is preferable since it is reassuring to the investors.

If the fund is heavily reliant upon investing in the securities from the Islamic indices, one *Shari'ah* supervisor could also be considered enough, the reason being that such securities are already well screened by the *Shari'ah* supervision board of the respective Islamic index.

Shari'ah supervisors are actually the investors' representatives as they take every possible measure to ensure that the fund's investments remain *halal* and that the distribution of dividends is pure and free from *riba* (interest) and any other *non-halal* income.

Purification of portfolio

Purification is used here in the context of cleansing the fund's investment portfolio of the impure elements.

What could be these impure elements? These are the undesired earnings by the companies in which the Islamic fund may have invested. Such impure earnings must be quantified and then purged from the fund's income. Even Shari'ah-compliant equities may often yield a small percentage of income that is considered impure by *Shari'ah* standards, and which must then be purged. Such undesired earnings include interest income and dividend from investments in Shari'ah-prohibited activities (such as banks and insurance companies, hotels and casinos, etc).

It is the responsibility of the *Shari'ah* supervisor to see that all such income is monitored and a corresponding percentage is deducted from the dividend before it is paid out to the investors. It is important that the fund is actually committed to and is regularly engaged in such a purification exercise from time to time on behalf of the investors.

The amounts so deducted will, no doubt, impact on a fund's return ratios. However, if not extracted, this will render the entire dividend amount murky and the purpose of investing in an Islamic fund will be defeated from the investors' point of view.

Monitoring

In the case of a cross-section of securities in a managed portfolio, the fund's management is responsible for monitoring the stocks periodically through their *Shari'ah* supervision board.

This is because a company having earned interest income at less than five per cent of the total net income during the first fiscal quarter may end up making over 15 per cent from the interest income by the year-end.

While the ratio of interest income in the first quarter is within the *Shari'ah* restriction, the total amount made by the company during the whole year exceeds that threshold. As such, regular vigilance will be required in these matters to ensure that all of the fund's holdings remain within the limits of the prescribed *Shari'ah* filters.

Furthermore, when a fund is connected to an Islamic index, the index provider will pass on all such information to the fund manager. In such cases, the responsibility of the *Shari'ah* supervisor will be to identify and recommend the removal of such securities from the fund's portfolio.

Sophisticated software has since been developed to track securities with ease. Such software, when connected to the Internet, will also provide real-time access to the portfolios as well as a host of other information. However, it is the prerogative of *Shari'ah* supervisors to determine which stocks should be exited.

Fund manager's fees

From an investor's point of view, this is a very important aspect where he would like to see the *Shari'ah* supervisors protect his interests in the best possible manner. He expects to be advised in clear terms as to the extent of the fund manager's fees and charges and how these are structured.

There is generally no formal channel of communication (other than periodical *Shari'ah* reports) between the *Shari'ah* supervisors and the investors of the fund. As such, *Shari'ah* supervision of the fee is all the more important.

Shari'ah supervisors, therefore, ensure that the fee structure is Islamically correct and does not contain a *Gharar'* (hazard) or element of uncertainty and, secondly, that the fees are clearly stated in the fund's literature and otherwise communicated without ambiguity to investors.

This acquires greater importance since at present most of the Islamic investors approach Islamic funds directly, and on their understanding that the product offered is *halal* and will yield *halal* profits.

As the market for Islamic funds grows, the investment professionals, including conventional brokers and consultants, may become familiar with the various offerings and will be able to explain ail of the nuances and differences between various Islamic funds available to their clients.

Documentation

It is of paramount importance that *Shari'ah* Supervision Board members are actively involved in the preparation of all documents related to the fund. The board members provide the necessary guidance in formulating the literature on offer, preparation of filings for regulatory agencies, drafting of subscription agreements, private placement memorandums, fund prospectuses, and the like.

Obviously, in the above process, references will need to be made at many places to various *Shari'ah* terms and their interpretations. For this reason, it is essential that the *Shari'ah* scholars actively participate in this initial process.

Furthermore, though not essential, *Shari'ah* scholars should also take an active interest in the promotional material of the fund such as brochures, advertisements, web sites, and even multimedia presentations so that they can ensure that the correct message is being sent out to the potential Islamic investors.

Monitoring the industry

It is essential that the *Shari'ah* supervisors remain well acquainted with the developments in their industry. However, it does not require them to interfere in the day to day management of the fund. In order to maintain an edge, *Shari'ah* supervisors need to closely follow the fluctuations in the fund's relevant stock markets and analyse various indicators.

Product development

The product development aspect is more synonymous with Islamic banks. Nonetheless there is a certain amount of scope for it in Islamic funds as well. With the goal of mitigating risk through portfolio diversification, an Islamic fund might consider turning to markets other than the stock market, such as property or venture capital activities, etc. Such product development must be pre-approved by the *Shari'ah* scholars of the fund.

Zakat

It is generally assumed that if Islamic funds can undertake purification, then they should also do something about zakat.

This, however, is not the case. The matter of zakat is complicated by a number of factors that lie outside the control of an Islamic fund manager. Since these factors are peculiar to the circumstances of each investor, the matter of zakat is best left to the investors themselves.

However, it is advisable that the *Shari'ah* Supervision Board of the fund should prepare some kind of guideline for the investors on payment of zakat and distribute it at the time of sending them the dividend cheques.

Regular reports

Finally, one of the most important functions of a *Shari'ah* Supervision Board is to prepare periodical reports on the status of the fund supervised by it. Such reports should address issues, if any, on the *Shari'ah*-compliance status of the fund.

Likewise, the reports should keep investors informed of the purification process and the charitable ways in which purification money has been put to use by the fund.

***Shari'ah* screening parameters**

Following are the essential screening parameters that make a company eligible for entry into an Islamic index and from there to an Islamic fund:

a) The company's activities should not include liquor, pork, hotel, casino, gambling, cinema, music, interest-bearing financial institutions, conventional insurance companies, etc.

b) The total interest-bearing debt of the company at any point in time should remain below one-third of its average market capitalisation during the last 12 months.

c) The sum of a company's cash and interest-bearing securities must not be greater than 33 per cent of its trailing 12-month average market capitalisation.

d) Its aggregate of account receivables should remain below 45 per cent of the total assets.

The manufacturers of tobacco and weapons/ammunition, although not clearly forbidden for investment under *Shari'ah,* are also excluded from the index under advice from scholars due to the known harmful effects of these industries on a society.

The index managers strictly monitor the measures approved by the panels of reputable *Shari'ah* scholars on an ongoing basis. A company is removed from the index if it fails to meet any of the above litmus tests. The integrity of an Islamic index is regarded by the frequency of periodic reviews conducted by its *Shari'ah* board.

One may ask whether these screening parameters ever proved effective to the benefit of the investors. The reply is in the affirmative. It is a matter of surprise but Islamic investors breathed a sigh of relief upon knowing that their fund managers had liquidated WorldCom shares (the giant U.S. telecom company with a valuation tag of about $200 billion) as early as by the third quarter of 2001.

The decision to remove WorldCom was taken simply because its debt ratio had far exceeded the said *Shari'ah* barrier.

Fund managers around the world follow Islamic indices and when the company was removed from renowned Islamic indices, they were forced to sell off WorldCom shares at a decent $14 per share compared to naught upon the company's collapse.

There are numerous other glaring examples, the major ones being Enron and Tyco where Islamic fund managers had come out unscathed, well ahead of the collapse of these conglomerates like a house of cards.

There is no magic power behind these safe passages. It is simply strict adherence to the *Shari'ah* parameters set by the scholars with great care.

The above significant developments, taking place one after another, provided much-needed support for the very concept of Islamic indices and funds.

Investors around the globe took notice of the aforementioned prudent measures adopted by the managers of the Islamic indices and now keep regular vigil as to the equities being added or removed from them.

It may sound bizarre but the multinational public joint stock companies around the world with activities within the ambit of Islamic ideology are getting increasingly wary of the above screening parameters, especially their debt levels. As such, the sudden recognition of the genius of Islamic indices and fund managers has started to work as quasi-regulatory.

The Islamic funds mart considered a rarity until the late 1990s is now buzzing with activity. Many prime banks with established brand names and large networks are already playing or seeking to play some role in launching or getting associated with an Islamic fund.

These banks find the idea attractive for their risk-shy clients who would not normally look at a high-risk conventional fund.

Furthermore, the massive Muslim population in the world makes the statistical work easy for these banks, as there is great scope for growth of Islamic funds within the Islamic world itself, especially the financially rich Gulf countries.

The current need is that Islamic banks should endeavour to introduce Islamic financial products, especially funds, into the Islamic countries as well as the West and the other non-Muslim countries by tying up the arrangements with their counterparts.

ROLE OF AGENCY IN VARIOUS ISLAMIC FINANCING STRUCTURES

Tn the implementation process of an Islamic financing Itransaction, the agency plays an important role in keeping the transaction Shari'ah-compliant as well as mitigating undue risks to an Islamic bank.

Now we will start our discussion on various types of agencies in different financing modes and their respective purposes.

***Murabaha* (sale of goods with profit)**

A *Murabaha* transaction entails sale of goods by an Islamic bank to its customer with cost plus profit, usually on a deferred payment basis.

In *Murabaha* financing, an Islamic bank appoints the customer itself as an agent to select the required goods on its behalf. The bank then purchases the goods and sells them to the customer along with its profit at agreed payment terms.

The same practice is adopted when a customer approaches the bank to establish a letter of credit for import of certain goods. The customer becomes the bank's agent in selecting the goods, which are delivered by the bank to the customer upon arrival in order to complete the sale.

It is worthwhile to note that as a principle, an Islamic bank also deals in goods, rather than confining itself to the documents as in the case of conventional banks. This is because as per *Shari'ah*, in order for it to 'sell' something, the bank must 'own and possess' it.

Both contracts, namely, Agency and *Murabaha,* are entered into between the same parties i.e. the bank and the customer, but in different capacities. According to *Shari'ah,* these contracts should be independent of each other since they have different scopes.

The agency contract culminates upon the delivery of goods by the customer to the bank in the capacity of its agent, whereas *Murabaha* takes effect from this point when the bank, acting as seller, hands over the goods to the customer, who now switches role to buyer.

By appointing the customer as its agent, an Islamic bank effectively mitigates the risk of being duped in the shape of goods being declared spurious by the customer, thus refusing to take the delivery.

Ijara **(leasing)**

Under *Ijara,* at the customer's request, an Islamic bank buys an asset to lease it to the customer for a specified tenure and at an agreed lease rent.

As the physical possession of the asset remains with the customer in order to enjoy usufruct, it is appointed as service agent for carrying out major maintenance, repairs and insurance on behalf of the bank.

It is important to remember that being the owner of the asset and in the capacity of lessor, it is the responsibility of the bank to carry out such acts in order to keep the asset in working condition so as to allow the customer (lessee) to enjoy the usufruct in an uninterrupted manner in return for the lease rent.

It is necessary to clarify at this point that the operational repairs and maintenance and the other kinds of insurance (such as third party insurance or workmen's compensation, etc.) connected to the usage of the asset is the direct responsibility of the lessee at its own cost.

Under *Shari'ah,* the lease terminates the moment a leased asset loses its agreed usefulness to the lessee irrespective of how it happens, whether due to the major loss caused by the lessor's negligence, force majeure, act of God, etc. Nevertheless, if it was caused due to the lessee's wilful misconduct and negligence, the lease will continue.

As such, by appointing the customer (lessee) as its service agent, the bank successfully shifts the risk and responsibility of major repair and maintenance and insurance of the asset to the customer.

It will be interesting to examine the dual role played by an Islamic bank and its customer in an *Ijara* transaction.

First, the bank is lessor (being the owner of the asset) and the customer is lessee. At the same time, the bank becomes a principal and the customer its service agent.

Unlike *Murabaha,* both contracts run parallel in *Ijara.* In the first contract, the customer as lessee is liable to pay the lease rent so long as it continues to enjoy the usufruct over the leased asset, whereas in the second contract, the customer, in the capacity as lessor's agent, is responsible for carrying out major maintenance and repairs and keeping the asset insured at the cost of the principal (lessor and owner).

Reimbursement of major repair & maintenance cost

Sometimes the cost of major repair and maintenance could be large if it is a high value asset such as a plant, vessel or aircraft. If the lessee carries out the above tasks as service agent on behalf of the lessor (owner). how is he reimbursed for the costs incurred by him in doing so?

In any case, *Shari'ah* emphasises that the service agent should not remain out of pocket for the amount spent by him in carrying out the jobs assigned to him by the principal (lessor).

As such, the Islamic banks have devised a procedure under the guidance of *Shari'ah* scholars whereby the cost incurred by the service agent may be reimbursed to him. Such an amount is then added by the bank to the amount of lease rent for the next period.

Let us try to understand it by way of an example. Assume that the lease rent of an aircraft is Dh5 million a quarter. The lessee, in the capacity of service agent, has spent Dh0.5 million during the current lease period on carrying out major repair and maintenance besides the insurance expenses.

The principal (owner and lessor) will be required to reimburse the service agent (lessee) by the said amount and at the same time increase the rent for the following rent period by this amount, thus making the lessee pay an amount of Dh5.5 million as lease rent for the following quarter.

Shari'ah scholars have approved this mechanism on the simple basis that the rent charged by the owner of an asset is always reflective of the cost incurred by him in keeping the asset in good usable condition.

Lease period

It is not necessary that the service agency contract also comes to an end upon completion of the agreed lease period. In fact, it is normal that the service agent continues to be responsible to the principal for a reasonable time even after the end of the lease period until the principal (lessor) has received all his dues. This is particularly useful to the principal in a situation where an insurance claim, lodged by the service agent, is in process.

In a situation where an Islamic bank is the co-owner in an asset along with the customer, the bank appoints the customer as its service agent to carry out major repair and maintenance, and insurance.

Musharika **(co-ownership in an asset)**

A customer gradually purchases the bank's share of the ownership in a *Musharika* (co-ownership in an asset) transaction. At the same time, he is also required to lease the bank's part of ownership in the asset.

As such, the customer actually makes two periodical payments to the bank - one towards part purchasing the bank's ownership in the asset and the other being rent on leasing out the remaining part of the bank's ownership in the asset.

It is interesting to note that in *Musharika,* the bank and customer play a triple role.

The bank is first a co-owner, then lessor and, finally, the principal. Similarly, the customer is also co-owner of the asset, then a lessee for the part of the bank's ownership in the asset and at the same time the service agent.

In the last capacity, the customer is also looking after his own interest since his share of ownership in the asset is on a gradual rise. Please note that the three contracts run parallel.

In *Musharika,* too, the customer, acting as service agent, incurs certain costs in carrying out major repair and maintenance besides the insurance.

However, such costs are shared between the bank and the customer pro rata, according to their share of ownership in the asset at that time.

Similar to *Ijara*, the service agent (customer) is eligible to get the reimbursement of the bank's share of such costs.

On the other hand, the bank, too, is entitled to add such costs back to the next lease rental period.

It is worth noting that as the customer's ownership in an asset increase, his eligibility to claim reimbursement in the capacity of the bank's service agent is reduced.

Istithna

Istithna is a transaction where an asset can be sold before it comes into existence. However, the asset must be developed or manufactured from scratch. This condition portrays the literal meaning of the word *`Istithna',* i.e. to manufacture or build.

In other words, *Istithna* is a contract where an Islamic bank undertakes to manufacture or build an asset according to a certain pre-agreed specification and at a pre-fixed price.

The bank releases finance in phases commensurate with the progress in developing the asset. *Istithna* may include any process of manufacturing, construction, assembling or packaging.

Islamic banks commonly adopt *Istithna* for providing finance to construct a building, develop an industrial concern, and build a vessel or an aircraft, among others.

Islamic banks, as on date, do not possess the necessary arrangement and expertise to carry out timely completion of any type of asset according to a pre-agreed specification and at a fixed price. It will require huge investment to maintain the necessary infrastructure and hire experts to accomplish the job, which is financially not viable. Furthermore, there will always be room for argument by the client that the completed asset does not fully conform to the agreed specification, thus leaving the bank exposed to the risk of refusal by the client to take delivery of the asset.

An Islamic bank overcomes this gray area by appointing the client as its agent. The scope of such an agency includes manufacturing or building the required asset as per specification and delivering it to the bank upon completion, which will then sell it to the client.

Since in reality it is the client who is going to acquire physical possession of the asset upon completion, he will obviously ensure full adherence to the required specification in building the asset.

Under the agency agreement, if the agent (client) fails to comply with the required specification, he will be responsible to the principal (bank) for damages.

As such, this built-in safety valve in *Istithna* financing adequately protects the bank from any risk of refusal by the client on the grounds that the asset has not been built according to his required specification.

Wakala financing

When an Islamic bank nominates the client as its agent for investing funds to earn profits it is finanxing under *Wakala*.

The Islamic bank undertakes this type of financing on a select basis and most of the time as part of a package, mainly in order to meet a client's working capital requirements.

The *Wakala* financing agreement contains clauses to state that the agent (client) will deploy funds into a specific business activity where he holds the necessary expertise and anticipates annual profitability in a certain percentage range (e.g. between 10-15 per cent).

The client is also required to submit a realistic feasibility study projecting such return.

The agent is required to deploy the principal's funds in a judicious manner and within the agreed parameters.

In case of deviation, the agent will be held fully responsible for financial loss, if any, caused to the principal due to the agent's wilful misconduct, negligence or default.

However, if the loss did not occur due to the agent's negligence, the principal will be required to bear the same in full.

In the normal situation, the bank may agree to obtain part of the income and allow the agent (client) to retain the rest as an incentive for prudent deployment of funds.

Agency Fee

According to *Shari'ah,* it is necessary that the principal pay a certain amount as fee to the agent in compensation for his agreement to act as agent.

An agency arrangement without provision of the fee cannot be considered irrevocable under *Shari'ah,* thus allowing an agent the right to terminate it at any time.

Obviously a principal would not like to be in a situation where an agent can just walk away leaving his obligations unfulfilled and he cannot be held responsible for anything.

Therefore, Islamic banks make it a point to insert a fee clause in an agency agreement in order to hold the agent responsible.

As the agency fee is purely an expense on the bank's part and cannot be recovered from the client, banks keep the amount to a minimum.

An Islamic bank as agent of other banks

We have discussed how an Islamic bank overcomes its *Shari'ah* obligations emanating from the ownership of the goods under *Murabaha,* ownership of an asset under *Para,* part ownership of asset under *Musharika,* as a builder under *Istithna* and as financier under *Wakala,* by nominating its client as agent on its behalf with varied responsibilities.

Can an Islamic bank also be nominated as agent and if so, under what circumstances?

Yes, an Islamic bank also plays the role of an agent, most frequently in large syndicated financial transactions. In such deals, Islamic bank is appointed as facility agent and security agent by the other banks participating as co-financiers.

It is not necessary that the other financiers should also be the Islamic banks. Whilst *Shari'ah* scholars allow conventional banks to participate in an Islamically structured financing transaction, they forbid an Islamic bank from taking part in a conventional financial deal due to presence of the element of *Riba* (interest).

Majority of the large-scale Islamic syndicated financing transactions carried out in the Gulf region so far have been based on the concept of *Ijara* (leasing) or *Musharika* (co-ownership).

Under such a transaction, an Islamic financial institution plays the role of 'lead arranger' with the primary responsibility for organising syndicated financing.

It negotiates terms of the Islamic financing facility with the client, assesses market appetite for the amount sought and accordingly recruits banks interested to participate in the required financing.

A lead manager Islamic bank may not necessarily underwrite part of the financed amount but due to its *Shari'ah* expertise it can structure a transaction Islamically for the other participating banks. It can also become a facility agent and security agent with or without participation.

Islamic bank as facility agent

As facility agent, an Islamic bank ensures that the financing structure is fully *Shari'ah* compliant and has been approved by its own *Shari'ah* supervision board. Members of the *Shari'ah* supervision board of the other participating Islamic banks may rely on the approval granted by the *Shari'ah* board of lead manager Islamic bank or conduct their own assessment of the structure.

Subsequently, the lead bank supervises completion of facility documentation comprising of various agreements and makes sure that it does not contain any clause repugnant to Islamic principles.

It is particularly important for an Islamic syndicated facility that the main finance documents such as head-lease, sub-lease, service agency, *Musharika* and the other agreements are reviewed and approved by the members of *Shari'ah* supervision board or committee.

Islamic bank as security agent

As security agent, an Islamic bank safeguards the ownership interests of participating banks in the financed asset, including that of the security agent if it is also a financier.

Shari'ah requires that all acts to finance and lease an asset in an Islamic syndication transaction should be carried out in a chronological order, which is as follows:

a) Agency and participation agreement

The security agent bank should first of all sign an agency and participation agreement with the other participating banks wherein it is appointed as their collective agent with an explicit authority to purchase certain asset on syndicate's behalf and lease it to the pre-specified lessee.

b) Purchase agreement

The security agent should then proceed to sign the purchase agreement with the existing owner of the asset. While doing so, the security agent must make it clear in the agreement that it is purchasing the asset on its own behalf and on behalf of the other participating banks. This is necessary so that the title to the ownership of the purchased asset could be passed on to all the financing banks.

c) Lease agreement

The next logical step will be to lease the asset to the lessee. While entering into the lease agreement with lessee, the security agent will assume the role of the lessor, again, on its own behalf and on behalf of the other participating banks.

d) Service agency agreement

Thereafter, the security agent will appoint a service agent to undertake major repair/maintenance and insurance of the leased asset.

The service agency agreement must clearly stipulate that the security agent bank is entering into the service agency agreement on behalf of the participating banks (including it) who jointly own the asset.

It is important to note that according to *Shari'ah,* all of the above agreements must be independent of each other and that no clause in one agreement should be conditional upon another clause in another agreement.

As emphasised last week, an agency arrangement remains revocable without the provision for payment of the agency fee to the agent. As such, principal banks must pay fee to the agent bank for carrying out the responsibilities assigned by them.

DIFFERENCES IN TRANSACTIONS BETWEEN ISLAMIC AND CONVENTIONAL BANKS

Tslamic banks are distinct from conventional banks. They disagree on certain aspects. Principal area of disagreement between Islamic banks and conventional banks are described hereunder.

Ownership risks

A fundamental difference between an Islamic bank and a conventional bank is the way they finance a project. It takes us to the argument of Risk Capital and Loan Capital.

Risk Capital is the capital that is rewarded for its participation in a productive process to the extent of the value that its participation creates, whether positive or negative, and which was unknown at the time of deployment of capital.

To the contrary, the Loan Capital dictates its price of participation in the shape of a pre-determined rate and irrespective of the outcome of its application, whether positive or negative.

Thus, under an Islamic financing environment, risk participation by the financiers is encouraged by way of becoming an owner of all or part of the assets. Naturally, it entails ownership risks and responsibilities.

Such risks and responsibilities are non-existent when a conventional bank simply lends money on the basis of conducting its due diligence but without assuming the ownership rights in the financed assets.

Being the owner of an asset under an *Ijara* financing makes the Islamic bank responsible for keeping the asset in good working order so that the client can have quiet enjoyment over its usufruct for which he is required to pay the lease rent. Then there is the responsibility of bearing taxes relating to the ownership of the asset as well as on the income generated from the asset.

What if the asset has a major breakdown, depriving the lessee of the usufruct? With immediate effect the lease rent ceases to accrue till such time that the asset is brought back to normal working condition by the Islamic bank, as the owner of the asset.

A conventional banker who is not familiar with taking aforesaid risks will naturally be reluctant to walk hand in hand with its Islamic counterpart. As such, he would endeavour his best to cover the "shortcomings" which may seem weird to an Islamic banker to whom risk taking comes naturally.

Risk and reward

Another point where a conventional bank has difference of opinion is the level of return it receives compared to the risk it takes in an Islamic transaction.

Whilst a conventional bank may traditionally be content with a set return level on its lending, it is averse to the idea of getting exposed to a greater risk in an Islamic transaction by way of becoming part owner in the asset, unless there is a convincing increase in its return.

On the other hand, an Islamic bank remains at a dilemma due to its inability to obtain higher return owing to market forces working against such increase.

Jurisdiction

Conventional banks draw the facility agreements based on civil code and are comfortable with it. However, when it comes to participating in an Islamic facility, they have to rely on *Shari'ah,* which is not their domain.

Although many Muslim countries do recognise *Shari'ah* to be the supreme source of jurisprudence, they also have parallel and highly active legal systems based on civil code. As such, when an Islamic bank declares *Shari'ah* as the governing law, naturally the conventional banks do get worried.

At times the task of convincing a conventional banker to accept *Shari'ah* as jurisdiction becomes monumental and there have been instances where the issue turned out to be the deal breaker.

Potential of increase in the cost of asset being leased

In a conventional leasing agreement of large value, it is common to find a clause relating to the potential of increase in the cost of the asset being leased.

The clause stipulates that if later on the lessor (lead bank) determines that any of the banks forming part of the lessor group has incurred any increased cost as a result of the introduction of any new tax in its area of operation making the financing expensive, or any new tax on the asset with retrospective effect or enhanced capital adequacy ratio leading to making the lending less attractive or for any other reason, then the lessor bank(s) will have the right to add such increased amount to the lease rent.

Moreover, the lessor bank(s) shall not be obliged to disclose any calculation to the lessee while claiming the increased costs.

A conventional bank would like to see this point in the lease agreement while participating in an Islamic financing transaction. However, from a *Shari'ah* scholar's perspective, the point falls under the category of *Gharar* or element of uncertainty which makes an agreement null and void.

It may not be correct to assume that *Shari'ah* is rigid to accommodate subsequent increase in the cost of financing an asset. Following are the *Shari'ah* parameters to address such a situation:

The lessee must undertake in the lease agreement that it will be willing to pay higher lease rent to allow the lessor to be able to bear the increased cost related to the financed asset in future, if any.

The undertaking should include, inter-alia, the foreseeable elements of increased cost such as insurance expense, major repair and maintenance, ownership and income taxes, etc. All this may have been paid by the lessor or the lessee in the capacity of lessor's service agent.

Lessee will not be obliged to pay for the increased costs to lessor if it is uncertain and cannot be arrived at with the help of a formula or if the lessor declines to provide the details of such increased costs, claiming it to be confidential.

In short, any element of uncertainty in a financing agreement is knocked down by the *Shari'ah* Supervision Board of an Islamic bank and which act is not looked with favour by a conventional bank.

Penalty for late payment

It is a practice unanimously adopted by the conventional banks to charge penalty on the amounts delayed for payment by the client. They insist to include this clause in an Islamic facility agreement since they always have it in their own documentation and hence find it difficult to live without it.

Whilst Islamic banks are not allowed by *Shari'ah* to charge any such penalty since it will be tantamount to *Riba* (interest), they usually accommodate this demand from conventional banks but add the phrase that such penalty amount will not be taken by them to their profit and will be donated to charity organizations of non-religious nature.

Why emphasis on non-religious charity'? Because penalty amount being usurious in nature cannot be compared to Zakat money which is spent on supporting widows, orphans, religious students, Islamic schools, marriages and the likes. This less contentious issue works in favour of Islamic banks as it discourages the customer from intentionally delaying the payment.

Events of Default

In conventional financing scenario, a long list of the events of default is provided which includes several events outside the borrower's control, such as, force majeure, nationalisation, requisition, etc.

To the contrary, in an Islamic financing transaction, imposing something on the customer over which he has little or no control is disallowed by *Shari'ah.*

Shari'ah accepts those events as default which are caused by the customer's own fault or negligence or which could have been prevented by him.

In a co-financing situation, events of default outside the control of the customer are redefined as 'events of mandatory prepayment' and are covered under a separate document, rather than in the main facility agreements. This is to comply with *Shari'ah* requirement that events of default should only consist of the ones controlled by the customer.

Interestingly, upon the occurrence of an event of mandatory prepayment, the customer will technically not be in default from *Shari'ah* point of view. However, he will be required to purchase the asset and upon his failure, the financier banks will have the right to auction the asset in order to recover their dues. Financiers can also waive the occurrence of such an event; however, this will require their unanimous decision.

Different roles, responsibilities of conventional banking

We will conclude our discussion on the situations a conventional bank finds difficult to put up with when participating with an Islamic bank in a *Shari'ah* based financing transaction.

Role

A conventional facility arrangement may amalgamate different roles of the bank(s), customer and the other parties into few agreements. It may include combining dual roles two parties may play in one agreement.

However, *Shari'ah* declares that if the parties are assigned different roles and responsibilities in a facility arrangement, these must not be mixed but covered in separate agreements.

As such, in an *Ijara* Islamic financing facility, if the lessor appoints lessee as its service agent, the arrangement will be covered under two separate agreements, viz. lease agreement between lessor and hssee covering the lease and subsequently between principal (lessor) and agent (lessee) for service agency. This is to put different roles and responsibilities of both parties in clear perspective.

It is worthwhile to note that *Shari'ah* requires both agreements to run independently. It will mean that in case of lease agreement coming to an end, it is not necessary that the service agency agreement will also cease to exist, and vice versa.

Conditionality

Conventional bankers are used to seeing in their facility arrangement that one agreement may be conditional upon another one. For example, a conventional lease agreement may state that the lessee agrees to take the asset on lease subject to the lessor purchasing it from a third party. Such conditional agreement is termed void by the *Shari'ah* scholars.

Moreover, it is commonly seen in the conventional banking environment that an agreement may have reference to a clause in another agreement, though signed by the same parties.

Shari'ah is against the practice of making one agreement dependent upon a clause in another agreement. It emphasises that each facility agreement should be independent and complete on its own. This is to ensure fair play and to protect the rights of all parties at all times.

Rise in facility amount

Often at customer's request the conventional banks allow lending against the revalued amount of an asset, such as a building. There is provision of such accommodation in conventional lending agreements which these banks would like to also find in an Islamic financing transaction. What is the *Shari'ah* point of view in this kind of situation?

Please note that under an Islamic financing transaction, the asset has already been acquired by paying the purchase price to the seller and the title transferred to the Islamic bank. Even if the value of the underlying asset subsequently increases, the Islamic bank will not be in a position to accommodate customer's request for additional financing.

This is due to an Islamic financier is barred by the *Shari'ah* to adjust the purchase price of an asset retroactively and allow the benefit to customer.

Moreover, the asset is owned by the bank and not the customer, as such any benefit emanating from its revaluation should rightly belong to the financing bank.

Indemnities

Conventional banks routinely seek all sorts of indemnities from the customer if they finance an asset in order to completely eliminate the credit risk. The issue of seeking indemnities therefore becomes central in a co-financing environment.

From an Islamic bank's point of view, there should be no need for such indemnities simply because the asset is owned by the syndicate of banks and seeking indemnities from a lessee will be unfair.

Consider that Ahmed agrees to lease his vehicle to Bader and seeks indemnity from Bader against the failure of engine. Would that be fair? Of course not. Maximum Bader can do is to provide an indemnity to cover the damage if it is caused due to his negligence.

As such, an Islamic bank will not be in a position to seek various indemnities generally demanded by the conventional banks from their customers.

Market disruption

Conventional facility agreements normally contain a provision relating to a situation where the bank may find it difficult to fund its participation amount due to non-availability of sufficient dollars in the London interbank market on the required funding date due to some reason. The provision allows the bank to postpone its funding till the situation normalises.

CONTRACT UNDER ISALMIC LAW

ontract in Arabic is called *Aqd.* Literal meaning of *Aqd* is to bind or to strengthen. The word *Aqd* is also used in Arabic in the sense of confirming an oath. As such, any covenant, pact, agreement and treaty will also be referred to as *Aqd* since all of them demonstrate firm resolve for execution. Plural of *Aqd* is *Uqood.*

Pre-requisites

According to *Shari'ah,* a contract cannot be defined as such unless it has the following four pre-requisites:

1) **Existence of minimum two parties:** A contract cannot be formed with the presence of a single party. Although a single intention may lead to various obligations, such as remission of a debt or declaration of donation, etc, these cannot be called contract in *Shari'ah.*

2) **Offer and acceptance:** It is necessary for a contract to have consent by both parties over the purpose and content of the contract. In Arabic it is called *Ijab wa Qubool,* meaning 'Offer' *(Ijab)* and 'Acceptance' *(Qubool).*

An offer can be made by either party in a contract — seller or buyer. Similarly, the acceptance also could come from any of them. As such, if the seller offers to sell his car for Dh25,000 and the buyer accepts it, this will form a valid contract. Likewise, if the buyer states that he is ready to buy the car at the above price and the seller expresses his agreement, this will constitute a contract.

Offer and acceptance could be written or verbal since Islam gives high priority to the fulfillment of one's obligation under a contract, irrespective of whether it is written or verbal.

***3) Shari'ah* compliant:** The offer and acceptance between the parties should be for a purpose not repugnant to *Shari'ah.*

We have earlier learned in detail what activities do not conform to *Shari'ah* and therefore, if the parties agree over an act which is out of line with *Shari'ah*, the contract will be void under Islamic law.

In order to understand it clearly, if Ahmed signs a contract to borrow money from Badar at a specified interest rate, it will not be considered a valid contract under *Shari'ah* since Islam forbids the practice of lending money on interest.

4) Contract's object: The subject of the contract must change hand upon completion of the contract.

For example, if the contract is for sale of the house by Ahmed to Badar, the ownership of the house must be transferred to Badar upon culmination of contract.

Similarly, if Ahmed agrees to lease the house to Badar, the possession of the house must be transferred to Badar in order to achieve the purpose of the lease contract.

Nature of contracts

Although the above major ingredients may be found in all types of contracts, Islamic jurists have taken great pains in examining various types of contracts one by one and defining their respective nature, parties, roles, conditions, rights and responsibilities.

For instance, a sale contract is different in nature from a hire agreement despite presence of some common elements such as the presence of two parties, offer and acceptance, *Shari'ah* compliance and the subject, etc.

Will the end result of both contracts be the same? Off course not, since the subject of the lease contract being a house will continue to be the property of the lessor as against the sale contract where the ownership would be changed to buyer.

Necessary parameters for an object in a valid contract

Let us examine the importance of an object (or consideration) under a contract.

Following are the eligibility parameters for an object of a contract, as defined by *Shari'ah* scholars:

Eligibility for transaction

The object of a contract should be fit or suitable for carrying out a transaction i.e. it should be executable or do-able within the normal business environment. *Shari'ah* renders any such contract invalid in situations in which it will be impossible to achieve the consideration for which the contract was agreed.

Let us try to understand this by way of an example. If `A' offers 'EV a certain amount of money to bring him the moon and `13' accepts the offer, *Shari'ah* rules it out as a valid contract since it will be impossible to carry it out.

Allowable under *Shari'ah*

The Islamic jurists have a unanimous opinion that anything which is forbidden by *Shari'ah* is not tradable and hence cannot become the consideration or object of a contract. As such, the contract will be void if A and B agree on a liquor deal.

In the same manner, there can be no valid contract for the sale and purchase of stolen goods or delivery of inferior goods now at the promise of returning superior merchandise later as it will constitute one kind of *Riba* or interest.

Betting, considered a forbidden activity, cannot be the subject of a valid contract under Islamic law. Hence, anything connected with immorality is invalid to be considered an object of a contract under Islamic law.

Own-able by an individual

According to *Shari'ah,* no public property or the property for common use such as public hospitals, government offices, roads, springs, canals, rivers, etc. can be made the subject of a contract. This is to prevent an individual from denying their usufruct to the general public.

Religious properties

Any property which is developed in God's name, such as mosques, religious schools, orphanage, graveyards, etc. also cannot be eligible for a contract as it will be tantamount to violating God's right.

Pledged properties

When it comes to the rights of a man, *Shari'ah* law protects them fairly by prohibiting to enter into a contract for a property or object which is already mortgaged or pledged to another man. However, it is allowable to trade in such property once the attachment is removed.

Other conditions

In addition to the above, Muslim jurists have attached certain additional conditions to make the object valid for a contract.

These are listed below:

The object of the contract must be existing at the time of making a contract. However, a *Salam* or *Istithna* contract will be valid despite non-availability of the goods or asset at the time of making the contract since there is certainty of the object of the contract being delivered to the buyer in view of the seller's promise and the ability to do so.

The object must exist in reality rather than in the opinion of contracting parties. For example, if the contract was made for the sale of barley but the bags purported to contain barley turn out to contain rice instead. In this case, the object for which the contract was made (barley) remained non-existent and no contract was made for the object which existed (rice).

The contracting parties must be aware of the exact quality, quantity and specifications of the object of the contract. This is to eliminate uncertainty which may lead to a dispute.

This could be achieved by the inspection of goods conducted by the buyer prior to entering into the contract or through detailed description, if the inspection is not possible due to the object being away from the contracting place.

There is no doubt that the contracting parameters, if adopted in their true spirit, can rid the world of a large number of disputes we regularly witness on the commercial scene.

Capacity

In *Shari'ah,* the word capacity or *Ahliyyah'* represents a person's competence to enter into obligations as well as carry out their execution under a contract. This includes financial contracts.

In other words, capacity can also be defined as the competence of contracting parties to acquire respective rights and liabilities.

Shari'ah accords rights to a party appropriate to his capacity to exercise them and at the same time imposes liabilities on a person commensurate with his ability to fulfill them. This is because *Shari'ah* wants the aim of any valid contract to be the achievement of performance by way of its satisfactory execution.

On the other hand, it is realised in *Shari'ah* that all people cannot be equal in acquiring rights and incurring liabilities, such as minors, insane persons, the terminally ill, among others.

For a contract between two persons to be regarded as valid under *Shari'ah*, it is necessary that they hold 'perfect capacity'. By perfect capacity, *Shari'ah* means that they should be above 15 years of age and possess a sound mind.

How would you judge the above criterion in a person? The Quran defines this in a clear manner through the following verse: "And put the orphans to trial (of their intelligence) until they reach the age of marriage (adulthood); then if you find in them sound judgment, deliver to them their property."

Although the verse is addressed to the guardian of an orphan, it also gives us a guideline to ascertain 'perfect capacity' in a person, which is essential for entering a contract. There are circumstances when this 'perfect capacity' can be temporarily lost. Such circumstances and their interpretation are listed below:

State of intoxication

Islamic jurists accept that a person may not be held responsible for his obligations under a contract if he can prove that he was placed under the influence for the purpose of entering the contract, which he would not have entered had he not been intoxicated.

However, they view that in case of voluntary intoxication, he will be held responsible since it is considered an offence under *Shari'ah* to consume such beverages. As such, he cannot be excused from punishment in case of non-fulfilment of his obligation in terms of a contract entered into by him while he was drunk. This is aimed to work as a deterrent.

State of coercion

In *Shari'ah,* coercion or duress means to force a person to perform an act which he dislikes and which he would not want to perform under normal circumstances. Coercion could be in the shape of bodily harm, threat to life, confinement, blackmail, or other such unethical steps.

As coercion eliminates genuine intention and the free will from a person of 'perfect capacity', jurists believe that such a person should not be held legally responsible for his obligations under a 'coerced' contract. If such a contract is executed, the coercer will be held responsible for the damages towards the coerced party.

Jurists have made it clear that a court verdict against a defaulter forcing him to sell his assets to pay the debt will not be considered coercion. This is because the verdict is for a just cause and is binding on him since he had signed a contract with his creditor of his own free will.

Furthermore, the court verdict is to protect the interests of the creditor who is a victim.

Responsibilities of guardians

An important aspect of a contract is *"wilayah"* or guard-ianship and the role and responsibilities of a guardian towards his ward.

In a literal sense, *"wilayah"* means help or assistance. *Shari'ah* has permitted the appointment of a *"wali"* or one having *wilayah* or guardianship for a person on behalf of another in order to make certain dispositions allowable on behalf of the ward, without seeking his consent.

A person with "perfect capacity" can become a contracting party. Such a person does not need the help or assistance of a *wali* to do so.

However, there could be a need for *wilayah* or guardianship if a person does not hold "perfect capacity". This could be in a situation where the person is a minor or is mentally unable to perform as a contracting party.

Whilst the natural guardian for a minor is his father, we will confine our discussion on guardianship relating to the property of an orphaned minor, since it directly involves managing of property and financial matters.

The *Shari'ah* court appoints a person of credibility to look after the interests of his ward — an orphaned minor until he attains "perfect capacity". This type of guardianship is vast in nature and authority, compared with natural guardianship.

A person holding such guardianship is also empowered to dispose of property to the benefit of his ward.

A father can select a guardian for his minor children during his lifetime, as he will be in a better position to make a good judgement from among the circle of his relatives and friends. However, in case of his death without such an appointment, the guardianship will automatically be conferred upon the judge of a *Shari'ah* court.

It is the duty of the judge to appoint a *Shari'ah* executor for the minor offspring of a deceased person to look after their interests in the best possible manner and to dispose of their property as their representative.

A question that arises is if *Shari'ah* confers upon the judge the duty of assuming the guardianship of orphaned minors, why does he, in turn, pass on this important responsibility to a third person. This is due to the reason that it is not practically possible for a *Shari'ah* judge to effectively look after the interests of many "guardian-less orphans" on account of his multifarious responsibilities and activities. As such, the executor appointed by the judge is his substitute in this matter.

The powers granted by *Shari'ah* to a guardian or *wali* cannot be challenged by the ward upon attaining "perfect capacity".

Shari'ah has, therefore, set the following stringent conditions for the appointment of a guardian:

1) The guardian should be adult and sane, i.e. holding "perfect capacity". This is because if he is not able to manage his own affairs, how will he be able to take care of the interests of a minor which is a greater responsibility.

2) The guardian must be from the same religion as that of the ward. Therefore, a Muslim cannot be a guardian to a non-Muslim ward and vice versa.

3) Although not a condition but preferable from the *Shari'ah* standpoint, both the guardian and the ward should be followers of the same school of thought out of four such schools — Hanafi, Hanbli, Shafaei and Malaki. This is to eliminate any chance of dispute since these great scholars of *Fiqh* and *Shari'ah* have minor differences in setting parameters for guardianship.

4) A very important condition for a guardian is that he should be honest, pious and credible.

5) The guardian must be the guarantor of the state of his ward. This makes a lot of sense since a minor's entire state would be under his direct control and as such it should not be difficult for him to stand guarantor for the same.

Concept of cause in a commercial contract

In legal terminology, the theory of cause means the motive and/or incentive to enter into a contract.

Similarly, in *Shari'ah,* the concept of cause in a commercial contract between a buyer and a seller represents their intention to enter into the contract. Both Islamic and civil laws have clearly stipulated that a contract will be deemed invalid on account of illegality of the cause or motive and intention.

Islamic jurists are unanimous in declaring that the intention of the contracting parties should adhere to the principles of *Shari'ah.* If the intention is found to clash with any *Shari'ah* principle, the contract will be invalid. Let us try to understand it by way of an example.

Ahmed makes a contract with Badar (an authorised arms dealer) to buy weapons, declaring that these will be supplied to the law enforcement agencies in a country in turmoil.

However, before the delivery, Badar finds out that Ahmed has actually contracted to deliver the weapons to a group of bandits in that country and refrains from delivering the weapons.

Scholars say that as per *Shari'ah* the contract becomes invalid and Badar will be protected by *Shari'ah* for not performing under the contract. This is because his non-performance helped curb illegal and criminal activities.

Invalid contract

Nevertheless, if Badar hadn't known about the actual destination of the weapons until after completion of the delivery of weapons, the contract will not be declared invalid and Badar's act will be regarded as legal. This is because Badar did not know the cause was illegal prior to execution of the contract.

Similarly, if a person leases a shop premises on the pretext of opening a pharmacy but instead sets it up for sale of alcohol, the landlord will have the right to evict him for declaring a false motive.

There is a view that the contracting party who is required to deliver should conduct due diligence as to the legality of the cause and the credentials of the other party so as to avoid situations such as the above.

However, due diligence should be conducted by him on a best endeavour basis and may not be considered his obligation under the contract. The situation is different if the poor credentials of the other party were commonly known.

Jurists declare that a completely legal commercial contract can be nullified if illegal means were used by a person to get the contract. This includes the giving of any gift or bribe by a person to another who has influence in deciding the award of a commercial contract.

Example

Though the cause of the contract may be *Shari'ah*-compliant, the means to achieve the contract were repugnant to *Shari'ah.* In light of the above, if it is revealed prior to the execution that unfair means were used by a party in achieving the contract, the contract will be declared null and void under *Shari'ah.*

Another excellent example proving the importance of intention and motive is that of a man who "donates" his wife's gold ornaments to a friend shortly before the completion of a full lunar year in order to evade the payment of zakat and then takes it back, again as a donation from the friend.

In this case the donation is invalid since it has not been given with the true intention of helping a poor and impoverished friend but to defeat a golden *Shari'ah* rule meant to help the poor and the needy.

To summarise, the motive of entering into a contract must be legitimate and an unlawful intention applied to achieve a lawful contract will render the contract null and void in the eyes of *Shari'ah.*

Revocable and Irrrevocable contracts

Islamic jurists divide a valid contract into two kinds — binding or irrevocable and not binding or revocable.

As per *Shari'ah,* a binding or irrevocable contract is one in which neither of the contracting parties has the right to cancel without the consent of the other. Examples are sales, leases, etc.

A contract which is not binding in the above manner is called an admissible or revocable contract. This can be cancelled by either of the contracting parties without seeking each other's consent.

There could be two reasons for a revocable contract:

1. The nature of the contract allows each of the contracting parties the independence to cancel it without needing the consent of the other. These include agency, deposit, debt, pledge or lien, etc.

Such contracts are allowed to be cancelled with respect to both the parties or to one of them. Agency, partnership and debt are the contracts which can be cancelled by both sides whereas pledge and lien can be cancelled by the pledgee and not the pledger.

2. The nature of the contract includes an option, preventing the parties from being bound to it.

What is an option?

According to Islamic jurists, an optional condition can be one stipulated by a contracting party for itself, for the other party, or for both. This option is actually the right to revoke or cancel the contract within a specified term. A revocable contract can be transformed into an irrevocable contract upon culmination of such a specified term.

The general view of the jurists is that an optional condition actually invalidates the effectiveness and power of a contract due to complete dependence on the will of the party or parties having the option.

A good example is a person purchasing an item with an option of returning it within three days. Such an option goes against the spirit of the sale and purchase contract but is stipulated for the convenience of both parties. The option is generally included in the contents of the contract but can also be added after the deal has just been concluded.

In *Shari`ah,* such an option is acceptable for contracts which are unbinding or revocable (see above), but not for contracts which are irrevocable.

The majority of Islamic jurists unanimously agree over the term of an option being up to three days. This is based on an incident where the Holy Prophet (PBUH) — himself a trader — once gave such an option to the buyer of an article to cancel the contract and to return it within three days' time. In fact, *Shari'ah* scholars and Islamic jurists have based their willingness to accept the option in a contract on this very instance.

However, some of them advocate the right of the party or parties to have an option that suits their requirement, irrespective of any cap on the tenure.

Another set of scholars is of the view that the option should be limited but depend on the nature of the transaction. For example, sale of a textile article should not require more than a day but for a house the period should be longer, say a month.

Legal effects of option on a contract

Islamic jurists opine that no legal effect accrues from a contract having an option until such time that the tenure of the option is exhausted. As such, the contract will be considered in abeyance but the contracting parties (and not anyone else) will have the right to grant permission for withdrawal of the option after which the contract will be effective.

ESSENTIAL ELEMENTS OF A *WAKALA'*

he literal meanings of *Wakala* are (a) to guard and (b)to entrust a matter to another and to rely on him. The *Shari'ah* illustration of *Wakala* is the substitute of a principal in order to perform a job permitted by the principal. In other words, *Wakala* or agency is to find a substitute for oneself to dispose of a certain assigned job or jobs.

For example, Ahmed wants to sell a house but finds himself unable to do so due to his pre-occupation or inexperience in the real estate field. As such, he appoints a friend, Badar, who has some experience is this field, and delegates his own power as the owner and permits him to sell the house at a specified price.

In *Shari'ah,* Ahmed would be called *muwakkil* or the principal, Badar the *wakil* or agent and the agreed arrangement between Ahmed and Badar would be *Wakala* or agency.

Essential elements

Islamic jurists have laid down some essential elements for a *Wakala* to be complete and effective.

These are:

Contracting parties

These are the principal and agent. The condition for a principal is that he should haw full authority under *Shari'ah* to perform the assigned job himself.

If a person does not have the authority to dispose of certain things himself, he will have no authority to appoint an agent.

Similarly, a person not holding 'perfect capacity' - such as a minor or someone insane - is not authorised by *Shari'ah* to appoint an agent.

Subject matter

It is an act for which an agent is appointed to carry out. It could also be described as the assignment entrusted to the agent by the principal.

Jurists state that the subject matter of an agency agreement must be unambiguous and clear to the agent. They give an example. If a person says to another, "I appoint you as my agent for all my affairs" but does not define the affairs, the agency will not be valid under *Shari'ah* due to hazards for both parties.

However, if a person says to another, "I appoint you as my agent to buy me an independent house for Dh1.5 million in the Jumeirah area of Dubai", the agency will be valid since there is little scope for ambiguity and hence no hazards for either party.

Shari'ah-compliance

It is necessary that the scope of the agency does not cross over any *Shari'ah* boundaries. For example, the agency will be invalid if awarded to collect interest on loans, or for any other Shari'ah-repugnant act for that matter.

Offer and acceptance

Shari'ah, a contract is constituted and considered valid if one party offers and the other accepts, irrespective of whether it is oral or written. Similarly, an agency agreement will deem to have come into existence if an offer has been made by the principal and accepted by the agent. However, some Islamic jurists believe that the formal acceptance by the agent is not a condition for the constitution of the agency contract.

Unconditional

Shari'ah does not allow an agency contract to be conditional. For example, it will not be a valid agency contract if a person tells another that he appoints him as an agent to sell his inventory if he needs to travel abroad in the near future.

Rules of *Wakala* and its termination

An agent can be appointed for any act allowed under *Shari'ah.* However, this discussion will focus on the commercial implications of an agency arrangement.

The principal and the agent or *wakil* have equal rights to withdraw from a *Wakala* agreement by giving agreed upon notice. If there is no notice clause in the agreement, *Wakala* can be terminated at any time.

However, the sudden or notified withdrawal is prohibited by *Shari'ah* if it jeopardises the interests of a third party who may have got engaged due to the very *Wakala* agreement.

For example, if the principal has authorised the agent to dispose of certain property owned by the principal for a certain amount and the agent is at an advanced stage of completing the transaction with an interested buyer (e.g. signing an MoU or receiving a down payment, among others), the principal will not be in a position to terminate the *Wakala* agreement whether or not the agreement has a provision for notified or sudden termination.

This is to protect the interests of the third party buying the property as well as to provide cover to the agent who will not be able to retract at that stage from the transaction, entered into by him on behalf of the principal.

Some jurists have provided a way out for dismissal of *Wakala* in such a situation. They lay down the necessary condition of consent from the third party to withdraw from the transaction. Moreover, any advance money paid by the third party must be returned to him.

They further elaborate there should be no repercussion or damage of any kind whatsoever to the agent if he has acted in good faith and diligently in discharging the agency's responsibilities.

However, if the agent is found to have transgressed any of the *Wakala* agreement terms, the principal will have the right to dismiss the *Wakala* agreement irrespective of the stage of transaction initiated by the agent on behalf of the principal. This is because the agent overstepped his authority.

An example is where an agent is found selling the principal's property at an amount lower than that specified by the principal or if the disposal was at the instructed price but on a deferred payment basis rather than cash as sought by the principal.

Such disposition will render the agent an unauthorised agent and he will be liable for compensation of the principal as well as the third party for any genuine damages.

A section of Islamic jurists believes that in such a situation, the disposal will remain valid provided the agent does this at his own risk and responsibility.

As such, if an agent disposes of the principal's property at an amount lower than the price sought by the principal but accepts the responsibility of making good the shortfall, it will be considered an authorised agency action.

Similarly, if the agent has been able to sell the property at a price higher than what has been sought by the principal, he will be entitled to retain the surplus. In order to eliminate any ambiguity leading to dispute, jurists do emphasise the need to be clear on the issues of shortfall and surplus within the text of the agency agreement.

In a situation where the agent is not bound by the sale price of a property and neither has he been given clear instructions as to the payment terms, he will be fully empowered to conclude the transaction at any amount or terms irrespective of the expectation of the principal.

Please note that an agent authorised to conclude a sale or purchase transaction on his principal's behalf cannot do so for himself or for his minor child or for a relative not having 'perfect capacity'. However, he can do so for his adult son or wife having 'perfect capacity'.

An act by unauthorised agent

In Arabic, *fuduli* is a person who intervenes in matters which does not concern him. The word *fuduli* is derived from *fudul* or *fuzool* as it is pronounced in the subcontinent.

However, under Islamic law, *fuduli* is an unauthorised agent who performs an act or concludes a contract on behalf of another person without the authority to do so.

The act may include selling or buying goods or property by the *fuduli* on behalf of another person without being a legal guardian for the person as recognised by *Shari'ah.*

Islamic jurists differ in their interpretation of the validity or otherwise of such an act carried out by *fuduli.* Some consider an act *of fuduli* can be considered valid if the person on whose behalf the act was carried out ratifies it subsequently.

Another set of jurists believes that the act will remain unauthorised irrespective of permission by the person and they base their opinion on the saying of the Holy Prophet

(PBUH) which is "no sale is valid except for things which you own".

Some scholars are of the view that a contract entered into by an unauthorised agent will be considered authentic if the person for whom it was entered (the 'principal') condones it prior to the execution. This is to allow the `principal' the right to know whether there is benefit or harm in the contract before he accords post-facto approval to u *fuduli's* act.

Proprietary rights

They say that if the execution of such a contract takes place before the approval is granted by the 'principal', the proprietary rights or title to the goods or assets sold in this manner will not be considered transferred to the buyer until approval is granted by the 'principal'.

If the buyer sold such goods or assets to a third party, the 'principal', being the title-holder of the goods or assets, will have the option to proceed against *fuduli,* the buyer, or both, for damages. This *Shari'ah* ruling is to safeguard the interests of the 'principal', the buyer and the person acting as unauthorised agent.

Why would one want to act as unauthorised agent?

There could be various reasons such as the unavailability of the 'principal' at the place of contract or transaction, urgency arising out of fear of losing out on some opportune deal, etc.

Good faith

Another aspect could be that a *wakil* or an authorised agent may overstep the assigned authority in good faith to provide benefit for his principal. An example of this is an authorised agent sent to a property roadshow with instructions to book one unit and who books two instead as he is convinced of the high quality of the investment on offer.

In this situation, while he will be regarded as an authorised agent for the first unit booked by him he will be considered *fuduli* for the second one. This status will remain until the principal approves of his action.

One other situation where it is most likely that a *wakil* or authorised agent may become *fuduli* or an unauthorised agent is the trading in stocks and shares where time is usually the critical factor.

It could happen that realising the potential in a particular Shari'ah-compliant stock, a dealer acting as agent, over-invests on behalf of his client (the principal). The over-invested amount is then reflected in the statement of account sent by the dealer to the client, seeking his ratification.

Now, if the client approves the statement, the initiative taken by the dealer will become valid and have *Shari'ah* protection. However, in the event that the customer feels that the dealer's action is detrimental to his interests he may discard it and claim damages from the dealer.

ISLAMIC FINANCING PRODUCTS

Our discussion will revolve around the definition and modus operandi of Islamic financing prod-icts and how these products — developed at the time of the emergence of Islam — are still able to meet the requirements of Islamic investors and entrepreneurs in the present age.

I. MUDARABA

One of the widely talked about Islamic banking products is *Mudaraba.* In simple terms, *Mudaraba* is a form of financing where an investor and an entrepreneur join hands. As per a formal agreement drawn between them, the investor provides funds whereas the entrepreneur uses his skills to earn profit for their joint venture.

Mudaraba or fund management is the original *Shari'ah* mode of financing a commercial activity along with *Musharika* or partnership (to be discussed later). *Murabaha, Ijara, Salam* and *Istithna,* among others, are modes of trade which have been modified to serve as financing tools.

History of *Mudaraba*

The residents of Makkah commonly practised *Mudaraba* financing even before the emergence of Islam, due to their location at the crossroads of the ancient trade caravans.

Credible *Mudarebs* regularly carried goods and/or money for many investors at a time and had to be accountable to them. Upon the return of the caravan, the

Mudareb used to prepare the *Mudaraba* account for each investor, enabling him to return the capital along with profit and claim his own share of profit from the investor.

However, in the Islamic era, the *Mudaraba* was fine-tuned to eliminate some *anti-Shari'ah* elements such as making the *Mudareb* liable for trading losses or theft in transit etc. Also, the dishonest *Mudarebs* were barred from carrying out the activity.

It is important to note that credibility played a vital role in the selection of a *Mudareb.* In the small population of Makkah at that time, almost every investor knew every *Mudareb* and credibility was the key factor in conducting *Mudaraba* transactions.

Parameters of *Mudaraba*

The following are the *Shari'ah* parameters of a *Mudaraba* transaction between two parties:

- The transaction must be for an agreed period of time.
- The investor does not interfere in the day to day running of the commercial activity, which is the sole responsibility of the entrepreneur.
- At the end of the agreed period, the *Mudaraba* account is closed and the profit is determined after accounting for all the expenses incurred in running the joint venture. It may include the entrepreneur's agreed remuneration.
- The net profit is distributed between the parties according to the pre-agreed ratio.
- Capital is returned to the investor upon completion of the *Mudaraba* period but prior to distribution of profit.

- In case of a genuine loss, the investor has to bear it fully. However, he is not liable beyond the capital amount contributed by him.
- Though eligible to share the profit, the entrepreneur is not liable to share the financial loss if incurred genuinely.
- In the event of loss, the entrepreneur does not have a right to claim remuneration.
- However, if the loss is caused by the entrepreneur's negligence, he will be liable to return the entire amount of capital to the investor.
- In this situation, the investor can also claim compensation from the entrepreneur for deprivation of the capital in anticipation of profit, which did not materialise.
- The negligence will be considered to have occurred if the entrepreneur is found to have acted outside the scope of agreement entered into by him with the investor.

Let us discuss some terminologies. The investor or provider of the capital is called *Rubb Al Mal* and the entrepreneur *Mudareb.* Please note that in case of an Islamic bank, the depositors would be called *Rubb Al Mal* whereas the bank will be considered *Mudareb.*

When it is the Islamic bank investing depositors' funds, it is called *Rubb Al Mal* and the entrepreneurs are termed *Mudareb.* As such, an Islamic bank enjoys the unique position of playing the dual role of *Mudareb* and *Rubb Al Mal* at the same time.

Investor and entrepreneur gain from *Mudaraba* venture

Let us try to understand how a *Mudaraba* joint venture can be beneficial to the capital owner (investor) and the *Mudareb* (entrepreneur).

Mudaraba ventures can be immensely beneficial to both parties for the following reasons:

- The owner of capital may not have the time or the expertise to efficiently utilise the capital and earn *halal* profits.
- The *Mudareb* may have the expertise and skills to earn *halal* profits but lacks the capital.

Credibility Factor

We discussed the vital role of the credibility factor in conducting *Mudaraba* transactions during the old days in Makkah.

How is credibility determined in concluding a *Mudaraba* deal in the present day?

It is a pleasure to note that the Islamic banks have successfully filled the much needed credibility gap by assuming the dual role of *Mudareb* as well as investor.

How do they do that? On the one hand, as an intermediary, the Islamic banks are ideally positioned to build formidable capital contributed by small, medium and large "investors" (i.e. depositors) and on the other, they are privy to lucrative investment opportunities where this capital can be profitability deployed.

An Islamic bank accepts the investment amounts (deposits) in the capacity of *Mudareb* whereas when it comes to deploying these funds, the Islamic bank switches its capacity from *Mudareb* to investor.

Concept Modification

The concept of *Mudaraba* has undergone some modifications for easy adoption by the Islamic banks.

This has been achieved with the help of extensive work undertaken by the *Shari'ah* scholars in order to suit the requirements of present day investors and entrepreneurs.

However, the following modifications are well within the *Shari'ah* parameters:

- There are many investors and scores of entrepreneurs.
- An Islamic financial institution acts as an intermediary, enjoying investors' confidence in receiving their funds.
- The intermediary finances the projects put forward by the entrepreneurs — rather than the investors — a change from the olden days.
- Investors (depositors) and the entrepreneurs (customers needing finance) do not have a direct relationship and have no responsibility or obligation towards each other.
- Whilst the ratio of profit sharing is pre-agreed between the intermediary and the entrepreneur, no such agreement takes place between the investor and intermediary.

Passive Investor

It is interesting to note that in this investor-intermediary-entrepreneur triangle, the investor continues to remain a passive partner, as was originally practised in Makkah.

He provides capital and then shares the profit or absorbs genuine losses. However, as described earlier, the investor will not be responsible for bearing the loss if caused by a *Mudareb's* negligence.

Responsibility of an Islamic bank

As the intermediary (an Islamic financial institution) plays the dual role of entrepreneur and investor, it becomes his primary responsibility to hire experienced staff for a thorough examination of the business propositions submitted by the entrepreneurs seeking funds and to invest the trusted funds in a judicious and prudent manner.

He is also responsible for maintaining proper books of accounts and conducting periodical audits in order to maintain high credibility.

This becomes all the more important since the investor does not know which project is being financed through his capital. Similarly, the entrepreneur does not know whose funds are being deployed for the development of his business.

When it comes to profit sharing, it is the net profit from all the avenues that is distributed by the intermediary to the investors after having netted out his operating expenses and retaining his share of profit.

However, it is important to note that the entrepreneurs share the profit generated by their business with the bank at an agreed ratio.

It is appropriate to clarify at this point that the investors (depositors) operate purely on the basis of *Mudaraba* while the bank is free to structure any mode of financing such as *Murabaha*, *ljara*, *Salam*, *Istithna*, etc., suitable for safe deployment of funds and also keeping in view clients' business needs.

11. *MURABAHA*

Murabaha is a widely used mode of financing by Islamic banks and financial institutions. However, it is interesting to note that the term simply refers to a sale transaction with an element of profit for the seller and has nothing to do with financing in its original sense.

Let us understand it by way of an example. If Ahmed agrees to provide Badar with 10 metric tonnes of rice at a price of Dh3,000 a tonne, which includes his cost at Dh2,700 a tonne plus profit at Dh300 a tonne, and Badar agrees to buy it from Ahmed at this price after knowing Ahmed's cost and profit, the transaction is called *Murabaha.*

The term is derived from *rabah* which means profit in Arabic, since the price is inclusive of the seller's profit.

From the above example, we come to know of the two basic parameters of *Murabaha.* First, that the seller must disclose the actual cost he has incurred on acquiring the commodity and, second, the amount or percentage of profit he has added to it. This 'cost plus' disclosure factor distinguishes *Murabaha* from the other Islamic financing products.

The buyer can settle the amount of *Murabaha* on the spot, or at a subsequent date agreed upon by the parties. The payment can also be made partly upfront and the rest in a lumpsum at an agreed future date. It was the 'deferred payment' element that, in fact. led to the adoption of *Murabaha* as a financing tool by Islamic banks and financial institutions.

Here, it is important to clarify that if the sale takes place between the parties without the seller having to disclose his cost and profit, it will be called *Musawama,* meaning bargain, and not *Murabaha.* Such transactions are allowed under *Shari'ah.*

Let us have a look at the pre-requisites of *Murabaha,* as devised by the *Shari'ah* scholars, keeping in view the present day requirements.

As indicated earlier, in *Murabaha* the seller is required to disclose the cost of goods and his profit to the buyer.

The seller is allowed to add all direct expenses such as freight, transportation, customs duty and labour, among others, to the cost of goods.

However, the expenses for running the business such as rent, salaries and other staff overheads, trade licence fee, utility charges, taxes, or any other administrative expense cannot be added to the cost of goods in *Murabaha.*

A *Murabaha* must fulfil the conditions of a valid sale transaction such as the seller's established ownership of the commodity, its present physical availability, and its use not being against *Shari'ah* principles, besides the sale being unconditional.

In light of the above explanation and parameters, we will now examine how the Islamic banks conduct *Murabaha* transactions.

When the bank sets up a *Murabaha* facility for its clients, it is for recurring trade financing transactions. The client and the bank sign a master agreement whereby the bank promises to sell and the client promises to buy the goods from time to time on an agreed ratio of profit added to the cost.

As the bank deals with many clients from a variety of segments, there is a possibility that the bank may end up buying certain goods for re-sale to the client, which may not conform to the client's requirement. In order to eliminate this likelihood, the bank appoints the client as its agent for selecting the right goods.

The client selects the goods on behalf of the bank and advises the bank of its particulars, including the seller's name and the purchase price.

In case of the availability of goods in the local market, the bank makes the arrangement for payment of the purchase price directly to the seller.

At the same time, the bank instructs its agent (the client) to take possession of the goods in the presence of its trained staff to oversee the physical delivery of the goods by the seller to the agent (client). This is to ensure that the *Shari'ah* requirement is complied with.

Upon completion of the agency function by the client for a particular transaction, the bank sells the goods to the client on the basis of 'promise to purchase'. The promise covers the agreed rate of profit to be added to the cost, which is known to the client, and a fixed date of payment.

In case of import, the client (acting as the bank's agent) seeks the bank's assistance in establishing a letter of credit in favour of the seller. Upon arrival, the goods are handed over to the client by the bank.

Roles played by bank and client in *Murabaha* transaction

Murabaha is a sale transaction where the seller's cost and profit is made known to the buyer. A reader called me with an interesting query. He asked whether it will still be called *Murabaha* if a trader is forced to sell his goods at cost or below cost due to unfavourable market conditions.

No, if a trader sells goods at a loss, it will not be called *Murabaha* simply because he is not earning any profit whereas the concept as well as literal meaning of *Murabaha* is to earn a profit for the seller.

The situation where a trader sells goods at a loss is termed in *Shari'ah* as *Hatitah.* Similarly, a sale transaction without any loss or profit (or cost-to-cost) is defined as *Tawliah* by *Shari'ah* scholars.

Returning to our subject, we were in the middle of discussing how the Islamic banks conduct *Murabaha* transactions. Having covered the modus operandi for local *Murabaha* transactions, today we will learn about goods under *Murabaha* to be imported.

Promise to purchase

If the goods under *Murabaha* are to be imported, an Islamic bank establishes a letter of credit, just like any other conventional bank.

However, the application from the customer asking the bank to establish the letter of credit is accompanied by a *Wa'ad Bil Sharaa* or "promise to purchase", the contents of which state that the customer will purchase the goods from the bank immediately on arrival.

As discussed earlier, the purchase price includes the bank's profit — determined on the basis of the mode of settlement being cash payment or deferred payment besides commission on establishing the letter of credit, foreign exchange earning for the bank and any other direct expenses which the bank may have incurred such as telex, postage, courier, etc.

Although 'promise to purchase' is obtained prior to establishing the letter of credit, in the event that the goods received are short the relevant amount is deducted from the total purchase price. This aspect is documented within the text of 'promise to purchase'.

If the client fails to fulfil its promise, the bank is pre-authorised to sell the goods after having waited for a reasonable period of time and recover the amount paid by it to the negotiating bank together with its profit. In case of a shortfall, the customer will be responsible for making good on this under the 'promise to purchase' he has signed with the bank.

The customer can withdraw from the transaction after the letter of credit has been established provided the seller (the beneficiary of the LC) and the advising bank have jointly consented to it.

Other points

As *Murabaha* is a sale transaction, the ownership/title to the goods is immediately transferred to the client irrespective of the term of payment by the client to the bank.

Similarly, the price of goods sold by the bank cannot be changed subsequently if there is a default in payment by the client.

To ensure timely payment of the *Murabaha* amounts, Islamic banks obtain a post-dated cheque or promissory note from the client. In addition, they may ask for additional security to protect the interests of the depositors and shareholders should they deem fit.

From the *Shari'ah* perspective, the most essential aspect of a *Murabaha* transaction is that the goods must remain the risk of the bank during the entire process until they are finally purchased by the client.

Furthermore, it is also a necessary condition for the validity of *Murabaha* that the goods are purchased from a third party. The purchase from the client against his own undertaking to 'buy back' is not allowed in *Shari'ah* since it is considered a mere debt creation exercise with an element of *Riba* or interest.

It is fascinating to note how the relationship between the bank and its client changes in a *Murabaha* transaction from stage to stage. At the first stage, the relation is that of a promisor and a promisee. It then changes into a principal and an agent. Moving further, they become buyer and seller. And, finally, if the sale is on a deferred payment basis, they assume the role of debtor and creditor.

It is, therefore, important that at each stage, their roles, capacities and the responsibilities and the consequences arising out of these must be clear in everyone's mind.

These different capacities should not be confused with the others.

Commitments to maintain in *Murabaha* transactions

Let us discuss some questions which are commonly raised in relation to a *Murabaha* transaction.

Why do Islamic banks obtain securities against *Murabaha* financing?

A question is whether it is allowed under *Shari'ah* to obtain securities against *Murabaha* financing and if so, why. The reply to the first part of his question is in the affirmative.

As regards the second part, in order to safeguard his interests, a seller may seek a security or a third party guarantee from the buyer when delivering the goods on a deferred payment basis. This is allowed under *Shari'ah* since both the possession and the title pass on to the buyer at the time of delivering the goods, thus leaving the seller with an unsettled debt in his books.

Islamic banks obtain funds from the public in the capacity of *Mudareb* and deploy these funds in the *Murabaha* transactions. Therefore, it becomes their primary responsibility to be prudent in order to protect the ultimate interests of their depositors.

As explained, a *Murabaha* transaction in an Islamic bank progresses through various stages. As such, the bank can ask for the security prior to the start of the *Murabaha* process if the deferred payment mode has been originally agreed to between the bank and the client. This is important where the bank places a revolving *Murabaha* facility at a customer's disposal.

In the event that the *Murabaha* goods/asset itself is given to the bank as security (e.g. mortgage over car or house), the purchaser should take physical or constructive delivery of the object and at the same time give it under the bank's mortgage. In this way the sale transaction will stand distinguished from that of mortgage.

What types of securities does an Islamic bank seek from a client?

The security sought by an Islamic bank could be a tangible asset, a third party guarantee, assignment of payment, or any other collateral acceptable to the bank under the *Shari'ah* requirements.

An Islamic banker must not overemphasise the aspect of security while considering a *Murabaha* facility. Security is invariably the second way out and as such, he should evaluate a *Murabaha* transaction on its merit and take a calculated decision whether he is comfortable with the level of risk with or without the collateral.

What if a customer defaults on *a Murabaha* payment?

If a customer defaults on timely settlement of the *Murabaha* amount due to genuine reasons, the Islami bank should allow him a reasonable period of time to arrange for the payment. In this case, the bank could hold on to the available collateral until the receipt of *Murabaha* proceeds and release it to the customer immediately thereafter.

In the event of a customer's failure to clear the *Murabaha* amount owed to the bank even after the lapse of a reasonable period of time, an Islamic bank can proceed with executing the security through the channels available to it. Any excess received from the security proceeds over and above the *Murabaha* amount must be returned to the customer.

Shari'ah does not allow Islamic banks to increase the *Murabaha* amount in case of default by the client on the basis that it is a sale transaction and reopening the sale price is against *Shari'ah* principles.

It has been observed that some companies take advantage of this ruling and deliberately default on timely settlement of their *Murabaha* commitments. Sadly, they take extra care in meeting commitments to conventional banks due to the practice by these banks of levying penalty interest. This is often done at the cost of their commitments to the Islamic banks in the absence of a penalty for late payment.

In order to rid the Islamic banks of this unfair treatment, *Shari'ah* scholars have been exploring the possibility of including a penalty clause in the *Murabaha* agreement whereby the defaulting customer will be forced to donate the penalty amount to a charitable organisation.

It is expected that by introducing this 'deterrent', Islamic banks will be able to discipline their *Murabaha* customers, thereby curtailing the list of past due *Murabahas* in their books.

This corrective measure will not violate any *Shari'ah* principle since the penalty amount will not be included in the Islamic bank's profit.

Different characteristics of money and commodities

Being a popular Islamic financing tool, *Murabaha* remains a subject of debate with respect to its being fully Shari'ah-compliant. It is, therefore, important that we discuss common misconceptions about *Murabaha* in order to clarify that this product does not violate any *Shari'ah* principle.

A major argument encountered by an Islamic banker is why the bank demands different prices for sale against cash and the disposal of goods on a deferred payment basis under *Murabaha.*

An Islamic bank deals in goods under *Murabaha* in different ways. In case of establishing a sight letter of credit on the customer's behalf, the goods on receipt can be sold to the customer against a cash down payment which includes the usual tariffs such as commission, exchange difference, postage/telex charges, etc., besides the cost of the goods.

The bank can also allow the customer to settle the amount at an agreed time. The price of goods under *Murabaha,* where the customer is allowed deferred payment terms, is always higher than when he purchases against cash.

Some argue that increasing the price of *Murabahn* goods for the deferred payment period is akin to charging interest. Let us examine this issue for our better understanding.

Please keep in mind that according to *Shari'ah,* money and commodities have different characteristics and, therefore, are to be treated differently. The owner of a commodity is at liberty to set the price and the buyer, too, can exercise his free will in buying the commodity at a certain price.

Deferred basis

As such, setting the sale price higher on payment on a deferred basis will be considered interest only if the subject matter is money at both ends e.g. a loan at a certain interest rate.

But if a commodity is sold in exchange for money, the seller — when fixing the price — may take into consideration different factors while determining his selling price. And that can include the time sought by the buyer in settling the purchase price.

This is because if the seller had received payment in cash he would have been in a position to re-invest it in the business by purchasing fresh goods and earning more profit by selling these.

The seller could have repeated this a number of times during the period that he now has to wait for the sale proceeds. By allowing time to the buyer for payment, he is being deprived of that chain of trading activity and the additional profit connected with it.

Important aspect

Let us not forget that under *Shari'ah*, a golden principle of making a contract is *Ijab wa Qubool* or 'offer and acceptance'.

By applying the *Ijab wa Qubool* principle on a deferred sale transaction, it will be clear that the seller can exercise his right to offer certain goods at a certain price and the buyer may accept or reject it. So where is the element of *Riba* (interest) in *Murabaha?*

Therefore, it is not prohibited by *Shari'ah* to set different prices for the same commodity if sold for immediate cash or on a deferred payment basis provided the buyer has accepted the price willingly since the agreed price is against a commodity and not against money.

However, the most important aspect which differentiates an Islamic bank from a conventional one is that once the price is fixed, it cannot be changed irrespective of whether the buyer pays on time or defaults. This position is accepted unanimously by all schools of Islamic jurisprudence and the majority of Muslim jurists.

Knowing this limitation, some customers often intentionally default on their *Murabaha* commitments to an Islamic bank. This 'pattern' is likely to be curtailed soon since most of the *Shari'ah* scholars have realised this anomaly and are working to allow the levying of a late penalty, which would then be donated to charity.

Calculating *Murabaha* cost if two different currencies are involved

The subject of discussion now is calculation of the cost of *Murabaha* if two different currencies are involved in the purchase and onward sale of goods by an Islamic bank.

This relates to imports on the basis of deferred payment letters of credit or usance collection whereby the goods are delivered to the customer on receipt but the payment to the foreign supplier is scheduled to be effected after an agreed period of time.

As most of the Gulf currencies are pegged to the US dollar, calculating the cost of goods does not pose any difficulty if the imports are denominated in this currency. However, how does one calculate the cost of *Murabaha* goods if the foreign currency is other than the dollar and has fluctuated during the deferred period?

This is a very important aspect to understand since it is paramount in *Murabaha* to ascertain the exact cost of goods. This leads to another argument - whether a *Murabaha* financing transaction should be based on the same currency in which the bank (acting as seller under a *Murabaha* transaction) had originally purchased the commodity from the foreign supplier so that the exact cost can be tracked down at all stages.

We know that this may not always be possible. Furthermore, the issue becomes more complex since *Shari'ah* does not condone any arrangement for forward purchase of the currency.

in order to deal with this situation, some Islamic banks have included a condition in the *Murabaha* agreement that in case of adverse fluctuation in the currency of purchase, the client shall bear the additional cost, whereas if the currency has varied favourably, he can retain the resultant benefit.

Foreign supplier

According to some *Shari'ah* scholars, *Murabaha* based on this condition is not valid because it leads to confusion and uncertainty as to the cost of goods in the local currency when *Murabaha* is created and at the time of completion of the credit period when the foreign supplier is paid.

The bank should only indulge in sight L/C transactions to avoid the cost uncertainty as the foreign supplier is paid in full even before effecting the sale of goods to the bank's customer, thereby complying fully with all *Shari'ah* requirements for *Murabaha.* In this case the question of fluctuation in currency rate does not arise.

Fluctuation risk

The *Murabaha* cost will be determined on the basis of the market rate of the currency of import on the date of payment to the foreign supplier.

In case of import on a deferred payment basis, the bank should determine the *Murabaha* cost in the currency of original purchase rather than in the UAE dirham so that the deferred *Murabaha* price is paid by the customer in foreign currency and not in the dirham.

In this case the bank will receive the amount representing the cost of goods and its profit in foreign currency from the customer upon completion of the credit period and will simply pass on the cost to the foreign supplier and retain its profit.

The risk of fluctuation in the currency of import will, therefore, rest with the importer and the bank will have complied with the *Shari'ah* requirements for *Murabaha*.

All deferred payment transactions should be carried out on the basis of *Musawama* rather than *Murabaha,* whereby no reference is required to be made to the cost of goods, and the price to the bank's customer may include a safety margin to cover the anticipated fluctuation in the relative foreign currency rate.

Nevertheless, the bank will have to bear the loss if the unfavourable fluctuation reaches beyond the safety margin obtained from the client.

In cases where the client is required to provide an Islamic bank with the foreign currency on the due date, he may cover himself through a forward contract with a conventional bank.

***Murabaha* transactions cannot be rolled over**

Some people think that - as in conventional banks - a *Murabaha* amount can also be rolled over by adding the profit for the extended period if the buyer agrees to bear the same. This contention is incorrect. A *Murabaha* transaction cannot be rolled over for a further period simply because it belongs to a specific commodity which has already been sold and hence cannot be sold twice.

It should be noted that *Murabaha* is not a loan transaction but the sale of a commodity, the payment of which is deferred to a specific date. Once the commodity is sold, its ownership is passed on to the client (buyer), irrespective of the terms of payment being sight or deferred.

Hence it is no more the property of the seller. As such how can the bank sell a commodity a second time around which is not owned by it any more?

A related question that arise is whether a rebate can be earned by early payment of *Murabaha* amount.

This issue hl.; been examined by *Shari'ah* scholars in detail, who have concluded that since *Murabaha* represents the sale of a specific commodity - the price of which is a settled issue - there can be no rebate or discount on voluntary early payment by the buyer.

Some jurists opine that if the early payment is tied to a discount, it is not permissible,

However, if the rebate is not an attraction for pre-payment and the bank gives an allowance voluntarily, it may be permissible under *Shari'ah.*

What needs to be understood is that the customer cannot claim it as his right and hence it cannot be made a condition of the *Murabaha* agreement.

Furthermore, the bank will have the sole discretion to decide what remission should be offered to a client in this situation.

Level of penalty on default

Shari'ah scholars are now in favour of levying a certain penalty on late payment of the *Murabaha* amount in order to discipline habitual defaulters. *Murabaha* is a sale transaction, irrespective of the mode of payment, and the sale price is a settled issue. Hence, if a client defaults on payment on the due date, the sale price cannot be increased.

Exploitation

It is common knowledge that this *Shari'ah* restriction has been intentionally exploited by some elements, knowing fully well that their repayment obligation to an Islamic bank will retain its status quo even if they delay repayment.

Shari'ah scholars have different views as to the penalty rate but most of them agree that the additional amount so charged should be the percentage of profit distributed by the Islamic bank to its depositors equivalent to the period of default.

For example, if the default continues for a period up to three months, the bank could charge the profit percentage distributed by it on a three-month fixed deposit on the defaulted debt as penalty.

They further stress that only recurring defaulters may be penalised. First time defaulters and those who default for reasons beyond their control should be spared.

As regards the amount to be collected as penalty, there is a unanimous fatwa that an Islamic bank is not allowed to take this as its profit but must use it for specific charitable purposes not associated with any activity where zakat or other pure charity funds are consumed.

The penalty amount can thus be donated by Islamic banks to scientific research organisations or spent on the construction of roads, drilling wells, laying sewerage lines, building public toilets, etc.

III. ***IJARA***

tiara or leasing is another popular Islamic financing product.

In simple terms, *Ijara* refers to the right of use of an asset by a person for a specified period of time at a financial consideration paid to the owner of the asset. This right is called usufruct.

In Islamic banking, rather than lending money to a customer and earning interest - which is forbidden by

Shari'ah - the bank purchases the asset for the purpose of leasing it to the customer at an agreed rent for a specified tenure.

Ijara wa latina

Extending the concept further, *Ijara wa Iqtina* (also called *Ijara Muntahiya Bil Tamleek)* is a leasing contract whereby an Islamic bank purchases an asset upon the request of a customer who pays rent for an agreed term.

Upon completion of the term the ownership and the title to the asset is transferred by the bank to the customer. The possession of the asset continues to remain with the customer.

The lease rent is fixed by the Islamic bank in such a way that upon completion of the agreed term, the bank is able to collect the cost of the asset plus its anticipated profit.

As such, at the end of the lease tenure, the asset has a nominal value which is then sold to the customer or presented to him by the bank.

The arrangement could be compared to the hire and purchase concept in a conventional financial lease. However, Islamic leasing is radically different from its conventional counterpart in many ways.

Leasing of human services

The above explanation deals with the leasing of a tangible asset. Can human services also be leased under *Shari'ah?* Yes. *Shari'ah* allows this in the sense of employing or hiring the services of a person against some financial consideration. Let us understand this by way of examples.

If Ahmed has hired Badar as an accountant in his office at an agreed salary, this arrangement will be called *Ijara.*

Similarly, if one needs to build a house, one would hire the services of a civil engineer and, in case of a dispute, the parties lease the services of lawyers.

Terminologies

The person rendering the services is called *Aajir,* the one who does the hiring is termed *Mustajir* while the financial consideration is *Ujra* and the transaction is *Ijara.*

Apply these terms to an asset, for example, a car rental. In this case, the owner of the car will be *Aajir*, *Mustajir* the person currently using it, the amount paid by *Mustajir* will be *Ujra* and the complete transaction will be called *Ijara.*

Comparison with *Murabaha*

While the basic concept is similar to a sale *(Murabaha)* where an asset is transferred to another party for a monetary consideration, the *Ijara* merely allows transfer of the 'right of use' to the *Mustajir* (lessee) for a certain period of time whereas the title and ownership to the asset continue to remain with *Aajir* (lessor).

As such, physical possession of the leased asset is returned to the owner of the asset upon culmination of the lease term.

Comparison with conventional lease

The core difference between a conventional financial lease and *Ijara* is that in *Ijara* the lessor assumes all risks related to the ownership of the leased asset.

Therefore, all withholding taxes, taxes on rent revenue, insurances and structural repair and maintenance will be the responsibility of the lessor. This is in contrast to conventional leasing where these are the responsibilities of the lessee.

Under *Shari'ah,* if the asset is destroyed beyond economic repair during the lease period, the lease will terminate with immediate effect and the lessor will be required to bear the loss besides losing the benefit of continuing to earn rent.

In addition, the lessor will be required to refund any prepaid rent paid by the lessee but not consumed until the date of total damage to the asset or termination of the lease.

However, if the asset is lost due to the lessee's negligence, he will be required to make up the loss to the lessor.

Shari'ah principles for an *Ijara* transaction

An *Ijara* transaction takes place when the owner of an asset transfers his 'right of use' also called usufruct — to another person or entity for a specified period and for an agreed monetary consideration. It is worthwhile to note that *Shari'ah* also allows the usufruct to be sub-leased. Now we will discuss the *Shari'ah* principles based on which an *Ijara* transaction is allowed to take place.

Principles of *Ijara*

The subject matter of *Ijara,* i.e. the asset or the usufruct right, must have some useful purpose. Therefore, things having no such use, e.g. gold jewellery, precious stones, among others, cannot be considered under *Ijara.* The purpose of leasing must not be against *Shari'ah* principles, such as leasing of a bar, casino, night club, etc. For a valid *Ijara* contract the corpus of the leased asset or usufruct right must remain in the ownership of the *Aajir* or lessor.

Anything fully consumable by its use cannot be leased. Examples are grain and other eatables, fuel, money, etc. As such, a leased asset must have a value, also referred to as a terminal value, upon completion of the agreed lease period. Any liability emerging from the ownership of the asset like property tax and revenue tax will be the responsibility of the lessor.

Similarly, the liabilities related to the use of the property such as utility charges etc shall be borne by the lessee while the asset is in his possession and use.

The lessee is restricted from using the leased asset other than for the purpose clearly spelt out in the lease agreement. The lessee is liable to compensate the lessor for any damage caused to the leased asset by virtue of his negligence, omission or misuse.

However, the lessee will not be responsible for any damage caused to the leased asset which is not a result of his negligence, such as destruction of the property due to earthquake or flooding.

In this case, the lease will cease to exist immediately and any prepaid lease rent will be refundable by the lessor. However, the lessee will be responsible for paying the accrued lease rent.

A joint owner of an asset can lease his share in the asset only to his partner(s). However, all the owners can jointly lease the asset to a third party.

Fixation of various lease amounts for different periods within the lease term is allowable under *ljara.* provided it is pre-agreed. For example, a 'stepping-up' rent in a shopping mall for premises on a long-term lease.

Ijara in Islamic banks

Islamic banks quite commonly use *Tiara* as a means of financing real estate, aircraft, vehicles, vessels, plants and machinery, and other useful assets.

A customer requests the bank to acquire the asset or the usufruct of an asset (with a right to sub-lease), which he wishes to take on lease from the bank. There can be two ways of doing this:

a) A master *Ijara* agreement is drawn up between the bank and the customer, stipulating general terms and conditions. This can also be referred to as Promise to Lease. This agreement is followed by a specific lease agreement after the bank has acquired the required asset.

b) Or a lease contract can be signed directly, without adopting the Promise to Lease route.

Please note that in the case of (a) it is forbidden in *Shari'ah* to lease an asset or sub-lease the usufruct not owned by the lessor. Therefore, if the bank does not have ownership of the asset or usufruct right, it cannot lease/sub-lease it to the customer. Before the bank moves to obtain the ownership/usufruct over the required asset, it would be prudent to obtain a 'promise to lease' from the customer.

In addition, the bank may ask the customer to deposit a certain amount of money to demonstrate his genuine intention to lease the asset once it has been acquired by the bank. If the customer does not honour the pledge, the bank can appropriate the deposit to the extent of actual damage.

In case the customer fulfils the promise, the amount will be treated as advance rent and an adjustment made to the lease rent payable by the customer.

Relating to the point (b) above, it represents a situation where an Islamic bank already owns an asset or usufruct right which can immediately be leased out to the customer.

Banks can buy customer's asset and lease it back

Can an Islamic bank consider allowing *Ijara* to a customer for an asset which is already in his possession?

Yes, Islamic banks are allowed under *Shari'ah* to purchase the asset for the purpose of leasing it back to the client. However, it would be necessary for the bank to first purchase the asset from the client against cash.

Another condition is that nowhere in the purchase agreement should the bank mention that it will lease the asset back to the seller. This is to set clear boundaries for the purchase and lease transactions, which should be treated as totally independent of each other.

It would be in order for an Islamic bank to fix the periodical lease rent of a leased asset in a manner so as to be able to retrieve its investment in the asset along with the anticipated profit within the agreed lease term.

The asset is then sold to the customer at a nominal price at the end of the lease term. This type of arrangement is called *Ijara Muntahia Bittamleek* or a lease culminating upon transfer of the ownership to the client.

Another dimension to *Ijara* is that a lessee may be allowed to enter into a sub-lease agreement. Nevertheless, he is prohibited from doing so with the lessor (asset owner) for the simple reason that such a transaction would clearly be tantamount to *inah* i.e. lending and borrowing at interest.

Consent

The lessee must have the lessor's consent for a sub-leasing arrangement with third parties, be it at the same lease rent the lessee is paying to the lessor, higher than that, or lower. Whilst the lessee may become sub-lessor in this situation, his rights and obligations towards the master lessor (owner) remain unchanged.

Parties can execute an *Ijara* agreement for an asset not yet owned by the lessor. This is called *Ijara Mousofa Fee*

Zimma and can loosely be defined as a forward lease agreement for an identified or specific asset.

In such type of *Ijara.* the lessor undertakes to produce the specific asset at the agreed time and the lessee assures taking it on lease. In the event that the lessor delivers an asset with different specifications, the lessee has the right not to accept the asset and demand that either the lessor produce the agreed specific asset or pay him damages.

Similarly, if the lessee does not fulfil his obligation to take the specific asset on lease, the lessor is allowed to claim damages from the lessee.

Compensation

An example of *Ijara Mousola Fee Zimma* could be of the lessor providing the lessee with a particular corner shop of a measured size in an identified shopping mall at a certain future date.

Now, if the lessor offers the lessee another shop of a different size at another mall, under *Shari'ah* he would be considered guilty of breach of agreement and liable for compensating the lessee for damages.

Ijara element in *Musharaka*

It would be appropriate to briefly touch upon the *Ijara* element found in *Musharaka.*

A customer may approach an Islamic bank with a proposition to jointly acquire an asset. This would be called *Musharaka* since both parties would be contributing equity in purchasing or developing the asset.

In *Musharaka,* the customer may have the right to take the bank's share of the ownership in the asset on lease and sub-lease it to third parties at a higher rent.

On the other hand, it is in the interests of the bank that the customer leases the bank's share of ownership in the jointly acquired asset since it would allow the bank an opportunity to earn profit on its investment.

Moreover, the bank would be in a position to fix the rent in such a manner as to gradually retrieve its actual investment and phase out the ownership in the asset. This type of *Musharaka* is called *Musharaka Mutanaqisa* or Redeemable *Musharaka.*

***Ijara* contract terms can be altered by mutual consent**

An *Ijara* contract is binding on both the lessor and the lessee. However, the terms of the contract may be altered with mutual consent, which may include termination of the contract itself

An *Ijara* contract can also be terminated due to force majeure or if the leased asset has a certain defect which impairs its effective use for which the lessee has agreed to pay the lease rent.

Another scenario where a lease contract can be terminated without obtaining the consent of the other party is the availability of an option. The option could be one-sided or available to both parties.

While leasing an asset, Islamic banks prefer to have an option at both ends. For the bank as lessor, it is called a `put option' whereas for the customer or lessee, it is termed 'call option'. Either party can exercise the option during the lease period by following an agreed upon procedure.

Default

A bank can exercise the put option upon occurrence of default by the lessee. A list of such events is pre-agreed between the parties and is incorporated within the text of the *Ijara* contract.

Usual events could be the non-payment of the lease rent on the due date, use of the asset for a purpose other than what was agreed upon, unearthing of any false representation made by the lessee at the time of signing the lease contract, the serving of a liquidation or re-organisation decree upon the lessee by a competent court, among others.

There could be numerous other events agreed to by the lessee. However, *Shari'ah* principles require that all such events must be under the lessee's control.

As such, events not under the lessee's control, such as force majeure, an act of God, total loss or requisition of the leased asset by government authorities, among others, cannot be considered a default caused by the lessee. This is the stark difference between an Islamically structured lease transaction and a conventionally developed operating lease.

Upon occurrence of a default caused by the lessee, the bank may have the choice of asking the lessee to purchase the asset at the cost yet to be recovered by the bank on that particular asset or repossessing the asset for the purpose of selling it or leasing it to a third party. In any case, the lessee will be responsible for paying to the bank the lease rent accrued until the date of the occurrence of the default.

If the bank is able to sell the asset at a loss (i.e. the sale proceed is insufficient to cover the bank's remaining investment on the asset), the lessee will be responsible to make good the shortfall plus the actual costs incurred by the bank in selling or re-leasing the asset.

Asset

Some scholars are of the view that the bank should not claim any such costs if it is able to sell the asset at a profit or re-lease it at a better rent than what it was earning from the defaulting lessee. In case of a sale with a surplus, the bank may retain it since it is the owner of the asset.

As exercising a put option could be a cumbersome process, Islamic banks usually prefer to allow reasonable time to the lessee for the remedy of such a situation. Once remedied, the lease contract continues unabated.

Interestingly, an *Ijara* contract entered into by an Islamic bank with an individual does not lapse upon the death of the lessee. In such a case, the lessee's heirs will continue to be responsible for paying the lease rent to the bank.

However, it will be the bank's prerogative to decide if the heirs find it a burden to carry on with the deceased's liability and request termination of the lease contract.

Why *tiara* lease rent is based on conventional benchmarks?

A question arises as to why Islamic banks, more often than not, base the *Ijara* lease rent on fluctuating conventional benchmarks such as London Interbank Offered Rate (Libor) or Emirates Interbank Offered Rate (Eibor)? Why not pre-fix the lease rent at the outset for the entire lease term?

There are two main reasons for doing so:

a) Absence of an internationally acceptable Islamic profit benchmark, as compared to Libor in the conventional banking

b) Apprehension in the customer's mind that he may end up paying higher lease rent if it is fixed, compared to the fluctuating benchmark-based interest rate charged by a conventional bank.

As there are few Islamic banks in the Gulf region as against a very large number of conventional ones, it becomes important on the part of Islamic banks to remain competitive and, as such, adjust their profit earnings close to the 'market'.

By not adopting to market standards, they may not be able to achieve the purpose of adding value to the trusted investments of their shareholders and depositors as *Mudareb* (fund manager).

Therefore, the *Ijara* agreements adopted by the Islamic banks provide that for the sake of clarity and ease of understanding, the rental will be equal to a benchmark rate at the start of an *Ijara* period (such as 3/6-Month Libor/Eibor) plus a spread called margin.

The rent is readjusted for each *ljara* period on the same basis in order for the Islamic banks to remain in line with market.

The objection raised against this practice is that, by subjecting the rental payments equal to a rate of interest, the transaction may be rendered akin to an interest-based financing.

The reply to this argument is that so long as all the other *Shari'ah* parameters discussed earlier in these pages are fulfilled, the *Ijara* agreement may use any benchmark for merely determining the amount of periodical rental.

Please remember that the main difference between conventional financial leasing and *Ijara* is that in *tiara*, the lessor assumes full ownership risks of the corpus of the leased asset.

If the asset is destroyed during the lease period without lessee's negligence, the lessor will bear the full loss besides also losing the right to continue to earn rent. In addition, the lessor will be required to refund any prepaid rent to lessee.

It is thus clear that mere use of the conventional benchmark does not render the contract invalid from *Shari'ah* perspective since it is simply meant to determine the rent for the underlying asset and is not the interest on lending since nothing is lent by the bank.

Another question arises that future variation in Libor/Eibor rate being unknown, the rent thus tied up to it may be uncertain (element of *Gharar),* which is not allowed under *Shari'ah* since all considerations in a contract must be clearly known and understood to the parties entering into it.

It is true that *Shari'ah* does not condone a contract with the element of uncertainty in it, primarily to avoid any dispute in future. However, this aspect is absent in *tiara* based on a well defined benchmark since both parties agree in writing upon it which will serve as criterion for determining the rent. As such, whatever rental amount is ascertained by lessor based on this benchmark, will be acceptable to lessee.

In any case, the lease rent of an asset is always variable, depending on the market conditions. As such, a property can be rented at a good amount in bullish market conditions whereas the same house can be difficult to rent in the opposite circumstances.

Different types of asset ownership

Scholars unanimously agree that there are three types of ownership in *Shari'ah.*

These are:

- *Milkia Raqaba* or corpus ownership: this is the ownership of the title to the asset and is also referred to as *Sanad Milikia* in the Gulf.
- *Milkia Manfa 'a* or beneficial ownership: here the corpus of the asset is held in a person's name but the benefit of ownership is enjoyed by someone else.

This type of ownership is often used in risk arbitrage. An example is setting up a trust company to own an asset on behalf of the holders of a *Sukuk* issue (Islamic bond - to be discussed later in these pages).

- *Milkia bil Yad* or ownership of the usufruct or possession: as discussed earlier, it is a temporary right to use an asset owned by somebody else against a monetary consideration.

Expanding the above definitions further, *Milkia Kamila* or complete ownership is the one where all the three elements of ownership are present. For example, an unencumbered house of a person where he himself lives.

In this situation, *Milkia Raqaba* is held with him since the title is in his name, *Milkia Manfa'a* is also owned by him since no one else shares this right with him (with the house being unencumbered) and, finally, *Milkia bil Yad* rests with him, too, as he resides there himself.

Similarly, *Milkia Naqisa* or incomplete ownership is one where one or two of the above characteristics of ownership are present but not all three.

Example

For the general benefit of the economy, distributing the above mentioned ownership characteristics among different parties with their respective rights and responsibilities clearly defined is allowed under *Shari'ah.*

A simple illustration stated below will help to prove the point.

If Ahmed wants to occupy a commercial premises in a particular area due to good business prospects but cannot afford to build or buy one, he can approach Badar who has surplus cash and may build or buy the property in the desired area and lease it to Ahmed, thereby providing economic benefits to both parties.

While Badar, being the lessor, will be responsible for maintenance of the property allowing it to be used by Ahmed, he will be entitled to receive an agreed upon periodic rent from Ahmed.

Likewise, it will be Ahmed's right to receive uninterrupted usufruct from Badar whereas his responsibilities will include not using the rented premises for any other purpose than what was agreed upon with Badar and timely settlement of the lease rent.

Another example of distribution of ownership characteristics is that of a man owning a certain property which is in his name, willing it to his son but on the condition that his wife will reside there for her lifetime. Here the corpus ownership is held with the man, beneficial ownership with his son and usufruct ownership with his wife.

Returning to the issue of usufruct, a lessee can sub-lease the same but with the lessor's permission. In such a situation, the original lessor and holder of corpus ownership will be termed head-lessor, the original lessee or holder of the original usufruct will be called sub-lessor and the new owner of the usufruct will be classified as sub-lessee.

A head-lessor or sub-lessor cannot sign several lease agreements for an asset with different lessees for the same period. However, *Shari'ah* permits this provided the lease periods are successive in nature since each lease will be considered successive to the preceding one clearly specifying the rights of each lessee/sub-lessee.

Use of usufruct

A lessee can sub-lease the usufruct if he has been permitted to do so by the lessor by way of a provision in the lease agreement. In that case he would be called a sub-lessor. A lessor or a sub-lessor cannot sign several lease agreements with different lessees where the lease commences concurrently and for the same or different periods. However, it would be in order for the lessor to do so, provided these lease agreements take effect successively.

In the case of sub-leasing, *Shari'ah* allows a lessee to form a consortium of co-lessees by assigning them shares in the usufruct in proportion to their contribution to the lease rent before the usufruct has been sub-leased at a higher rent. The co-lessees then earn their return pro-rata from the sub-lease rental.

Time-sharing concept

The time-sharing concept found at various holiday resorts is permissible under *Shari'ah.* In this situation, a lease contract is signed with several lessees without specifying a particular period of time for a particular lessee. Each lessee is then allowed to enjoy the usufruct on a first-come, first-served basis.

There is a misconception in some quarters that an Islamic leasing should be restricted to Muslims only. This misconception must be alleviated on the basis that the Prophet Muhammad (PBUH), being a trader himself, had successfully conducted various business transactions with Jews and Christians of Arabia. The important aspect to be taken care of while allowing usufruct of an asset is that it should not be utilised for any Shari'ah-prohibited purposes.

Relevant question

A question, relevant from the regional perspective, may arise as to whether the leasing of residential units to non-Muslims is allowed under *Shari'ah* since they may consume liquor and pork within the premises.

The reply provided by the scholars is that such leasing falls within the *Shari'ah* parameters since the purpose of taking the property on lease is to reside and not to sell liquor or pork. Moreover, the lessee's right includes enjoyment of the usufruct and as such the lessor does not have the right to intervene in this respect.

The scholars further state that the lessee is required to use the residential property in a manner that conforms to the relevant common practices which include, inter alia, avoid creating nuisance for the neighbours and not damaging the property by misusing it.

If the usufruct is lost by the lessee due to his own negligence whereby the leased asset is impaired wholly or partially, the lessee would be obliged to repair the property and restore the usufruct at its own cost. The lease rent would continue to be payable by the lessee during the repair period.

Maintenance

Scholars are unanimous that if the usufruct is lost due to impairment of the asset, partially or wholly, but without lessee's negligence, ;t would be the responsibility of lessor to repair the asset so as to restore the usufruct for lessee or provide him with alternate same quality asset. The lease rent will cease to exist during the time of repair or until such time that the lessee is provided with an alternate asset.

In addition, the lessor cannot shift his responsibility for any structural repairs and major maintenance — necessary to keep the asset in good working order — to the lessee's shoulders. However, *Shari'ah* permits the lessor to delegate such services to the lessee by appointing him the lessor's agent. This would require a servicing agency agreement which would be governed by the standard *Shari'ah* rules for agencyship.

As regards operational maintenance to an asset, this would be the responsibility of the lessee in his capacity as lessee. Such maintenance may include taking care of the landscape, replacement of fused electric bulbs, etc.

tiara may not start with a deal

A lease term may not necessarily start immediately upon signing the contract between a lessor and a lessee.

The lease actually commences on delivery of the leased asset by the lessor to lessee or in other words when lessee gets possession of the usufruct.

If the lessor fails to fulfil his obligation within the agreed or a reasonable timeframe from signing the lease contract, the lease will terminate and the lessee will have the right to claim actual financial loss, if any, from the lessor. The lessor will also be required to refund any advance rent collected from the lessee.

Responsibilities

As per *Shari'ah*, since the ownership of the leased asset rests with the lessor, he will be responsible for any structural repairs or major maintenance deemed essential to keep the asset in the good condition.

In addition, the lessor will be liable to pay the ownership taxes and the taxes on the income stream (rent) connected to the asset. It would also be his responsibility to keep the asset fully insured from all possible risks at all times. The lessor will perform all the above functions at his own expense.

As regards the lessee, *Shari'ah* makes it fully responsible for any ordinary maintenance and operational hazards, including liabilities relating to third-party damage.

An Islamic bank may find it manageable to fulfil its ownership tasks when it comes to handling simple assets, such as property or vehicles. However, does an Islamic bank possess the requisite technical expertise to be able to carry out these responsibilities when it comes to being an owner of an array of high-value sophisticated assets such as oil tankers, cargo vessels, aircraft, power plants, oil refineries and many other varied industrial projects?

How can an Islamic bank develop such a high level of expertise to be able to efficiently take care of such complex assets? Does it keep on its payroll an army of engineers, technicians, consultants and surveyors to remain on top of the periodical maintenance requirements of these assets?

What if the bank fails to obtain in time certain spare parts considered vital in smooth functioning of these assets. Will it be liable to the lessee for any loss of operational revenue in this situation?

What if a floating or flying asset owned by the bank is held responsible for creating a certain environmental nuisance in another country? Who will bear such heavy financial penalties and third-party damages?

Questions

To make life easier for an Islamic banker, *Shari'ah* scholars have agreed over an arrangement whereby the client is made a servicing agent on behalf of the bank.

Through this mechanism, the bank (being the principal) is able to appoint the client (who is also the lessee) its Wakeel or agent to take care of all technical requirements connected to the structural repair and major maintenance of any sophisticated and highly technical asset.

Moreover, the servicing agency agreement between the bank and the client also takes care of the need to keep the leased asset fully insured and pays applicable taxes and levies on behalf of the bank (i.e. the owner).

This takes us to another important question: Who pays for all the above expensive jobs and whether the Islamic bank finds such leasing operations profitable?

Agent's responsibilities in the case of a leased asset

The agent's responsibilities include carrying out structural repairs, major maintenance, keeping the asset fully insured, and payment of all such ownership taxes and the other charges and levies as payable by the owner of an asset in the ordinary course.

It would be quite logical to appoint the customer (lessee) as servicing agent since the asset, under its usage, has been purchased by the bank at the customer's specific request and relates to its own field of activity.

Furthermore, the customer is expected to be familiar with all the servicing requirements of the asset, including replacement of vital parts as per manufacturer's recommendations, all major maintenance milestones and the technical specifications necessary for insuring the asset to its full value and from all possible risks.

The agent fulfils these tasks on behalf of and at the cost and expense of the owner (Islamic bank). For the sake of easy understanding, all such costs and expenses are termed as the Service Amount.

According to *Shari'ah,* the service amount must be reimbursed by the principal to the agent. Keeping this principle in mind, scholars have approved a mechanism whereby on one hand the bank pays the service amount incurred by the agent upon submission of proof of payment by it and on the other it increases the lease rent of the asset for the subsequent sub-period by the same amount.

Period

A sub-period is the division of an overall lease term into several equal periods. For example, if an asset is taken on a five-year lease term and the rent is payable in arrear, it would not be fair to make lessor wait for completion of the full term to receive the rent.

At the same time, it would be burdensome for the lessee to arrange for the payment of the amount in a lumpsum if the rent is payable upfront. It is therefore allowed under *Shari'ah* to break the mid/long lease term into convenient equal parts, usually six months, to facilitate smooth operation of the lease arrangement for both parties.

The increase is allowed under *Shari'ah* since it is the owner's prerogative to vary the rent to its asset from period to period. It is therefore, agreed at the outset between the bank (lessor) and the customer (lessee) that, except for the first sub-period when the service amount would be non-existent, the bank will have a right to hike up the rent by the amount reimbursed by it to the servicing agent.

Adjustments

These adjustments are usually accounted for at the end of a sub-period. As such, the question arises as to how the bank covers itself for the service amount reimbursed to the agent relating to the last sub-period? It is done by increasing the terminal value of the asset at which the lessee is required to purchase the asset from the bank upon termination of the lease agreement.

As the lease may terminate either upon successful completion of the agreed lease term, the lessee's exercising the option for premature termination of the lease term or upon default when the lessor would be eligible to exercise its put option right on the lessee.

The difference between ordinary maintenance and major maintenance of an asset needs to be understood.

The term Ordinary Maintenance and Repair means all repair, replacement and maintenance required to keep, repair, maintain and preserve the asset in good order and operating condition, and in compliance with such maintenance and repair standards and procedures generally expected from a prudent company carrying on a business similar to that of the lessee.

Major maintenance means all repairs, replacement and maintenance required by an asset without which the asset could not reasonably and properly be used by the lessee in the ordinary course of its business.

SUKUK A VIABLE ALTERNATIVE TO CONVENTIONAL BONDS

ukuk is the plural for *Suk*, which means a certificate. *Sukuk* are certificates of equal value representing undivided shares of ownership of an asset. In other words, a *Sukuk* takes place when a set of investors pool their wealth to invest in accordance with *Shari'ah* to earn *Halal* profits which are then distributed pro rata.

A conventional bond can be described as an interest-bearing or a discounted corporate or sovereign or quasi-sovereign security that obligates the issuer to pay the bondholder a specified sum of money (interest), usually at specific intervals and to repay the principal amount (loan) upon the agreed maturity. Bondholders have confirmation of indebtedness from the issuer but do not enjoy corporate ownership privileges as shareholders do.

Unlike bondholders, *Sukuk* holders have ownership rights over the invested asset.

There are nine types of recognised *Sukuk.* They were developed by prominent *Shari'ah* scholars and Islamic finance experts to cater to various needs. However, most commonly used is *Sukuk Al Ijara* or Leasing *Sukuk.* Let us examine the structure of *Sukuk Al Ijara,* which will make the understanding of the other *Sukuk* easier. Following is an explanation in simple terms to describe the mechanism of *Sukuk Al Vara:*

- An agreement is reached between investors and the party interested in obtaining an identified asset (or a project) on lease from the investors.

- Investors acquire the asset in the name of the trustee (usually a special purpose vehicle) by pooling in their funds.
- The asset may be moveable or immovable but its use must not violate *Shari'ah.*
- The trustee then holds the right of ownership of the asset on behalf of the investors and issues *Sukuk* (certificates) to them. All *Sukuk* are of equal value.
- By virtue of the *Sukuk,* holders have pro rata undivided beneficial ownership of the asset.
- The asset is then leased by the trustee to the interested party, known as the lessee, for an agreed period.
- The trustee receives the lease rent from the lessee and distributes it pro rata to the *Sukuk* holders. The frequency of the payment of lease rent is pre-determined. It could be quarterly, bi-annually or yearly.
- The basis of lease rent is pre-agreed, but the rate can be fixed for the entire period or floated over a benchmark, depending upon the lessee's preference.
- Leasing is done under the concept of Lease Purchase *(Ijara Muntahia Bittamleek)* in which the lessee undertakes to purchase the asset piecemeal during the lease period or by making a bullet payment upon culmination of the lease.
- In either case, on maturity of *Sukuk* (which is also the end of the lease), the trustee makes a final distribution out of the sale proceeds of the leased asset to *Sukuk* holders, returning their investment along with the lease rent for the last period. At the

same time, trustee transfers the title and all ownership rights to the lessee.

Shari'ah requirements for issuing *Sukuk Al Tiara*

Islamic bonds are widely known more appropriately as Investment *Sukuk.*

Investment *Sukuk* are certificates of equal value representing undivided shares in the ownership of an invested asset. The asset is then deployed to earn profits which are distributed pro-rata among the certificate holders. Unlike bonds, the *Sukuk* holders have ownership rights over the invested asset.

Leased asset

Summarised below are the *Shari'ah* prerequisites which must be fulfilled while issuing *Sukuk Al Ijara:*

- It is necessary that the leased asset has some purposeful use. Land which cannot be used for cultivation or development purposes cannot be considered for leasing *Sukuk.*
- The lease rent must commence on the date of concluding the lease agreement provided the asset is delivered on that date.
- However, in a forward lease, the lease agreement fixes the commencement date on completion and delivery of the asset to the lessee when the lease rent starts.
- The nature of the asset should be such that it can be used in a *halal* (permissible) manner. As such, a property comprising a wine bar, casino, night club, pork-serving restaurant, interest-based bank, insurance company, among others, cannot be considered for lease under *Shari'ah.*
- The lessor must undertake all the responsibilities of an owner such as carrying out structural repairs, major

maintenance, insurance, ownership taxes, taxes on lease income, among others, at his own expense.

• Nevertheless, the lessor may appoint a lessee to carry out these responsibilities on his behalf as a servicing agent and to deduct the relevant costs from the periodical rent, as and when due.

• These costs can be taken into consideration by the lessor when the rent is fixed since *Shari'ah* allows the lessor to fix the periodical rent based on the costs incurred to maintain the leased asset.

Since the *Sukuk* represent the undivided share of the equity in the leased asset, these are tradable with the same terms and conditions as were enjoyed by the original *Sukuk* investor.

As such, the *Sukuk* can be bought and sold freely in the secondary market like the shares of a listed joint stock company in a bourse.

Similar to any other quoted investment, the trading value of *Sukuk* is determined by the market forces based on the demand and supply principle.

In such a situation, the new purchaser replaces the seller in the undivided ownership of the leased asset and all the rights and obligations of the seller are passed on to the new buyer.

Sukuk issue is redeemed in the following two ways:

The first way is leasing with a promise from the lessor to sell the asset to the lessee at the end of the lease period i.e. upon maturity of *Sukuk*.

Rent

Here, the lessee pays the cost of the leased asset (termed as 'fixed rent') to *Sukuk* holders over the lease term, in addition to the normal rent.

The normal rent is calculated at the agreed percentage based on the outstanding fixed rent (or the asset cost still to be paid by the lessee). In this case, the *Sukuk* is gradually redeemed for the full invested value during the lease period.

The other way is when the lessee promises to purchase the leased asset by the end of the lease period.

In this case, the lessee only pays the normal rent (calculated at a percentage based on the cost of the asset) and does not pay any part of the fixed rent. This *Sukuk* is redeemed in full at the end of the lease term upon the lessee making a bullet payment for the purchase price of the asset.

Comparison of *Sukuk* with traditional bonds

As against conventional bonds, which mostly comprise a debt with interest, *Sukuk* represent the undivided part of an asset that is commercially deployed to generate returns.

The ownership aspect provides privileges to the *Sukuk* investors compared with holders of conventional bonds in that there is a built-in safety element for Islamic investors.

We have seen many times that in over-subscribed scenario, the corporates promoting the bonds issue are eager to mop up excess liquidity. This phenomenon is termed green-shoes option.

Although the option is pre-approved by the financial regulatory authorities of the issuing jurisdiction, more often than not the funds retained in excess of the original requirement have returned to haunt the investors in the form of defaulted bonds simply due to over-borrowing by the corporates.

According to a careful estimate, at the end of last year, the defaulted corporate bonds index comprised 280 issues with a face value of $45 billion and a market value of $17 billion (37 per cent) only in the United States.

These are the issues that still have some value to quote. There were scores of issues where bondholders lost the entire investment.

How is *Sukuk* different from bonds in this respect? Let us try to understand this critical divide.

A *Sukuk* promoter is aware of its limitations to retain up to a certain amount in case the issue is oversubscribed. This is because the total amount subscribed by the *Sukuk* promoter cannot exceed the value of the underlying asset. This self-controlled mechanism in *Sukuk* works as a wonderful safety valve for the benefit of investors.

Let us understand this by way of an example. In June, 2002, the Malaysian government decided to launch its first *Sukuk* Al *Ijara.*

The decision to go Islamic was taken after the issuing of a number of conventional bonds by the government.

The amount sought was set at $500 million with green-shoe option. Due to the issue being structured on Islamic lines, however, there was high appetite among the investors. It resulted in the issue being oversubscribed at $1.1 billion.

Had it been a conventional bonds issue, the government would have been in a position to retain an amount much higher than the original launch value.

Because the *Sukuk* assets were valued at $600 million, the subscription could only be raised from $500 million to $600 million.

Imagine a situation where a *Sukuk* issue goes into default. A question is ehether the investors will be hit. The *Sukuk* holders are the rightful owners of the *Sukuk* assets. In worst case scenario, where a forced sale may take place, these assets can at least assure return of a considerable amount of capital to *Sukuk* holders, if not all.

It may also happen that the auction proceeds could be even higher than the face value of the *Sukuk* if the value of the assets comprising real estate has appreciated.

Benefits to the investors

In addition to the safety of their investment, *Sukuk* holders can also benefit from the following:

Higher return on investment by eliminating middleman costs. This is because the administrative costs charged by financial institutions before providing benefits for depositors considerably reduce the return on investment.

Insolvency-remote mechanism through Special Purpose Vehicle (SPV). Being an independent legal entity, SPV remains free from promoter's influence. Furthermore, an SPV is usually formed in an environment where strong trust laws are operative.

Benefits to the promoter

Promoters can enjoy the following benefits by taking the *Sukuk* route:

(1) Departure from *Riba* (interest), which is strictly forbidden.

(2) Availability of cheaper capital compared with bank borrowings.

(3) Conversion of on-balance sheet liabilities to off-balance sheet items.

(4) Fixed maturity giving peace of mind to the promoter, compared with the bank's lending, which is payable on demand from the bank.

Different types of investment *Sukuk*

Apart from *Ijara Sukuk*, there are other types of investment *Sukuk. Murabaha Sukuk* is one such type. First, let us examine whether there can be a *Sukuk* issue for the usufruct of an asset.

Shari'ah allows that the owner of a usufruct (i.e., the lessee of an asset) can issue certificates of equal value of the usufruct relating to an existing asset. This can only be done if the lessee holds the right from the lessor to sub-lease the asset.

In this case, the lessee will collect the investment from *Sukuk* holders for payment of the entire head lease rent to the owner of the asset. Thereafter, the rent collected by sub-leasing the asset will be distributed pro-rata among the *Sukuk* holders who will be considered the owners of the usufruct of the asset (and not of the asset).

The sub-lease rent will be higher than the head lease rent to provide return for the holders of usufruct *Sukuk.*

Usufruct *Sukuk* can also be taken out for an identified asset to be delivered in future. This is akin to *Ijara Mousufa Eel Zimmam* or forward lease, whereby the return to the holders of this *Sukuk* will commence upon delivery of the asset to the sub-lessee.

Murabaha Sukuk:

These equal-value *Sukuk* are issued to collect funds that are then utilised to purchase an asset to be sold under *Murabaha.* First, the *Sukuk* holders assume the ownership of the asset bought with their money. They then become the rightful recipients of the proceeds from the sale of the asset.

While launching this type of *Sukuk,* the issuer (which can be an Islamic financial institution or a duly administered special purpose company) should adhere to the following established *Murabaha* parameters.

Murabaha parameters:

The buyer should ask the seller to acquire the asset and submit a promise to purchase, stating a price at which he will purchase the asset from the seller.

The seller must pay the purchase price of the asset directly to the supplier and obtain physical or constructive possession of the asset. The supplier of the asset must not be related to the eventual buyer.

The seller's established ownership by way of title to the asset is a must.

The sale must be unconditional and the sale price should include the cost of the asset and seller's profit. The seller may include any direct expenses, such as freight, transportation, customs duty and labour to its cost.

The seller should not charge any fee relating to his commitment to sell the asset to the buyer on a deferred payment basis.

The seller must provide a break-down of the selling price for the buyer. Usage of the asset must not be repugnant to *Shari'ah* principles.

Asset

An asset that has earlier been sold on *Murabaha* (the proceeds of which continue to remain unpaid) cannot be sold again to the same buyer under *Murabaha.*

Obtaining the ownership title and physical or constructive possession by the seller prior to concluding the *Murabaha* sale is vital to clearly identify the transfer of ownership risk to the asset from the supplier to the seller. This presumes that the seller held legal title and ownership to the asset when it sold the asset to the buyer under *Murabaha.*

Murabaha Sukuk are not publicly tradable since their redemption is tied up to the phased receipt of the sale proceeds at the intervals agreed to with the buyer at the time of concluding the *Murabaha* sale.

Such *Sukuk* are ideal to replace conventional project financing since the entire plant and machinery relating to an industrial project can be sold through *Sukuk* and the cash flow generated by the project can be utilised to redeem them.

Some innovative *Sukuk* structures

Islamic jurists, scholars and economists have done an admirable job in recent years in devising innovative *Sukuk* structures. While doing so they have ensured that each of these structures is based on *Shari'ah.*

Apart from *Ijara* and *Murabaha Sukuk,* other innovative investment *Sukuk* can also be issued to fulfil the requirements of promoters as well as investors in a Shari'ah-compliant manner:

Sukuk Al Istithna

By nature, *Istithna* is a sale contract for an asset which is to be developed or manufactured at the specific request of a buyer at an agreed price. The asset is delivered to the purchaser at a pre-determined time when it is expected to be ready.

The adoption of *Istithna* for investment *Sukuk* entails issuance of equal value certificates and the funds collected are deployed to manufacture or develop the asset which is commonly owned by all *Sukuk* holders.

Sukuk holders are able to redeem their investment along with profit when the completed asset is delivered to the buyer and the sale proceeds are realised, which can either be in lump sum or instalments.

Sukuk Al Musharika

As is evident from its name, these are certificates of equal value with an aim of using the proceeds to obtain partnership in an existing business or a new project. *Sukuk* holders become co-owners of the project where the funds are invested.

Since it may not be possible for scores of *Sukuk* holders to play an active role in the day-to-day running of the *Musharika* business, a *Mudareb* (fund manager) or Wakeel (agent) is appointed by them to manage the business on their behalf and on behalf of the *Musharika*. The *Mudareb* or Wakeel could be the other partner having the requisite expertise or an independent professional entity.

Musharika profit is distributed at periodical intervals and the redemption of *Sukuk* can be carried out in an agreed phased manner or in a lump sum upon completion of the Mush-arika term.

Sukuk **Al** *Salam*

A *Salam* contract is one where the sale proceeds are paid upfront but delivery of commodities or goods is deferred to a certain date and place. *Salam* was introduced in the early days of Islam to help the farmers get rid of interest-based borrowings.

The subject matter of *Salam* can be crops of grain, livestock, or any other agricultural or industrial goods which need a certain time-frame for delivery. The principle on which it works is that the *Salam* price must be lower than the market price so as to be attractive enough to the buyer to pay the full price upfront and receive the goods on an agreed future date.

Sukuk Al Salam, although yet to be experimented with, will allow collection of funds from certificate holders to purchase the goods on a deferred delivery basis. Once the goods are received, these will be jointly owned by the *Sukuk* holders.

Disposal of the goods will take place under a parallel *Salam* contract which the issuer must have pre-arranged i.e. prior to issuing *Salam Sukuk.*

On receipt, the commodities or goods will be sold by the issuer at a higher price than that at which they were acquired, the difference between both prices being the return to *Sukuk* holders on their respective investment.

***Sukuk* are contract-based investment instruments**

Investment *Sukuk* are based on any one of the *Shari'ah*-driven investment contracts such as *Ijara, Murabaha, Istithna, Musharika, Mudaraba, Wakala,* and *Salam,* among others. In each case, the defined contract of issue will govern the relationship between the issuer and subscribers along with all legal effects with respect to rights and obligations of the parties.

Under *Shari'ah* jurisprudence, as well as common law, a contract is formed upon complztion of the process of offer and acceptance. Based on this principle, let us examine how this is achieved in a *Sukuk* issue.

The issuance of a *Sukuk* prospectus, also known as the offering circular, constitutes an issuer's invitation for investment. Investors' response by way of pledging funds through subscription is considered an offer whereas the issuer's approval of the subscription by way of allotment is regarded as acceptance, thus forming a valid and legal contract binding on both parties.

In other words, once the allotment is completed, the issuer and subscribers (now allottees) assume full legal status along with respective contractual rights and obligations towards each other.

Elements of a *Sukuk* issue

It is important to understand different elements in an investment *Sukuk* which form a working mechanism based on *Shari'ah* principles. A brief look at some of the *Sukuk* structures will convey the point.

In the case of *Sukuk Al tiara* or leasing *Sukuk*, the seller of an asset will be the issuer whereas certificate holders are buyers of that asset and the subscription amount is the price paid by the *Sukuk* holders for purchasing the asset. Furthermore, *Sukuk* holders will collectively enjoy the same legal status available to an individual lessor.

Similarly, in case of *Murabaha Sukuk*, the issuer of the certificates is the seller of the goods or commodity, the investors are collective buyers whilst the investment proceeds are the cost of the goods. The sale price of the goods, upon realisation, will constitute redemption of *Murabaha Sukuk* with profit for the investors.

Here, too, the investors will enjoy full legal rights which are available to an individual seller of the goods under *Murabaha*, be it a financial institution or a person.

How is this done in *Musharika Sukuk?* Here, the issuer of *Sukuk* will be the one inviting the investors to inject funds into its project, whether new or existing.

Subscribers to the invitee's call will become its partners, the investment amount collected will be the capital inducted by subscribers into the *Musharika*, whereas all the *Musharika* assets and liabilities will be jointly owned by the investors together with the other partners. *Sukuk* holders will enjoy the profits earned by

Musharika and at the same time will also be responsible for bearing the losses, if any.

In case of *Istithna Sukuk,* the issuer of the certificates will be the one responsible for developing or manufacturing the requircd asset, the investors will be the buyers of the asset to be developed and the invested amount is the cost of developing the asset.

Certificate holders will own the developed asset and will sell it under a pre-arranged parallel *Istithna.* The sale price will redeem their investment with profit.

However, it is important to note that the respective status as described above will be accorded to the investors only after closing of the subscription and the allocation or allotment of the *Sukuk* certificates.

USE OF CONVENTIONAL BENCHMARKS FOR PEGGING

pricing for most of the large development projects done under the Islamic umbrella are based on conventional benchmarks. Financing of projects by Islamic banks is not simply lending the money and charging a certain benchmark-based rate. It is dependent upon various factors. If it is a green-field project, the most suitable Islamic financing mode could be *Istithna,* where the project is built or developed by the bank for the customer at a pre-agreed price that includes its profit, to be delivered at a future date.

In case of a running project, the bank can buy it from a third party for onward sale to the customer under *Murabaha.* Please remember that *Istithna* and *Murabaha* are sale contracts and the customer will be paying the purchase price. As such there is no borrowing or lending at a rate.

Leasing is quite a different option where the bank purchases a completed project for itself (or finances the project for completion), which is then leased to the customer for a pre-agreed period during which the bank recovers its cost plus profit by way of lease rent periodically paid by the customer. Upon successful completion of the lease term, the project is sold to the customer at a nominal price.

Sometimes Islamic banks also purchase customers' own assets for the purpose of leasing them back to the customer. This is quite all right under *Shari'ah* since title to the ownership and the constructive possessions of the assets get passed on to the Islamic banks immediately upon signing the purchase agreement with the customer. This gives them the right to become a legitimate lessor whereas the customer becomes a lessee.

Such transactions are undertaken to facilitate the expansion or modernisation of the customer's existing projectwhere the cash requirements are large.

In *Musharika* or partnership, an Islamic bank co-owns the project with the customer and leases its part of the ownership to the customer. Again, upon completion of the agreed lease period, the bank exits the *Musharika* by selling its part of the ownership at a notional price since it recovers the investment plus anticipated profit during the lease period.

Without doubting the sincerity of the intention of the writer of the article, the impression one generally gets by going through the article is that Islamic project financing is akin to its conventional counterpart. This is perhaps due to Islamic pricing being pegged to the conventional benchmarks.

Such adoption of a conventional benchmark in an Islamic financing transaction does not mean that it is similar to interest-based financing. Use of a conventional benchmark is simply for indicative purposes due to the absence of a universal Islamic benchmark for profit.

Shari'ah scholars have unanimously approved usage of Libor (London interbank offered rate) for financing transactions in a foreign currency or Eibnor for the UAE dirham, or any other benchmark prevalent in the country of transaction, as long as all the core *Shari'ah* parameters are complied with.

It is important to know that the Islamic banks are barred by their *Shari'ah* boards from borrowing the funds from the interbank market or from depositors at interest. The funds deployed by the Islamic banks are in fact given by their customers to the bank as *Mudareb* (fund manager) for prudent investment under the *Shari'ah* guidance.

Islamic Indices

An Islamic index is a hypothetical portfolio comprising of the stocks of companies whose activities do not conflict with Shari'ah.

The first Islamic index was launched in late September 1999 by Dow Jones, the world's leading stock index providers. Riding the wave of success, DJ has so far taken out 29 different Islamic indexes worldwide, comprising about 1,600 Shari'ah-compliant companies from a cross-section of economic sectors.

These indices are a well-balanced combination of large, medium and small actively traded companies with a total market capitalisation in the proximity of $9 trillion.

Emergence of other indices

The large-scale acceptability and success of the initial DJ Islamic indexes gave rise to the emergence of a series of such other indices, a prominent one being the Financial Times Stock Index or FTSI.

Today there are over 100 Islamic indices spread all over the world with an estimated aggregate market capitalisation running into trillions of dollars. These include high-cap, mid-cap and small-cap indices, which are further segregated into various economic sectors and regions.

Synergy

Islamic indices have generated a great deal of interest amongst non-Muslim investors too due to their synergy with social indices on ethical grounds. The concept of a social index was developed in the US during early 90s. It emphasises "invest with values".

The argument put forward by promoters and supporters of a social index is that personal values and personal finance should go hand in hand.

They say it is possible for one to achieve financial goals and at the same time help make this world a better place to live in by encouraging investment in ethically appropriate companies. They define "natural investors" as people who actively seek to balance their need for financial return with their yearning to make life a little better for others.

The avoidance screening in a social index includes such issues as liquor violation, environment pollution, toxic products, gambling, causes for global warming, nuclear field, tobacco and weapons.

Perhaps the cause of social indices is gaining popularity since a 10-year comparison recently carried out has revealed that a leading social index in the US had outperformed the prestigious S&P 500 index. Today the total size of the social indexes runs into trillions of dollars.

Other Parameters

An activity being Shari'ah compliant is not the only criteria for a stock to find place in an Islamic index.

The following additional parameters, which differentiate an Islamic index from a social one, are also essential to make a company eligible for an Islamic index:

a) Interest bearing debt of the company at any point in time should remain below one-third its average market capitalisation in the last 12 months;

b) Total interest income of a company should not be more than 15 per cent of its total income;

c) The sum of a company's cash and interest bearing securities must not be greater than 33 per cent of its trailing 12-month average market capitalisation;

d) The company's account receivables should remain below 45 per cent of its total assets.

Shari'ah boards of respective Islamic indices have approved a mechanism through which periodical financial results of each individual company are scrutinised with the help of the latest sophisticated software. These programmes are designed to track down any breach of any of the listed Shari'ah covenants upon entering the data.

The next step for an Islamic index manager is to immediately proceed for elimination of the stock, which has failed in the screening. Simultaneously, a press release is issued advising the public of deletion of failed stock from the Islamic index which is also posted on the index provider's website.

On the other hand, regular screening is also carried out for the stocks, which, although they may qualify as far as the company activity is concerned, are outside the Islamic index owing not to meeting one of the above Shari'ah parameters. If they pass on all counts, these stocks are included in the index.

Indices have started to spring up far and wide

An Islamic index is supervised by the *Shari'ah* board and one can protect one's investment by monitoring the movements in an Islamic index.

The Islamic indices have been effective and competitive when it comes to providing the desired return to investors when compared to the other indexes.

There is an argument that the *Shari'ah* screening process does not leave much by way of selection from a long list of stocks as the majority of the companies fail to qualify to enter an Islamic index.

Furthermore, the companies listed in an Islamic index can be compelled to exit at any time if their interim or annual results fail to pass through the *Shari'ah* filters.

This leads to another argument. In addition to market forces, the movement in an Islamic index could also be independent of the market.

This is because at any time a stock considered good by the market and wished for by the investors may be dropped from the index due to its failure to survive the periodic *Shari'ah* screening process.

This can cause a sudden drop in the Islamic index if the exiting stock held enough weight in the index. It is important to note this may happen despite market sentiments being bullish and that particular stock gaining a lot of attention.

Technology bubble

Another argument brought against the Islamic indexes is that these are tilted towards technology stocks due to their relatively low indebtedness and higher *Shari'ah*-compliant nature.

As such, just when the Dow Jones Islamic Index had started to emerge, the market saw the bursting of the technology bubble. Although the impact was felt by the indexes globally, the drop in the Islamic indices was bigger since these were laden with technology stocks.

It is true that out of a given basket of stocks, the ratio of stocks not making it to an Islamic index may sometimes be more than two-thirds.

Clean bill of *Shari'ah* health

One should not forget that until recently an Islamic investor did not have an opportunity to enter the world's leading stock markets with the complete satisfaction of his conscience.

Managers of Islamic indices have taken it upon themselves to provide a clean bill of *Shari'ah* health to the stocks listed in their respective indexes. Now an investor can pick stocks from an Islamic index knowing he is not violating any *Shari'ah* principle by investing in these stocks.

This is a great step forward when we look back to when the stock market was devoid of any such facilities for investors.

Shari'ah screening process requirements have been laid down with the help of an in-depth commercial analysis and extensive *Shari'ah Ijtihad* (research) by some of the highly respected and learned *Shari'ah* scholars of our time.

The base of Islamic indices is gradually broadening with the stricter regulatory environment, self-containment of debt by the publicly traded companies and, as stated earlier, their effort to remain part of an Islamic index.

ISLAMIC MUTUAL FUNDS

A mutual fund (or funds) comprises money pooled by investors, which is generally used to buy stocks of publicly traded companies or bonds.

Ideally, a fund's size coupled with its high management expertise provided advantages for a common investor.

These include prudent diversification, timely exit and entry into stocks and bonds, proper selection of securities, comparatively low running costs and convenience regarding liquidation of their portfolio.

The legal structure of a mutual fund is similar to that of a corporation that receives preferential tax treatment in most countries with investment-friendly laws.

Most funds are open ended, allowing investors to enter and exit at any time.

Mutual funds issue shares to investors in exchange for cash. Unlike shares of publicly traded companies, the shares of a fund do not comprise a pre-determined amount of stock.

For example, while the market value of a public joint stock company share is determined by the supply and demand correlation and has nothing to do with the net asset value (NAV) of the company, the ownership value in a mutual fund is ascertained by dividing the net assets of the fund by the number of shares the fund holds.

An Islamic fund operates on the same concept but with a difference in the criteria it follows in selecting stocks. These criteria include *Shari'ah* screening guidelines. They are:

1. Total interest-bearing debt of a company at any point in time should remain less than one-third of

its average market capitalisation in the past 12 months.

2. Total interest income of a company should not be more than five per cent of its total income.
3. The sum of a company's cash and interest bearing securities must not be greater than 33 per cent of its trailing 12 months average market capitalisation.
4. The firm's account receivables should be less than 45 per cent of its assets.

Islamic funds have existed in some form or another since the mid 1980s. They were on a small scale and largely localised, serving certain social purposes, such as community welfare.

These funds became popular on a commercial scale in the early 1990s. At that time, it used to be a Herculean task for a fund manager to select the right stocks.

In addition to Shari'ah-permitted activities, the criteria in selecting a stock were stringent and narrowed down to relatively debt-free companies that at times were difficult to find.

Some managers also bought zero-coupon bonds while considering their higher value nearing maturity as capital gain rather than interest. This approach was not in line with *Shari'ah* principles.

The launch of Islamic indices in February 1999 provided a shot in the arm for the growth of Islamic funds. The appearance of a number of companies in an Islamic index made it convenient for an Islamic fund manager to select stocks.

This is because of the approval granted to a stock by the *Shari'ah* board of an Islamic index.

While investing in a fund could be a relatively low-risk option in view of its diversified nature, there is an attendant cost to it in addition to the dividend tax.

This is the administrative cost at a pre-agreed rate a fund manager is authorised to charge in the capacity of a *Mudareb*.

Different types of Mutual Funds

Portfolio of an Islamic fund may typically consist of a mix from the following *Shari*'ah-compliant asset classes:

- Equities of companies whose activities are not against Shari'ah.
  Spot trading of commodities, such as grains, cereals, metals and minerals but excluding gold and silver.
- Real estate.
- *Sukuk* (Islamic bonds).
- Short-term cash and cash equivalent pending investment but held with Islamic financial institutions.
- Finance and operating leases.

An Islamic fund can be open or close ended and an investor can buy a stake at its launch or invest later if it is an open-ended fund.

The investor receives a certificate as proof of his subscription to the fund, entitling him to receive profit that is distributed pro rata to the period that his funds remain invested.

Distribution of profit could be annual or interim.

An investor must enter into the Islamic fund with a clear understanding that the return on his subscription is tied up with the actual performance of the fund, which means the fund could also perform negatively, thereby eroding the value of his investment partly or fully.

Nevertheless, if the loss is caused by the negligence or mismanagement by the fund manager, the investor will have recourse for the fund manager to make good the loss.

As such, it is important to examine the credentials of the fund manager before selecting an Islamic fund for investment.

A brief description of various types of Islamic funds follows:

Islamic equity fund

It is the most common form of the Islamic fund. It is comprised of investments made by deploying the fund's resources into buying the equities of joint stock companies whose activities are permissible under Shari'ah. Profit in an equity fund is mainly comprised of capital gains achieved by way of disposing of the shares in a bullish market environment. Dividend on securities held also contributes to the bottom-line an equity fund generates.

***Ijara* (leasing) fund**

Here, the subscription amounts are used to buy leaseable assets, such as real estate, aircraft, vessels, motor vehicles or equipment.

The ownership of the leased assets remains with the fund or a special purpose vehicle whose shares are charged to the fund. The profit in this type of fund is comprised of rentals paid by the lessee. These rentals are then distributed pro rata to the fund's subscribers.

Investors are provided with certificates representing the ownership in the leased assets of the fund, and not the liquid amounts or debts. These certificates are fully negotiable and can be traded in the secondary market. Anyone who purchases these certificates in the secondary market replaces the seller in the fund assets and all the rights and obligations of the original subscriber are passed on to him.

Market price of the certificate will be based on the performance of the *tiara* fund.

Manager of an *Ijara* fund must ensure that the underlying leasing contracts conform to Shari'ah principles, which radically differ from the conventional financial lease.

Broad parameters of Shari'ah compliant lease contract are as follows: Asset must have some usufruct and the rent must be charged from the day the usufruct is handed over to the lessee. Assets must be for *halal* (Shar'ah permissible) use.

Ownership responsibilities relating to the leased asset, such as maintenance, insurance, withholding tax, etc must rest with the fund.

Rent for each lease period must be fixed and known to the lessee from the outset. Fund management should act as an agent for investors and should be paid a fee for the services.

OTHER ISLAMIC FUNDS

Commodity fund

In this type, the subscription amount is used to buy commodities for resale and the profit is distributed to investors. For the fund to be Shari'ah-compliant, it is necessary to observe the following rules:

1. At the time of purchase, the seller must own the commodity.
2. There should be no forward sale in the conventional perspective, however, it might be allowed under *Salain*, which is a different concept.
3. Commodities purchased must not be forbidden under *Shari'ah.*
4. The seller must have physical or constructive possession of the commodity. Constructive possession is where the seller holds indirect possession of the goods, usually through its agent.
5. The price of the commodity must be prefixed and known to both parties.
6. The fund must own some commodities at all times.

Murabaha fund

Another Islamic fund that could be established, albeit with little care, is the *Murabaha* fund. *Murabaha* transactions are carried out by Islamic banks as the most common mode of financing.

The banks buy certain goods from a third party against cash and sell them on a deferred payment basis to clients at a pre-agreed amount of profit. So far, no *Murabaha* fund has been launched but promoters of this type of fund will have to launch it as a close-ended fund.

The certificates of a *Murabaha* fund cannot be traded in the secondary market because the goods under *Murabaha* will be sold to buyers immediately after the title and possession has been acquired by the fund from the suppliers.

While the payment to suppliers will be made by the fund at sight, the buyers will pay to the fund on deferred basis. As such, what funds will recover over a period of time from the buyers will be a debt and, as most people are aware, trading of debt is forbidden under *Shari'ah.*

In other words, a *Murabaha* fund will not own any tangible assets, except the portfolio of receivables, which, of course, cannot be traded under *Shari'ah.*

Therefore, launching a *Murabaha* fund is a possibility but on a one-off self liquidating basis and is most suited to project financing.

SHARFAH SUPERVISORY BOARD

Retaining the services of a *Shari'ah* supervisory board, with at least three qualified members, is preferable since it is reassuring to investors. If the fund is heavily reliant on investing in securities from Islamic indices, one *Shari'ah* supervisor could also be considered enough because such securities are subjected to screening by the *Shari'ah* supervisory board of the indices.

Shari'ah supervisors are representatives of investors as they take every possible measure to ensure that the fund's investments remain *halal* and distribution of dividends is pure and free from *riba* (interest) and any other *non-halal* income.

Role of *Shari'ah* board in monitoring funds

Let us learn more about what the *Shari'ah* board of a fund does to serve the Islamic investors.

Purification of the Islamic fund's portfolio

We are aware that Zakat stands for purification in Arabic. It is also used in the meaning of growth, in the same sense as pruning of a plant to give way to the new growth. Zakat is mandatory for every Muslim adult man or woman of sound mind, who may be holding wealth beyond a certain level and for a period of one Islamic year.

How does an Islamic fund purify its portfolio for the benefit of investors? Here the term 'purification' has a different meaning.

There can be some impure elements in an Islamic fund's portfolio. These are the undesired earnings by the companies in which the Islamic fund may have invested its money.

It is the responsibility of an Islamic fund's management that such impure earnings must be quantified and then purged from the fund's income.

Even Shari'ah-compliant equities may often yield a small percentage of income that is considered impure by *Shari'ah* standards, and which must then be purged.

Such undesired earnings include interest income, dividend received by a company from investments in *Shari'ah* prohibited activities (such as banks and insurance companies, hotels and casinos, weaponry).

The fund manager, under the supervision of *Shari'ah* scholars, arrives at all such impure income and arranges that a corresponding percentage is deducted from the dividend, before it is paid out to the investors. Such impure income is diverted to charitable NGOs or to scientific research societies.

It is important that the fund is actually committed to and is regularly engaged in such purification exercise from time to time on behalf of the investors

The amounts so deducted will, no doubt, impact on a fund's net return ratios. If not purged, however, the impure income will turn the entire dividend amount murky and the purpose of investing in an Islamic fund will be defeated from the investors' point of view.

Performance

In the case of a cross-section of securities in a managed portfolio, the fund's management is responsible for monitoring the financial performance of these companies on a periodical basis under the guidance of its *Shari'ah* Supervisory Board.

This is important to ensure that a company has not breached any of the *Shari'ah* guidelines we have discussed. For example, a company having earned interest income at less than 5 per cent of the total net income during the first fiscal quarter may end up making over 5 per cent from the interest income by the year-end.

While the ratio of interest income in the first quarter is within the *Shari'ah* restriction, the total interest income received by the company during the whole year exceeds that threshold. In this case, the fund should immediately proceed to liquidate its investment in the company stock.

Regular vigilance is required in these matters to ensure that all of the fund's holdings remain within the limits of the prescribed *Shari'ah* filters at all times.

Furthermore, when a fund is connected to an Islamic index, the index provider will pass on all such information to the fund manager. In such cases, the responsibility of the *Shari'ah* supervisor will be to identify and recommend the removal of such securities from the fund's portfolio.

Sophisticated software programmes have since been developed to track securities with ease. Such programmes, when linked with the internet, will also provide real-time access to the portfolios as well as a host of other information. It is the prerogative of the *Shari'ah* supervisors to determine which stocks should be exited by an Islamic fund.

STANDARDISATION OF SHARI'AH PRINCIPLES

The Shari'ah boards of different Islamic banks in the Gulf differ on how a certain financial or investment transaction should be carried out. Sometimes a transaction approved by a certain Islamic financial institution may not be acceptable to the Shari'ah Board members of another institution, unless it is amended to accommodate their views and recommendations.

It is said that having a difference of opinion is healthy, but it seems to leave a bad taste in the case of Islamic financial institutions.

While the sympathisers of Islamic finance wish there were no differences among the ranks of scholars at the helm of this silent financial revolution, the critics of this rapidly spreading financial system take every opportunity to demonstrate the vulnerability of the system.

This is in contrast to the well-entrenched interest-based conventional financial system, where the standards are treated almost as unwritten laws.

One of the arguments against carrying out an Islamic transaction is the length of time taken by the Islamic financial institutions in getting a transaction cleared from their respective Shari'ah boards, especially when it relates to complex syndicated financing, split between Islamic and conventional transactions.

Why are there differences of opinion among the Shari'ah boards of different Islamic financial institutions, and what is being done to address them?

Most readers may be aware that the main and undisputed sources of guidance in Islam are the Holy

Qur'an and Sunnah (sayings and life of the Prophet Muhammad, peace be to him, considered to be the reflection of the Holy Qur'an by Muslims).

While most aspects relating to finance have been clearly spelt out in both the above sacred sources — leaving little room to differ — such as inheritance, sale and purchase transactions, partnerships and Zakat, there are guidelines embedded in the verses of the Holy Qur'an and the teachings of the Prophet Muhammad (peace be to him) that need to be further explored by Islamic scholars and jurists.

The wisdom behind this is to stimulate the human mind to discover the hidden treasures of the Qur'an and Sunnah.

There are many aspects in the Qur'an relating to filiance that were not widely practised and hence not clearly understood by Muslims in the past. One such example is leasing, which is commonly used today, but was almost non-existent in the early days of Islam.

Coming back to the differences between the various Shari'ah scholars today, let us try to understand the rationale behind them.

There are four schools of thought (called Madhabs) in the predominantly practised Sunni sect of Islam. These are Hanafi, Shafai, Maliki and Hanbli. These are the aliases of the four great *imams* (leaders) in Islamic *Fiqh* (Islamic jurisprudence).

What is *a Madhhab*?

Simply speaking, a *Madhhab* is a precise methodology developed by one of the above *imams* that its followers (scholars) adopt to derive Islamic rulings, as and when needed.

It is important to understand that each *Madhhab* differs only slightly in its methodology. This causes them to have different rulings in some cases, although the differences are usually on minor and secondary issues and all four agree on the basic belief guidelines of Islam, including on the majority of their rulings.

These *Madhhabs* do not constitute separate sects, denominations or groups within Sunni Islam. It is possible that in some cases the scholars within a particular *Madhhab* can have different opinions as well.

The Four Guides Behind Shari'ah-based Investment

The Holy Qur'an and Sunnah, the life and sayings of the Prophet Muhammad (peace be to him) were the primary and undisputed sources of guidance in Islam. But the four legendary *imams* (leaders of their respective *Madhhab,* or methodology) of the predominantly practised Sunni Islam differed on relatively minor issues.

The four *imams* are Imam Abu Hanifa, Imam Shafai, Imam Malik and Imam Hanbal. Some followers of these *imams* believe the various rulings by their respective *imams* are actually the opinions or views of that particular imam. Research shows this is not correct since a vast majority of the opinions related to these *imams* are directly based by them on the Holy Qur'an and Sunnah.

Ruling

If a person belonging to the Hanafi madhab seeks a ruling on a certain issue, he is actually looking for the ruling derived by Imam Abu Hanifa directly from the Holy Qur'an and the Sunnah.

This is also the case with the followers of the other imams, proving the point that there is consensus by these great *imams* on the vast majority of issues faced by their followers in everyday life.

This actually narrows down the scope for any differences and such matters are left to the interpretation of present-day scholars.

However, there is an underlying condition that the interpretations, which may differ from scholar to scholar, must remain within the Shari'ah boundaries.

In this context, it is helpful to allude to a verse from the Holy Qur'an which says that whoever wants to explore the text of the Qur'an for something new and undiscovered will not be disappointed and the treasures of the Qur'an will never be fully exhausted.

Let us get to know the first of the four legendary *imams* on whose combined methodology the present pillars of Islamic finance and investment are based.

Imam Abu Hanifa

He was born as Numan Ibn Al Thabit Al Numan in C.E. 698 (80 Hijri) in Kufa (about 170 km from Baghdad). He was the first of the four *imams* and was fortunate enough to see the last few companions of the Prophet MUhammad.

Intellect

He learned *Fiqh* (Islamic jurisprudence) from Imam Jaffer Sadiq and Hammad Bin Abi Sulaiman great *Faqihs* (Islamic jurists) of his time.

He was brought up to be a *Qadi* (judge) but because of his amazing intellect and superior ability to memorise and interpret innumerable Hadiths (sayings of the Prophet Mohammad) in a flawless manner, he was declared an imam. This decision was based on the pressing need to provide authentic guidance in the early era of Islam.

Due to his dedicated efforts he attained an unparalleled position in a short period of time and as the message of Islam spread far and wide, his fame spread worldwide.

Imam Abu Hanifa's work over his 70-year lifetime included the first classification and compilation of matters relating to Islamic jurisprudence, which still commands great admiration and respect among Islamic scholars.

Today, more than half of the Sunni Muslims follow Imam Abu Hanifa, who is also called Imam Al Azam (the greatest imam).

His followers are found in India, Pakistan, Afghanistan, Turkey, Iraq, Syria, China, North Africa, Egypt, Albania, Balkans, Central Asia and in the Malay Archipelago.

Imam Shafi'i

He was born in Gaza in 767 C.E. After the death of his father, the family migrated to Makkah, before moving to Medina in his youth. While there, he met Imam Malek and remained his student until his teacher's death in 795.

Imam Shafi'i earned praise from Imam Malek because of his ability to memorise as well as his piety, honesty and dedication to the knowledge of *Fiqh* and the cause of Shari' ah.

He returned to Syria in 804 and from there went to Egypt, where he was given a warm welcome because of his close association with Imam Malek. In 810, he visited Baghdad, where he received similar treatment and was surrounded by eager students.

These students subsequently formed the Shafi'i school of *Fiqh* by practising and propagating his rulings and views.

Imam Shafi'i wrote several books, the most famous of which is Kitab Al Umm — a collection of his work and lectures. A number of his learned students have also collected his work and rulings in the form of books, or frequently quoted him in their books. Imam Shafi'i died in Cairo at the age of 53.

Baghdad and Cairo became centres of Imam Shafi'i's teachings during the 9th century to the extent that the Egyptian ruler Sultan Salahuddeen adopted the Shafi'i doctrine as an official *madhhab.*

Imam Malek

He was born in Medina in 711 C.E. His full name was Abu Abdullah Malek ibn Anas ibn Malek Ibn Abi `Amir Ibn `Ainr Ibnul-Harith Ibn Ghaiman Ibn Khuthail Ibn `Amr Ibnul-Haarith. His family was originally from the al-Asbahi tribe of Yemen, but his great grandfather Abu `Amir relocated the family to Medina after converting to Islam in the second year after *hijra.* Imam Malek is known as "Sheikh of Islam," the "Proof of the Community," and "Imam of the Abode of Emigration."

Living in Medina gave Malek access to some of the most learned minds of early Islam. He memorised the Quran in his youth, learning recitation from Imam Abu Suhail an-Nafi' ibn `Abd ar-Rahman. He studied under various famed scholars including Hisham ibn Urwah, Jafar al Sadiq, and Ibn Shihab al-Zuhri.

Imam Malek practised extreme care in regard to narrating Hadith. His chain of narrators was considered the most authentic and called *Silsilat ul-Zhahab* or "The Golden Chain of Narrators" by notable hadith scholars including Imam Bukhari. This 'Golden Chain' of narration consists of Malek, who narrated from Nafi', who narrated from ibn Umar, who narrated from the Prophet (peace be to him).

Despite his reluctance to render religious verdicts, Imam Malek was outspoken. He issued fatwas against being forced to pledge allegiance to the Caliph Al-Mansur, and was punished via flogging for his stance.

Imam Malek wrote *Al-Muwatta,* "The Approved," which was said to have been regarded by Imam Shafi'i to be the soundest book on earth after the Qur'an.

Imam Malek died at the age of 89 in Medina in 795.

Muslims inhabiting Western Arabia, exclusively subscribe to the Maliki sect.

Ahmad Bin Mohammad Hanbal

He is known as Bin Hanbal. Like Imam Abu Hanifa, he was also from Baghdad, where he was born in 780 C.E. He studied various Islamic subjects in his hometown and travelled extensively to Iraq, Syria, Hijaz (now part of Saudi Arabia) and the other Arab countries in his quest for knowledge.

He devoted himself to acquiring knowledge of the hadith — sayings and traditions of the Prophet Muhammad (peace be to him). Upon his return to Baghdad, he became a student of Imam Shafi'i.

Imam Hanbal was a traditionalist and opposed innovation in religious matters. This stance earned him wide following among the people of that time who thought the new ideas in religious matters may dilute the strength of Islam. Imam Hanbal died in Baghdad in 855 at 75.

Imam Hanbal's works include *Musnad Ahmad* — an encyclopaedia of traditions compiled by his son based on Imam's lectures and supported by supplements — containing more than 28,000 traditions.

His other works include *Kitab Us Salaat,* on the discipline of prayer and *Kitab Us Sunnah,* on the traditions of the Prophet Muhammad. Although Imam Hanbal did not establish a *Fiqh* system of his own, the above books form mainstream guidelines for the Hanbali school of *Fiqh.*

Followers of Imam Hanbal constitute the smallest group of the four Sunni *madhhabs,* mostly confined to Saudi Arabia, Iraq and a few Middle East countries.

Unified platform for financial institutions

All four Islamic schools of thought (madhabs) are equally correct. A Muslim who adopts any one of them does not come any closer to the Holy Quran and Sunnah than does any other Muslim.

Based on this, *Shari'ah* scholars belonging to all four schools of thought have created a unified *Shari'ah* platform intended to help Islamic financial institutions achieve obstacle-free growth.

This platform is called Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). It was registered in Bahrain in 1991.

ACCOUNTING AND AUDITING ORGANISATION FOR ISLAMIC FINANCIAL INSTITUTIONS

Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is a non-profit organisation, supported by 108 member Islamic financial institutions and observers from 26 countries.

AAOIFI's core objectives are as follows:

a) To develop the accounting, auditing and banking standards on Islamic principles
b) To provide necessary guidance and training to Islamic financial institutions on how to apply these standards
c) To prepare auditing procedures for external auditors charged with the task of auditing Islamic financial institutions
d) To constantly refine existing standards and practices in the wake of ever changing business environment
e) To introduce guidelines for Islamic insurance *(takaful)*
f) To liaise with different regulatory bodies, central banks, audit firms, etc and increase their awareness of *Shari'ah* standards.

AAOIFI comprises a general assembly, an executive committee, board of trustees, *Shari'ah* board, accounting and auditing board and a general secretariat.

The general assembly comprises all member institutions and a panel of observers, including accounting firms such as Ernst & Young, PriceWaterhouseCoopers and KPMG.

The assembly holds at least one session a year to approve a new *Shari'ah* accounting, auditing or governance standard, or promulgate an improvement in an existing standard. This is by majority vote.

The executive committee comprises the chairmen of the above boards. It manages the administrative affairs of AAOIFI. The board of trustees is appointed by the general assembly.

It comprises 15 part-time members from entities such as regulatory and supervisory bodies, *Shari'ah* boards of different Islamic financial institutions, accountants and auditors.

Scholars from *Shari'ah* supervisory boards in different Islamic financial institutions form AAOIFI's *Shari'ah* board. The board has 15 members. This could be termed AAOIFI's "nerve centre".

Board

At the time of its formation the AAOIFI's *Shari'ah* board members included Shaikh Mohammad Taqi Usmani from Pakistan (chairman), Shaikh Abdullah Bin Sulaiman Al Manea from Saudi Arabia (deputy chairman), Shaikh (Dr.) Hussain Hamid Hassan from UAE (member), Shaikh Ajeel Jasim Al Nashmi from Kuwait (member), Shaikh Nizam Yaquby from Bahrain (member), Dr. Mohammad Daud Baker from Malaysia (member) and Shaikh Abdul Sattar Abu Ghudda from Syria (member).

The board's primary responsibilities include helping member and non-member scholars achieve consensus, critical review of questions referred by member institutions, arbitration of disputes, and researching ways to improve existing standards and practices.

The accounting and auditing board has 15 part-time members. The board includes accountants, auditors, university professors, regulators, lawyers and financial experts.

This board prepares, interprets, and adopts accounting and auditing standards for Islamic financial institutions. It also conducts periodical reviews and comparisons of Islamic accounting standards with the International Accounting Standards (IAS).

I wish to draw the reader's attention to the highly professional way that AAOIFI conducts its business. It has placed itself on a footing that is clearly on par with international regulatory standards.

It enjoys enormous credibility among international financial and regulatory circles, despite having existed for only 14 years.

AAOIFI's professionalism and ethics have also been acclaimed by the likes of the World Bank in one of their recent reports.

Method of Approving New Instruments and Practices

To make it easier to understand the processes used by the Accounting and Auditing Organisation for Islamic Financial Institutions to approve new instruments and practices, we will choose an existing financial instrument and track it through the hurdles it must pass before it obtains designation from the Organisation as Shari'ah-compliant. We will look at the *Murabaha* debt instrument.

The process started at an Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) meeting on February 27, 1999. On that day, AAOIFI's Shari'ah Board decided to prepare a comprehensive standard regarding Shari'ah rulings for *Murabaha*.

After about a month, AAOIFI's Fatwa and Arbitration Committee hired a consultant to prepare a legal study and a draft of Shari'ah rules for conducting a *Murabaha* transaction.

The consultant submitted a detailed study to the committee for its review and comments. In an October 22, 1999 meeting, the committee asked the consultant to amend the draft in light of further discussion about how to carry out a *Murabaha* transaction.

In December 1999, the revised draft was submitted to AAOIFI's Shari'ah Board for the first time. The board shared some additional observations. In this meeting, the Shari'ah Board members unanimously decided to present the draft to financial and legal experts for their review and comments.

The comments received from the experts were circulated, along with the *Murabaha* draft, to a wider group of professionals from central banks, accounting firms, other Shari'ah scholars, academics, Islamic bankers and traders for additional comments.

A meeting was held in April 2000 in Bahrain, where the group provided AAOIFI with their responses. The Fatwa and Arbitration Committee and the Shari'ah Studies Committee held a joint session on April 26, 2000 to discuss these comments.

After detailed deliberations, the draft was amended according to Shari'ah parameters set by the Shari'ah Board.

The matter was then presented to AAOIFI's Shari'ah Board in Medina in May 2000. The board comprises Shari'ah scholars from all four schools of thought. In that meeting, the draft was examined in its entirety. Formal approval was sought from the members of the Shari'ah Board. A good part of the draft was approved unanimously, but some of the paragraphs received majority approval.

The *Murabaha* ruling was approved by the Shari'ah Board members in the form of a text. People using it as a guide when constructing *Murabaha* transactions found it difficult to cite, however. Realising the difficulty, the Shari'ah Board passed a resolution in November 2001 to reformat all Shari'ah rulings approved by it in a more user-friendly fashion, without affecting their substance. A committee was formed to carry out the task.

In its historic meeting held in May 2002, the Shari'ah Board accorded formal approval to the reformatted Shari'ah Standards on *Murabaha,* and allocated it the AAOIFI Standard number 8. The standard has 5 main articles, 28 sub-articles and 40 sub-clauses.

The cumbersome process a proposed standard passes ensures it has a solid theoretical foundation by the time it takes concrete shape. The reformatting procedure means the articles in the standards can be easily quoted by transaction lawyers, Islamic financial institutions and customers.

These standards have been published by AAOIF1 under the name Shari'ah Standards. They can be accessed via AAOIFI's website (www.aaoifi.com).

The entire AAOIFI team, including many learned scholars, has made an extraordinary effort to create a Shari'ah benchmark.

Now, it is up to Islamic financial institutions to adopt these standards and harmonise the interpretation of Shari'ah principles and ensure the growth of Islamic banking and financial services proceeds in an orderly way.

DIFFERENCE BETWEEN ISLAMIC AND CONVENTIONAL BANKING

What makes an Islamic bank different from a conventional one? How real is the divide? Why should one choose an Islamic bank over a conventional bank? How do Islamic banks manage to provide higher returns for their customers, compared to conventional banks? These and similar other questions remain unanswered in the minds of many people.

Let us start with a discussion about how an Islamic bank treats the deposits it receives from its customers, be they from an institution or individual, compared to the way a conventional bank treats deposits.

Recent developments on the scene

Middle East Bank becomes Emirates Islamic Bank.

Amlak Finance shifts from conventional to Islamic financial institution.

Standard Chartered Bank and ABN Amro Bank set up Islamic window operations.

Mashreqbank announces new Islamic financing company.

Abu Dhabi Commercial Bank to establish an alliance with an Islamic bank.

Four Sharjah-based banks to pool their resources to form a large Islamic financial institution.

Benefits of *Mudaraba* Deal

A conventional bank borrows funds from its depositors at a predetermined rate of interest, and lends the same to its customers, again at a pre-fixed rate. The interest rate paid by the bank to depositors is considerably lower than the interest rate it charges to its borrowers. This difference becomes the bank's profit.

Furthermore, while the conventional bank holds the sole authority to raise the interest rate on the funds lent by it to the borrowers at short or no notice, the depositors who lend their money to the bank are deprived of such discretion. They receive the rate fixed by the bank while accepting the deposit for an agreed period.

When it comes to Islamic banks, the first and foremost difference is that Islamic banks do not borrow funds from the customers (depositors). Neither do they lend the funds to entrepreneurs.

An Islamic bank accepts funds from individuals and institutions in the capacity of a fund manager, under a fund management contract. The provider of the funds is called the *Rab Al Mal,* the Islamic bank called the *Mudareb* and the transaction is referred to as a *Mudaraba.*

A *Mudaraba* contract is based on the following broad parameters in order to be Shari'ah-compliant:

- The *Mudareb* will deploy the funds on behalf of the *Rab Al Mal* in a profitable manner, by utilising its expertise and skills;
- The *Mudareb* cannot pre-advise the rate of return to the *Rab Al Mal* on its capital; it can, however, indicate a certain range based on its past performance;
- The *Mudareb* has full discretion to manage the funds as it sees fit; funds will not, however, be deployed in activities or businesses repugnant to *Shari ah* principles;
- The *Rab Al Mal* will not interfere in the affairs of the *Mudaraba;*

- The *Mudareb* will share the profit with the *Rab Al Mal* at a pre-agreed ratio;
- The *Mudareb* will return the funds to the *Rab Al Mal* upon completion of the *Mudaraba* period, along with the share of profit for *Rab Al Mal* generated by the *Mudaraba;*
- If the *Mudareb* has been negligent in deploying the funds prudently, resulting in a loss for the *Rab Al Mal,* it must bear the loss and return the entire amount originally provided for the *Rab Al Mal;*
- Additionally, the *Rab Al Mal* will have the right to seek compensation from the *Mudareb* for any actual loss suffered by it due to the *Mudareb's* negligence. A genuine loss not, however, caused by the *Mudareb's* negligence will be borne by the *Rab Al Mal.*

An Islamic bank receives funds from the customers through their current accounts, investment saving accounts and investment deposit accounts.

The current account funds do not attract any return, and hence are excluded from the *Mudaraba.* The Islamic bank guarantees the safe return of these funds.

The deposits received by an Islamic bank in investment savings and investment deposits accounts are part of the *Mudaraba,* and therefore receive a proportionate share of profit. These funds are put into a common pool the bank draws on for its day-to-day fund deployments.

Withdrawals from the investment saving accounts are allowed once a month, and the lowest balance during the month is considered part of the common pool. The investment deposit accounts are placed for different fixed periods such as one, three, six, nine and twelve months and beyond.

Advantages of an Islamic Bank

An Islamic financial institution in contrast to its conventional cousin does not borrow funds at interest. Neither does it lend funds at interest. Instead, an Islamic bank enters into a *Mudaraba* (or agreement) with its fund-providing customers (known as *Rab Al Mal).* Under the terms of the *Mudaraba,* the Islamic bank acts as a fund manager (or *Mudareb)* for the customers, using its expertise to find profitable opportunities to use the funds.

Profits flowing from these deployments are divided at a pre-determined profit-distribution ratio.

The Islamic bank's funds are received through investment saving accounts and investment deposit accounts. No fixed rate is agreed or indicated at the time of receiving the funds. The current account funds are excluded from the *Mudaraba,* because the Islamic bank does not pay any return on them.

The fund-providing customers and not the Islamic bank remain the owners of their respective funds at all times. As such, any genuine loss incurred in the course of fund deployments by the Islamic bank is borne by the customers.

The Islamic bank will be responsible, however, for losses incurred due to its misconduct or negligence.

After recalling these differences between Islamic and conventional banks, it is time to move on to a new question. How can an Islamic bank earn enough income to be able to meet its operating expenses, as well as distribute returns to its depositors and pay dividends to its shareholders?

Transaction

Before answering this question, however, there is another dimension of the difference between the two banks to explore the matter of licences.

Conventional banks all over the world are licensed by their respective regulatory authorities (central banks, financial services authorities, ministries of finance, etc).

The licences permit the banks to accept deposits from members of the public on a pre-fixed rate of interest, and to lend these funds at pre-agreed rates of interest (which are subject to change at the bank's discretion).

Conventional banks are strictly barred from utilising these funds for any other purposes. These purposes could include: trading in goods or assets, or equity investments, etc. The banks can carry out such transactions, however, but only by utilising shareholders' funds, in such forms including equity, general reserves, residual income, etc.

Good analogy

If a conventional bank uses depositors' funds for trading and investment purposes, it will have violated the terms and conditions of the licence. Such action puts the licence at risk.

The key thing to remember here a conventional bank is not permitted to use depositors' funds in any other manner, except to lend them at pre-determined rates of interest.

In contrast, the Islamic bank is permitted by licensing authorities to utilise customers' funds for the purpose of trading in goods and assets, leasing, investment and any other commercial activities, provided these activities are *Shari'ah* compliant.

An Islamic bank is prohibited from borrowing funds from individuals and institutions at a fixed interest rate and then lending them at a pre-agreed interest rate. Any Islamic financial institution caught doing this would lose its licence.

As readers can see, it is not for nothing that the chairman of the *Shari'ah* board of the Islamic bank where I work has observed the only thing conventional banks and Islamic banks share is the word "bank."

An Islamic bank, technically, does not operate on the lines of the recognised definition of the word "bank", which is defined as "a licensed deposit taker and money lender". How should an Islamic bank be classified, functionally speaking? Scholars say a good analogy is to compare it to that of a trader.

11:*udaraba* in the historical context

Two questions arise. How is a customer's deposit channelled through an Islamic bank's system en-route to deployment and the subsequent retrieval? Another question is what happens in a situation where an Islamic bank may incur a loss in deploying money as a *Mudareb* (fund manager) on behalf of the *Rab Al Mal* (fund providers)?

To shed light on these questions, we need to consider the *Mudaraba* concept in its historical context.

A *Mudaraba* is a marriage of convenience and provides benefits for both parties, i.e. the fund provider and the fund manager. The fund provider may not have the time or the expertise to efficiently utilise his capital and earn profits.

Similarly, an entrepreneur may have potentially profitable ideas and skills, but lack the needed capital.

Mudaraba allows the fund provider to hand over funds to the fund manager under an arrangement which safeguards the interests of both parties and, at the same time, provide an adequate and *halal* return.

The residents of Makkah had practised *Mudaraba* even before the advent of Islam, due to their location at the crossroads of ancient trade caravan routes.

Credible *Mudarebs* carried goods and/or money for investors and had to be accountable to them.

Upon return of the caravan, the profit and loss account was prepared, allowing the *Mudareb* to claim his share of profit and then return the original capital, along with the profit, to the investor be it in cash or kind.

In ancient Makkah, almost every investor knew every *Mudareb.* Credibility in the community was key for anyone hoping to conduct *Mudaraba* transactions.

Islamic era

In the Islamic era, the *Mudaraba* was fine-tuned to eliminate certain elements which were not compliant with Islamic principles.

These included making the *Mudareb* liable for any financial losses, even in the absence of misconduct. This meant *Mudarebs* became liable for losses due to theft or robbery while goods or capital were in transit.

Mudarebs also became liable to pay interest on the capital invested if they failed to produce the returns desired by the original fund provider.

In today's world, Islamic banks have found ways to credibly fulfil the roles of *Mudareb* and investor at the same time.

Islamic banks are ideally positioned to aggregate capital from small and large depositors alike, while researching and discovering lucrative investment opportunities where this capital can be profitability deployed.

Mudaraba concept in the modern world

The following adaptations allow an Islamic bank to practise a *Mudaraba* role today, while respecting *Shari'ah:*

a) Today, there are many investors and scores of entrepreneurs, compared to the one-to-one equation prevailing in olden days;

b) The bank acts as an intermediary, enjoying investors' confidence and receiving their funds a concept which did not exist before;

c) The intermediary acts as a *Mudareb* (agent) with a large number of *Rab Al Maly* (investors);

d) The projects/commercial transactions proposed by the entrepreneurs are financed by the intermediary rather than by the investors directly;

e) Investors and entrepreneurs do not have a direct relationship and therefore have no obligation towards one another;

f) While investors deal with the bank purely on a *Mudaraba* basis, the bank is free to invest funds via any financing or investment option, such as *Murabaha, Musharaka, Mudaraba, Istithna, Salam, Ijara, Sukuk,* etc;

g) There is no specified period or limit to the number of projects, and it is an on-going investment process for the intermediary.

In the triangular association between the investor, intermediary and entrepreneur, the investor remains a passive participant, as in the old days.

Investors are not permitted to interfere in the *Mudaraba' s* transactions, and wait to share the profit or loss (that is, if the loss is not caused by the negligence of the *Mudareb).*

The Islamic bank has come to play the roles of a *Mudareb* and a *Rab Al Mal* at the same time.

There are two questions we can now examine: how a customer's funds are channelled through an Islamic bank, and how a loss is handled.

When an investor hands over funds (i.e., makes a deposit) to the Islamic bank, the bank enters into a *Mudaraba* agreement with him.

The agreement appoints the bank as trustee (or agent) for the investor for his funds. This trustee arrangement allows the bank to place the funds into a common pool.

The common pool may or may not include some of the bank's own funds, such as paid up capital, reserves and provisions and retained earnings. Both practices are acceptable under *Shari'ah,* albeit with a different treatment to the two types of funds.

While the bank bears responsibility for the risk for the placement of its own funds through the common pool, the depositors carry the risks on their investment, as owners of the funds.

A conventional bank borrows funds from depositors, and hence "owns" such borrowed funds. This means the conventional bank bears all the risk when it lends these funds to a third party.

Islamic banks do not "borrow" funds from depositors and therefore do not assume "ownership" of these funds.

The banks' responsibility to their depositors instead follows from the fact the banks have assumed the role of a trustee or agent and "handle" the depositors' funds.

Banks with less bad debt

An Islamic bank is different from a conventional bank in that it does not borrow funds from depositors. Neither does it lend the funds to customers (entrepreneurs).

Instead, it acts as an agent for depositors. The scope of its agency is to manage deposits and to invest depositors' funds within Shari'ah parameters.

The agent is free to manage the funds without day-to-day interference by the depositors. The agent shares a pre-agreed portion of the overall profit generated by the bank's investment activities. The rest of the profit, usually a major chunk, is distributed among depositors.

If there is no profit, the agent is entitled to nothing. If there is a loss, it will be borne by the depositors unless the loss was caused by the agent's breach of trust, default or negligence. All of this is well documented under the *Mudaraba* agreement signed with the Islamic bank by a depositor at the time of opening the deposit.

Once the Islamic bank receives funds from a customer under a *Mudaraba,* these funds become part of a common pool. The bank uses the pool to meet its daily funding requirements while entering into financing and investment activities with entrepreneurs.

These activities are carried out so that there is no direct obligation binding the depositors and the entrepreneurs. Both of them have rights and obligations connected to the intermediary Islamic bank. The bank is both the fund manager *(Mudareb)* and the investor *(Rab Al Mal).*

There are tens of thousands of depositors who appoint the Islamic bank as their agent and trustee, and scores of entrepreneurs who invite the bank to invest in their projects or transactions. Once the funds are routed through the common pool and deployed, there is no way to identify whose specific funds are being used to fund -„'hose entrepreneurial venture.

In case of a loss on deployment of funds, the Islamic bank debits it to the common pool, where the profits generated by the bank are also credited. This means any loss gets spread out across the overall portfolio.

The portfolio of provision for bad and doubtful debts in an Islamic bank is traditionally very small compared with conventional banks. Why is this?

The reason for the comparatively fewer hits taken by an Islamic bank is because its transactions are carried out on asset/investment-backed basis. Each Islamic financing or investment structure, be it *Mudaraba, Musharaka, Murabaha, Istithna, Ijara, Salam* or *Sukuk,* either has an underlying asset, or there are transactions in which the goods or assets have moved.

As such, the value of a transaction carried out by an Islamic bank is automatically restricted to the value of underlying goods/assets or investment, thereby providing an automatic safety cushion, insulating the bank from chances that the customers will become insolvent.

This is in contrast to the conventional banking system in which the lending by a bank is usually clean, luring a customer to borrow beyond his requirement. Conventional lending products, especially the overdraft, bills discounting and working capital loans if not utilised judiciously more often than not may adversely impact a borrower's debt serviceability.

This is the reason an Islamic bank is barred by Shari'ah from indulging in activities leading to trading in debt.

Money is not a commodity

Can money be called a "commodity"? What do Islamic scholars say about this idea?

Before we get to these questions, let us briefly go over some important points regarding how Islamic banks differ from conventional banks. An Islamic bank deploys funds from a common pool (obtained from depositors on a

Mudaraba basis). It credits profits as well as debits and losses to the same pool.

At any given point in time, the residual excess, or deficit, over the aggregate value of the common pool (as per the bank's last drawn balance sheet) constitutes the profit earned or loss incurred by the bank as *Mudareb.*

An Islamic bank is less prone to financial losses due to the fact its transactions are based on goods, assets or investments. This provides it with a built-in safety cushion. The financial assistance extended by a conventional bank to a customer, by contrast, is more likely to turn delinquent due to non-availability of such backing.

In fact, lending by a conventional bank, in the form of overdrafts, discounting of debt (cheques or bills), working capital loans, etc., have a tendency to hurt the borrower's debt serviceability. The borrower's serviceability declines with every dirham borrowed for non-productive purposes.

Similarly, the lending on the retail banking front in shape of personal loans, top-up finance, credit cards, cash-your-car and so on can lure customers to overextend themselves. The result they can become trapped in a vicious cycle of having to constantly borrow fresh money to cover what they already owe.

Medium of exchange

An Islamic bank is guided by the wisdom of Shari'ah. Shari'ah negates such practices described above, by prohibiting people to part with money in exchange for more money. The old argument that money is a commodity and hence can be traded is disputed by Shari'ah scholars. Shari'ah scholars say money is merely a medium of exchange, and hence cannot be regarded as a commodity.

According to Shari'ah, one can enter into a transaction where one exchanges money for some kind of good.

Economic definition

Such transactions are Shari'ah-compliant: one side gives money, the other gives some commodity or good in return. When one party, however, gives money and expects to receive money in return — this is where the Shari'ah scholars become concerned.

What is a commodity? The economic definition of a commodity is a product that can be "sold" to make profit.

A trader's nightmare is to have his previously-sold goods returned to him. It is equally undesired by an accountant to record a "sales return entry". In light of this, we can understand how commodities are indeed intended to be sold at a profit, with no intention of having them returned.

All this might remind one of the notes that appear at the bottom of many shop bills: "Goods once sold will not be taken back or exchanged".

Let's apply this logic to money. The lender of money parts with his capital with a clear intention to not only make a "profit", but also to have the capital returned to him after an "agreed period".

In case of delay, the lender not only insists for the early return of his capital, but may also threaten the borrower with legal action. The lender will also try to increase the amount of "profit" due to him given the delay in repayment.

Will someone who trades in a particular commodity resort to such measures in order to get his "sold" commodity returned to him?

From the perspective of Shari'ah scholars, therefore, money cannot be described as a commodity. All such "trading" in money, or the view that money is a "commodity", leaves much to be desired, from the perspective of an Islamic bank.

Comparing transactions

It is interesting to note how both types of bank undertake business transactions with clients. We will explore this question by way of an example to make this topic accessible to all readers.

When we go to a conventional bank to arrange financing to purchase a car, we all have a good idea of how the process works. The conventional bank provides a loan for the customer for the car, and charges a pre-agreed rate of interest on the loan. We also have a good idea about the penalties that follow in case of a delay in payment. If the customer misses a payment, the bank can charge a penalty. When a customer defaults, he feels the bite of three layers of interest on his loan. There is the "normal" interest, the "penalty" interest and the compounding effect of both of these, when added to the loan. From a legal perspective this is all fine, as the customer agreed to the loan after the conventional bank disclosed all the various conditions attached to it.

In this hypothetical transaction it may be noted how money is involved at both ends. At the start of the transaction, the bank extends the loan to the customer to purchase the car. After receiving the loan, the customer starts repaying it in instalments. The amount coming back to the bank from the customer is certainly greater than the amount the bank originally loaned to the customer.

We can now compare this process with the process of buying a car through an Islamic bank.

When a customer goes to purchase a car through an Islamic bank, after he initially approaches the bank, he is asked to provide it with specifications of the car he wishes to buy. The customer visits a showroom and selects the car he wants the bank to, in effect, sell to him.

The Islamic bank receives the full specifications (including the purchase price) of the car selected by the customer. The specifications come in the shape of a pro-forma invoice from the dealer addressed to the bank. The bank then obtains a "Promise to Purchase" from the customer, meaning the customer will purchase the car from the bank upon the bank purchasing it from the dealer.

Upon completion of all required formalities, the bank sends its representative to the dealer, along with a manager's cheque favouring the dealer for the full payment. This is all according to the pro-forma invoice issued by the dealer to the bank.

The bank's representative makes the payment to the dealer and obtains the title and possession to the car for the bank. Subsequently, he hands over the title and possession of the car to the customer, who is also present in the showroom.

All this activity is documented at the time of the transaction. This example provides us with critical insight into how an Islamic bank differs from a conventional one when it comes to structuring transactions. The Islamic bank is not parting with money in our hypothetical example. Rather, the bank is selling an asset to a customer one it has purchased from a third party.

The car is sold by the Islamic bank to the customer under a *Murabaha* arrangement, at a sale price including the bank's purchase costs and its profit, which has been agreed to by the bank and the customer.

The *Murabaha* amount is then payable by the customer to the bank according to an instalment schedule, usually spread over three to five years.

What if the customer fails to pay the instalments on time? Can an Islamic bank levy penalty on late payments, in the way a conventional bank does?

UNIQUE TRANSACTIONS IN ISLAMIC BANKS

An alternative way of importing goods

Islamic banking does not merely spread an Islamic veneer over the processes of conventional banking. Rather, it represents something different, something based on ethics and deep-rooted principles.

The world is searching for alternative financial systems after the debacles in the conventional financial system during the past few years. In this modern age, when the world has become a global village, the search for best practices is not restricted to a particular place or region.

The spread of Islamic banking and finance around the world is fuelled by the world's need for a just and fair financial system, based on sound ethics acceptable to all parties. This system is here to stay and will grow rapidly as it continues to satisfy both its critics and more neutral observers as to its economic viability and its lack of exploitative practices.

We have compared the differences between obtaining a car loan through an Islamic bank versus arranging one through a conventional bank. Recall how a car buyer working with an Islamic bank actually purchases the car from the bank, and is not borrowing funds on interest.

Let us corroborate the principled difference we saw in the above example with another example. Consider this scenario: A conventional bank extends a loan against trust receipt (LATR) to a customer to import goods under the letter of credit established by it.

Process

Working on the longstanding theory that the bank does not deal in goods, but in documents, the bank shows the customer as the buyer in the letter of credit. The bank allows the buyer to have access to the goods, without first settling the import bill.

The importer gets possession of the goods, sells them on the market and pays the LATR, along with interest to the bank, in an agreed period of time. The bank does not part with title to the goods until the LATR and interest is fully repaid by the customer - even though it claims to deal only in documents, and not goods.

If the customer finds the goods to be spurious or not commensurate with the specifications of the letter of credit established by the bank, the bank disassociates itself from the arrangement. The bank then claims the full amount of its loan, along with interest. The bank will insist it simply dealt in documents and not goods.

In case of delay in repayment of the LATR, the bank levies penalty interest. In case of non-payment, the bank endeavours to exercise its right to the title to retrieve the goods, which may have been sold by the importer.

An Islamic bank also finances the import of goods - but in a different manner. It is done by way of a *Murabaha*, whereby the customer approaches the bank with full specifications, prices and sources of the goods. The bank establishes the letter of credit in its own name as buyer.

Once the goods have arrived, the bank transfers both the possession and the title to the goods to the customer under the *Murabaha* sale contract. This is because, under *Shari'ah,* the sale cannot take place unless the title and possession of the goods are passed to the buyer.

A different way to deal in goods

Conventional banks and Islamic banks — some of the differences between them are obvious, and some may require detailed explanation.

Conventional banks simply lend money to a trader to finance the import of goods by him, while an Islamic bank will sell the goods to the trader.

We can use the following hypothetical scenario to illustrate how Islamic banks differ from their conventional counterparts on this point.

a) A trader approaches an Islamic bank requesting it sell him goods with certain specifications, available from a foreign supplier.

b) The bank seeks full details from the trader as to the supplier's name and the price, quantity and total cost of the goods. This is usually covered under a pro forma invoice issued by the supplier in the bank's name, arranged by the trader.

c) The trader submits a document called a Promise To Purchase (PTP), along with an application to establish a Letter of Credit (LC). The PTP document states the trader will purchase the goods from the bank upon the bank purchasing them from the supplier at a price which constitutes the bank's purchase cost and its profit. This will be paid by the trader by a certain date. Both these factors are known to the trader in terms of value at the time of submitting the PTP.

d) The bank establishes the LC in favour of the supplier. The supplier ships the goods to the bank and submits the documents corresponding to the LC to the bank. Unlike in conventional banks, where the documents list the trader's name as the purchaser, the documents drawn up as part of the

Islamic bank's LC show the bank itself as the purchaser.

e) The above provides the bank with the title and constructive possession to the goods, which is essential under Shari'ah to enable it to sell the goods to the trader, as part of the *Murabaha.*

0 It is important to understand there can be no *Murabaha* if the documents under the LC are received in the trader's name, since it implies the title to the goods is already held by the trader, rather than the bank. In other words, the bank cannot sell something to the trader which it does not own or which is already owned by the trader.

g) There can be exceptional circumstances where the bank can allow the documents to be received in the trader's name. These relate to the goods covered under a sole distributorship agreement where the supplier is bound to sell the goods only to the trader. Another situation could be the machinery and equipment for a development project with customs duty exemption.

h) In this situation, the bank appoints the trader as its agent to import the goods for and on behalf of the bank. This special arrangement does not confer the title to the goods to the trader, simply because the documents are received in the trader's name.

Please note the title will continue to be held by the bank since the trader has merely acted as an agent for the bank. The trader is holding the title in trust for the bank until such time as the bank actually sells the goods to him.

i) Upon receipt of goods from the supplier, the bank sends a notice to the trader, asking him to purchase the goods from the bank as per the terms of his promise. The trader responds by concluding the purchase transaction with the bank under the *Murabaha* contract, which entails transfer of the title and possession to the goods from the bank to the trader.

The above explanation shows how an Islamic bank deals with the goods differently. The Islamic bank acts as an actual seller rather than a lender, in contrast to a conventional bank.

Penalties reduce default and aid charities

Islamic banks and conventional banks finance the purchase of assets in different ways. When an asset is sold by the bank to the customer under *Murabaha,* both the title and the possession are transferred to the customer at the time when the transaction is concluded — that is, on delivery.

The bank protects itself by having the asset mortgaged in its name until such time as the customer fully pays back the *Murabaha* amount. In addition, the Islamic bank would also obtain post-dated cheques made out to cover the total *Murabaha* payment instalments owing.

What if the customer defaults in timely payment of the *Murabaha* instalments? Unlike a conventional bank, which can levy penalty interest, an Islamic bank is barred by Shari'ah from charging such penalties.

In contrast, the conventional bank does not sell the car to the customer. Instead, it provides a loan with interest to the buyer, enabling him or her to purchase the car. The bank can charge penalty interest for the late repayment of the loan.

Readers must be asking the following question: if Islamic banks do not charge delay penalties, might that not encourage some customers to default?

Unfortunately, some customers may indeed take undue advantage of an Islamic bank's limited freedom of action under Shari'ah. While these customers are careful to meet all their commitments when it comes to dealing with conventional banks, so as to avoid penalty interest charges, sometimes they accomplish this at the cost of their obligations to Islamic banks.

Shari'ah scholars have noted how delay penalties act as an effective deterrent against this failure to pay. They have agreed to allow Islamic banks to charge such penalties on their customers' past-due obligations.

This has been approved with the condition that the amount collected through these penalties will not be added to Islamic bank's profit, but must be donated to charity in a transparent manner. This must be done in a way that the customer receives proof that the penalty charged has actually been given to a charity.

Alternatively, the customer may also be asked to pay the penalty not to the bank but to a charitable organisation of his or her choice and submit the receipt to the Islamic bank. The receiving charity should be advised that the donation represents a kind of interest payment, so it can refrain from utilising the donation for projects involving Zakat funds (Islamic charity).

Islamic banks have therefore started to insert delay penalty provisions in their *Murabaha*, *Ijara* and *Musharaka* agreements. In some recently concluded high-profile transactions, a list of charitable organisations slated to receive funds as a result of any penalty interest charges has been appended to ensure clarity in this matter. Under such agreements, the lead bank, acting as the agent for the other participating banks, is pre-authorised to collect penalties from the customer and donate them to charity.

Leasing transactions

Let us take a look at the way Islamic banks handle the subject of leasing, and contrast it with the approach of conventional banks.

Leasing is a service commonly offered by conventional as well as Islamic financial institutions. An asset is given on lease to an interested party for a certain period of time, and an amount is charged as rent.

There are two kinds of leases operating leases and financial leases. In simple terms, under an operating lease, the leased asset goes back to the lessor upon completion of the period of time covered by the lease. Under a financial lease, the asset becomes property of the lessee upon successful conclusion of the lease term, since the rent paid by the lessee adequately covers the cost of the leased asset plus the lessor's profit for the entire lease term.

In their ordinary course of business, conventional and Islamic financial institutions do not handle operating leases. A good example of an operating lease is the rent-a-car business, where the vehicle is returned by the lessee to the rental company upon completion of the period for which the car was hired. On the other hand, financial leasing is commonly used by these institutions for high-value assets such as aircraft, seagoing vessels, real estate, etc.

When an Islamic bank enters into a financial lease, it purchases the asset and gives it on lease to the interested customer. In addition to acquiring ownership rights over the asset, the Islamic bank also assumes full ownership obligations and the risks associated with it.

The ownership risks demand the bank should act like any normal owner in any given situation relating to the asset. As such, in the event the asset sustains damage, thereby reducing or completely eradicating its usefulness to the lessee, the Islamic bank reacts one way, while the conventional bank reacts in a completely different manner. What do I mean by "different"? Does an Islamic bank stop charging rent to the lessee in such a situation? Yes, it does. This contrasts with the conventional bank which, when it acts as a lessor, would continue to charge rent irrespective of partial or total damage to the asset.

Take the example of a seagoing vessel leased on Islamic lines. In terms of Shari'ah principles, it is prohibited to continue charging the lease rent if the vessel sinks, irrespective of whether or not the lessee was at fault. Comparatively, a conventional bank, in the capacity of lessor, will continue to levy the lease rent despite non-existence of the asset, the very subject of the lease agreement. Not only that, the bank will also impose a penalty interest on delay in payment of the rent, which is imminent in this type of situation where the lessee has been deprived of the commercial benefit of the usufruct connected to the asset.

Picking up on the example of a leased seagoing vessel, let us examine the implication of partial damage or total loss of the vessel for the lease.

Even after the hypothetical vessel had sunk, a conventional bank would continue to charge lease rent to the lessee. The abrupt end of the valuable income stream flowing from the vessel's operation to the unfortunate lessee, which he was using to service the lease rent, would not deter the conventional bank from continuing to demand the rent plus compound and penalty interest.

Let us see how differently and fairly an Islamic bank would deal with a situation where a leased asset becomes damaged.

First, let us look at the partial loss situation. Renowned *Shari'ah* scholars have set guidelines for such a situation, given that the leased asset is actually owned by the lessor Islamic bank.

In case of partial damage to the leased asset not caused by the lessee, the lessor Islamic bank would be responsible for repairing the damage.

The lease rent would pause during the repair period. There is flexibility in this situation. Instead of completely halting the rent during the repair period, it can be reduced in proportion to the reduction in the effective use of the asset by the lessee.

The lessee's consent, however, would be essential in determining the reduced amount of rent he would be required to pay during the repair period.

If the lessee's negligence led to partial damage to the leased asset, he will be fully responsible for repairing the damage in order to restore the asset to its normal effective use. At the same time, the lessee will continue to pay the lease rent in full, since the damage to the asset was caused by him.

Shari'ah also covers situations where the leased asset is ruined beyond all use or repair.

If the asset was wrecked through no fault of the lessee, the lease rent will stop from the date of the asset's destruction.

The lessor Islamic bank will wait for the realisation of the insurance claim. During the period between the occurrence of the total loss and the payment of the insurance claim, the lessor bank - being the owner of the asset - will remain out of pocket.

The lessee will not be required to pay any lease rent, since the underlying leased asset exists no more. If the lessor bank experiences any shortfall in the realisation of the insurance claim, it will bear such losses itself and will not seek any compensation whatsoever from the lessee.

Even if the lessee was responsible for the destruction of the asset, *Shari'ah* principles require that in any given situation where the leased asset exists no more, irrespective of the lessor's fault, the lessee's negligence, an act of God, force majeure, etc, the lease rent must come to an immediate end.

Here, too, the lessor Islamic bank will wait until the realisation of the insurance claim. The Islamic bank will ask the lessee for compensation only if the insurance proceeds were less than anticipated, since the lessee caused the damage to the asset.

This position, adopted by Islamic banks that enter into leases, is totally different from the leasing practices of conventional banks. It sets a high standard of fair play and equality for all parties concerned in leasing transactions.

Complicated transactions

Shari'ah offers endless opportunities to create financing structures that can facilitate complex transactions and also ensure the needs of all parties involved are satisfactorily met.

This is in contrast to conventional banking practices. There has been little in the way of true innovation where conventional banking practices are concerned since they took shape about 300 years ago. Each and every conventional banking product, no matter how it is labelled, centres around the underlying loan and interest.

Islamic banking is barely 35 years old. We are just beginning to grasp its full potential as a way to help corporations, entrepreneurs and individuals attain their financial goals.

To understand this, we need to take a closer look at how *Shari'ah* shapes Islamic banking procedures and practices. We need to then compare this to the banking practices prevailing elsewhere. This comparison will demonstrate the following *Shari'ah* principles are free from exploitative practices and work well for both individuals and businesses.

Any financing transaction conducted by a conventional bank invariably results in an interest-based debt. Under the Islamic modes of financing, there are two basic types of contracts --the contracts that create a cost-free debt borne by the client, and the contracts where the bank invests its own equity through or with the client.

Some examples of the first type are:

Bai Muajjal: the sale of goods or assets owned by the bank to a client on deferred payment basis. It is not necessary for such sales to result in a profit for the bank.

For example, a previously-leased car is re-possessed by an Islamic bank. It is sold on a deferred payment basis to a third party at a price that may not cover its cost, let alone allow for a profit. This transaction will create a debt in the bank's favour, however. The debt will remain cost-free until it is paid, even if the payment is made by the purchaser beyond the due date.

Bai *Murabaha:* the sale of goods or assets on a deferred payment basis at cost, plus profit. The items sold under *Murabaha* are bought by the bank from a third party supplier at a client's specific request. While the supplier is paid by the bank upfront, the client will become indebted to the bank.

Bai *Istithna:* this is the sale of an asset to be built or developed by the bank and sold to the client at a profit on a given date. The sale price will be a debt borne by the client from the day the Bai *Istithna* contract is signed by him with the bank. He can repay the debt either while the asset is being developed or after the delivery of the asset, as per mutual agreement.

Bai *Salam:* The bank purchases certain goods from the client by making an upfront cash payment, with the delivery by the client deferred to a future date. In this unique structure, the client is indebted and will make payments to the bank with goods, rather than cash. This is called *Damn Aini,* whereas the other three structures are termed as *Damn Naqdi* in *SharPah.*

SHARI'AH COMPLIANT INVESTMENT ARRANGEMENTS

We will take a look at investment structures where an Islamic financial institution invests either through or with a client. The Shari'ah-compliant contracts where a bank invests its funds through a client can be summarised as follows:

Aqd Mudaraba **(fund management):** This is a marriage of convenience where a customer, with a specific expertise, and a bank (with capital) join hands.

The bank is termed *Rab Al Mal* (fund owner/provider) and the customer as the *Mudareb* (fund manager). The *Mudaraba* capital is invested by the *Mudareb* in *Shari'ah*-compliant commercial activities for a fixed period of time. The profit is shared according to a pre-determined distribution ratio.

The loss, if any, is borne by the *Rab Al Mal,* provided the loss is not caused by the *Mudareb's* negligence. Under such circumstances, the *Mudareb* must return the original sum invested to the *Rab Al Mal.* A good example of *Aqd Mudaraba* is the relationship between an Islamic bank with its customers, where the former is the *Mudareb* and the latter the *Rab Al Mal.*

Aqd Wakala Fil Istithmar **(investment agency):** Here the Islamic bank appoints a customer as its agent to carry out certain investment activities on its behalf for a defined period. The bank is termed as the *Muwakkil* (principal) and the customer as its *Wakil* (agent).

Unlike in a *Mudaraba,* the *Wakil* does not have a free hand to manage the investments. The *Wakil* is dependent upon instructions from the *Muwakkil.* The *Wakil* does not share the profit with the *Muwakkil*, but gets a fixed agency fee to undertake the assigned function.

The *Wakil,* however, may get a reward from the *Muwakkil* for profitable deployment of the capital but this is purely at the *Muwakkil's* discretion. If the investment fares poorly due to the *Wakil's* negligence, then it is the *Wakil's* responsibility to make good on the losses. Examples of *Aqd Wakala* in action can be seen in the workings of Islamic funds and portfolios.

The only contract where an Islamic financial institution invests its funds with the client is called *Aqd Musharaka*. This is a joint venture. You could also call it a partnership between an Islamic bank and a client.

In contrast with *Aqd Mudaraba* and *Aqd Wakala*, where only the Islamic bank deploys its funds, *Aqd Musharaka* requires both parties (individually termed as *Shareek* and together as *Sharikain)* to invest capital, albeit in different proportions. The *Musharaka* could be arranged for a certain pre-agreed period or on an ongoing basis.

The Islamic bank may appoint the customer as the managing partner (known as *Shareek Mudeer)* with authority to run the business. While profits are shared according to a pre-agreed ratio, losses are sustained in proportion to the respective original equity contribution by the partners.

When one surveys the diversity of financing structures offered by Islamic financial institutions, the contrasting paucity of options offered by conventional banks becomes even more apparent.

Debt deal structures for financial institutions

In Islamic finance, there are deal structures which create debts for the participating financial institution - either a funds-based debt or a goods-based debt. These are known as *Bai Muajjal, Bai Murabaha, Bai Istithna* and *Bai Salam.* The first three are funds-based, while the last one is goods-based.

Similarly, there are structures where an Islamic financial institution invests funds either through a customer or with a customer. The structures where the institution invests through the customer are called *Aqd Mudaraba* (fund management) and *Aqd Wakala Fil Istithmar* (investment agency).

The only structure where an Islamic financial institution invests with the customer is *Aqd Musharaka.* This refers to a partnership where both parties are required to invest their respective equity.

In *Musharaka,* the partners can contribute equally, in terms of equity or they can agree to some other ratio (60-40. 70-30 and so on). While an Islamic financial institution invests its equity in cash, customers may contribute their share of the equity in cash or in kind.

If the customer's contribution is in kind, scholars recommend its value should be properly evaluated, preferably with the help of professional analysts. in order to safeguard the interests of the institution's depositors. After all, it is their funds that are being deployed in the *Musharaka.*

Profit sharing

The profits generated by the *Musharaka* are distributed as per the agreed ratio. Losses, if any, are absorbed by the partners pro-rata, ie, in the proportion of their equity investment, compared to the total equity of the *Musharaka.*

The *Musharaka* could be for a fixed period of time. It could also be structured on a diminishing basis. Under this arrangement, the customer gradually purchases the share of the equity held by the Islamic financial institution until such time he has bought it out in full, at which time the *Musharaka* is terminated.

In the diminishing *Musharaka* structure, the share of profit for the Islamic financial institution is gradually reduced, in relation to its dwindling stake in the *Musharaka.* The customer's profit share conversely increases, as he continues to increase his stake in the *Musharaka.*

If the *Musharaka* is constituted to purchase or develop a tangible asset, such as real estate, an industrial project, a vessel, or an aircraft, the customer is allowed under *Shari'ah* to acquire the institution's share in the asset on lease.

In this case, the customer will simply pay the lease rent to the institution, which will then not be entitled to share the *Musharaka* profit with the customer. The diminishing *Musharaka* structure is the norm in the Islamic financing world due to the said flexibility.

Unique structure

There is another unique structure. It represents a fascinating combination of Islamic finance and Islamic investment. It is called *Ijara* (leasing). Under *Ijara,* an Islamic financial institution acquires an asset for the purpose of leasing it to the customer.

For an Islamic financial institution, on one hand the *Ijara* is considered an investment, as the institution is investing its own funds in purchasing the asset. Unlike *Bai Muajjal, Bai Murabaha* and *Bai Istithna,* the purchased asset is not transferred by the institution to the customer.

The other part of the *Ijara* is financing, as the institution actually sells the usufruct (or the right to use) connected to the asset to its customer, by way of leasing on deferred basis.

Similar to the Islamic financing structures which create debts, the leasing of the asset also creates a debt borne by the customer, which is the lease rent.

In summary, the financial lease entered into by an Islamic financial institution allows the customer to pay the cost of a leased asset to the institution in shape of periodical rent. Upon successful completion of such payment, the institution transfers the title of the asset to the customer by way of a separate sale agreement.

Of course, the lease rent also includes a component relating the institution's return on the investment in purchasing the asset.

RISKS IN TRANSACTIONS AND THEIR MITIGATION

Inherent risks in *Ijara* transactions

We can examine risk assessment and mitigation in an Islamic financial context.

Technically, the new subject may be considered an extension of our earlier discussion about the differences between Islamic and conventional financial institutions. The two perceive and mitigate risk in quite different ways.

Risks

We will start by looking at the various risks faced by an Islamic financial institution in an *Ijara* (leasing) transaction and how these are mitigated within the parameters of the transaction i.e., without resorting to external support elements such as guarantees and collaterals.

Leasing is the most commonly used structure in IFIs after *Murabaha* (sales transaction). Generally, the leasing transaction is preceded by a request from a client who desires the IFI to lease certain identified asset to him.

The asset could be readily available or may need to be created. In case of an existing asset, the lease will be called *Ijarat Ain* (lease of an existing asset). If the asset needs to be built from scratch, the lease will be termed *Ijara Fil Zimma*.

We have earlier discussed how Islamic leasing can take two forms operating leases and financial leases. To recap, in the case of an operating lease, the leased asset goes back to the lessor upon completion of the lease term.

One example of an operating lease could be the renting of a car for a specified period, upon conclusion of which the lessee is required to return the car to the rent-a-car company.

Financial lease

In contrast, a financial lease necessitates that the leased asset is retained by the lessee and its title transferred to the lessee at the end of the lease period. The lease rent for the financial lease is structured so the IFI can recover its original investment in acquiring the asset as well as its desired return.

Upon receiving the request from a customer, the IFI can purchase the asset from an identified third party or from the customer. The asset is leased to the customer by the ITT for an agreed term at a lease rent which is pre-determined for the first lease period. The rent can be based on a certain formulae for the subsequent periods.

The customer continues to pay the lease rent until the lease term is completed. At this stage, the IFI transfers the asset title to the customer.

What are the risks involved in such type of leasing and how these are mitigated by an IFI? Let us try to understand. I am sure readers with some experience in the financial services industry will easily be able to identify the following risks in the transaction.

Mitigating factors

We will discuss the mitigating factors relevant to each risk available within the parameters of the transaction.

1. What if the customer does not lease the asset upon the IFI purchasing it from a third party?

2. If the asset is bought by the IFI from the customer, what is the assurance that it is worth the value the IFI is being asked to pay?
3. What about the issue of the physical possession or delivery of the asset? Will the asset continue to remain in the custody of the customer?
4. The IFI may not have the technical expertise to maintain a high-value asset such as an aircraft or a vessel. How can it ensure that the asset is maintained so it can operate smoothly?
5. Who will bear the cost of such maintenance?
6. Being the owner of the asset, it will be the IFI's responsibility to keep the asset fully insured at all times. How can the IFI manage the insurance costs and still make a profit?
7. What remedy or recourse is available to the IFI if the customer defaults in payment of the lease rent?
8. How would the IFI safeguard its interests in case of partial damage to or total destruction of the asset?

Risks and responsibilities of maintenance in leased asset

The importance of risk management or risk mitigation in a financing transaction cannot be denied, irrespective of whether the financing is carried out through conventional interest-based mode or by adopting the Shari'ah approach.

We are familiar with the way a conventional financial institution seeks to alleviate lending risks to the farthest extent possible. Such measures at times render the transaction meaningless to the borrower either on account of excessive costs in providing the lending bank with various required securities or the borrower's inability to comply with bank's demands.

Is there a way that the particular mode of financing may prove self-reliant in providing adequate confidence for a financier so that it refrains from seeking the customer to comply with the long list of securities and collaterals?

Yes, there exists such a system and it is the Islamic mode of financing. Through its six basic structures viz *Mudaraba, Musharaka, Murabaha, Istithna, Ijara* and *Salam,* or a combination thereof, this system can provide the financiers with an ingrained risk mitigation of a comfortable level.

Let us discuss the risks associated with the maintenance of an asset leased by an IFI to its customer and how these are mitigated.

It may be simple to maintain a real estate asset since most IFIs in the Gulf region hold necessary expertise, having considered property financing their forte.

However, how does an IFI cope when it comes to maintaining a high-value complex asset, such as vessels, aircraft, industrial plants and others needing rich technical expertise? Remember, being the owner and lessor, it is the Shari'ah prerequisite for an IFI to maintain the leased asset in good working condition at its own cost so that the lessee (customer) can take full benefit for the rent paid by it to IFI for using the asset.

The mechanism devised by IFIs with the blessing of Shari'ah scholars is to appoint the customer as their agent to accomplish the maintenance required by the asset on an ongoing basis. It is important to note that Shari'ah classifies the maintenance of an asset into two parts: major maintenance and minor maintenance.

Whilst carrying out major maintenance to a leased asset is the responsibility of the IFI, the minor maintenance must be conducted by the customer (lessee).

For the sake of clarity, we provide below the recognised definitions of major and minor maintenance:

Major maintenance means replacement or repair of any part of the asset in line with the manufacturer's instructions contained in the manual, without which the asset cannot be used by the lessee in the ordinary course of its business. Therefore, the non-execution of major maintenance may render the asset in an un-usable condition.

Examples of major maintenance are overhauling of an aircraft engine after completing certain number of flying hours or periodic dry-docking of a marine vessel.

Minor maintenance represents all ordinary repair, replacement of any part of the asset and routine maintenance (other than major maintenance) required to preserve the asset in good operating condition.

In contrast to major maintenance, minor maintenance does not render the asset in an un-usable condition but may hamper its efficiency. For example, inordinate delay in changing oil, oil filter and spark plugs in a car may not result in the car stalling but will certainly reduce its pick up and speed.

Methods of mitigating risk

The first of the numerous lease-related risks enumerated above concerned a customer's request that the bank purchase a certain asset, accompanied by his promise to lease the same from the bank. We looked at how the IFI is at risk if the customer does not fulfil his promise to lease the asset from the bank upon the bank having acquired it.

Shari'ah scholars have allowed IFIs to structure the "promise to lease" to be obtained from the customer in a manner covering all probable risks. As such, the following aspects are covered in the promise to lease submitted by the customer:

First situation: The customer seeks to cancel the promise prior to the bank having acquired the asset.

In this situation, the customer will have to compensate the bank for any actual administrative expenses the bank may have incurred in arranging the lease financing. This may include establishing the letter of credit for import of the asset, if it is plant or machinery, or any other measure involving a financial expense, including hiring the services of professionals to survey the asset.

Second situation: The customer fails to lease the asset after IFI acquires it.

After waiting for a reasonable while for the customer to turn up, the IFI will have the right to sell the asset or lease it to a third party. In case of sale of asset at a loss, the IFI will have recourse to seek the deficit between the sale price and the aggregate of its acquisition cost from the customer. The bank can also seek direct expenses beside actual financial loss suffered due to the customer's non-compliance. If the IFI was able to sell the asset at a profit, however, it will retain the surplus. The same principle applies if the IFI is going to lease the asset to a third party.

Third situation: The customer signs lease agreement, but fails to take possession of asset.

Shari'ah requires the lease to commence upon the lessee having acquired possession of the asset. Merely signing the lease agreement does not activate the accrual of the lease rent. This is to ensure the lessee must start enjoying the usufruct while paying the rent.

If the customer does not take possession of the leased asset after the lapse of a reasonable length of time, the IFI will be fully authorised to terminate the lease and either lease the asset to a third party or sell it.

In case the new lease is at an amount and terms lower than the ones promised by the customer, the IFI will be entitled to claim actual financial damages from the customer.

Similarly, if the asset is sold at a price less than the investment the IFI has made in it, the customer will be liable to bear the shortfall. If the IFI does not suffer any financial loss by adopting either of the two options, however, it will not seek compensation from the customer.

The third situation may not apply in a transaction where the asset is purchased by the IFI from the customer for the purpose of leasing it back to the customer. In that case, there will be no need to obtain promise to lease since the full set of documents will comprise the purchase agreement and the lease agreement, both to be signed in one session.

Shari'ah requires, however, that the purchase agreement must be signed prior to signing the lease agreement. This is because the IFI must first obtain the title to the asset before leasing it to the customer. There will be no need for the IFI to deliver the asset to the customer in this case, since he will already possess it.

Risk Profile of *Ijara* Structure

A question arises relating to such a situation and what if the customer is unable to honour his promise to compensate the IFI? Will it therefore, be in order to obtain external guarantees or collaterals to secure the customer's obligations in terms of his promise?

The scholars have responded that whilst it will be appropriate to rely on the mere promise, which is absolutely binding on the promisor (customer), Shari'ah does not object on seeking additional securities in support of the execution of the customer's promise.

What's more, it is implied that the IFI will enter into such transaction only after having carried out its due diligence on the customer. This is because the IFI is *Mudareb,* and therefore a trustee for the funds it has acquired from the investors and is duty-bound to deploy those funds diligently.

The next risk an IFI may be confronted with in an *Ijara* transaction concerns the accuracy of the value of the asset if it is purchased by the IFI from the customer in a `Purchase and Lease Back' structure. In other words, what is the guarantee that the asset is worth the value IFI has been asked to pay?

Contrary to the situation where an asset is purchased by the IFI from a third party for the purpose of leasing it to the customer, it is rather tricky at times to rely on the quoted value of the asset owned by the customer and which the IFI intends to purchase for leasing it back to the customer.

There are a variety of ways to allay such valuation risk. First, the IFI can opt for the independent valuation of the asset through professional surveyors of its choice. Of course the cost of such survey will be borne by the customer.

Second, the purchase agreement signed by the IFI with the customer will contain several representations and warranties, one of them relating to the valuation of the asset being genuine. We know that the subsequent discovery of the customer providing a false warranty can make an agreement null and void, giving absolute right to the aggrieved party i.e. the IFI to claim damages from the customer.

Another mitigating aspect may be through the lease rent which comprises the fixed element being the cost of the asset divided over the number of lease periods and the variable rent representing the IFI's return on investment in the leased asset.

First of all, by inflating the asset price to the IFI, the customer will not gain much since he will be required to pay the purchase price as part of the periodical rent, thus over-burdening himself for the entire lease period.

Moreover, in case of the occurrence of an event of default, the IFI will have the right to exercise the put option given by the customer to IFI by way of a purchase undertaking at the time of entering into lease agreement.

The customer may find it difficult at that time to wriggle out of his commitment and pooling in the necessary financial resources to purchase back the leased asset at an over-inflated value could become a nightmare for him.

We have thus observed from the above explanation that the structuring of a financing transaction on Shari'ah principles alleviates unwarranted risks without resorting to outside help.

Mode of carrying risks in leasing transactions

We are discussing the risks an Islamic Financial Institution (IFI) carries in the financial leasing transactions.

We know that an IFI, being the lessor to the asset, has the responsibility of an owner and while fulfilling the same, is exposed to certain high value and at times unknown costs. How this risk is mitigated by the IFI in a leasing transaction?

If an IFI is expected to cover these big ticket expenses, will it be in a position to remain profitable from a leasing transaction?

Let us examine as to how an **IFI** conducts itself in such a thorny situation and what solution is offered by Shari'ah to maintain the leasing transactions profitable from an IFI's perspective and at the same time to keep the transaction Shari'ah-compliant.

To summarise, we have dealt with the mechanism for IFIs to successfully manage the risky part of a leasing transaction whereby, being the owners, they must fulfil their primary obligation of maintaining the leased asset. The task gets challenging if the asset is of technical and complex nature such as aircraft, marine vessel, industrial plant, etc.

We also briefly touched upon the conditions precedent which has no room in Shari'ah documentation since Shari'ah requires completion of all such conditions prior to attending the signing of transaction documents.

Reverting to our subject, in order to meet with its ownership obligations, an IFI enters into a service agency agreement with the client, appointing it as the IFI's agent to carry out major maintenance and take care of insurance and taxation matters on behalf of the IFI.

The service agency agreement stipulates that the customer, in the capacity of agent, would carry out all required major maintenance to the leased asset in order to keep the asset in good working condition.

Since the customer would do it in the capacity of IFI's agent, all costs incurred by it are payable by the IFI (principal). Some scholars take the position that in fact costs of such routine major maintenance should be ascertained and paid out by the principal to the agent from time to time in advance as the agent is not supposed to spend any amount from its own pocket.

If the agent spends any money on carrying out the agency tasks, it will be tantamount to a case in which the agent has given a loan to the principal and as you are aware, any loan in Shari'ah must be free of any costs/interest. These scholars argue that it is unfair to put the agent into such a position that it is forced to incur certain costs on behalf of the principal in order to fulfil its obligations under the service agency agreement.

Notwithstanding the above position taken by some scholars, the majority of them have approved a position whereby if the agent has incurred certain costs in carrying out major maintenance to the leased asset or in keeping the asset fully insured, it will be entitled to deduct such costs from the rent it pays to the IFI in the capacity of lessee.

Here the question arises that how two different aspects i.e. the lease and service agency can be amalgamated. The answer is that Shari'ah is fair when it comes to protecting the interests of all concerned parties in a transaction and as such, the lessee automatically acquires the right of set off if it has not been paid by the lessor for certain jobs which it carried out as the lessor's agent.

This mechanism allows the agent, who is also the lessee, to deduct the costs of major maintenance, insurance, taxation, etc. (all termed as the service amount) from the periodical rent it pays to the IFI. On the other hand, if the IFI has paid or reimbursed the service amount to the agent, it is permitted to increase the lease rent for the next rental period by the same amount.

Major maintenance obligations

It is the responsibility of the Islamic Financial Institution (IFI) to carry out tasks connected to a leased asset, such as maintenance and keeping the asset fully insured at its own cost.

There are two types of maintenance: major and minor. Major maintenance is the responsibility of the IFI and without it the asset may cease to operate, whereas minor maintenance (not leading to such situation) which is the lessee's responsibility will certainly hamper the efficiency of the asset to a great extent.

How does the IFI discharge its responsibility towards undertaking major maintenance, and especially in case of the asset being technical and complex in nature for which IFI may not have the requisite experience?

Shari'ah scholars have approved of a mechanism whereby the IFI may appoint the customer (lessee) as its service agent to fulfil the institution's obligations in this respect. This is because the asset is in the possession and use of the customer who is well versed with its technical nature and maintenance requirements.

It is interesting to note that although parties to the lease and service agency agreements are the same, i.e. IFI and the customer, their capacities are completely different. In fact, in a purchase and lease back transaction, the roles of the IFI and the customer have three diversities.

In the purchase agreement, they are buyer and seller whereas in the lease agreement they become lessor and lessee, and finally in the service agency agreement they assume yet other completely different roles of principal and agent.

Shari'ah requires that the three agreements remain totally independent of each other. Any interdependence between them may render the agreements, and thus the transaction, null and void.

Legal bindings

Let us examine the Shari'ah treatment to the Conditions Precedent (CPs) which we often encounter in a syndicated financing transaction.

There is no denying as to the high importance of completing certain conditions prior to release of finance to the customer. However, unlike conventional financing documentation where the agreements include a long list of CPs, the Shari'ah documentation does not contain any such list. This is because under Shari'ah, no agreement should be conditional upon the aspects outside the scope of the agreement.

Under Shari'ah, an agreement is concluded upon the initiation of the offer from one party and acceptance by the other, provided that it is unconditional and that the subject matter of the agreement is not against the Shari'ah principles.

How then the IFIs ensure that certain vital conditions are met prior to release of finance to the customer? Well, the scholars recommend that all such conditions must be met before the parties reach the stage of signing the agreements.

At times, this point has been a bone of contention between conventional and Islamic banks in co-financing transactions where the conventional banking colleagues feel sensitive about removing the clause from the agreements.

I think there is greater need to understand the scholars' point of view since it makes a lot of sense. Whilst all CPs can be agreed between financiers and the customer as per a separate arrangement, the transaction agreements should only be signed upon fulfilment of all CPs.

An alternate could be to incorporate a complete list of CPs into the preliminary term sheet with a clear statement that all of them must be met to the satisfaction of financiers before the financiers proceed to sign the transaction agreements with the customer.

Shari'ah scholars would not be concerned with all CPs getting mention in the term sheet since it merely contains the initial indicative terms and that it is not signed by the parties and is considered working documents or a memorandum of understanding which does not have any *Shari'ah* or legal value.

Remedies against lease rent defaults

Our discussion will now revolve around the remedies available to an Islamic financial institution if a customer fails to pay the lease rent, a risk every lessor is invariably exposed to while leasing the asset.

The customer's default may be further categorised into a short-term default and a permanent one. The short-term default can be remedied within the remedial period allowed in the lease agreement. Such default, once remedied, does not affect the validity of the lease agreement and is technically construed as it did not happen at all.

The remedial period varies, depending on the agreement between the institution and the lessee. It could be any number of days or weeks. However, an institution endeavours to keep it to the minimum since Shari'ah does not allow it to charge anything over and above the agreed lease rent even if there is a delay on the part of the lessee in payment of the periodical rent. This is where institutions are different from their conventional counterparts who would normally levy compound and penalty interests on top of the agreed (normal) interest in such situations.

As explained earlier, in order to discipline the lessee in timely payment of the agreed lease rent, Shari'ah scholars have permitted levying a reasonable amount as penalty, which is then donated to charity.

Options

If the default continues beyond an agreed remedial period, it is tantamount to permanent default where the lease terminates and the institution has the following options:

a) The institution can repossess the leased asset and either re-lease it to a third party or dispose it off to recover its investment in the asset; or

b) It may ask the lessee to purchase the leased asset and the sale proceeds are applied to recover the institution's investment in the asset.

In case of the first scenario, being the owner of the asset, the institution is entitled from legal and Shari'ah perspective to re-possess the asset. What do you do when you rent a house and the tenant stops paying you the rent? Don't you get him evicted and lease the house to someone else?

Here I would like to recall the two types of leasing we had discussed: the operating lease and the financial lease. In the operating lease, the asset is returned to the lessor who continues to hold the title or ownership to the asset during and after the lease term. An example is 'rent-a-car' activity.

To the contrary, the financial lease allows the lessee to get the title transferred to itself from the owners or lessors upon successful completion of the lease term. This is because the lessee has been paying a part of the cost of asset, embedded in the lease rent amount, and by the time the lease term gets completed, he will have paid full cost of the leased asset to the lessor. Kindly note that the rent in the operating lease does not include cost of the asset.

It is important to note that in financial lease, the successful completion of the lease term is essential for the lessee to become eligible for getting the title of the leased asset from the lessor.

If the lease gets terminated in the middle of the lease term, the lessee runs the risk of losing this valuable right and along with it the entire amount it has been paying towards the cost of the asset embedded within the periodical lease rent amount.

It should now be easy to understand how cre'lit risk is automatically mitigated in a Shari'ah-based financial leasing structure. The stakes are too high for the lessee to allow an opportunity to the lessor to terminate the lease agreement, since the lessee may lose the entire amount he or she paid to the lessor for the cost of the asset it has leased from the lessor.

Risk-mitigation in financing

We carry on with our discussion on the uniqueness of risk alleviation techniques available to a lessor from within the Islamic *Ijara* (leasing) structure, instead of seeking external guarantees and collaterals. It is astounding to know the vast dimensions the subject of risk-mitigation holds in this genre of financing.

If a Shari'ah-compliant financial lease gets terminated in the middle of the lease term due to lessee's fault, the lessee may lose the right to purchase the leased asset from the lessee at a price which is calculated by taking into consideration the rentals paid by the lessee till the time of such termination.

Hence, lessor's credit risk in a Shari'ah-compliant lease structure is effectively and automatically mitigated by default. The odds are staked against the lessee to allow the lessor with an opportunity to terminate the lease agreement, given that it stands to lose out any amount it has paid to the lessor towards the cost of the asset it leased from the lessor.

In *Ijara Muntahiyya Bittamleek* (Islamic financial lease, also called *tiara wa lqtina)* an Islamic Financial Institution (IFI) being the lessor receives a purchase undertaking or put option from the lessee.

It is an undertaking from the lessee stating that in case of lessee's default in adhering to the terms of the lease agreement, it will purchase the leased asset from the lessor at a certain price.

Although the put option is in favour of the lessor IFI, it is a one-sided undertaking or promise binding on the customer lessee only and not on IFI. As such, it will be sole prerogative of the IFI whether to make use of the put option, asking the lessee to purchase the leased asset, or take other suitable steps which may include leasing or selling the asset to a third party. Readers will appreciate that this is yet another risk-mitigation measure an IFI enjoys to protect its interest in an undesired situation.

It is relatively easier for an IFI to adopt alternate route if the leased asset is real estate or any other soft asset with favourable characteristics such as convenience to manage and steady capital gain. In such situation, by not using the lessee's put option and adopting alternate route, the IFI may not only manage to recover its outstanding investment in the asset but also benefit from the valuable capital gain sole right of the owner of the asset.

Third party buyers

However, the IFI does not enjoy the same luxury of choice if the leased asset is complex and technical in nature. For example, the institution usually does not have third party buyers lined up to purchase or lease a power plant or petro-chem set-up where the original lessee may have defaulted in meeting its obligations under the lease agreement. Here, the lessor IFI is more likely to use the put option given to it by the lessee.

The typical procedure is to send a notification to lessee stating the event(s) of default and advising it of the lease termination by virtue of powers vested in the lessor through the terms of the lease agreement and seeking the lessee to pay within a certain timeframe the termination sum.

The termination sum comprises the accrued lease rental remaining unpaid up to the occurrence of the event of default and the cost of servicing the asset, if any (such as major maintenance, structural repair, insurance, ownership taxation, or any other ownership related expense).

The lessee, upon receipt of the termination notice, is expected to do its best to arrange for the required funds to be paid to **IFI** in order to salvage the amounts it has been paying as periodic lease rentals, a part of which was meant towards paying the cost of the leased asset.

Reasons for low default levels

We discussed the situation where the lessee may default in meeting with its obligations under a lease agreement requiring an Islamic Financial Institution (IFI) being the lessor to make a conscious decision whether to exercise the put option granted to it by the lessee at the time of signing the lease agreement, or to dispose of the leased asset on its own.

We examined that the put option is one-sided promise binding only on the lessee to purchase the leased asset in the event of its default and it is not obligatory on the part of IFI to sell the asset to lessee.

As such, IFI being lessor, may or may not bestow the opportunity to lessee to purchase the leased asset at a concessional price which is equivalent to the IFI's original investment in the asset less the aggregate amounts paid by lessee to IFI towards the cost of leased asset by way of periodical rentals, from the commencement of lease term till occurrence of the event of default.

An IFI decides to sell the leased asset to a third party when the prime consideration is to earn capital gain if the asset is real estate or any other sought-after item.

Nevertheless, in case of the asset being intricate or technical in nature, the IFI will most likely exercise the put option asking the lessee to purchase the asset if it fails to find a suitable taker.

If the IFI exercises the put option granted to it by lessee and the lessee does not respond or fails to meet its commitment to purchase the asset by paying the termination sum to IFI, it will be IFI's right to either step in and take control of the asset in order to manage and operate the same by appointing professional managers or resort to sell or auction the asset.

In case of the disposal of the leased asset by IFI, if the proceeds fall short of the IFI's investment remaining outstanding in the asset, the lessee is responsible to make good such shortfall to IFI.

However, if the sale of asset results in a surplus, it will be IFI's discretion whether to share it with the lessee or retain the entire surplus.

If the leased asset is plant and machinery affixed on lessee's land or infrastructure, the IFI or its agents shall be entitled to enter the premises in order to sever or uproot such plant and machinery and to remove them from lessee's premises.

The lessee shall be responsible for any damage to the premises caused by such severance or removal, but at the same time the IFI is obliged to use its reasonable endeavours to keep such damage to a minimum by hiring professionals to accomplish such job, cost of which will be borne by the lessee.

If the lessee is willing to purchase the asset upon receipt of IFI's termination notice, the lease rent will continue to accrue from the occurrence of the event of default till lessee makes full payment of the termination sum. Of course, such rent will be in addition to the rent remaining unpaid up to the occurrence of an event of default.

The above explanation that the whole composition of the Islamic financial leasing arrangement provides solid protection for the IFI by ensuring that the lessee strives its best not to default in its financial commitments towards the IFI who has purchased the asset for the purpose of leasing it to the lessee, solely at lessee's request.

Perhaps this is the reason for remarkably low level of defaults in the Islamic leasing transactions.

Win-win situation for all parties

We have covered almost all imaginable risks emanating from an Islamic financial leasing transaction undertaken by an Islamic Financial Institution (IFI) and their by-default respective mitigation from within the structure.

Now our discussion will revolve around the situation of partial damage or total destruction of the leased asset and the means available to an IFI to protect itself from such probability.

First of all, there is a need to understand the definitions of partial damage and total destruction acceptable under Shari 'ah.

Partial damage is where a leased asset may be impaired which, although it does not bring the operational capacity of the asset to a complete halt, the lessee is certainly deprived of the benefits from the asset's full potential.

Total destruction means a situation where the leased asset suffers a damage which is beyond the economic repair. Economic repair being the cost of refurbishment in order to restore the asset to its pre-damage full potential.

If the repair cost equals or exceeds the replacement value of the asset, it will be considered that it is not worth the job and the asset will be considered to have suffered the total destruction.

So how an IFI safeguards itself from such eventualities? Let us first talk about the partial damage.

Shari'ah rules that if the partial damage has been caused due to the misconduct and negligence of the lessee (customer), not only that the lessee is responsible to repair the damage but at the same time it is also liable to continue paying the normal lease rent to the IFI.

It will be appreciated that it would only be fair that IFI is not made to suffer any financial loss if the damage to leased asset is caused due to lessee's mishandling and negligence. As such, getting the asset repaired and at the same seeking lessee to continue to pay the rent will more than adequately mitigate the IFI's risk in such a situation.

While fixing the responsibility on the lessee to get the asset repaired at its own cost in the above case, the IFI authorises the lessee to claim the insurance proceeds which can be appropriated by it towards meeting the cost of repairs. Thus, the Islamic financial leasing transaction facilitates a win-win situation for both parties.

The situation is totally different when the lessee does not play any role in the partial impairment of the leased asset. In this case, the lessor being the owner of the asset would get the repair carried out at its own cost towards restoring the asset to its full efficiency.

Moreover, during the repair period, the lessee will not be required to pay the lease rental to IFI.

This is because the IFI charges the rental to the lessee for allowing uninterrupted usage of its asset and if such benefit is temporarily denied due to no fault of lessee, the IFI should not be entitled to receive the rent since it has technically failed to provide such uninterrupted usage for the lessee as per the lease agreement.

It is however, allowed under Shari'ah if, instead of completely halting payment of rentals, both parties mutually agree to reduce the rentals during the repair period in the said circumstances.

This is because the lessee may still continue to benefit from the asset, albeit at a lower scale. Therefore, it will be in order if the lessee pays subdued rentals during the restoration period, which is directly in proportion to the extent of partial damage suffered by the asset.

Similarly, in case of partial damage caused due to the lessee's fault, the IFI may also agree, at its own prerogative, to reduce the amount of lease rental payable by the lessee during the fixing period.

Workings of *Istithna* contract

We are on the subject of risk management in Islamic financing structures. We started our discussion of the structure of *Istithna,* and the risks it involves, together with their mitigation within the structure, rather than seeking external help in the shape of collateral and guarantees.

Istithna is primarily a sale contract resulting in a debt on the buyer and is used for transactions requiring purchase of an asset which requires to be built from scratch. It is different from *Murabaha* which is utilised for transacting the goods or assets available readily.

The *Istithna* is commonly used by Islamic financial institutions to finance construction of real estate

developments and also for aircraft, vessels, industrial projects and any other asset that requires construction from scratch, as long as its purpose is Shari
Istithna structure can also be utilised to purchase an asset from the customer.

The title to the asset which needs to be developed gets passed to the buyer immediately on signing the *Istithna* contract. This is contrary to the general misconception that the title to the *Istithna* asset is linked to its delivery by the seller upon completion.

The misconception is based on the apprehension that the transfer of title to the *Istithna* asset at the time of signing the contract (i.e. prior to delivery of the completed asset) will entail all ownership-related risks to the buyer. These risks include partial/total damage to the asset, any third party liability and any financial implication resulting from any environmental hazard connected to the asset.

On the contrary, the *Shari'ah* position is very clear saying that all such risks are to be borne by the seller till completion and satisfactory delivery of the asset to the buyer. This will be discussed in detail but first let us understand the mechanism of *Istithna* and how an IFI utilises it to finance the completion of an asset.

Under the sale *Istithna* structure where an IFI sells an asset to the customer, the asset is developed by the IFI in accordance with the complete specifications provided by the customer. The specifications form an important and integral part of the *Istithna* contract and are referred to by the parties and the arbitration/court authorities in case of any dispute between the IFI and the customer.

Once the construction of asset is completed by the IFI according to the agreed specifications, it will be considered that the institution has fulfilled its responsibilities under the contract and the customer will be obliged to accept delivery of the asset and meet its financial liability in respect of the purchase price.

If due to certain reasons the IFI delays the delivery of the asset, it will be required to compensate the customer by way of a pre-agreed daily charge, termed as liquidated damages, until such time that the asset is satisfactorily completed and delivered to the customer.

We have earlier learned that the delay penalty imposed under *Ijara* and *Murabaha* transactions must be donated to charity since Shari'ah does not permit increasing the lease rent under *Ijara* or the sale price under *Murabaha* in case of delay in payment by the lessee/buyer respectively since it will be tantamount to *Bai Al Ina* (interest-based transaction). As such, the readers may deduce that the buyer under an *Istithna* contract must also donate to charity such late penalty paid to it by the seller.

In contrast to *Ijara* and *Murabaha,* the buyer under an *Istithna* contract is authorised by Shari'ah to retain the amount paid to it by the seller on account of liquidated damages. The IFI therefore, is liable to compensate the buyer on a daily charge basis under a sale *Istithna* contract for delay in delivering the asset for the period from the agreed delivery date appearing in the contract till satisfactory completion and delivery of the asset.

Risk mitigation from within *Shari'ah* structure

While a conventional banker seeks to collect several guarantees and collaterals to secure itself, simply because it lends money and would like to have it back with interest, the Islamic banker feels content since it is not lending the money on interest but is part of a transaction which has in-built attributes to protect him.

In addition, whilst a conventional banker is not at peace in considering to take risks, it is quite natural for an

Islamic banker to accept risks in Shari'ah-compliant financing and investment transactions.

A prominent scholar of our time views that if all risks are eliminated from a financing transaction, the same will be rendered as Shari'ah-repugnant. This is because Islamic principles support taking genuine risks in order to earn *halal* profits.

Continuing with our vast subject of risk management in Islamic financing structures, now we will commence our review of *Istithna,* the risks emanating thereof and their mitigation from within the structure, rather than relying on external guarantees and collaterals.

Under Shari'ah, there are three structures which result in debt on the buyer. The most widely used is *Murabaha*, followed by *Istithna* and then *Salam.* While *Murabaha* and *Istithna* produce financial debt on the counter party, *Salam* creates debt in kind.

Although all of them are sale contracts, *Istithna* and *Salam* are different from *Murabaha* in a sense that it is used for the goods or assets that are readily available to transact whereas under *Istithna* and *Salam* the assets and goods are transacted before they come into existence.

Istithna means to build or to manufacture. The structure of *Istithna* contemplates the sale of an asset which needs to be built from scratch on the basis of description provided by the buyer and agreed to by the seller. The price and delivery date is agreed upon in the *Istithna* contract.

Istithna is widely used as a means of financing by the Islamic financial institutions (IFIs) for real estate development projects. The structure has also been adopted to a lesser degree for financing the construction of high value marine vessels and aircraft besides laying of oil and gas pipelines. The *Istithna* structure can be utilised for any other asset or project which needs to be built from foundation upwards, so long as the purpose of the asset is Shari 'ah-compliant.

The *Istithna* structure can be used for two different types of transactions. One situation where the IFI sells the asset to the customer and the other where it purchases the asset from it. The first type of transaction can be termed as Sale *Istithna* and the other as Purchase *Istithna.*

Under the Sale *Istithna* contract, the IFI undertakes to build a described asset for the customer who provides full specifications which form an integral part of the *Istithna* contract.

The roles are reversed when it comes to Purchase *Istithna* contract. Here, the customer constructs or builds the asset for the IFI at an agreed price and according to specifications provided by it for delivery to the IFI on an agreed date.

Istithna contract creates an obligation on the seller *(Shari 'ah* term *Sani)* to develop the required asset within a certain timeframe and for the buyer *(Shari 'ah* term *Mustasni)* to take delivery thereof upon completion.

It is important to note that the title to the "described" *Istithna* asset is passed to the buyer at the time of signing the *Istithna* contract without requiring any further documentation such as bill of sale, etc. to be signed at the time of delivery of the completed asset for the transfer of title.

Risks associated with sale *Istithna*

We have discussed the credit and equity investment risks and also the market risk arising out of a sale *Istithna* contract entered into by an Islamic financial institution (IFI) with a customer, whereby the IFI agrees to sell to the customer an asset which needs to be constructed, developed or manufactured from scratch.

The other risks associated with a sale *Istithna* contract are the rate of return risk, operational risk and ownership-related risks.

Rate of return risk

The sale price quoted by an IFI in the sale *Istithna* contract comprises its cost of building or developing the asset and the profit representing its return on investing the equity in the asset.

In a default situation where the customer fails to pay the sale price as per the agreed terms which includes IFI's profit, the IFI is exposed to the rate of return risk since the receipt of the sale price with delay or its complete non-receipt will render the entire transaction unattractive for the IFI.

What measures, if any, are available to the IFI to cope up with this situation?

Well, there can be two situations here. One, the amount at which the **IFI** has contracted to sell the asset to a customer is the fixed sale price.

If the customer makes the payment of the fixed sale price with delay, the IFI is forbidden in Shari'ah to levy any additional amount to the customer. This is because the amount invested by the IFI over the asset is equity, and not a loan with interest.

Any amount charged by the IFI over and above the agreed sale *Istithna* price due to delay in payment by the customer will be considered interest in Shari'ah and hence will turn the entire transaction into *Bai Al Ma* (interest bearing loan) which is outlawed under *Shari'ah.*

Second, if a customer does not pay the agreed *Istithna* price at all before the agreed delivery date of the asset, the

IFI will be rightful in terminating the contract and selling the asset to a third party and any shortfall from the sale proceeds will be borne by the customer. The IFI will not be able to charge any amount over and above the sale *Istithna* price.

In this backdrop, how can an IFI secure itself from the rate of return risk in a sale *Istithna* transaction where it is faced with customer default?

The way open to an IFI is to claim compensation of the actual financial loss suffered by it due to the customer's wrongdoing through arbitration in the court of law where it will be required to prove its case?

Operational risk

In a situation where the customer breaches the sale *Istithna* contract, the IFI may end up with the asset and alongside it the responsibility to maintain and operate the same if the IFI wants to put the asset up for certain commercial use, such as leasing, till such time that it is sold.

The IFI may mitigate this risk by hiring professional managers to run and maintain the asset. However, the cost of hiring such professionals would have to be borne by the IFI who is also entitled to receive the lease rent. Any amount paid by the customer till termination of the *Istithna* contract may prove adequate to meet with such operating costs.

Ownership risk

Though the title to the asset described under a sale *Istithna* deal is passed to the customer upon signing the contract, all ownership-related risks, such as part or full damage, third party liability, force majeure, etc. are borne by the IFI till such time that the asset is delivered to the customer.

The IFI can alleviate such risks by entering into a parallel *Istithna* contract with a contractor where the terms and conditions, including payment terms, are the mirror image of the ones agreed to by it with the customer, only difference being the purchase price which would invariably be lower than the sale price under the master *Istithna* contract.

Hence, the IFI will be in a position to pass on all ownership-related risks to the ultimate contractor.

Risk management in *Istithna* transaction

We have examined various risks associated with the sale *Istithna* structure and how these can be mitigated from within the structure. A sale *Istithna* transaction is where an Islamic Financial Institution (IFI) sells an asset to its customer which is non-existent and is required to be developed, built or manufactured.

Lct us evaluate what risks are connected to a purchase *Istithna* transaction where an Islamic Financial Institution (IFI) contracts to purchase an asset from the customer.

The purchase *Istithna* transaction entails the purchase of a certain asset by the IFI from a customer that requires to be developed, built or manufactured and delivered by the customer to the IFI as per the specifications and delivery date agreed to between the parties.

Once delivered, the asset is leased by the IFI to the customer at a lease rent and for a term which would ensure that the IFI would be able to redeem its equity in the asset, along with the anticipated return.

The IFI would be exposed to the following risks in a purchase *Istithna* transaction:

How an IFI would safeguard its equity investment if the customer (the seller) fails to timely deliver the asset to the IFI, or does not deliver at all?

This situation may render the IFI to face another risk which is the rate of return risk since late delivery of the asset by the customer (as seller) will deny the IFI (as buyer) to lease the asset back to the client.

As per Shari'ah, the IFI would not be in a position to start earning the lease rent (which will ensure the return of its equity plus the anticipated profit) unless the asset is leased to the client.

Let us examine how these risks are mitigated in a purchase *Istithna* transaction.

In case of late delivery of the asset by the customer to IFI the IFI would be entitled to receive compensation in shape of a pre-determined daily liquidated damage from the customer.

We have learned in a recently published article that Shari'ah allows the buyer under *Istithna* to claim liquidated damage from the seller if the seller fails to keep up with the agreed delivery deadline.

Unlike the compensation earned in *Ijara*, *Murabaha* and the other structures where it must be donated to charity by the recipient, the liquidated damage under *Istithna* is the right of the buyer and hence there is no need to donate it to charity.

As such, the compensation in shape of liquidated damage will alleviate the rate of return risk for the IFI under the purchase *Istithna* contract where the delivery of the asset takes place with certain delay.

What if the asset is not delivered at all by the customer to IFI? In such a situation, the IFI has the right to terminate the *Istithna* contract and demand the return of the total amount paid by it to the customer on account of the purchase price of the asset.

Shari'ah allows the IFI (being the buyer under the *Istithna* contract) to also claim actual financial damages arising from the customer's failure to perform its obligation under the *Istithna* contract. However, unlike the liquidated damage, such additional compensation cannot be pre-agreed but will have to be proved by the IFI to the arbitration panel or the court of law.

Upon termination of the *Istithna* contract by the IFI, the incomplete asset will be retained by the customer and will not be passed to the IFI on account of refund of the purchase price by the customer to the IFI. The customer will have full ownership rights over such incomplete or undelivered asset.

There could be a situation where after having received the full payment and delivering the ass to IFI, the customer does not take the asset on lease from the IFI.

This apparent risk can easily be managed by the IFI by seeking the customer to sign a forward lease agreement with the IFI which will bind the customer to take the asset on lease immediately upon-having delivered the same to IFI.

Musharaka deals pose risks

We have so far discussed in detail a variety of risks found in *Ijara* (leasing) and *Istithna* (forward sale of an asset) and their management/mitigation by utilising the characteristics of the structure itself, without needing to rely on external collaterals and securities, which are often demanded by the conventional banks from their clients to protect their interest-based lending.

The subject of risk management is of high substance and the financial institutions around the world spend huge sums of money on research and development (R&D) to come up with latest tools and softwares to safeguard them from risks such as credit/default risk, capital impairment risk, liquidity risk, market risk, operation risk, interest rate/rate of return risk, etc.

What the Islamic scholars and practitioners have just started to discover is the way of managing these risks embedded within the Islamic structures revealed to mankind over 14 centuries ago.

Furthermore, whilst the conventional risk management is centred around protecting the interests of the lender alone, the Islamic structures emphasise fairplay by providing adequate shield for both the parties.

However, since we are on the subject of discussing the risk mitigation for the Islamic Financial Institutions (IFIs), we will move on to look at how an IFI protects itself from various risks in a *Musharaka* transaction.

A *Musharaka* is a partnership between an IFI and its customer whereby each of them contributes a specific amount of capital (be it in cash or kind) in a manner that gives each of them a right to deal in the assets of the partnership on condition that the profit will be distributed according to what has been agreed in the partnership contract, irrespective of the equity contribution ratio, but the losses (if any) would be borne by them strictly as per the equity ratio.

Shari'ah considers a *Musharaka* to be an independent juristic personality, similar to any legal entity, irrespective of whether it is in shape of a registered company or merely on document.

Musharaka does not own the assets of its partners, except what has been specifically declared by them in the *Musharaka* contract to be their respective equity in the *Musharaka*.

Similarly, *Musharaka* does not bear the individual liabilities of its partners but only the liabilities of the *Musharaka* created during the course *of Musharaka* operation.

IFIs usually enter into redeemable *Musharaka (Shari'ah* term *Musharaka Mutanaqisa)* with their clients which allows them to gradually sell their equity to the clients over an agreed period of time and manner. This structure suits the clients too who would not welcome and accept an IFI to be a permanent partner with them in their business.

Let us examine the risky an IFI is exposed to while entering into a *Musharaka Mutanaqisa* transaction and the "by-default" mitigation from within the *Musharaka* structure.

The *Musharaka* structure is exposed to high capital impairment.

How does an IFI protect itself from such risk?

Once an IFI enters into *Musharaka* with a client, it is bound to respect and obey the principles of *Fiqh* (Islamic jurisprudence) relating to *Musharaka* which are clear as to the responsibilities of each partner in running the affairs of the *Musharaka,* including bearing the losses, if any.

Shari'ah permits an IFI to appoint the customer as the managing partner of the *Musharaka* with a well-defined and clear managerial mandate.

Having accepted the mandate, the managing partner (customer) would be liable to strictly abide by the assigned responsibilities for running the *Musharaka* affairs in a prudent manner and with an aim to generate *halal* profit for the *Musharaka.*

However, any loss caused to the *Musharaka* due to managing partner's negligence will protect the IFI in a manner that the IFI's equity will be transformed into a debt on the managing partner and it will no more be carrying the risks of being part owner in the *Musharaka* business.

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