PROSPECTS OF ISLAMIC BANKING:
Legal and other Challenges and Issues

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Preface

At present times, it would not be inappropriate to state that Muslims the world over face the dilemma that their religion, Islam, prohibits interest in stringent terms and aims at establishing an economy that is not only free from all forms and kinds of interest, but also from anything that bears any resemblance to it. The modern economy is heavily based and reliant on interest and it is hard to envisage any set of economic relations where interest does not play a part, whether directly or indirectly. Resolving the above-mentioned contradiction seems to be a challenge that Muslim intellectuals, bankers, industrialists, businessmen, policy-makers and ordinary consumers face.

In a nutshell, this monograph seeks to provide an analysis of the workings and practices of Islamic banking industry and the products it offers; covering legal, political, social and economic issues as they relate to it.

Chapter 1 commences by providing a rationale to the Islamic banking and outlining its historical journey, and ends with a discussion on the riba and its prohibition in Islam.

Chapter 2 deals with the modes of Islamic finance, which certainly requires a detailed study, as it is these products that form the cornerstone of the entire Islamic banking industry. Shariah precepts are also introduced at this stage (and are discussed throughout this monograph), as they aid the process of comprehension. This chapter would also serve to introduce a discussion on Islamic Project Finance, dealt within the following chapter.

Chapter 3 deals with Islamic Project Finance in practice, focussing on the legal and other economic issues as they relate to Shariah-Related Documentation, Construction and Lease Financing and Islamic Bonds.

Chapter 4 consists of two case-studies, highlighting the Common law developments in Shariah law, as it relates to the Islamic banking industry. Two recent judgments (one from UK and another from Pakistan) are specifically perused, reflecting the stance that the judiciary in the two countries have adopted towards Islamic precepts, its interpretation and application.

Chapter 5 raises issues relating to structuring and offering of Shariah-Compliant investment products. In particular, focussing on the role of financial institutions, fund promoters and Shariah advisors. The chapter concludes by providing a comparative analysis on the legal issues linked to the marketing of Islamic investment products in different jurisdictions.

Chapter 6 provides an insight to the regulatory and supervisory practices of Islamic banking in various countries. Obstacles faced by the Islamic banking industry in their progress as regards their set up in interest-based banking jurisdictions is further addressed, which is supplemented by a case study on the regulatory issues of Islamic banks in India.
Chapter 7 is meant to be general, and briefly discusses the lessons that Conventional and Islamic banks can learn from each other, addressing issues such as the effect of technology transfer and the Bank-Client relationship, which would ultimately lead to the progress of one another.

Chapter 8 concludes this monograph. It ascertains the merits of introducing Islamic banking globally. Reforms and suggestions for the Islamic banks are also appended to this chapter, together with a few conclusive remarks on the subject.

It is aspired that this work will be a positive contribution on the subject of Islamic banking and its practices. Suggestions and criticisms are solely intended to enhance the progress of this relatively nascent banking industry, which has undoubtedly shown major signs of progress.
Glossary of Arabic Terms

This section explains some of the Arabic words and terms, most of them appearing in this study, whereas others might relate to them and would thus be of interest to the reader.

Allah is Arabic for God.

Fatawa (singular. Fatwa) are legal decisions or opinions rendered by a qualified religious leader (mufti).

Fiqh is Islamic Jurisprudence, the science of religious law, which is the interpretation of the sacred Law, Shariah.

Gharar is uncertainty, speculation.

Hadith (plural. ahadith) is the technical term for the source related to the Sunna; the sayings- and doings- of the Prophet Mohammed (pbuh), his traditions.

Halal means permitted according to the Shariah.

Haram means forbidden according to the Shariah.

Jualah is the stipulated price (commission) for performing any service.

Maysir mean gambling, from a pre-Islamic game of hazard.

Muslim is on who professes the faith of Islam or is born to a Muslim family.

Qard Hasan is a benevolent loan (interest-free).

Qiyas means analogical deduction.

Quran is the Holy book, the revealed word of God, followed by all Muslims.

Riba is literally excess or increase, and covers both interest and usury.

Shariah is Islamic religious law derived from the Holy Quran and the Sunna

Shirka (or Sharika) is a society or partnership.

Surah is a chapter of the Holy Quran.

Takaful refers to mutual support, which is the basis of the concept of insurance or solidarity among Muslims.

Umma means the community; the body of Muslims.

Waqf is a trust or pious foundation.

Zakat is a religious levy or almsgiving as required in the Holy Quran and is one of the Islam’s five pillars.

(Courtesy: Lewis & Algaoud, Islamic Banking, Edward Elgar, 2001, Glossary, x, xi.)
Chapter 1

Introduction and the Basis of Islamic Banking

A. Rationale from an Islamic perspective

It is argued by proponents of the Islamic banking that in today’s world, the economic system that is based on interest has resulted in concentrating the wealth in the hands of selected few, creating monopolies and further widening the gap between the affluent and the poor. Islamic finance operates in compliance with the Shariah law. Islam is not anti-commerce (the Prophet Mohammad was himself a merchant). In contrast to the modern Western principles and philosophy, Islam encourages circulation of wealth and considers its role as vital to an economy. As Dr Usmani notes in his book, “just as clotting of blood paralyzes human body, concentration of wealth paralyzes economy.” The fact that, today ten richest men in the world have more wealth than forty-eight poorest countries of the world is relied by the supporters of the Islamic banking as a testament to the fact that the current economical set up is unjust and has failed to distribute the wealth proportionately, thus leading to the downfall of humanity.¹

On considering the injunctions of the Holy Quran, it is apparent that the system of distribution of wealth laid down by Islam envisages three objects, namely:

(a) The establishment of a practicable system of economy.

(b) Enabling every one to obtain, what is rightfully due to them.

(c) Eradicating the concentration of wealth.

The traditional concept of Muslims that Islam is a unique way of life distinct from all other isms and ideologies extends to the economic life of the Muslims (Umma). In the process of reshaping the economy, the areas of money, banking and investment are regarded as extremely vital to the process of Islamisation of the economy. The Islamic emphasis on co-operation as the key concept in economic life has led to reliance on profit-sharing and participation as the alternative bases for banking and investments in the Islamic framework.²

The concept of Islamic banking is regarded as one of the few original and creative Islamic ideas that have been successfully tried in recent times. In the not too distant past, the entire banking system in all Muslim countries was designed on the Western banking model; the latter being inconsistent with Islamic law primarily due to the disapproval of Riba (i.e. interest) in Islam. In other words, the elimination of Riba

from financial transactions is the *raison d’etre* of Islamic Banking. Attempts to avoid dealing in interest led to the introduction of a non-interest based banking system, commonly termed as “Islamic banking”.

*McDowall* notes that Islamic banking not only provides services that are compliant in terms of the Muslim faith, but through the fundamental concept of profit and loss sharing with their customers, deliver a highly ethical proposition to Conventional banking.

As Islamic banking offers services to its customers free from interest, any dealing or transaction that involves interest is seen as erroneous and thus forbidden. Technically, *riba* refers to the addition in the principal amount of a loan, which the lender receives from the borrower. This deliberately simplified picture of the true complex state of affairs is something I shall return to in the following chapter in detail.

**B. History**

The Islamic financial system has a centuries-old history, as noted by *Chapra and Khan* (2000):

> “From the very early stage in Islamic history, Muslims were able to establish a financial system without interest for mobilising resources to finance productive activities and consumer needs. The system worked quite effectively during the heyday of Islamic civilisation and for centuries thereafter.”

However, over the centuries, the centre of economic gravity inclined towards the Western world, and the Western financial institutions (including banks) became dominant and the Islamic tradition remained dormant.

The Muslim society never approbated interest; throughout the thirteen centuries of its history prior to domination by imperialist powers, it managed its economy and carried on domestic and international trade without any involvement of interest. Profit – sharing and different kinds of participation arrangements served as adequate basis for savings and investment and considerable capital was mobilised for mining, ship-building, marine trade, textiles and other industries.

The issue of interest free banking regained the attention of Muslim intellectuals in the 1940’s and 1950’s. By this time, numerous local and national banks were established along the lines of interest-based foreign banks. By this time, the government of Muslim countries, in particular, those who gained political independence, found themselves compelled to engage in international financial transactions using banking systems. The necessity for commercial banking was realised. The challenge was to

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3 *Profit and Loss Sharing, An Islamic Experiment In Finance and Banking* by Shahrukh Rafi Khan, Introduction and Overview, page 1, OUP, 1987.


5 *Islamic Banking and Finance* by Munawar Iqbal and David T. Llewellyn, Introduction, page 1, para 1, 2002.

6 Ibid at 1, page 9, para 2.
avoid the concept of interest within commercial banking. The path to this was the development of the concept of profit and loss sharing (Mudarabah), the key concept from which the structure of most Islamic banking products and services are derived.\footnote{Islamic Banking by Mervin K. Lewis & Latifa M. Algaoud, Chapter 2, Islamic Law, pages 4 & 5, Brief History, 2001.}

C. Current Status

All over the world, Muslim bankers and economists are faced with the question as to how they should eliminate interest and evolve new institutions and practices, which would enable economic activities to flourish without resorting to Riba in any form.\footnote{Banking Without Interest by Muhammad Nejatullah Siddiqi, Foreword, para 1 & 2, 1983.}

In recent years, there has been a revival of interest in formulating a modern version of the historic Islamic financial system, as many Muslims are endeavouring to avoid interest-based practices and transactions. Islamic banking was virtually an unknown concept thirty odd years ago. Now, fifty-five developing and emerging market countries have some nexus with Islamic banking and finance and “Riba free” has become the buzzword for financial institutions that wish to attract the large and attractive customer base in the form of Muslims all over the world who are looking for Shariah-Compliant modes of investments and financings. In addition, there are Islamic financial institutions operating in 13 other locations.\footnote{Australia, Bahamas, Canada, Cayman Islands, Denmark, Guernsey, Jersey, Ireland, Luxembourg, Switzerland, United Kingdom, United States and the Virgin Islands.} In Pakistan, Iran and Sudan, all banks must operate under Islamic financing principles. As noted by Justice Mufti Usmani, there were 200 Islamic banks and financial institutions in forty-three countries of the world, controlling a financial pool of US$ 100 billion,\footnote{New Horizon, No.82, December 1998, p.17. He is the Chairman of Centre for Islamic Economics, Pakistan, and a judge of the Islamic Shariah Court.} increasing at an annual rate of 10-15 percent. The Islamic financial industry is already one of the fastest growing industries and has tremendous potential as observed by academics in general.

The unorthodoxy of Islamic banking model is apparent from the fact that those who argue in favour of Islamic banking are often regarded as ‘utopians’ and ‘romanticists’, but they claim that the best form of realism could be achieved by challenging all those systems that are based on the exploitation of man in one form or the other and in seeking to set up a just socio-economic order. Dr Siddiqi argues that an Islamic economy is capable of freeing modern man from the debt-ridden economy in which he survives, and of guiding him towards a society based on justice and equity, and ultimately leading to the path of growth and stability.\footnote{Ibid at 1, page 7 & 8.}

D. Riba and its Prohibition in Islam

As observed by Lewis, in order to conform to Islamic norms, five religious features are well established in the literature, and must be adhered to in investment behaviour. They are as follows:

8  Banking Without Interest by Muhammad Nejatullah Siddiqi, Foreword, para 1 &2, 1983.  
9  Australia, Bahamas, Canada, Cayman Islands, Denmark, Guernsey, Jersey, Ireland, Luxembourg, Switzerland, United Kingdom, United States and the Virgin Islands.  
10 New Horizon, No.82, December 1998, p.17. He is the Chairman of Centre for Islamic Economics, Pakistan, and a judge of the Islamic Shariah Court.  
11 Ibid at 1, page 7 & 8.
(a) the absence of interest-based \textit{(riba)} financial transactions;

(b) the introduction of a religious levy or almsgiving, \textit{(zakat)};

(c) the prohibition of the production of goods and services that contradict the value pattern of Islam \textit{(haram)};

(d) the avoidance of economic activities involving gambling \textit{(maysir)} and uncertainty \textit{(gharar)};

(e) the provision of Islamic Insurance \textit{(Takaful)}.

These five elements give Islamic banking and finance its distinctive religious identity.\textsuperscript{12}

For the purposes of our present chapter, we need to focus briefly on element (a), i.e. absence of interest-based transactions, which is indeed the central element among the latter. Islamic finance, like Islamic commercial law in general, is dominated by the doctrine of \textit{riba}, and it is imperative that we discuss this in some detail, as to its nature and prohibition.

The literal meaning of the Arabic word \textit{riba} is ‘increase’, ‘excess’, ‘growth’ or ‘additional’. According to \textit{Sahacht (1964)}, \textit{riba} is simply a special case of unjustified enrichment or, in the terms of the Holy Quran, consuming (i.e. appropriating for one’s own use) the property of other for no good reason, which is prohibited.

Prohibition of interest is ordained in Islam in all its forms. The latter prohibition is strict, absolute and certain. The whole concept of interest is fundamentally repugnant to the spirit of Islam, as could be observed from the following verses of the Holy Quran:

“O, believers, fear Allah, and give up what is still due to you from the interest (usury), if you are true believers.” (\textit{Surah 2: Aayat 278})

And:

“If you do not do so, then take notice of war from Allah and His Messenger. But, if you repent, you can have your principal. Neither should you commit injustice nor should you be subjected to it.” (\textit{Surah 2 : Aayat 279})

\textsuperscript{12} Ibid at 7, page 28, para 2, 2001.
Chapter 2

**Islamic Modes of Financing**

**Introduction**

One can vividly perceive the transition in the global banking sector, from core/retail banking, to the complex and detailed role of financing, which clearly depicts sophistication and organisation of international banking community. With the passage of time, the banks have undoubtedly become multifunctional bodies, performing various roles and providing their clients with numerous desired products.

Speaking of the international banking community, Islamic banking is undoubtedly a part of it. To keep up with this modernised community and to compete with their fellow-competitors, Islamic banking has introduced and refined some alternative Islamic financing products, to the ones available in the Conventional markets, in order to cater for the Muslim community around the globe. Having said that, it is open to anyone, whether a Muslim or a non-Muslim, to take advantage of these products, as long as they comply with the requirements and precepts of Islamic Shariah.

At this instance, it helps to add that the prohibition of interest in Islam does not imply that the capital is not to be rewarded, nor that risk is not be priced. The Islamic system has both fixed and variable return modes to price the capital and add ‘risk premia’ in relation to the degree of risk involved. Islamic banks provide financing using two methods. The first is based on profit-sharing and the second one deals with modes, which rely on fixed return (mark up) and often conclude in creating indebtedness of the party seeking finance.

The Islamic modes of finance are unique as the debt related with financing using mark-up modes results from real commodity sale/purchase operations, rather than the exchange of money for interest-bearing debt. Furthermore, unlike the Conventional debt, such debt is not marketable except at its normal value. The whole idea behind the Profit and Loss Sharing (PLS) is seen as an innovation, a modern trend if you like, and it is aspired that it will bring several merits to the industry of investment and finance, thus benefiting the community at large.

It must be borne in mind that the Islamic Shariah does not prohibit Islamic banks from issuing guarantees. However, the question of the legality of the commissions and charges received by banks in issuing the guarantees has been a subject of much debate and discourse. Several banks in the Middle East have sought to tackle the latter issue by agreeing to issue guarantees at no charge, while simultaneously asking for cash collateral of a specific percentage (30 %) of the guaranteed amount, which is then invested by the bank for its own account and benefit for the duration of the guarantee. The Islamic Shariah does not prohibit Islamic banks from issuing guarantees. However, the question of the legality of the commissions and charges received by banks in issuing the guarantees has been a subject of much debate and discourse. Several banks in the Middle East have sought to tackle the latter issue by agreeing to issue guarantees at no charge, while simultaneously asking for cash collateral of a specific percentage (30 %) of the guaranteed amount, which is then invested by the bank for its own account and benefit for the duration of the guarantee.

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13 Progress and Challenges of Islamic Banking by Abbas Mirakhor, Review of Islamic Economics 4 (2) 1997.
In order to circumvent the ambiguities raised, a group of Muslim scholars gave their opinion on the legality of Islamic banking practices as regards guarantees. Their opinion is summarised in two segments and is as follows.

1. The legality of the issuance of a bank guarantee relies on the legality of Shariah principles of the contract in question, in respect of which the guarantee was issued. It is evident that no Islamic bank should issue guarantees in relation to items that are prohibited under the Shariah, including guarantees for the payment of usurious interest, the sale of alcohol, drugs, the construction of gaming places, etc. The latter may seem to be an obstacle towards an entirely independent guarantee, but its scope should not be overstated. As long as the contract in question is considered lawful by the standards of Shariah precepts, a guarantee stipulated to be unconditional and payable on first demand would be deemed valid and in force under Shariah, notwithstanding the performance or termination of the underlying contract.

2. Banks are entitled to receive remuneration for the issue of a guarantee. Having said that, the amount of remuneration, to be in accordance with the Islamic Shariah, ought not be fixed in accordance with the amount of the issued guarantee, but should instead be calculated to provide a reasonable compensation to the issuing bank for the time and effort that the latter spent to issue and manage the guarantee.15

This chapter will focus on the Islamic modes of finance, other than guarantees, namely Musharakah, Mudarabah, Murabaha, Bai’ Muajjal, Ijaraha, Ijaraha Wa Iqtina, Salam, Istisna’ and Istijjar, which are available in the global financial market today, whilst providing a comparison with the Conventional finance products, wherever possible.

A(i). Musharakah

The literal meaning of the Arabic word Musharakah is sharing, or Shirkah, which means being a partner. There are several kinds of partnership, and they all come under the heading of Shirkah. Musharakah is perceived as an ideal alternative for the interest based financing with far reaching effects on both production and distribution.16

The term Musharakah as used in the modern terminology, has been recently introduced by Islamic Scholars writing on the subject and is normally restricted to a particular type of Shirkah, which is Shirkat-ul-Amwal, where two or more persons invest some of their capital in a joint commercial venture. However, at times it could also include Shirkat-al-Aamal, where partnership takes place in the business of services, whereby all the partners jointly undertake to render some services for their customers, and a fee is charged from the latter and is distributed among the partners as per an agreed ratio.17

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17 Ibid at 11, page 90.
Musharakah is a mutual contract between the parties, and thus all the mandatory ingredients of a valid contract must be present. Furthermore, the capital in Musharakah agreement should be quantified, specified, but not necessarily merged or in liquid form. If all the partners agree to work for the joint venture, each one of them shall be treated as the agent of the other, in all matters concerning the business. Any act carried out by a single partner, in the normal course of business, shall be deemed as authorised by all other partners.18

All scholars are unanimous on the principle of loss sharing in Shariah, which is based on the saying of Syedna Ali ibn Talib, which is as follows:

“Loss is distributed exactly according to the ratio of investment and the profit is divided according to the agreement of the partners.”19

Termination of the Musharakah agreement:

Musharakah agreement will be terminated in the following circumstances.

1. If the purpose of forming the ‘Shirkah’ has been achieved.

2. Every partner can exercise his/her right to terminate Musharkah at any time after giving his partner a reasonable notice.

3. In the case of a demise of any one of the partners or any partner becoming insane or incapable of effecting the commercial transaction.

4. In the case of damage to the share capital of one partner before mixing the same in the total investment and before affecting the purchase, the partner will stand terminated and the loss will be borne by that particular partner. However, if the share capital of all the partners has been mixed and could not be identified singly, then the loss will be shared by all and the partnership will not be terminated.20

Termination of Musharakah without the closure of the business:

If one of the partners intends to terminate the Musharakah, in disagreement with the other partners, the latter issue could be resolved by mutual consent. The partners intending to run the business may purchase the share of the partner who wants to terminate his partnership, as the termination of Musharakah with one partner does not affect the Musharakah between the other partners. The latter seems to be a just and a viable approach, especially in the modern situations, where the success of a particular business is conditional upon its continuity, and the liquidation or separation at the instance of a single partner may only cause irreparable damage to the other partners.21

18 Ibid at 11, page 91 & 92.
19 Ibid at 11, page 94 (Rules of Distribution).
20 Ibid at 11, page 95 (Termination of Musharakah).
21 Ibid at 11, page 96.
Security in Musharakah:

As regards a Musharakah agreement between the bank and the client, the bank should in its own right and discretion, obtain adequate security to ensure that the capital invested/financed and the profit that may be earned are safe. As part of the usual practice, the securities obtained by the bank, are kept comprehensively insured at the party’s cost and expenses, till the Islamic mode of insurance (Takaful) becomes operational. It is understood that the purpose of the latter security is a precautionary measure to cover for damage(s) or loss of the principal amount due to the client’s negligence.\(^\text{22}\)

Differences between interest-based financing and Musharakah:

1. As regards interest-based financing, a fixed rate of return on a loan, advanced by the financier is predetermined, irrespective of the profit earned or loss suffered by the debtor.

   Musharakah agreement does not envisage a fixed rate of return, it is in fact based on the actual profit earned by the ‘joint venture’.

2. The financier cannot suffer loss in an interest-based financing.

   The financier under a Musharakah agreement can, possibly suffer a loss, if the joint venture fails.

3. It is argued by Islamic scholars and other academics that the interest-based financing results in injustice, either to the creditor or the debtor. If the debtor suffers a loss, it is unjust on the creditor’s part, to claim a fixed rate of profit. And, if the debtor earns a high rate of profit, it is injustice to the creditor to provide him with only a small proportion of the profit, while the debtor taking the chunk of it.

   As regards a Musharkah agreement, the returns of the creditor are tied up with the actual profits earned through the enterprise, which he/she financed. The greater the profits of the enterprise, the higher the rate of return to the creditor. If the enterprise earns ‘substantial’ profits, the creditor cannot acquire all of it, but has to share it with the common people, e.g. depositors in the bank.\(^\text{23}\)

Tenure of Musharakah:

As regards the determination of the period of the Musharakah agreement, the following conditions operate.

(a) The partnership is fixed for such a duration that at the end of the tenure, no other business can be conducted.

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\(^\text{22}\) Ibid at 11, page 97 (Security in Musharakah).

\(^\text{23}\) Ibid at 11, page 98.
(b) The partnership can be for a very short term, during which neither partner can dissolve the partnership.24

A(ii). Diminishing Musharakah

Another form of Musharakah, which has developed in the recent years, is known as Diminishing Musharakah. It involves the participation of a financier and his client, either in the joint ownership of a property/equipment, or in a joint commercial enterprise. The financier’s share is further divided into several units, and it is intended that the client will purchase the financier’s units of the share, one at a time, periodically, increasing his own share, until all the units of the financier are purchased by him, so as to make him the sole owner of the property or the commercial enterprise, whichever be the case.25

B. Mudarabah

This is also a kind of partnership, whereby one partner provides finance to the other for investing in a commercial enterprise. The investment is provided by the first partner called the ‘Rab-ul-Maal’, while the entire responsibility for the management and work falls upon the other partner, who is called the ‘Mudarib’. The profits generated, are shared in a predetermined ratio.

There are two kinds of Mudarabah - restricted and unrestricted.

Rab-ul-Maal may specify a particular business for the Mudarib, in which case he shall invest the money in that specified business only. This is known as ‘Al-Mudarabah-al-Muqayyadah’ (restricted Mudarabah).

But if he leaves it open for the Mudarib to undertake whatever business he wishes, the Mudarib shall be authorised to invest the money in any business he wishes. This type of Mudarabah is called ‘Al-Mudarabah-al-Mutlaqah’ (unrestricted Mudarabah).

A Mudarib cannot forward the money lent to him, or carry out any activity that is beyond the course of his business, without the Rab-ul-Maal’s express permission or consent. Rab-ul-Maal is entitled to oversee the activities carried out by the Mudarib. The former can also work with the Mudarib, provided the latter gives his consent. A Rab-ul-Maal can contract Mudarabah with more than one person through a single transaction, for instance, he can offer financial assistance to X and Y both so that each of them becomes a Mudarib, and the capital of the Mudarabah transaction shall be utilized by both of them, jointly.26

It is imperative that both the parties should decide in advance, on the proportion of profit that each one of them should receive. However, the parties cannot suggest a lump sum amount of profit, nor can they determine the share of any party ‘at a

24 Ibid at 11, page 102 (Tenure of Musharakah).
25 An Introduction to Islamic Finance by Muhammad Taqi Usmani, Chapter 2, page 82, para 1 (Diminishing Musharakah).
26 Ibid at 11, pages 105-108.
specific rate tied up with the capital’. If the business has suffered loss in a few transactions and made profit in some others, then the profit should be used to offset the loss/losses incurred, and whatever remains, shall be a distributed between the parties according to the agreed ratio.  

Roles of Mudarib:

He is an Ameen (trustee), who is responsible to look after the investment, with an exception of natural calamities.

He is a Wakeel (agent), as he makes the purchases from the funds provided.

He is also a Shareek (partner), thus sharing the profits with Rab-ul-Maal.

He can also possibly be a Zamin (liable), and thus will have to compensate for any loss suffered during the course of Mudarabah, due to any erroneous act on his part.

Termination of Mudarabah:

The Mudarabah will come to an end when the specified period in the contract expires. It can also be terminated by either of the two parties, at any time, by giving notice. Furthermore, in case Rab-ul-Maal has terminated the services of Mudarib, the latter will continue to perform his acts under the contract, until he is informed about the termination.

C. Murabaha

In this particular kind of sale, the seller clearly mentions the cost of the sold commodity, and then sells it to the buyer by keeping a profit margin. Thus, Murabaha should not be seen as a loan given on interest, it is rather a sale of a commodity for cash/deferred price.

As regards Bai Murabaha, the bank purchases a commodity, on a client’s behalf, and then resells it to the latter, on the basis of plus-profit. Under this kind of agreement, the bank discloses its cost and profit margins to the client. Thus, unlike Conventional banks (which advance money to a borrower), the bank will buy the goods from a third party and sell it onwards to a customer for a pre-agreed price, thus abstaining from interest. The growing use and vitality of Murabaha agreement is proven by the fact that in Islamic banks world over, 66% of all investment transactions are through Murabaha.

It is argued by critics of Islamic banking that Murabaha agreements are in reality interest-based contracts, under the garb of a notional sale and buy back transaction, profit being synonymous to interest in this case. Islamic scholars have reverted to this argument by stressing that a ‘true’ Murabaha financing structure is quite different.

27 Ibid at 11, 109-111.
28 Ibid at 11, page 111, para 5.
29 Ibid at 11, page 112, para 2 (Termination of Mudarabah).
30 Ibid at 11, page 125, Chapter 16 (Murabaha).
from an overdraft provided by Conventional banks and the former offers various benefits to the bank and its customers, namely that depositors have a share in the bank’s profits. Furthermore, the basic difference is the *Aqd* (contract), which specifies the Islamic conditions, as against the interest element in Conventional banking transactions.\(^{31}\)

**Basic Rules for a Murabaha transaction:**

1. The subject of sale must be in existence at the time of the sale.
2. The seller must have the ownership of the commodity in question.
3. The subject of sale must be in physical or ‘constructive possession’\(^{32}\) of the seller while he is selling it.
4. The sale must be instant and absolute; no provisions for contingencies should be made part of the contract.
5. The goods/commodity to be sold, must reflect a value and must be specified to the buyer, leaving no room for ambiguities or confusion as between the parties.
6. The sale must be unconditional and the price of the commodity should be certain.\(^{33}\)

If a client defaults on any payment(s) by the due date, the price cannot be changed nor can the penalty fees be charged, as against him. Nevertheless, as regards dishonest clients, who knowingly and deliberately default, they should be made liable to compensate the bank, subject to the following two conditions.

(a) The defaulter must be given a grace period of at least a month.

(b) It must be proved beyond reasonable doubt that the client is a defaulter, and he has no justifications for his latter behaviour.\(^{34}\)

Murabaha can only be used when a commodity is to be purchased by a customer/client. It is highly pertinent to peruse the subject matter of the Murabaha, as the documents must be signed for obtaining funds for a specified purpose only. It needs to be stressed that the Murabaha consists of several different contracts and they all play their part one after another, in respective stages.\(^{35}\)

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\(^{31}\) Ibid at 11, page 126, para 2 (Arguments against Murabaha).

\(^{32}\) It refers to a situation where the possessor has not yet taken the physical delivery of the commodity, yet all rights and liabilities of the commodity are passed on to him including the risk of its destruction.

\(^{33}\) Ibid at 11, page 126-127 (Murabaha Rules).

\(^{34}\) Ibid at 11, page 129, para 1 (Penalty for Default).

\(^{35}\) Ibid at 11, page 130-131 (Basic Mistakes in Murabaha Financing).
D. Bai’ Muajjal

This is basically a sale on deferred payment. The deferred payment becomes a loan, which the buyer pays in a lump sum or instalment (as agreed between the parties). In Bai’ Muajjal all those items/commodities can be sold on a deferred payment, which come under the heading of capital, where quality does not make a difference but the natural or intrinsic value does. The price to be paid must be agreed and fixed at the time of sale. The buyer must be given complete possession of the commodity in question, whilst the seller is free to ask the buyer to provide him with guarantee in the form of a mortgage or any other item.36

E. Ijaraha

In an Islamic leasing (Ijaraha), the owner of the asset, while retaining the corpus of the asset, transfers its usufruct to another person for an agreed period, at an agreed consideration. All the liabilities arising from the ownership must be endured by the lessor. The period of lease must be determined in clear terms and the asset must be clearly identified as between the parties.37

The lessee is liable to compensate the lessor for all the damage(s) caused to the leased asset by any misuse or negligence on his part. The rental should be determined at the time of the contract for the whole duration of the lease. The lessor cannot increase the rental unilaterally, and must consult the lessee in that regard.38

Lease was not originally a mode of financing, however, certain financial institutions have adopted leasing as a mode of finance instead of a long term lending arrangement, which is based on interest. The transaction of ‘financial lease’ may be used for Islamic financing, subject to certain conditions. It does not suffice for the latter purpose to interchange the term ‘interest’ by ‘rent’ and ‘mortgage’ by ‘leased asset’. It must be emphasised that there is a difference between leasing and an interest-bearing loan, as regards Islamic Shariah.39

Unlike the contract of sale, an Ijaraha agreement can be based on a future date, thus it is different from a Murabaha agreement in that respect. In majority of the cases concerning ‘financial lease’, the lessor (financial institution) will purchase the asset through the lessee himself. The lessee makes the purchase on behalf of the lessor who then pays the price to the supplier, either directly or through the lessee.40

The lessor, being the owner of the asset, and having purchased it through his agent (lessee), is liable to bear all the expenses incurred in the process of its purchase and its import to the country of the lessor (if that is the circumstance), e.g. expenses of freight and customs duty etc.41

36 Ibid at 21, pages 102-103 (Bai’ Muajjal).
37 Ibid at 21, pages 158-160.
38 Ibid at 11, pages 148-149.
39 Ibid at 11, page 149 (Lease as a Mode of Finance).
40 Ibid at 11, page 150 (The Commencement of Lease).
41 Ibid at 11, page 152, para 3 (Expenses Consequent to Ownership).
**Variable Rentals in Long Term Leases:**

Several Islamic banks use the rate of interest as a benchmark to calculate the rental amounts, e.g. London Interbank Offered Rates (LIBOR), which is the rate of interest at which Conventional banks borrow funds from other banks, in marketable size, in the London interbank market. The idea is to earn the same amount of profit through the mode of leasing, as earned by the Conventional banks by advancing loans on interest.

Instead of fixing a definite amount of rental, the Islamic banks calculate the cost of purchasing the asset that is to be leased and intend to earn an amount equal to the rate of interest. Thus, the agreement between the parties provides that the rental will be equal to the rate of interest or to the rate of interest in addition to something. Since the rate of interest is variable, it cannot be set for the whole duration of the lease. The latter arrangement has been objected to on the following two grounds:42

(a) By subjecting the rental payments to the rate of interest, the transaction is made to resemble an interest-based financing. The modern Islamic scholars have denied that argument and have stressed that the rate of interest is only used as a benchmark. As far as the requirements of Shariah are concerned, they must be fulfilled for a valid lease to be executed, and it is the latter that counts, as regards the legality of the Islamic financial lease. The vital difference between an interest-based financing and a valid Islamic lease does not lie in the amount that has to be paid to the financier or the lessor. However, it is recommended that the use of rate of interest as a benchmark must be avoided at times, where possible, so as to distinguish it with the non-Islamic transaction.43

(b) The second criticism relates to the situation that the variations of the rate of interest are not determined and the tying up of rental with that rate of interest implies *Jahalah* and *Gharar* (uncertainty, especially in a contract that may lead to disputes later on), which are not permissible by Shariah precepts. It is one of the basic tenets of Islamic Shariah that the parties must be well aware of the consideration in every transaction they enter into. This objection has been responded by looking at the reasons of prohibition for *Jahalah*, namely that *Jahalah* may lead to disputes between the parties and it might render the parties susceptible to an unforeseen loss. As regards the first objection, both parties make their decisions with mutual consent upon a well-defined benchmark serving as a criterion for determining rent, thus no question of dispute arises. Relating to the second objection, several contemporary scholars suggest that the relation between rent and the rate of interest is subjected to a limit. E.g. the base contract may provide that the rental amount given after a specified period will be altered according to the change in the rate of interest, but in no instance, it will be higher than 15% or lower than 5% of the previous monthly rent. The latter implies that if the increase in the rate of interest is more than 15%, the rent will be increased only up to 15%, and if it decreases by more than 5%, the rent shall not be decreased to more than 5%.44

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42 Ibid at 11, page 154 para 1.
43 Ibid at 11, page 155.
44 Ibid at 11, pages 155 & 156.
F. Ijaraha Wa Iqtina

It is permissible in Islamic Shariah that instead of there being a sale, that the lessor signs a separate agreement, making a promise to gift the leased asset to the lessee at the end of the lease period, on condition that the lessee makes all the payments due for his/her rent. The latter arrangement is known as Ijaraha Wa Iqtina. It has been affirmed by a large number of contemporary Islamic scholars and is widely practised by the Islamic banks and financial institutions. Although, the validity of this arrangement is subject to two conditions. They are:

(a) The agreement of Ijaraha itself should not be subjected to signing of sale or gift. The promise should be made in a separate document.

(b) The promise must be unilateral and binding on the promisor only.

If the leased asset is used by numerous users, the lessee cannot sub-let the asset, except with the express permission of the lessor. The lessor can sell the leased property to a third party, whereby the lessor is replaced by the new owner, and the lease agreement would then be between the new owner and the lessee.45

This form of financial leasing has been subjected to criticism as it is not compatible with the modern financing agreements, as a non-binding promise cannot be enforced before courts and is thus not a legally satisfactory solution.

In an attempt to reconcile Ijaraha Wa Iqtina with the modern financial structure, it is suggested that the lessor’s failure to honour his non-binding promise should be subjected to a pre-contractual liability, or *culpa in contrahendo*. In civil law jurisdictions, this concept of pre-contractual liability contemplates that the contracting parties will conduct their pre-contractual dealings in good faith and also points to any relevant facts, which are within the commercially usual limits, to the other party. If a party is unsuccessful in carrying out its duties, and thus in breach of contract, then it will have to pay the damages to the other party for not fulfilling the agreement. By adopting this suggestion, the promisor in breach, is made liable for the promisee’s costs, in finding another similar object to purchase.46

G. Salam

This mode of financing can be used by modern banks and financial institutions, especially in order to finance the agricultural sector. In Salam, the seller undertakes to supply specific goods to the buyer at a future date, in exchange of an advanced price fully paid at the spot. The payment is made in cash, and the supply of purchased goods is deferred.

Purpose of Salam Contracts:

The purpose is to meet the need of farmers, who operate on a small scale, and thus need the finance for farming purposes, so that they can carry out their day-to-day activities. Moreover, it is designed to assist the traders, in their export/import transactions. Salam proves beneficial to the seller, as he receives the price in advance, and at the same time, advantageous to the buyer, as the price under the Salam arrangement is normally lower than the price in spot sales.47

The permissibility of Salam is seen as an exception to the general rule that prohibits forward sale and thus it is subject to certain stringent conditions, which are as follows:

Conditions of Salam:

1. The buyer must pay the full price to the seller at the time of effecting the sale. The basic idea behind the Salam agreement, is to satisfy the ‘instant need’ of the seller. If it is not paid in full, the latter purpose is not achieved.

2. The quantity and the quality of the goods must be specified.

3. Salam cannot be effected on a particular commodity or on a product of a particular field or farm.

4. The contract must expressly state the quality of goods, thus leaving no room for ambiguities, which might lead to disputes later on. Same is the case as regards the quantity; it must be agreed upon in absolute terms.

5. The exact date and place of the delivery must be specified.

6. Salam cannot be effected in respect of things, which require them to be delivered at the spot.

7. Since the price in Salam agreements is generally lower than the price in spot sales, the difference between the two prices may be a valid profit for the bank.

8. A security in the form of a guarantee, mortgage or hypothecation may be required in order to ensure the delivery from the seller.

9. The seller must deliver to the buyer, the commodity, and not the money at the time of the delivery.48

H. Istisna’

Istisna’ is a sale transaction whereby a commodity is transacted before it comes into existence. It is an order for a manufacturer to manufacture a certain kind of commodity, to be used by the purchaser. The manufacturer uses his own material to

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47 Ibid at 11, page 133 (Purpose of Use).
48 Ibid at 11, pages 134-135 (Conditions of Salam).
manufacture the required goods. The price must be fixed with consent of all the parties involved. All other vital specifications of the commodity must also be fully settled. Subject to the acknowledgment or receipt of prior notice, either party can cancel the contract before the manufacturing party has begun the work. The time of delivery need not be fixed, however a time limit may be imposed as between the parties.49

I. Istijrar

Istijrar means purchasing the goods from time to time, in different quantities. It is an agreement, whereby the purchaser buys something at regular intervals, without any formal offer or acceptance mode or bargaining. There exists one master agreement, which contains all the terms and conditions of the purchases in a finalised form. There are two kinds of Istijrar:

(a) where the price is determined after all the transactions/purchases are completed;

(b) where the price is determined in advance, but the purchase payment is made from time to time.

As regards the Islamic mode of financing, only (a) is relevant.

Istijrar can be adopted as a viable mechanism, in the case of suppliers of the borrower. In the latter case, the bank enters into a Murabaha agreement (Agreement to Purchase) with the suppliers (mainly trading companies), that it will purchase the assets from them at a market price or at a pre-determined discount from the market price. Whenever the customers demand, the bank can purchase that particular asset from the suppliers on the basis of Istijrar, and sell it onwards to the customer, on the basis of Murabaha.50

49 Ibid at 11, pages 139-142.
50 Ibid at 11, page 143-145 (Istijrar).
Chapter 3

Application of the Islamic Modes of Finance: A Research on Islamic Project Finance

A. Shariah-Related Documentary and Other Issues

In recent years, Islamic financial institutions have actively started to structure and participate in transactions, which are associated with long-term trade, as opposed to the short term trade related transactions (e.g. Murabaha). This transition has given rise to a number of important Shariah and documentary issues. The prevalent backdrop is that the Islamic bankers and their advisers now face even more stringency, regarding the setting up of Shariah-compliant structures that are accepted commercially and are also in conformity with the existing governing law of that particular jurisdiction where they operate.51

As noted earlier, one of the basic principles of Islamic finance is that at a particular stage in the transaction, the financial institution will be the owner of all or part of the asset that is being financed, and under Shariah precepts, several forms of risk related with being an owner cannot possibly be passed on to the customer or a third party. The latter is the most defining difference between an Islamic financial system and a Conventional one. These additional ownership risks become more serious when the transaction involves complex capital assets, e.g. a power plant or an aircraft, as the potential exposure faced by the Islamic financier as an owner can be very critical and significant. It is expected that since the Islamic financial institutions are willing to take greater risks as compared to their Conventional counterparts, this should result in greater rewards for the former. It is submitted by the academics that this is not necessarily the case.52

In several countries, e.g. the idea of interest is sanctioned by an Act of Parliament, and the latter being affirmed by the courts. Having said that, it is imperative to notice that laws of several states are embedded in Shariah law and concepts, if not in whole then in part. It is observed that a proposed Islamic structure that has the approval of a Shariah board must be examined against the local statutes of that particular state to check whether the structure raises any adverse issues under those laws, and if so, then the proposed structure will surely need amendment and another approval from the Shariah Board. For example, under the Shariah precepts, a transfer of an interest in real estate is effective upon an agreement, signed between the buyer and seller. However, such an agreement may not be recognised by the local laws (at least as regards the bona fide third parties) until and unless the transfer is recorded in the concerned land registry. Sometimes, the problem might be such that a person to whom a real estate interest has been validly transferred under Shariah principles, would not necessarily be recognised as the legal owner under the local municipal

51 Ibid at 14, page 317.
52 Ibid at 39, page 317 (Risk Reward Issues).
laws. In such situations, the legal and financial consultants, giving their expert advice on such structures, are required to strike a balance, so that the Shariah conditions and requirements are satisfied and are also accepted and applicable under the governing law.53

There are certain issues relating to the nature of Islamic financing that come up too often and thus need to be discussed. Some of these are discussed below but the list is not intended to be exhaustive.

**Indemnities:**

The Shariah principle governing the operation and conditions of Islamic financing expressly prohibits indemnity for a loss or damage that is not caused by the customer’s default. Shariah sees the whole idea of seeking indemnity from the customer as unfair, notwithstanding the fact that the particular asset may have been chosen by the customer. Matters relating to the title to the asset, its fitness for its intended purpose and taxes that are imposed on ownership raise some serious and significant credit issues when one is dealing with a major capital asset, e.g. aircraft or a vessel. Having said that, there must be some alternate basis for an Islamic financier to claim indemnity. Suggestions have been forthcoming in the form of seeking indemnities based on the concept of public need or necessity or by other methods, to cover the risks. E.g. such methods could include obtaining the benefit of warranties from the supplier or the manufacturer of the asset and assurances that the asset(s) are in perfect condition and have been validly perfected for the intended use. The financial position of the assignor (and any available insurance protection relating to the assignor) would also have to be assessed.54

In contrast, in the case of Conventional financing, the customer often provides wide-ranging indemnities in order to protect the bank from any risks related with the ownership or use of the asset. The banks are not concerned with the issue of fault and are more keen to ensure that they are insulated from credit risks, arising from the ownership, use or operation of the asset.55

**Warranties:**

As the owner of the asset, the Islamic financier may not be able to exclude the benefit of some warranties to its customer under the Shariah principles. In few instances, the Islamic financier has the benefit of the warranty from a third party that can be assigned to the customer (i.e. from a manufacturer). It has been permitted that the Islamic financier could expressly exclude any warranty from the Islamic financial institution in the customer’s favour to the extent that it is covered by the assigned warranty. This does not seem to be an adequate solution in that it is often impossible to describe with accuracy the extent of the warranty being assigned. Inevitably, some of the warranties may not be covered by a third party assignment and thus the Islamic financier will still be providing the benefit of some warranties to the customer. In a *Ijaraha* (leasing) transaction the balance of such warranties, which cannot be excluded under Islamic principles may possibly be covered by insurance.

53 Ibid at 39, page 318, para 2 & 3.
54 Ibid at 39, page 319 (Indemnities).
55 Ibid at 39, page 319.
Thus, if warranties will raise Shariah related issues, the Islamic financier must immediately try to identify those residuary warranties that cannot be covered to decide whether or not this renders the transaction commercially unacceptable, particularly, if its financial return will not reflect these additional risks.\footnote{\textit{Ibid} at 39, page 320, para(s) 2 & 3.}

\textit{Compensation and Liquidated damages:}

In Conventional financing, if the borrower defaults on any payment due on him, default interest is charged as against him, thus compensating the banks. This approach is unacceptable as regards Islamic financing, due to the obvious reason of any such compensation/liquidated damages tantamount to charging interest.

Unfortunately, the experience of Islamic financiers in trusting their customers, that they would pay on time, has not really been successful, and there is a general agreement that there must be some form of penalty if a customer does not pay on time. The Islamic financier can only claim compensation if it suffers loss or damage due to the true fault of the customer. The compensation must reflect the actual loss of the financier. Most Islamic financings have a compensation provision dealing with failure to pay on a due date and which uses a benchmark linked to LIBOR, as discussed above. The entire purpose of such provisions is not to compensate the financier, but to treat it as an incentive to the customer to make payments by the due date.\footnote{\textit{Ibid} at 39, page 321, para 1.}

\textit{Events of default:}

In a Conventional financing, there will be a progression of events of default, which will give rise to rights in the favour of the banks, and in particular, the right to demand the repayment of outstanding debts. As a general principle, the latter view is accepted by the Shariah law, as long as the customer is at fault. In a Conventional financing, there will be events of default that are not within the customer’s control. It is considered as unviable to include such events of default in an Islamic financing, and each event must be diligently drafted to take account of the latter.\footnote{\textit{Ibid} at 39, page 321, (Events of Default) para 1.}

This, however, raises credit risks, which if not compensated for by the customer in the form of an increased return to the Islamic financier, may force the latter to take on extra risk, which will be without any reward. This issue becomes even more vital in the case of a co-financing that involves both Islamic and Conventional financing. The Conventional banks will surely not like the idea of Islamic facility not going into default at the same time as them, and this could possibly have adverse effects on the security sharing under inter-creditor arrangements. It has been argued that in these circumstances the Conventional banks should accept the position of Islamic financiers, however, the prevailing position is that the Conventional financing is the controlling financial force in the world and thus it is often arduous for Islamic financial institutions to have their views stand in a co-financing. Examples of events of default that can potentially cause dispute between Conventional and Islamic financiers would be nationalisation, requisition, loss of air traffic rights and \textit{force majeure}. If there is disagreement as regards any of the above mentioned events of

\footnote{\textit{Ibid} at 39, page 320, para(s) 2 & 3.}
\footnote{\textit{Ibid} at 39, page 321, para 1.}
\footnote{\textit{Ibid} at 39, page 321, (Events of Default) para 1.}
default, then it is advised that they must be put into a separate category of events called by some other name, such as events of 'mandatory prepayment'.

If there is an event of default the customer may be obliged to purchase the asset, at a predetermined price. That obligation must not be listed in the same document (i.e. the lease) to avoid concerns regarding conditionality but should be contained in a separate document, e.g. an option or a deed of covenant. If the event of mandatory prepayment arises, the customer will not be in default but the happening of such an event will enable the financier to exercise a right or option granted to it by the customer in a separate document requiring the customer to purchase the asset. The conclusion to this whole procedure being that, on the face of the document, the events of default will be Shariah-compliant and for events of mandatory prepayment, there will be a Shariah-compliant system that results in the asset being purchased, thus clearing the amount that the customer owed the Islamic financier.

Set-off:

It has often been disputed that the grant of set-off rights that are solely in favour of the Islamic financier, is against the Shariah precepts, which require an Islamic finance transaction to be fair and reasonable when taken in the context of the customer.

The aforementioned issue has been resolved in various transactions by providing that there are statutory set-off rights that cannot be waived and which keep an acceptable balance as regards favouring the financier and the customer.

B. Construction and Lease Financing

Specific Issues in Relation to Ijaraha (Leasing) Transactions

Insurance and Maintenance Obligations:

As per the Shariah principles, the lessor must remain liable for several insurance and major maintenance obligations. Obligation and the financial consequences cannot be transferred on to the lessee, pursuant to the terms of the lease. The insurance obligations relate to the structural or property insurance. However, the lessee can be held responsible and liable for the cost of operational insurance, such as the business interruption insurance and third party insurance (to the extent that it relates to operational risks). The latter mentioned principles can possibly have serious implications for an Islamic financier. The direct costs involved in, e.g. maintaining an aircraft and the indirect costs and liability resulting from the failure to perform such maintenance can prove to be very significant.

There must be some mechanism to transfer some risk on to the lessee, or sharing of risk if you like, which, on the face of the document is Shariah-compliant.

60 Ibid at 39, page 321, para(s) 4 & 5.
61 Ibid at 39, page 321, (Set-off), para 1.
The most obvious approach is to appoint the lessee as the ‘service agent’ of the lessor (Islamic financier) in order to perform these activities, which would include paying the insurance premiums and the maintenance costs. The service agency agreement must specify that the service agent will indemnify the lessor for any default on his part, in the performance of these obligations. However, on the basis of general precepts, an agent must be compensated for any costs properly incurred on behalf of its principal. Usually, a nominal fee is paid to the service agent for his share of work. The idea is to add to the amount, which is to be paid to the customer (as service agent) under the service agency agreement by the Islamic financier with additional rent to be paid by the customer (as lessee) to the Islamic financier (as the lessor) under the lease agreement. The documentation will expressly mention that such payments will be made on the same date and will be netted-off. Through the ‘netting-off’ mechanism neither the lessor nor the lessee makes any payment. This has earned the recognition of Shariah and is thus seen as Shariah-compliant in various transactions. Through the netting-off mechanism, the financial risk is transferred away from the Islamic financier in a way that, on the face of the documentation, it does not violate the Islamic precepts. However, it should be borne in mind that the drafting of these provisions can be quite complex and there are special areas, such as ‘clawback’ of expenses relating to the first and the last individual lease periods, which should be dealt with care and diligently.63

An Asset That Has Already Been Leased:

The Islamic financier should hand over the leased asset in a state that allows the lessee to use it. If an asset has already been leased, then early consultation will be required with the concerned Islamic financier’s Shariah Board to ascertain its views. The reason being that, it is argued by several academics and scholars that the right that is being leased by the Islamic financier is the right to receive debts (e.g. the rent payable by the tenants). The transaction will therefore be viewed as the sale of a debt, which is riba and as repeatedly stated, prohibited. The issue must be addressed at the first possible instance, to see whether relying on the applicable law, it is possible to come up with a way that satisfies the Islamic Shariah.64

Total Loss:

If a total loss of the underlying asset occurs, the lease must be terminated immediately. Total loss, in relation to Shariah precepts means an event that results in the customer (lessee) no longer being able to use the asset for its required purpose. The rental cannot be claimed once a total loss has occurred, even if the loss is caused due to the fault of the lessee, however he may be asked to compensate the lessor.65

Taxes:

An Islamic financier, as the owner of the financed asset must also bear the tax obligations, which can be quite significant. An Islamic financier may not be willing to accept the liability for the latter, if he is not earning any extra reward for it. In such a situation, it might be suggested that the service agent should be obliged to make such

63 Ibid at 39, page 323.
64 Ibid at 39, page 323 (An asset that has been already leased).
65 Ibid at 39, page 324 (Total Loss).
payments on the lessor’s behalf. However, an amount equal to taxes paid by the service agent will be taken as additional rent. Any monies owed by the Islamic financier to the service agent, as regards the taxes, will be netted-off against the amount of additional rent in the same way as the costs of certain insurances and major maintenance, as discussed above.66

Illegality:

When an Islamic institution’s participation in financing becomes illegal according to Shariah precepts, a particular concern arises. With regard to Conventional loan, the borrower would be obliged to prepay the affected bank’s share and the loan would continue at a reduced amount. The problem with an Islamic leasing facility is that an asset has been purchased for a specified amount and has been given on a lease for certain duration. The Islamic financier’s investment in the asset is recognised through the fixed rental payments. The main problem is how can part of the asset be disposed of, when the whole asset is subject to the lease?67

There is no ready-made answer to the problem above. One solution is that the lessee could be asked to purchase the investment interest of the existing bank and the amount of fixed rental to be reduced on a pro-rata basis, with a provision that the lessee is not entitled to any share in the reduced rental proceeds. This does not seem to be an absolute viable solution, and in certain kinds of transactions, may cause problems linked with insurance and also on the exercise of rights vested in the Islamic financiers to dispose of the leased asset, if there should be an event of default.

Another possible approach, although onerous and troublesome, is for the lessee to buy the leased asset, thus bringing the leasing to an end. The proceeds could be forwarded to pay the exiting bank. The continuing syndicate members would then buy another asset from the customer with a lower capital value, taking into account the amount paid to the exiting bank. The new asset would then be leased to the lessee for a term that equals the un-expired period of the original lease. This methodology is reliant and premised on the fact that the customer will have other available assets of the required value, and may possibly lead to problems if there are pari passu prepayment obligations in an inter-creditor or common term agreement.68

Increased Costs:

As regards a Conventional facility there is usually a provision that relates to a change, interpretation, application or introduction of any law or regulation that may cause an adverse effect on a participating bank. In such cases, the affected bank can ask the borrower to pay an additional compensatory amount to it. Several Islamic institutions are unsatisfied with such a provision, due to the fact that they are based on the conception that it is wrong to penalise the customer for matters outside his/her control. It is further submitted that the increased financial exposure resulting from such events is not really applicable, since the leased asset will have been purchased,

66 Ibid at 39, page 324, para 4 (Taxes).
67 Ibid at 39, page 325.
68 Ibid at 39, page 326, para 1.
and from then onwards, any subsequent change in the circumstances covered by such a provision is not really relevant to an Islamic lease.69

A Variant to the Ijaraha Lease Scheme:

The Shariah Committee in the UK has lately approved a variant to the Ijaraha lease scheme, which they believe will assist the banks in overcoming the major obstacles by being the owner. Instead, Special Purpose Vehicle (SPV), located in any tax-efficient jurisdiction, is formed, which will be the owner and will thus acquire the property. It then enters into the following documents in order to provide the financing structure:

(a) the Ijaraha lease;

(b) managing contractor agreement;

(c) put and call options;

(c) tax matters agreement.

The bank will take security by obtaining a fixed first charge by way of legal mortgage on the property. The owner also receives a debenture from the (SPV) project company or managing contractor. Moreover, the bank will obtain a debenture from the owner to charge the Ijaraha lease, the put and call options and the debenture in favour of the owner. As a result, should the owner be in default, the bank will be able to enforce its charge over the property and thus will be able to enforce the owner’s security over the project company, the latter being vested with the beneficial interest of both the property and the shares of the owner.70

The banks should be able to obtain adequate rental in order to service the loan, ensuring the property is properly insured and to cancel the arrangements if the owner/project company is in default. The default provisions in the Ijaraha lease should contain all the default provisions that would otherwise appear in a loan agreement. The whole point of bank’s exercising its right on default is to enable the Ijaraha lease arrangements to collapse, thus providing the banks with a typical structure for the purpose of enforcement.71

The use of Istisna is quite evident in a number of Islamic project finance structures, e.g. ranging from house financing, installations at residences and work places, to construction of bridges/highways etc. It is often combined with other modes of Islamic finance, such as ‘bai salam’ (forward sale), Ijaraha, Musharakah, Mudaraba, Murabaha.

Istisna’ in Construction Contracts - Use of Parallel Istisna’:

As a matter of practice, the contractors rarely deal directly with the producers of capital goods without the particular bank’s involvement. It is for this reason that the

69 Ibid at 39, page 326, para 2 (Increased Costs).
70 The Lowdown on Islamic Mortgages by Malcolm Ring, The Banker, Retail Banking, page 142, October 2003.
71 Ibid at 66, page 142, (A variant on the theme & Key Elements).
financial institutions are usually included in back to back Istisna’ structures, commonly known as “parallel Istisna”. A parallel Istisna’ is a transaction through which a financial institution purchases items based on clear specifications by the final purchaser, paying the manufacturer in cash at the end of contract. At the same time, the financial institution, as a manufacturer, enters into another agreement with the final purchaser for the sale of the items, normally on a deferred sale basis. As regards the latter transaction, the financial institution must assume liability for the risks and costs of ownership, maintenance and insurance of the item, till the date when it is delivered to the purchaser, (SPV). These risks cannot be contractually transferred to the SPV.72

As per Shariah precepts it is forbidden to link the obligations of two separate contracts (Bay’atan fi Bay’a), so the first contract of Istisna’ with the manufacturer cannot be linked to the second contract with the SPV. The financial institution, therefore, bears the risk for being liable for damages towards the SPV, if the manufacturer fails to deliver. One can overcome this problem by introducing a provision in to the first contract, between the financial institution and the manufacturer, expressly stating the manufacturer’s obligations under the second contract, between the financial institution and the SPV, and clarifying that if the manufacturer fails to deliver he shall pay liquidated damages.73

Istisna’ in Power Purchase Agreements (PPA):

Istisna’ is also a feasible option as regards the financing of the initial stage of a project by purchasing a determined quantity of the project’s future output. It works on the basis that the output of the completed project facility, e.g. a dam, orders a certain amount of electricity from the facility under a PPA agreement, which is of great significance in project finance, as the income generated from the project facility is used to pay the project’s creditors and investors. In this form of Istisna’ agreement, the purchaser takes up the role of the principal and the SPV (the dam) that of the manufacturer of electricity. The prime contents and the prices (which are likely to be paid on a monthly basis), are extensively defined in the PPA.74

C. Islamic Bonds

Shariah-Compliant Debt Instruments:

Islamic bonds, commonly termed as Sukuk bonds, have become extremely popular in the past few years. The Bahrain Monetary Agency has issued Sukuk bonds on a regular basis for a total value of almost US$1 billion. Individual bond issues ranged from amounts of US$50 million to US$250 million each.75

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73 Ibid at 42, page 64, para 8.
74 Ibid at 42, page 64, para 9, (Istisna’ in off-take contracts).
75 Ibid at 42, page 66, (Shariah Compliant Debt Instruments).
Muqarada (revenue) bonds:

Muqarada or qirad bonds are issued by a company to investors in order to finance a specific project or function distinct from the company’s general activities. Muqarada bonds are often used to securitise the revenue flow in Ijaraha Wa Iqtina structures. These are commonly known as Sukuk-al-Ijaraha. The holders of Muqarada bonds receive a share in the profit of the project, which resembles the amount of their investment. The bondholders have no voting rights.

The prime interest in these bonds as they relate to project finance is clearly their function as revenue bonds, i.e. bonds that are backed by the revenues of a particular project, e.g. tolls from the operation of a bridge or tunnel, or the produce of a power station. A predetermined section of the latter income is then paid to the investors, which depicts a classical profit and loss sharing system. Moreover, these Muqarada bonds are freely tradable, since they represent a majority of the material assets.

Sukuk-al-Salam:

The Muqarada bonds normally cater for medium to long-term securities, Sukuk-al-Salam reverts to the need for short-term debt securities. They are securities that entitle their holders to receive a commodity (should be a fungible good), of a specified quantity and quality at a specified moment in time. In a project finance structure, the project company would issue Sukuk-al Salam bonds for the sale of its output at a specified period, before the production commences. The funds collected through the sale of the bonds may then be used to complete the project. On maturity, the project company is bound to deliver the commodity specified in the bonds to their holders. The vital interest of potential buyers of Sukuk-al-Salam will be the anticipation of a rise in the price of the sold commodity.

Islamic construction and lease financing in infrastructure projects have massive potential. Improved and sound Islamic finance standards are said to provide additional certainty as regards the legality of Islamic contractual structures. Having said that, Islamic finance cannot, at all times, substitute certain Conventional forms of finance. Islamic participation in project finance has thus remained limited to the financing of specific areas of projects. Islamic debt securities have made it possible for projects to obtain liquidity and to allow Conventional financial institutions to be involved in Islamic finance, although it has been a gradual process. This should eventually lead to the growth of the Islamic finance industry.

76 Mervyn K. Lewis and Latifa M. Algaoud, Islamic Banking (Cheltenham and Northampton, 2001), pages 59-60.
77 Resolution of the Islamic Fiqh Academy No. 61/12/6 of March 1990, pages 119-120.
78 Ibid at 73, page 60.
80 Ibid at 42, page 67, para 1.
81 Ibid at 42, page 67, para 2 & 3 (Sukuk-al-Salam).
82 Ibid at 42, page 67, para 4, (Conclusion).
Chapter 4

Common Law Developments: Impact of the Shariah law on Judicial Decisions and Contrariwise

Case Study 1:

A Case Study: Supreme Court of Pakistan’s Judgment as to the Legality of Riba in Pakistan

In 1991, a full bench of the Federal Shariah Court (FSC) heard various petitions regarding several statutory provisions relating to ‘interest’ as being against the Injunctions of Islam. In its judgment of the case (Dr. Mahmud ur Rehman Faisal and others v Secretary Ministry of Law Justice & Parliamentary Affairs Government of Pakistan and others)83, (which triggered the whole issue of Islamisation of the economy of Pakistan), the FSC unanimously held that provisions relating to interest contained in twenty two legal enactments were repugnant to the Injunctions of Islam as laid down in the Holy Quran and Sunnah, and are thus void. The FSC84 had asked the Government to bring the conflicting provisions in line with the Injunctions of Islam by a deadline. The Government lodged an appeal with the Supreme Court (SC) of Pakistan. The Shariah Appellate Bench of the SC heard this appeal in 1999. The decision was unanimous but three judgments were delivered. The Court concluded85:

1. All prevailing forms of interest, either in banking transactions or in private transactions fall under the definition of riba.

2. Any interest stipulated in government borrowings acquired from domestic or foreign sources is riba and certainly prohibited by the Holy Quran.

3. The present financial system, based on interest, is against the Injunctions of Islam as laid down in the Holy Quran and Sunnah, and in order to bring it in conformity with Shariah it must go through radical changes.

4. Provisions for payment of interest in eight specific laws were held to be repugnant to the Injunctions of Islam and should cease to have effect from March 31, 2000.86

84 The FSC decisions are binding on the Government of Pakistan, but not inter-party and merely recommendatory as regards the Supreme Court.
86 These are Interest Act 1839, Money Lenders Acts, Banking Companies Ordinance (1962, s9).
5. All other laws, or provisions thereof, considered in the judgment and held to be contrary to the Injunctions of Islam should cease to have effect from June 30, 2001.

The Court expressly mentioned the measures that needed to be taken and the infrastructure and legal framework to be provided in order to have an economy consistent with the Injunctions of Islam. They were as follows:

a. strict austerity measures should be adopted to drastically reduce Government expenditures and deficit financing (particularly foreign currency obligations);

b. laws to be introduced, which would regulate Government borrowing powers, their purpose and scope of borrowing and its utilisation, regulation and monitoring thereof.

c. laws should be introduced to ensure transparency and freedom of information;

d. establishment of a Serious Frauds Office to control economic crimes;

e. establishment of credit rating agencies in the public sector;

f. establishment of an evaluator for scrutiny of feasibility reports;

g. establishment of special departments within the State Bank of Pakistan and in particular a Shariah Board should undertake scrutiny and evaluation of the above guidelines, for successfully managing Islamic economics.87

The Constitution of Pakistan 1973 was amended in 1983, and an Objectives Resolution was added as an Annex to the Constitution. The latter amendment led to the enactment of Shariah Act 1991, which declared that Shariah, i.e. the Injunctions of Islam as laid down in the Holy Quran and Sunnah, shall be the supreme law of Pakistan and that all laws shall be interpreted with Shariah in mind. The Government was required to take steps to ensure that the economic system of Pakistan is formed on the basis of Islamic economic objectives, principles and priorities. However, it was expressly provided that international financial obligations incurred and covenants/contracts with a foreign agency (e.g. Government body) will be protected and considered as binding and operative in effect, until an alternative economic system is introduced.88

Until the recommendations of the Commission are affirmed and accepted by the Government and the required legislation enacted, all existing banking laws will continue to be effective as before. The word ‘interest’ had already been previously eliminated from banking transactions and replaced with the word ‘profit’. Consequential changes were also made in financial instruments so that there should be no guarantee of a fixed return. The Supreme Court held the latter changes as

87 Memorandum: Status of Riba in Pakistan in light of the decision of the Supreme Court of Pakistan on 24.6.02, Oordignam & Co, Karachi, Pakistan, pages 1-5.
inadequate and has called for a radical transformation of all financial instruments and transactions.  

The current position as it stands is that the entire matter has been reverted back to the FSC by the Shariah Appellate Bench of the Supreme Court (SAB) of Pakistan in order to review the earlier judgments and issues therein, whilst also stressing the need of an elaborate and a comparative study of the financial systems of other contemporary Muslim countries, world over.

In the words of the (SAB):

“ A case for review of the impugned judgment is made out as there are errors floating on the surface of record...we are of the considered view that the issues involved in these cases require to be re-determined after thorough and elaborate research and comparative study of the financial systems which are prevalent in the contemporary Muslim countries of the world. Since the Federal Shariat Court did not give a definite finding on all the issues involved the determination whereof was essential to a resolution of the controversy involved in these cases, it would be in the fitness of things if the matter is remanded to the Federal Shariat Court which under the Constitution is enjoined upon to give a definite finding on all the issues falling within.”

In an interview to a journal called the ‘The Banker’, Mr Hussain stressed:

‘We have embarked on a process of Islamisation by allowing a regulatory framework for Islamic banks to be self standing or for banks to create subsidiaries...’

Hard line Islamic clerics are firmly of the view that Islamic banking has progressed considerably (citing its international investments, which are over $150 billion), and thus their argument that there should be no delays as regards the out-right change to the banking system of Pakistan, from Conventional to Islamic. However, the opponents argue that Pakistan’s banking history and the burden of billion of rupees of bad debts does not justify a quick and a full-scale transition to Islamic banking. There is a prevalent perception among the bankers in Pakistan that the banking system faces difficulties due to large “bad loans”, mostly owed to public sector banks. The corrupt borrowers have plundered and looted large sums of money. Bankers are concerned that unless major loopholes in the banking system are tightened, allowing a conversion to a system in which profits and losses have to be shared among depositors and borrowers, fresh corruption may follow. In such a new system, it would be tough to prevent borrowers from declaring themselves bankrupt and funnelling away a portion of their bank loans, bankers add.

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89 Ibid at 88, page 3 (Action by Government of Pakistan).
91 Islamic Banks Suffer Hold up, The Banker, page 80, February 2003.
92 Ibid at 15, (Re-examining Riba).
Khaled Ahmed, a renowned Pakistani columnist and analyst, observed:

“……. the government of Pakistan is already in the process of negotiating a rescheduling of its loans from the Paris and London Club creditors on the basis of the old system which is now deemed riba-infected. This process will have to be restarted in case the creditors express lack of confidence in the new riba-free system. The foreign creditors may foreclose rather than listen to the Islamic argument. 93

The whole issue of implementing Islamic banking and its prospects in Pakistan is seen as a Pandora’s Box by the government, which it seems the latter is hesitant to open, keeping in mind the current economic and political situation of the country and the perplexities involved in solving the basic Islamic concepts, such as Riba.

The introduction of Islamic banking system in Pakistan is seen as a long process requiring development of legal and regulatory framework, institutions, markets, and efficient and suitable practices. The latter process requires constant monitoring and refining. Undoubtedly, a lot of work has already been done and in addition, Pakistan can surely benefit from the experience of other countries. It seems that Pakistan is following the example of Malaysia, Egypt and Saudi Arabia by adopting a dual/parallel banking system. There is a strong desire among the masses to see the whole of Pakistan's economic system Islamised as soon as possible. However, it is a gigantic task needing research, for setting up of controls and designing of new operational procedures and documentation. It is wisely submitted that unnecessary haste may lead to serious problems, which would surely be exploited by the critics to discredit the entire Islamic system.94

There is an argument (mainly from the hard line clerics) that non-interest based banking could only be successful in an Islamic state, where interest is legally prohibited and any transaction involving interest is declared as a punishable offence. Furthermore, where the latter is not strictly enforced, it would be very likely that capitalists would jeopardise the larger interest of the people, by putting their interests first and making private gains. If such a setup exists in a country, the transactions would end up entering a black market and would thus lead to the disruption of the entire interest-free system. 95

On the contrary, Pakistan’s central bank governor, Mr Ishrat Hussain affirms a more prevalent, liberal view that there should be a dual system of banking - one Conventional, and the other Islamic, thus providing the clients with a freedom of choice to decide, which mode of banking they would prefer to adopt. Domestically, it will assist in creating a level playing field for all. The latter view has earned support from numerous Conventional bankers who argue that swift conversion would harm business confidence, and may even potentially jeopardise Pakistan’s ability to seek further foreign loans, as international lenders may become cautious of the problems facing Pakistan. 96 A prime example of a country, which has successfully maintained

parallel banking systems is Malaysia. It is the first country in the world to implement the Islamic banking system along the lines of Conventional banking. As Maysami notes in his article:

“The marriage between the two is a happy one and the one country, two systems adage can well apply to Malaysia’s banking system.”\(^{97}\)

From the above, it can be stated that instead of creating a law or regime to prohibit interest, Governments in Muslim states should concentrate in creating an alternative system of finance which should freely compete with the interest-based system. Only through free-interaction, and based on the results of its operations, people should freely decide to adopt the Islamic system and opt out of the interest based system.

**Case Study 2:**

*Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd\(^{98}\):*

**A. Synopsis of Facts**

The claimant bank was incorporated under the laws of Bahrain, and expressly held itself out as applying Islamic principles in the course of its business. The bank’s own ‘Religious Supervisory Board’ affirmed that its business was in ‘full compliance with Glorious Islamic Shariah’. The first two defendants were Bangladeshi companies in the Beximco Group. The third and fourth defendants were directors of the first and second defendants and of the fifth defendant, their parent company.

The bank advanced loans to the first and second defendants, and there was an understanding between the bank and the defendants, in the form of an agreement that if there would be any payment due which remained unpaid for any period after the due date, the defendants would be liable to compensate the bank.\(^{99}\)

Unable to repay the amount due, the defendants entered into two *Exchange in Satisfaction and User Agreements* (ESUA), the details of which are not relevant for our present purposes. There was also a condition precedent that the third, fourth and fifth defendants guaranteed the first and second defendants’ obligations under the ESUAs.

The ESUA contained choice of law clauses, which were as follows:

1. Subject to the principles of Glorious Shariah, this Agreement shall be governed by and construed in accordance with the laws of England.

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\(^{98}\) CA (Civil Division) [2004] EWCA Civ 19, [2004] 2 Lloyd’s Rep 1, Hearing Date: 28\(^{th}\) January 2004. (LexisNexis)

\(^{99}\) Ibid at 24, page 1 (Head Note).
2. The guarantees stated that they were ‘governed by and shall be construed in accordance with English law’. There was no reference to the principles of Shariah.

The bank sought redress by claiming the amount due under the two ESUAs and the compensation, as agreed under the two ESUAs.

The defendants denied liability, their principal argument being that on a true construction of the governing law clause, the agreements and ESUAs were unenforceable, unlawful and invalid as regards the Shariah principles, as the transactions were in truth, disguised loans at interest. The defendants also raised the defence of common mistake, which is obviously irrelevant for our purposes.\\

### B. The Judgment

The High Court (HC) judge, **Mr Justice Morison** held that the agreements were governed by English law and that it was not sensible to be concerned with the principles of Shariah at all. He elaborated the rationale of his judgment, which is detailed as follows.

(a) There could not be two separate systems of law governing the contract, so either English law applied or Shariah principles.

(b) The clause did not amount to a choice of Shariah law, as **Contracts (Applicable Law) Act 1990** (enacted by the UK, following the Rome Convention), required the chosen law to be the law of a country rather than a non-national system of law.

(c) The principles of Shariah were by no means principles of law, which applied to other aspects of life and behaviour.

(d) Even if the principles of Shariah were the principles of law, there was controversy (particularly in matters relating to commerce and banking), as regards the stringent nature with which the Shariah law was to be construed and applied, and it was highly unlikely that the parties to the agreements intended an English Court to determine any dispute as to the nature and application of such controversial and highly ambiguous principles.\\

The defendants appealed to the Court of Appeal (CA), where the crucial judgment was delivered by **Lord Justice Potter (Potter LJ)**, dismissing the appeal, with whom the other two Lord Justices agreed. He gave a lucid judgment, which I believe deserves a detailed discussion, as it highlights various issues and could possibly be regarded as a disappointing, yet a vital judgment as regards the growing case law on Islamic banking and its jurisprudence.

**Potter LJ** stressed, that the two conflicting provisions of law should be interpreted in a way so that it could be reconciled with the purpose evident from the words that follow, rather than operating to defeat such purpose.\\

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100 Ibid at 24, page 2, para(s) 1, 2 & 4.
101 Ibid at 24, page 3, para 1.
102 Ibid at 24, (par 47 of the Judgment). The latter para within the brackets and the ones that will follow, indicate the para in the Lloyd’s Report, which is cited above at foot note 24.
He affirmed Lord Morison’s view that the Rome Convention as a whole contemplated and sanctioned only one choice, that is, the law of the country, and not any law of a non-national system.103

He accepted that it was possible to incorporate, identified specific provisions of a foreign law or set of rules into a contract, which were governed by English law. The general reference made to the Shariah principles in the present case did not mention or identify any particular aspects of the Shariah law, which were intended to be incorporated into the contract, and thus it did not suffice to say that the basic rules of Shariah were not controversial.

“….. the reference to the principles of…Shariah stood unqualified as a reference to the body of Shariah law generally. As such, they were inevitable repugnant to the choice of English law as the law of contract and rendered the clause self-contradictory and therefore meaningless.”104

Nevertheless, Potter LJ observed that the reference made to the Shariah was there for a reason and not a mere “surplusage”. It was intended to reflect the Islamic religious principles, in accordance with which the bank held itself out as doing business rather than a system of law to “trump” the application of English law, as regards the ascertainment of the liability of the parties under the terms of the agreement.105

C. Case Analysis

The Shamil Bank of Bahrain’s case highlights and clarifies several legal principles as regards the conflict of laws between Shariah principles and English law. From Shariah law’s (and thus Islamic banks’) perspective, there is much to learn from this case, and at the same time, as one would like to comment, being a source of disappointment as the English courts unsuccessfully attempted to give weight to the Shariah principles. It would not be out of place to introduce Mr Hacker’s (counsel for the appellants) submissions at this stage, which he very ably argued before the court, but could not convince the latter.

Mr Hacker submitted that, contrary to the judge’s view, it is neither unusual nor improbable that the parties to the contract should intend the English Court to determine and apply the Shariah, nor, as he wisely submits, is the English Court ill-equipped to do so when they have the assistance of expert evidence,106 in which regard he referred to the decision of Mr. Justice Moore-Bick in Glencore International A.G. v Metro Trading International Inc107 and that of Mr Justice Hart in Al-Bassam v Al-Bassam.108

Mr Hacker argued that the clause should be read as incorporating those specific rules of Shariah that simply relate to interest and to the nature of Murabaha and

103 Ibid at 24, page 3, (par 48 of the Judgment).
104 Ibid at 24, (par 51 & 52), as per Potter LJ.
105 Ibid at 24, (para 54).
106 Ibid at 24, page 15, Submission of the Appellants
107 [2001] 1 Lloyd’s Rep 284 at para(s) 113-125.
Ijaraha contracts, thus qualifying the choice of English law as the governing law only to that extent.\textsuperscript{109}

He further contended that the judge’s views as to the ambiguity and the controversial nature of the Shariah principles were erroneous and Mr Hacker referred to the judgment of \textit{Mr. Justice Tomlinson in Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV}\textsuperscript{110}, where Dr Lau (whilst giving expert evidence) suggested that there was no difficulty in identifying the requirements for an effective Murabaha agreement under Shariah law.\textsuperscript{111}

Having said that, whilst the Courts should and would answer any relevant question that is put forward to them, no matter how complex it is, it is not viable, as the judges and many academics comprehend, that with all due respect, the Courts should get into matters of any religion and orthodoxy. In the case of Shariah principles, the latter view is affirmed by the fact that the Islamic banks have their own religious board to monitor the compliance of the bank with the Board’s own perception of Islamic principles of law, as it relates to the international banking context.\textsuperscript{112}

It is an established fact that the parties to a contract should clearly and expressly spell out the terms on which they intend to bind each other. This undoubtedly aids the judges in their work of statutory interpretation and of the interpretation of the contract(s) in question. The express mention of the clauses in a contract becomes more pertinent when the contract involves issues regarding Shariah principles, as the judges might not necessarily be fluent with them.

As regards a contract that is drafted on Islamic principles and comes before a non-Islamic court, it is observed that the Islamic banker could also possibly be at a disadvantage (unlike the situation in the Shamil bank’s case), as the judges are not familiar with Islamic concepts, as noted above.

There should be efforts to link up jurists from the west together with Shariah scholars. If a question were to arise in an English or American court relating to Shariah law, the English or American judge might, under his/her conflict of laws principles, turn to Shariah law and try to assess the case and resolve the issue(s) in question. It is suggested by \textit{Carlson} that the way to avoid this whole situation arising would be to draft the contract in a manner that a western judge will comprehend. When you refer to the passage of title under a section of the law in a certain State, whose law applies to the contract, this would point to the fact that if there is litigation in the State whose law you have chosen, the judge will instantly know what you mean. The latter is seen as part of the process of blending the Shariah principles with western legal and financial principles.\textsuperscript{113}

And finally, it could possibly be argued that there is a need to speculate on how to ‘square the circle’. In other words, is it possible that just as English law is now

\textsuperscript{109} Ibid at 24, page 17, para 1.
\textsuperscript{110} (unreported) Feb.13, 2002.
\textsuperscript{111} Ibid at 24, page 15, para 4.
\textsuperscript{112} Ibid at 24, page 14, para 5.
\textsuperscript{113} Islamic Banking and Finance, Butterworths, 1986, Chapter 6, Legal Issues and Negotiations, page 82, para 4.
obliged to read legislation and other precepts in a way that is consistent with the European Convention on Human Rights by virtue of S3, Human Rights Act 1998, that they will have to adopt a similar approach to Islamic transactions, if not in the near future, then at some point in time?
Chapter 5

Legal Deliberations and Implications of Structuring and Offering Shariah-Compliant Investment Products

Keeping in view the need to incorporate Islamic financial institutions into the international banking community, appreciable progress has been achieved lately as regards structuring and marketing Shariah-compliant investment products within the existing frameworks of several legal systems.114

Deciding on a suitable Shariah-compliant investment structure begs an analysis of issues of both form and substance. The bankers and legal advisers must take into account various aspects, e.g. structure of the fund, investment objectives of the underlying products, regulatory compliance issues and marketability.115

It is highly pertinent to mention that in any discussion that relates to Islamic law, it is the latter, which is the arbiter of not only legality but also virtue and vice. In perusing Islamic rulings, whether issued by jurists, judges or Shariah advisers, it is at times difficult to differentiate between what is a legal obligation and what is ethical in nature. Great care must be practised in structuring investment vehicles to ensure that they operate in compliance with Shariah principles.116

A. Role of financial institutions and fund promoters

From a Shariah perspective, it is well established that almost any financial institution (whether a non-Muslim or a non-Islamic bank) is permitted to offer Islamic investment products, unless that institution/person is prohibited for regulatory reasons from doing so. Promoters of Islamic funds and issuers of Islamic instruments, including conventional banking institutions, should develop both a generalised understanding of Islamic law and a working knowledge of the regulatory system, as practised in the particular jurisdiction in which the product is to be offered. The financial advisers should work in harmony with the legal and Shariah advisers to refine their product ideas and vehicle structures in order to ensure complete legal and Shariah compliance.117

115 Ibid at 40, page 196.
116 Ibid at 40, page 196, para 3.
117 Ibid at 40, page 197, para 1.
B. Legal and Shariah advisers role

The decision by a financial institution to structure an Islamic product requires the involvement of legal counsel and Shariah advisers at an early stage.

In order to actively participate in the process of structuring and documenting ‘quality’ cross-border Islamic financial products, legal advisers require a thorough understanding of Shariah law and familiarity with Western financial market practices. Specialised legal advice seems mandatory in view of a number of recent complex rulings issued by English courts, one of them being the case of *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd*, which I have already discussed and analysed in some detail.

The mandate given by promoters of Islamic investment instruments to Shariah advisers includes:

a. assisting in the development of a suitable structure for the proposed investment product;

b. reviewing documentation;

c. issuing a Shariah-compliant certificate and providing ongoing supervision - also termed as Shariah audit - to ensure that the implementation of such structure is Shariah-compliant.118

C. Choosing a jurisdiction

As a general comment, it would be fair to state that Islamic finance should be conceived, developed and offered as a viable and practical alternative to the prevalent system. This can only be achieved if honest efforts are made to develop and structure products applying the principles of Shariah in their spirit. It is imperative to move away from the tendency to try and mould the existing concepts into an unnatural and superficial form of Islamic financing. The local legal environment must accommodate the proposed structure as well as offer a favourable tax treatment, regardless of whether a financial institution is structuring a Conventional or Islamic investment fund. Jurisdictions, such as Malaysia and Bahrain have been quite flexible in adapting to both Conventional and Islamic structures.119

Jurisdictions such as Luxembourg and Dublin have enacted and implemented scrupulous compliance policies, which could be crucial when fund promoters intend to give Muslims in European Union (hereinafter as EU) member states access to Shariah-compliant investment vehicles. Islamic financial institutions are facing new challenges, due to the enactment and implementation on a world-wide stage of rigorous know-your customer and other compliance policies.120

118 Ibid at 40, page 198, para 1 and 2.
119 Ibid at 40, page 198, para 3 (Choosing a jurisdiction).
120 Ibid at 40, page 198, para 6.
D. Legal issues related to the marketing of Islamic investment products in different jurisdictions

European Union (EU)

The EU permits the promoters of Islamic funds the opportunity to access a growing and affluent European Muslim community. The promoters must first obtain a certificate, commonly termed as the ‘European Passport’ in compliance with Council Directive of 20th December 1985 on the Coordination of Laws, Regulations, and Administrative Provisions relating to Undertaking for Collective Investment in Transferable Securities (hereinafter as UCTIS Directive). No unit trust can carry on activities as such unless it has been authorised by the competent authorities of the member states in which it is situated.

The enforcement of the provisions of the UCTIS Directive would not necessarily result in ruling out Shariah-compliant securities, as the bulk of the investment criteria, as spelled out in the Directive relates to market admissibility and allocation of investments. Promoters of Islamic funds would be relying on internal funds and Islamic certificates, to have limited access to the EU markets.121

In a seminar on Islamic banking held in London in September 2002, Howard Davies, the chairman of the Financial Services Authority (FSA), stressed the significance with which the FSA views the Islamic banking industry and promised to work closely with the industry to make sure that the United Kingdom attracts financial institutions that specialise in Islamic banking, and which fulfil the needs of the Muslim community in the UK. Furthermore, Europe’s first Islamic retail bank, known as the Islamic Bank of Britain (IBB) will be opening its branches in Britain, serving the 1.8 million Muslims resident in the country, as the bank has been given a green light by the FSA. It is hoped that the UK banking licence will provide an effective banking passport across Europe. Without a doubt, the UK authorities’ attitude towards Islamic banking has transformed in recent years. A decade ago, there were numerous Islamic finance houses in UK but none of them achieved the bank status.122

Although there are marked differences between the Islamic and traditional banking, the financial authorities in UK are “willing to be more open and to accommodate the two systems together. There appears to be not only a greater desire to provide Islamic financial services but also the will to find the appropriate legal framework to make these new services work alongside traditional products ” as noticed by Michael Foot, an FSA official.123 It is submitted that this approach is the way forward for achieving a harmonised parallel system of Islamic financing.

United States

Generally speaking, organisations or bodies seeking to carry out investment banking activities in the US are required to comply with the requirements of the US Investment Company Act 1940, as amended. The Act governs the registration and activities of

121 Ibid at 40, page 204, paras 4, 5 & 6.
123 Ibid at 99.
investment companies. To avoid the application of this Act, entities carrying out investment banking activities in the US should monitor their activities to ensure that either the Act does not apply or that specific exemptions are available.

Distinctly, the offer and sale of units of an investment fund, or other securities, in the US must be registered under the US Securities Act of 1933. To avoid this requirement, transactions can be structured to utilise the facility provided by safe harbours from registration by Rule 144A and Regulation S.124

In the offering circulars of Islamic and Conventional investment funds and products, where the promoters intend to avoid the requirements of the US securities laws, comprehensive declarations and notices are integrated into the offering documents and subscription agreements to ensure that investors represent and warrant that they are not US Persons, and that they are not subject to the US Securities Act in any regard.125

US securities laws do not differentiate between Conventional and Islamic products. The focus of Islamic institutions, to-date, as well as institutions active in the development, offering and marketing of Islamic products, has been on non-US investors, despite the growing demands of the Muslim community in the US. It is submitted that the obstacles posed by the US Securities Act and the compliance criteria circulated in the Patriot Act 2001, should not hold back the development of suitable Shariah-compliant investment products to be offered to Muslims in the US. The regulatory bodies in the US have been supportive of the development of an Islamic financial industry, and lately, the US Congress has arranged round-table discussions on various modes of Islamic financing, e.g. asset leasing.126

Regulatory agencies in the US are becoming increasingly familiar with Shariah-compliant investment products. As reported, state tax authorities and banking regulators issued rulings that provide tax benefits, which are vital to certain Islamic finance and investment structures, and others have declared that certain Islamic structures are permissible under state banking laws.127

Bahrain

Bahrain attracts fund promoters who are influenced by its open economy and its laws and regulations that are advantageous to foreign investors, and its efficient regulatory body in the form of Bahrain Monetary Agency (BMA), which supervises all financial activities in Bahrain.

The BMA, in order to achieve its goal to attract reputable foreign (including Islamic) fund promoters, implements a vigorous interpretation of its regulations.

While the BMA has issued a separate set of circulars that apply to Islamic banks, it continues to treat Islamic investment funds as being subject to the same requirements as Conventional or non-Islamic investment funds, particularly as regards compliance,

124 Ibid at 40, page 205, para 4 & 5.
125 Ibid at 40, page 206, para 2.
126 Ibid at 40, page 206, para 3.
127 Ibid at 40, page 206, para 5.
investment guidelines, investors’ notices, risk factors and net asset value calculations. Thus, the offering document of an Islamic fund must state the investment criteria that the fund will implement, and the Shariah compliance and supervision implemented by the funds’ promoters.\textsuperscript{128}

\textit{Saudia Arabia}

The \textit{Saudi Arabian Monetary Agency} (SAMA), Saudi Arab’s central bank, has circulated draft \textit{Investment Business Regulations} (IBR), purporting to apply to local and international brokerage and advisory services, distribution activities, offering of investment funds, offering of custodial services and advertising in relation to the offering of investments and securities. Bankers in Saudi Arabia have advised, that although the IBR is not issued in a formal manner, affected persons should still comply its terms.

The Saudi Arabian legal system is based on the principles of Shariah and apparently there is no formal distinction between Islamic and non-Islamic banking activities even in the context of investment funds. However, SAMA does require the offering document of an Islamic fund to provide detailed Shariah investment guidelines.\textsuperscript{129}

As could be observed from the preceding paragraphs, the integration of the Islamic banking industry, involving Shariah-compliant investment funds and products, into the global banking community will undoubtedly result in greater exposure to legal systems and compliance requirements at various levels of development and complexity. The world’s most sophisticated commercial legal jurisdictions are increasingly reverting to the needs of Shariah-compliant investment funds, so that they could attract the vital, and growing investment pool available to those funds.

It is imperative that the Islamic banking industry continues to work with regulators in the US and Europe to enhance the availability of Shariah-compliant products in the West, although much of the demand for these products will continue to come from the Muslim world. The Islamic banking industry can certainly evolve into a more sophisticated and modern industry, if its promoters and professional advisers continue to work together to meet the regulatory, legal and judicial challenges, which arise due to the industry’s operation in jurisdictions that implement differing legal systems and compliances.\textsuperscript{130}

\textsuperscript{128} Ibid at 40, page 202, para 4 & page 203, para 2.
\textsuperscript{129} Ibid at 40, page 203, paras 3, 5 & 6.
\textsuperscript{130} Ibid at 40, page 207, para 3.
Chapter 6

Regulation and Supervision of Islamic Banks

The potential perils that the national economies face today due to the fact that the new emerging Islamic banks are left free to conduct their business without any proper supervision is an issue that has continued to trouble the national regulators. However, the regulation of Islamic banks is not a clear and straightforward matter as is thought by several economists.131

It could not be denied that the state has the sovereign right to regulate all the economic activities within its control, in order to benefit the community at large. However, the protection of the depositors and the shareholders of any bank, remain a supreme concern of any central bank. The problem exacerbates when the rules of conducting an activity does not fit in with the existing framework for regulating that activity. The latter is the case with the Islamic banks, which are regulated by a complex legal regime consisting of different maxims and doctrines.132

A. Prohibited Activities

The Shariah precepts regulate the activities of Islamic banks, prohibiting all Muslims from dealing in certain commodities and economic activities. E.g. Islamic banks are prohibited from conducting business trading in alcohol, pork and pork-related products, gambling. Some of these items are strictly prohibited in Quran that is the divine law. The prohibition extends to trading in shares and securities of companies, which deal in the prohibited goods and activities. Thus, Islamic banks are restricted in terms of products that they can offer to their customers and can only engage in a limited and narrowly defined range of authorised Islamic activities.133

It is also significant to note that the Islamic banks cannot conduct business in the international capital markets and stock exchanges, due to the fact that most of the shares of companies, which are engaged in several activities, could not be presumed to be carried out in accordance with Shariah precepts. In most cases non-Islamic countries lend and borrow in relation to Conventional banking, which unarguably involves an element of interest (riba), as already discussed above in great length. Also, Islamic banks cannot deal in options and futures as the latter products involve certain features of uncertainty (gharar) and speculation, which is clearly prohibited.134

As Dr Sheikh notes in his article, “There is now growing impetus for a fresh evaluation and a new interpretation of the original Shariah principles with the aim of reasserting Shariah as a valid and sensible corpus of commercial and civil law.”135

132 Ibid at 125, page 70, para(s) 5 & 6.
133 Ibid at 125, page 70, para 10 & 11.
134 Ibid at 125, page 70 (Prohibited Activities).
There have been various attempts in the past to establish Islamic banks in North America, but they have not really been successful due to the stringent banking and securities regulations. In Canada, for example, the main hindrance is the Bank Act, which requires a bank to keep a prescribed share of its depositors as a primary reserve with the Bank of Canada, which would attract interest. The Act also restricts particular types of activities and investments that a bank can participate in, and further requires that the depositors be given the option to have savings account, on which they must give interest. In order to overcome these obstacles, a group from the Toronto and Region Islamic Congregation have started working around these restrictions by trying to establish a credit union, that would not have to satisfy all the austere rules.\(^{136}\)

**B. Islamic Banking Regulation**

Regulation of the Islamic banking industry remains a top priority for the Bahrain’s authorities. Prudential regulations, aimed at ensuring the soundness of Islamic banks, were introduced in the year 2002. Furthermore, to ensure that the Islamic ‘windows’ of Conventional banks also adhere to the same standards as fully fledged Islamic banks, a new standard was introduced, specifically for that purpose.\(^{137}\)

Dudley, in his article, noted that Islamic banking is still a very diffuse business and suggested that it needs to establish universally accepted accounting, auditing and regulatory standards, if it aspires to achieve global acceptance and thus continue its expeditious expansion. The latter view has been affirmed by many academics, economists and lawyers all over the world. Keeping the latter views in mind, the Islamic Financial Services Board (IFSB) was launched in March 2003. It was the first time that central banks which were responsible for most of the Islamic financial sector had fused together in the form of an institution, which had a mandate to set industry-wide regulatory standards, however the government of the United States criticised the latter institution as being a ‘soft touch’ for money launderers and terrorism financiers,\(^{138}\) without providing any substantial evidence to the aforementioned.

The role of the Kuala Lumpur-based IFSB will be partly prudential, very similar to that of Bank for International Settlements’ Basle Committee on Banking Supervision, and partly to establish best practice. As per Professor Rifaat Ahmed Abdel Karim, the secretary general of IFSB, “The creation of IFSB marks a new beginning for the industry. It is sending a clear message that we are establishing standards for the whole industry.” He stressed that the creation of the IFSB would assist the Islamic banking regulators to “co-ordinate their approach and enable the industry to gain credibility…..We will strengthen the soundness and stability of the Islamic financial system. We want to ensure there is a prudent and transparent structure by creating new standards or adopting existing ones….Borrowers and investors have a vested interest in creating the universal standards that will open up this market.” He is confident that the IFSB, whose members include Bahrain, Indonesia, Iran, Kuwait,  

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135 Ibid at 125, page 71, para 2.
138 Structure is a Necessary Target by Nigel Dudley, Middle East and Africa: Islamic Banking, The Banker, page 121, May 2003.
Malaysia, Pakistan, Saudia Arabia, Sudan and the Islamic Development Bank (IDB), will certainly bring order to the system, mainly due to the willingness on the part of the Islamic bankers.\footnote{Ibid at 132, page 121, The IFSB’s Role.}

The IFSB is further responsible for capital markets and insurance, and will be setting up working groups focusing on capital adequacy, risk management and corporate governance. On the lines of Basle Committee, its proposals intend to give considerable weight to the moral authority, which will not be mandatory on its members states. As per Professor Riffat, “We will consult widely, issue drafts and, where it is feasible, hold public hearings.” The latter approaches will assist in eliminating the Western misconceptions about Islamic banking, particularly as regards money laundering. “Money laundering is harder through Islamic banks because the element of risk sharing means there is a closer know-your customer approach. The IFSB will work the anti-money laundering and anti-terrorist finance departments of regulatory authority.”\footnote{Ibid at 132, (Moral Authority), page 121.}

As discussed in detail earlier on, there are undoubtedly differences between the manner in which Conventional and Islamic banks conduct their businesses. For example, Conventional banks balance deposits against assets, while Islamic banks technically receive and invest their customers’ money, the latter, not literally the bank’s liability. This implies that a new way must be defined to calculate risk ratios. The way jurisdictions approach the question of regulating Islamic banks is inconsistent. E.g. some states, like the U.A.E, treat them in a similar fashion to that of Conventional banks, while others have developed a separate regulatory framework. Moreover, there is no unified approach in the Islamic banking community. The Shariah boards, consisting of group of scholars set by each institution to adjudge whether products and services are acceptable under the Shariah precepts, often put forward varying opinions and come to different conclusions on Shariah-related matters.. E.g. Malaysian Islamic banks believe that increased securitisation assists in the balance sheet management and fostering of liquidity. However, Arab scholars often argue that relating the financial assets to specially designed vehicles that can be sold in smaller elements to institutions, is not Shariah-compliant.\footnote{Ibid at 132, para 2, (Structure is needed).}

A major hurdle faced by the Islamic banks operating in the countries with interest-based banking is that they cannot function as banks unless they attain powers of issuing cheques. They cannot be members of settlement/clearing house if they do not accept two conditions regarding their liabilities and assets like Conventional banks who have to maintain fractional cash reserve with the Central bank and statutory liquid assets in their assets. Since these assets are interest-based Islamic banks cannot hold them, as a result of which, the Central bank cannot act as the lender of last resort as such housing by the monetary authority is also interest-based.\footnote{Banking Regulations and Islamic Banks in India: Status and Issues y M. Y. Khan, IJIFS, Vol. 2, No. 4.}

Furthermore, the effects of the September 11th terrorist attacks in the United States and the US-led war on Iraq, have seriously affected the progress of Islamic banks world over.
As per a senior executive of an Arab bank,

“Since September 11 attacks, Islamic banks with any linkages to the Western world have found themselves coming under microscopic scrutiny. Its almost as if all suspect funds have have to be stashed in such banks. Questions are being asked about where some of the larger funds are coming from and where they are heading.” In such an environment, the future prospects of Islamic banks and borrowers is questionable, who feel passionately committed to Islamic precepts but must now also acquaint themselves with international demands, as well as the environment following the war on Iraq.

C. Islamic Banking Supervision

Organisation of Islamic Conferences (OIC) Member States play an integral role as regards the regulation of Islamic banks. Some of its vital features are listed below:

1. Most of the Member States of the OIC have adopted the international standards, including the Basle Committee’s Core Principles and minimum risk-weighted capital requirements and the International Accounting Standard’s Committee’s international accounting standards.

2. Several countries are introducing crash programmes to adopt the international standards, but are facing difficulties, particularly as regards risk-weighting of assets formed by the Islamic modes of finance. A few countries have not disclosed the extent of their compliance with international standards.

3. Compliance with the standards set by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has not been fully materialised; save for two countries (Bahrain and Sudan) who have expressly adopted the standards set by it.

4. The fact is, most of the Islamic banks are, compared to the financial giants in the Conventional system, small in size. Bearing that in mind, some of the countries have launched a program of compulsory merger of Islamic banks and strengthening their capital to make them successful and viable in an international environment that has been characterised by large banks.

5. Three countries, Iran, Pakistan and Sudan, have initiated the transformation of their entire economies in line with the Islamic precepts, and have announced major restructuring programs for their banking sectors. Pakistan and Sudan have announced a mandatory program for strengthening the capital of banks and of mergers to the extent to which this is required for the purpose.

Furthermore, Iran, Malaysia, Pakistan and Turkey have established both onsite and offsite supervisory systems to achieve and strengthen the standard objective of such

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143 Islamic Banking for the Masses by Farhan Bokhari, page 171, The Banker, April 2003.
144 Ibid at 137, page 171.
systems. Malaysia has adopted the CAMELS rating system - Capital adequacy, Asset quality, Management quality, Earnings, Liquidity and Systems for internal controls.\textsuperscript{146}

It has been suggested that the regulation and supervision of Conventional banks would be more effective if they were merged by a paradigm shift in favour of greater discipline in the financial system by requiring the investment depositors as well as the banks to share in the risk of business. It is vital to comprehend that it is not just enough to make the shareholders suffer whenever a bank fails, but the depositors must also be told to be cautious in choosing their bank and the bank management to be more attentive when making their loans and investments. Without such risk-sharing, the depositors may continue to receive competitive rates of interest because the bank receives a pre-determined higher rate. The banks should be made to share in the risks, and the depositors should get a share only of what the users of bank funds ‘actually’ earn, thus ensuring that the quality of the banks’ assets remains transparent. Bank managers are better positioned to evaluate the quality of their assets than regulators and depositors, and risk-sharing would motivate them to take the decisions that they predict are in the best interests of banks and depositors. Thus, reinforcing regulation and supervision of banks by profit/loss sharing, by both the banks and the investment depositors would help in ensuring the soundness of banks. A good deal of credit would not be used for unhealthy speculation and unsound projects. Governments would also be forced to rely less on debt by designing and organising their tax systems and reducing their unproductive and wasteful spending.\textsuperscript{147}

D. Islamic Mutual Funds

Investment based on Shariah precepts incorporates seven key pillars, which work together to deliver competitive performance and to promote socially and ethically responsible business practices that in turn contribute to the betterment of the quality of life throughout the society.

*Shariah Supervision:* by a qualified Shariah supervisory board is a vital component of any serious Islamic equity fund structure. The board is typically consists of prominent scholars, who are well versed and disciplined in Shariah, particularly in the fields of transactions and business dealings. The board must be independent and should perform advisory and supervisory roles with the fund’s management and assist in the development of fund management policy, Shariah screens, investment strategy, implementation, monitoring and reporting.\textsuperscript{148}

*Screening:* involves including or excluding publicly traded securities from investment portfolios or mutual funds based on the religious and ethical principles of the Islamic Shariah. Most of the Shariah presently in use by fund managers include three financial-ratio filters, they are:

1. Excluding companies if total debt divided by total assets is equal to or greater than 33%.

\textsuperscript{146} Ibid at 140, page 184 (Offsite and Onsite Supervision).
\textsuperscript{147} Ibid at 7, Alternative visions of international monetary reform, Chapter 11, pages238-239 (The Remedy).
\textsuperscript{148} A Comparative Literature Survey of Islamic Finance and Banking by Zaher And Hassan, page 177, para 1, (Islamic Mutual Funds).
2. Excluding companies if accounts receivable divided by total assets is equal to or greater than 45%.

3. Excluding companies if non-operating interest income is equal to or greater than 5%.\textsuperscript{149}

\textit{Purification}: is the process of eliminating or cleansing the portfolio from income or resulting from interest or other impure revenue sources. The fund should have a stringent, quantifiable formula and procedure of separating interest related and impure income from the portfolio, including dividends and capital gains.\textsuperscript{150}

\textit{Shareholder Advocacy}: defines the actions taken by several socially aware investors in their roles as owners of public corporations. The efforts include dialoguing with corporate management on specific issues, and submitting and voting proxy resolutions. Socially responsible proxy resolutions are generally meant to effect corporate behaviour and practices towards a more responsible level of corporate citizenship.\textsuperscript{151}

\textit{Monitoring and Reporting}: basically involves a process of observation over the fund’s holdings to make sure that the latter complies with the Shairah filters, fund strategies and policies. A screened portfolio is only an initial step towards Shariah compliance, which is seen as an ongoing process and requires careful analysis of company’s financial statements, practices and revenue sources. Ongoing management and shareholder reports are vital to provide fund principals and investors with timely information regarding Shariah issues, the funds, its practice and performance.\textsuperscript{152}

\textbf{E. Regulatory issues of Islamic banks in an Interest-based banking system: Case of India}

Islamic banks, known as \textit{Non-Banking Finance Companies} (hereinafter as \textit{NBFC}) in India and \textit{Reserve Bank of India (RBI) Regulations} for Islamic banks in India do not function under banking regulations, and operate on a profit and loss basis based on Islamic precepts.

The \textit{RBI (Amendment) Act 1997}, has efficiently addressed the issues of laying down a comprehensive system for regulating \textit{NBFCs}. The Act intends to provide a greater degree of comfort and safety to depositors, whilst boosting the development of a healthy and diversified financial sector, simultaneously. Additionally, entry-level norms for new and existing \textit{NBFCs} involved in financial intermediation, prescription of minimum level of Net Owned Funds (NOF), maintenance of certain percentage of liquid assets as percent of public deposits in government bonds, creation of reserve fund and transfer to that every year a certain percentage of profits to reserve fund. The regulations further provide for measures like credit rating for deposits, capital adequacy, income recognition, asset classification, mandatory credit rating provision

\textsuperscript{149} Ibid at 140, page 177, para 3 (Screening).
\textsuperscript{150} Ibid at 140, page 178, (Purification).
\textsuperscript{151} Ibid at 140, page 178 (Shareholder Advocacy).
\textsuperscript{152} Ibid at 140, page 178 (Monitoring and Reporting).
for bad and doubtful debts, exposure rules and other measures to keep a check on their financial solvency and financial reporting. Furthermore, the supervisory mechanism for NBFC’s is based on three criteria, which are:

1. The size of the NBFC.
2. The type of activity performed.
3. The acceptance or otherwise of public deposits.

To achieve the latter purpose, a four-pronged supervisory mechanism has been setup consisting of on-site inspection, off-site surveillance, exception reporting by NBFCs statutory auditors and market intelligence. The NBFCs have further been directed to constitute audit committee, consisting of not less than their members of their Board of Directors, if the deposit exceeds Rupees Five Hundred Million. They are also required to follow a uniform accounting.\textsuperscript{153}

It is worth stressing that for Islamic banks, resource mobilisation and investment through units or equity, need well functioning equity exchanges market without any tax or penalty on frequent trading. A vital development in Indian financial market is the upcoming and widening strong capital market with a broad based regulatory system in favour of investors. Now Islamic banks can use a two-way route in order to mobilise capital resources by issuing equity shares and can invest in equities of corporate and financial institutions. The setting up of mutual funds is another viable route. Islamic banks can float mutual funds schemes offering dividend on units and these funds can be invested in corporate shares.\textsuperscript{154}

The profit and loss structure of Islamic banks, however, has developed a number of inadequacies. Islamic banks have an undeveloped and inadequate control system, which points to the fact that their accounting system is not transparent, bearing in mind that the transparency is the directive of Islam. On various occasions they are unable to follow the directives of regulatory authorities relating to deposit acceptance from the public. E.g. credit rating is infrequent. They do not regularly submit the required information and data to the Reserve bank. Their monitoring system requires the appointment of technical staff, which is familiar with reporting system. The bank officials need to be more fluent with the accounting practices. However, there is good news for the Islamic banks as the Indian government would be permitting NBFCs to accept foreign share holdings even on foreign partnership basis up to 100%. The latter relaxation will permit Islamic banks to increase their resources through foreign holding by foreign investors, enabling them to consolidate and formalise their operations. Foreign partners will undoubtedly bring them improved standard of disclosures and better management practices.\textsuperscript{155}

F. Problems and Challenges of Islamic Banks and Markets

\textsuperscript{153} Ibid at 136, page 3, (Islamic Banks NBFCs in India and RBI Regulations).
\textsuperscript{154} Ibid at 136, page 4, para 4.
\textsuperscript{155} Ibid at 136, page 4, para(s) 5, 6 & 7.
Numerous limitations and challenges are faced by the Islamic banks in their structuring of a stable financial system that is competitive and can efficiently provide services to its customers world over. Before the Islamic banks intend to set up any long-term strategy, they must reflect and resolve some of the following mentioned issues.

First, a uniform regulatory and legal framework is required that is compliant with the Islamic financial system. Current banking regulations in Islamic states are formed on a Western banking model. Moreover, there are major difficulties and hurdles that Islamic financial institutions face as regards their operation in non-Islamic states, due to the absence of a regulatory structure, which is in compliance with the Shariah precepts. The development of a regulatory and supervisory framework that attempts to address the specific issues relating to Islamic institutions would further enhance the integration of Islamic markets and international financial markets. While the stock markets in emerging Islamic nations such as Egypt, Jordan and Pakistan are active, they are entirely compatible with Islamic principles.156

Secondly, there is a dire need for risk analysis and risk-management tools to provide agents with hedging instruments to hedge against the high volatility in currency and commodities markets, especially for those Islamic banks which are operating in Western markets. In the absence of interest rates (which plays a vital role in managing liquidity, pricing risk and allocating credit), the risk manager associated with an Islamic bank faces a greater challenge than the risk manager of a similar size Western bank. Additionally, Islamic banks are unlikely to benefit from a critical mass of similar bodies with which Islamic interbank market can be developed, thus asking the Islamic banks to hold higher levels of liquidity than Western banks, with a resulting negative image on their ability to compete.157

Thirdly, sound accounting practices and standards must be adopted that are consistent with the Islamic Shariah. Westerns accounting procedures are not compatible and thus cannot be adopted due to differences in the nature and treatment of financial instruments. Well-defined procedures and standards are vital for information disclosure, building investors’ confidence and monitoring.158

Fourthly, there is a lack of uniformity in the religious precepts as regards its application in the Islamic countries. In the absence of a universally accepted central Islamic religious authority, Islamic banks are reliant on their religious Shariah Supervisory Board, for guidance and advice. Differences and inconsistencies in interpretation of Islamic principles by different schools of thought only lead to ambiguities and more perplexity, as a result of which the customers and investors are put off by the system. It is not even beneficial for the Islamic banking and finance industry, as the last thing they need at this stage is further confusion and losing their customers faith. Some of the basic concepts regarding the Islamic banking and finance are uncertain. A prime example is the issue of ‘riba’, as discussed earlier in Chapter 4, which has not yet been comprehensively defined and there are conflicting views as to its application and operation.159

156 Ibid at 140, page 188 (Problems and Challenges of Islamic Banking and Markets).
157 Ibid at 140, page 188.
158 Ibid at 140, page 188.
159 Ibid at 140, page 189, para 1
Finally, Islamic banks are unable to avail the facility of the lender of last resort, as the latter can be seen to operate in most of the traditional banking systems in Muslim countries, operating on the basis of interest payments, due on the loans. The only exception is being Malaysia, as it has an active interbank money market and an Islamic clearing system, which is run by the central bank. Malaysia is in the process of setting up a liquidity management house to internationalise their system that could eventually develop into a lender of last resort.160

Thus, Malaysia has set up a very good example for other Muslim countries intending to revolutionise and modernise their banking system on Islamic patterns. One must be reminded at this stage that the central bank in the West is intended to stand behind the banking system to offer liquidity lending to banks if there befalls a shortage of funds in the system.

160 Ibid at 140, page 189, para 3.
Chapter 7

The Interface between Islamic and Conventional Banking: Are there any Lessons to be Learned?

There are areas in the field of technology where Islamic banks can learn from Conventional banks, which operate in the most advanced industrialised countries that may assist its entry into these sophisticated markets. Conventional banks can, however, learn from the Islamic banks concerning staff and client motivation, as well as about staff-client relationships, which are the basis of Islamic banking. As lucidly put by Wilson, “there can be a technology transfer one way, but a human value transfer in the opposite direction.”161

A. Technology Transfer

Conventional banks have developed telephone banking, online-services using proprietary software and Internet banking, which is probably seen as the greatest innovation in history of banking industry, and is surely of long-term importance. Although the start-up costs of these remote delivery services are significant, they are much less than those of branch network expansion. Provided that Muslim clients have the required equipment, they can readily carry out most of their banking business without actually visiting a branch. The same services can be made available by means of the internet, with clients themselves able to print off account statements and records of their transactions. As is quite obvious in the present world, the more the internet becomes accessible through televisions and personal organisers and personal computers, a large portion of the population will involve itself in home and office banking.162

B. Islamic Financial Values

As regards Conventional finance, ‘relationship-banking’ is confined to the provision of private banking services for clients of high net worth, but with Islamic banking there is this likelihood of a close nexus between the bank and the client, even though this does not have to be developed through a highly personalised level of service. Instead, as the clients themselves share same characteristics, notably a common faith that affects their economic and financial behaviour, the bank can provide a standardised service that nevertheless, the client feels is designed for their specific circumstances.163 Islamic banks can ‘connect’ with their clients through adequate marketing and sponsorship activity.164

161 Ibid at 7, Chapter 10, page 202, (Lessons Islamic and Conventional Banks can Learn from Each Other).
162 Ibid at 7, Chapter 10, page 203.
163 The Development, Marketing and Selling of Islamic Financial Products by James Humes, New Horizon (93), pages 10-12, November 10-12, 1999.
Moreover, as there is arguably a higher level of trust between Islamic banks and their clients than that between the Conventional banks and their clients, the risks of moral hazards are less in the former. Clients are highly likely to disclose the true levels of their business profits if they observe the relationship with the bank as a partnership rather than being adversarial. It is submitted that higher levels of trust minimise risk and uncertainty and results in lower monitoring costs for Islamic banks. Undoubtedly, commercial risks still remain, but the risks attached with actual or potential dishonesty or disclosure failures are substantially reduced when both the bank and the clients are following the same moral principles.165

165 Ibid at 7, Chapter 10, page 204, para 2.
Chapter 8

Conclusion: A Realistic Evaluation of the Workings of the Islamic Banking Industry; A Few Sagacious Remarks

A. Evaluation

The Islamic banking movement is still in a developing stage, and thus it is too early to give a conclusive remark as to its success or failure, but it has undoubtedly come a long way since its inception. It is the most significant and real manifestation of an attempt by Muslims, in the wake of Islamic resurgence, to develop an alternative economic system that is based on Islamic law.\footnote{Ibid at 2, Chapter 1, Islamic Resurgence and Islamic Banking, page 12.}

However, it is true that the industry is becoming stronger and is not just a niche financial services industry, but rather a niche market. Bankers, world over, are predicting that Islamic banking could be responsible for management of over 50% of savings in the Islamic countries in the next ten years or so. Global financial institutions have realised this trend and are taking their chances to take advantage of this attractive niche market. Some major Western banks\footnote{Citibank, Bank of America, Commerzbank, Deutche Bank, Merrill Lynch, ABN AMRO, Standard Chartered, Barclays, HSBC, American Express, ANZ Grindlays, Flemings, etc.} have established dedicated Islamic banking subsidiaries or have major dealings in this field. An increasing number of Western investment companies are now offering Islamic investment products to interested Islamic investors all over the world. However, the bulk of the Islamic investments continue to be provided by the Islamic banks themselves.\footnote{Ibid at 140, page 167, para 2 (History and Growth of Islamic Banking).}

Several potential benefits can be traced from the emergence of Islamic banks, notwithstanding their desirability from an Islamic perspective. They are as follows.\footnote{Ibid at 7, page 13 & 14 (Conclusion) 1-8.}

1. The range of contracts available to customers is widened. As Llewellyn observed, this is an example of the efficiency-enhancing characteristics of spectrum-filling.\footnote{Financial Innovation: A Basic Analysis, in H. Cavanna (ed), Financial Innovation, London: Routledge by David T. Llewellyn, 1992.}

2. It would enable a financial system, which is populated by financial institutions with a different *modus operandi* that has the effect of widening the choice for consumers. This would also enhance competition as between alternative banking models, thereby increasing the efficiency of the financial system.

3. Allocation of financial resources on the basis of profit/loss sharing provides maximum weight to the profitability of investment, whereas on the other hand interest-based allocation gives it to the creditworthiness. It is submitted that the allocation made on the basis of profitability would be more efficient than the one made on the basis of interest.
4. Due to the nature of the Islamic contracts, Islamic banks are less susceptible to external shocks and thus less vulnerable to insolvency. A wider range of liability holders share in the risks of the bank as compared to the Conventional banks.

5. As holders of investment deposits share in the risks of an Islamic bank (e.g. through PLS contracts) and are not offered guarantees, incentives are created for a wider range of stakeholders in the banks to monitor its behaviour and risk-taking.

6. By means of more systemic diversity, the stability of financial system may be enhanced, as the behavioural characteristics of different types of banks are likely to vary.

7. As regards both the PLS and Murabaha contracts, since bank assets are created in response to investment opportunities in the real sector of the economy, the real factors related to the production of goods and services (in contrast with the financial factors) becomes the main movers of the rates of return to the financial sector.

8. It would allow Islamic religious beliefs to be reflected in financial transactions, thus satisfying the financial needs of Muslims, in line with their faith.

**B. Recommendations and Suggestions for Islamic Banking Industry**

Islamic banks should implement prudential norms so that they can strengthen their quality of functioning and capital adequacy, whilst asset upgradation should receive particular attention. They must mobilise resources on the basis of ‘Mutual Funds’ model. Investment should be equity based and partnership, contract based. They should promote inter-Islamic banks trading in ‘Contracts’. If Islamic banks can approach the public through capital issues and get listed on stock exchanges then capital would become marketable and liquid. Inter-bank lending can be set up on the profit sharing basis. Instruments of investment need diversification on the model of some of the Middle-Eastern countries. Special dividends can be declared by the banks, and ‘Risk Funds’ could be set up in order to compensate the shareholders or depositors of the bank for the losses they sustain. Furthermore, they should expand their scale of operation by means of mergers and should modernise themselves to compete with their Conventional counterparts and other financial institutions.\(^{171}\)

Before the Islamic financial institutions strive to expand their business, they should seek to evaluate their own workings and performances from their past experiences, as this is the only viable way that will enable the Islamic banking industry to improve its future activities and will also assist in identifying and rectifying any scarcity in its operations and practice.

It is suggested that the case of Islamic banking cannot be advanced unless a strong system of inter-bank transactions that is based on Islamic precepts is developed. The lack of such a system gives rise to such situations that the Islamic banks are left with no other option but to turn to the Conventional banks for their short term needs of

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\(^{171}\) Ibid at 136, page 7 (Recommendations and Suggestions).
liquidity that the Conventional banks do not provide without, either an open or ‘camouflaged’ interest. The increasing number of Islamic banks must get their acts together and should unite to establish a fund with a mixture of Murabaha and Ijaraha instruments, the units of which can be used even for overnight transactions. Such a fund would undoubtedly help the Islamic banking industry to flourish, whilst solving a number of problems.¹⁷²

Prerequisites for stable interest-free banking include proper social security arrangements to look after the needy consumers and prevention of greed through imposition of taxes. Other Islamic laws should also be enforced and steps should be taken to achieve the objectives that are deemed as desirable by the Islamic code of life. Besides these collective measures, if every member of the society aspires to be honest, to have a passion for public service and possesses a sense of responsibility that Islam expects of him/her, the proposed interest free banking system can run conveniently and produce decent results. In a society where moral standards of citizens is low and where the tendency to sacrifice public good for personal gains is too strong and prevalent, strong and frequent legal action will be needed to run interest-free banking, in the absence of which the functioning of the proposed system could be seriously affected.¹⁷³

C. Final Remark

The Islamic banking and finance industry has undoubtedly shown a remarkable growth during the last few years, although it is still in a nascent stage and requires careful nurturing and attention to make a perceptible impact in the global financial markets. The birth of institutions such as IFSB, AAOFI, IIFM, etc has ensured that the industry is on the right track and all its challenges and other impediments will be handled in a systematic and most viable manner.

An Islamic financial system can play a pivotal role in the economic and social development of Islamic and non-Islamic states by mobilising ‘inoperative’ savings, which are being intentionally kept out of interest based financial channels and enhancing the development of capital markets. Furthermore, the development of this system would enable savers and borrowers to choose financial instruments compatible with their business needs, social values and religious beliefs.¹⁷⁴

Several problems and challenges of Islamic banks relating to instruments, financial markets, regulation, clarity of its concepts and its awareness, as discussed throughout this study, must be addressed and a viable solution must be found immediately, which is hindering the progress of Islamic banks. Perhaps the most problematic aspect is the image and perception of Islamic financial institutions in the global market. The BCCI saga is still fresh in the memories of the financial industry and the post September 11 events have had many repercussions for this industry.

¹⁷² Ibid at 21, page 245, para 1.
¹⁷³ Ibid at 4, page 13, para 2.
¹⁷⁴ Ibid at 140, page 195 para 2.
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